Construction

Industry Advisor

Fall 2011

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Year end tax planning

Contractors should take a strategic approach

As 2011 winds down, it's time to think about year end tax planning. The right moves depend on your construction company's tax and financial circumstances. It's critical to take a strategic approach, balancing your desire for short-term tax savings against your interest in preserving the long-term financial strength of your business.

Be tax-smart with timing

Traditional year end tax planning principles say you should defer income and accelerate deductions as much as possible. But if you expect your marginal tax rate to be higher in 2012, consider shifting taxable income into this year.

There are many techniques for deferring income. If your company uses the cash method of accounting, you can delay billings until next year or accelerate payables into this year. If you use the accrual method, you may be able to defer income by delaying certain services until after year end. Also, you may be able to defer taxes on advance payments you receive this year for services that won't be performed until next year.

Your accounting method can have a major impact on how you can time income and expenses.

In some cases, accrual-basis businesses can deduct employee compensation accrued this year — such as year end bonuses or vested vacation pay — even if it's not paid until next year. To qualify, payments must be made within the first 2½ months of next year and must not be made to a "related party," such as an S corporation shareholder or a partner.

Both accrual- and cash-basis companies can claim a deduction on this year's return for qualified retirement plan contributions made up until the return's extended due date.

Also consider longer term strategies that allow you to defer income *indefinitely*, such as like-kind exchanges of equipment or other property, and sales of stock to an employee stock ownership plan.

Review your accounting methods

As you can see, your accounting method can have a major impact on how you can time

income and expenses. Many contractors use the accrual method of accounting, but some qualify for the cash method. In general, you're eligible for the cash method if:

- Your average annual gross business receipts are $1 million or less,
- You operate as a C corporation (or a partnership with at least one C corporation partner), your average annual gross receipts are $5 million or less *and* you don't have inventories, or
- Your company is a sole proprietorship, S corporation, limited liability company, or partnership (without any C corporation partners) and *either* your average annual gross receipts are $10 million or less *or* you don't have inventories.

If your company is eligible for either method, consider whether switching methods would reduce your tax bill.

It's also important to consider that contractors are generally required to account for long-term contracts using the percentage-of-completion method (PCM), which recognizes revenues and expenses as a job progresses. But there are exceptions that allow you to use the completed-contract method to defer taxable income until a job is substantially complete.

Home construction projects (such as single-family homes and townhouses) are typically exempt from PCM accounting, and the IRS has issued proposed regulations expanding the definition of the term to include some larger projects (such as infrastructure work in a subdivision). In addition, contractors can defer up to 30% of the profits on "residential" projects, such as apartments, using PCM accounting for the other 70%.

Even if a job requires PCM accounting, you can defer reporting income and expenses until it reaches the 10% complete stage. Doing so may allow you to defer taxable income to next year on projects you start late this year.

For PCM contracts, be sure to examine your job schedules carefully before year end and adjust estimated revenues and costs if appropriate. Otherwise, if profits on a job are declining, you may overreport your income in the current year.

Investing in fixed assets

An effective way to reduce your tax bill — without a significant impact on your balance sheet — is to acquire equipment and other fixed assets before year end. For example, bonus depreciation allows you to immediately deduct 100% of the cost of qualified *new* assets (such as equipment, business vehicles and furniture) placed into service in 2011. Next year, it's scheduled to drop to 50% (with certain exceptions), though an extension of 100% bonus depreciation has been proposed. (Check with your tax advisor for the latest information.)

Alternatively, you can expense qualified asset purchases under Internal Revenue Code Section 179. Such expensing is available for both new and used property. However, Sec. 179 expensing is limited to $500,000. And that cap is further reduced, dollar for dollar, once total purchases for the year exceed $2 million. Next year, these limits are scheduled to drop to $125,000 and $500,000, respectively, though both amounts will be indexed for inflation.

Keep in mind that Sec. 179 expensing requires an affirmative election on your tax return, but bonus depreciation is automatic. If you don't want to claim bonus depreciation, you can opt out for one or more asset classes. You might want to forgo expensing or opt out of bonus depreciation if you believe that increasing marginal tax rates or other changes will make depreciation deductions more valuable in the future.

Take advantage of tax breaks

Consider tax deductions and credits that may also reduce your 2011 tax bill, such as:

- Bonus depreciation and expensing for equipment purchases (see "Investing in fixed assets" above),
- The manufacturers' deduction, which can allow you to deduct up to 9% of your income from many construction activities,
- The Work Opportunity credit for hiring workers from certain disadvantaged groups,

- The research credit (often referred to as the "research and development," "R&D" or "research and experimentation" credit), which may be available for certain construction or engineering innovations, and
- Tax incentives for energy-efficient buildings.

Some of these tax breaks require you to take a particular action, such as purchasing equipment, before year end. But you may already qualify for others, such as the manufacturers' deduction — you simply need to claim them on your tax return. Keep in mind that some of these breaks expire at the end of 2011.

Consider the financial impact

As you review year end tax moves, consider the impact they may have on your lending and bonding relationships. Banks and sureties look for strong year end financial statements, but some strategies for reducing taxable income may cause you to violate loan covenants or reduce your bonding capacity.

As jobs come to a close and backlog shrinks, banks and sureties may be concerned about your cash flow in the coming year. To ease these concerns, report a healthy cash balance on your year end financial statements and boost your backlog by executing prospective contracts before year end.

Strategize and optimize

As you can see, there are plenty of ways to be strategic this year end when it comes to your tax planning. Your tax advisor can help you determine which strategies will help optimize your construction company's overall financial position while lowering its tax bill. ■

Is your construction company at risk?

Understand how to account for claim revenue

As you know, the IRS takes great interest in your construction company's revenue — and particularly how and when it's received. If you encounter unanticipated income, also known as "claim revenue," you might find yourself in hot water with the taxing authorities. So, the question is: Are you at risk?

Know the rules to avoid problems

Generally, long-term contracts (those stretching more than one tax year) require percentage-of-completion accounting, under which you determine gross income for each taxable year of the contract and then, when the job is done, calculate any look-back interest owed to or due from the IRS for each year.

An exception: If your gross receipts were less than $10 million for the three years preceding the contract, and the contract will be completed within two years, you may opt for the *completed-contract method*, under which you recognize both expenses and income in the year in which they're incurred or received. Be advised: The IRS won't look kindly at switching back and forth between methods — even if your volume fluctuates around the $10 million mark.

With the *percentage-of-completion* approach, you report income over the life of the contract based on the total amount of revenue you expect to receive, and you deduct expenses in the year in which they're incurred. Your revenue estimates are likely to change as the job evolves, but the

total contract price should always reflect the amount you expect to bring in.

Under IRS regulations, total contract price must include claim revenue as soon as you can reasonably predict you'll earn it. Even if a claim is being disputed, you must adjust the total contract price to include the revenue you expect to receive from it.

Like claims, any early completion bonuses should also be included in the total contract price as soon as you're reasonably sure you'll get them. If the bonus, or any other contingent revenue (such as a claim), doesn't materialize, you can deduct that amount in another tax year.

Note that requirements for financial statements generated under Generally Accepted Accounting Principles (GAAP) differ slightly when it comes to recognizing contingent assets. GAAP typically requires that the contingent asset be more certain before recognition.

Look back to move forward

In deciding what to include each year, gather objective, verifiable evidence supporting each claim. If you don't include the right amount of claim revenue in the year in which you do the work, you may be liable for underpaid taxes as well as penalties and interest.

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How will you know one way or the other? As mentioned, when you complete a long-term contract, you'll use the look-back method to determine whether you've over- or underpaid taxes or interest. Ask your CPA for help: IRS regulations in this area are complex, and many contractors calculate look-back interest incorrectly, don't calculate it at all or fail to properly file the results.

In simplest terms, when a contract is completed, you must reallocate income to reflect actual (rather than estimated) results for each year of the contract. Based on that reallocation, you can determine whether you've over- or underpaid taxes. If the former, you can receive interest. If the latter, you'll owe interest.

Work with a pro to stay out of hot water

Accounting for claim revenue can be downright tricky — especially if you're relatively new to the construction trade. But seasoned veterans understand that, when it comes to ascertaining claim revenue for their construction companies, it's best to leave it to the pros. Your CPA understands the ins and outs of accounting for claim revenue — so much so that he or she can keep you out of that hot water we mentioned earlier. ■

Discover new opportunities with joint ventures and strategic alliances

In today's highly competitive business environment, many construction companies are venturing into unfamiliar territory. Some are exploring opportunities across state lines or international borders. Others are branching out into different, larger or more complex projects.

For many contractors — particularly smaller ones — a joint venture or strategic alliance offers an opportunity to join forces with other construction companies to achieve business goals that one business couldn't achieve on its own.

Differences and advantages

Joint ventures and strategic alliances have similar objectives, but they're structured differently. Typically, a joint venture involves formation of a new legal entity, such as a partnership or limited liability company (LLC).

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A strategic alliance, on the other hand, is simply an agreement between two businesses to pool their talents and resources. Both offer many advantages to the partners involved, including:

- Additional manpower without the need to hire,
- Access to new markets,
- Pooling of talent,
- Availability of specialized capabilities, equipment and technology,
- Ability to bid on larger, more complex jobs,
- Ability to spread risk among the members,

- Enhanced bonding and financing capacity, and
- Formation of new supplier relationships.

The most effective joint ventures and strategic alliances leverage members' complementary strengths. In cross-border or international ventures, for example, a contractor with specialized skills or experience might join with an out-of-state or foreign company that offers an established local presence, knowledge of the market, and on-site labor and equipment.

Due diligence required

Before embarking on a joint venture or strategic alliance, it's critical to vet prospective partners thoroughly. If your business partner fails, you'll be responsible for completing the project. It's also important to document the arrangement carefully to ensure that it has well-defined objectives, each party's responsibilities are clearly spelled out, and both rewards and risks are fairly allocated. ■

3% withholding on government contracts comes under fire

A controversial tax provision is scheduled to take effect in a little over a year, and it could have a huge impact on your cash flow. The provision requires most government entities to withhold 3% of payments for goods and services. A number of business groups oppose the new requirement and, as of this writing, several proposals are pending in Congress to repeal it.

Closing the tax gap

The withholding requirement was added by the Tax Increase Prevention and Reconciliation Act of 2005. After having been postponed twice, it's scheduled to apply to payments made after Dec. 31, 2012, pursuant to contracts executed (or "materially modified") after that date. For payments made under existing contracts, the 3% withholding kicks in on Jan. 1, 2014.

The purpose of the requirement is to help close the "tax gap" created by government contractors' unpaid tax bills. The withholding is required for all payments for goods and services by federal, state and local government entities with total annual expenditures of $100 million or more.

Regulations finalized earlier this year create several exceptions to the withholding requirement, including payments to contractors of less than $10,000, wages and other payments already subject to income tax withholding, interest payments and payments for real property. Antiabuse rules prevent contractors from sidestepping the requirement by breaking up larger payments into several sub-$10,000 payments.

The regulations also clarify that withholding is required only for payments to *prime* contractors, that is, the main contractors who have contracts with the government. So, payments by a general contractor to a subcontractor wouldn't be subject to withholding. Payments by a government entity to a payment administrator would also be exempt, but the administrator would be required to withhold 3% of its payments to prime contractors.

Arguments for repeal

Several organizations, including the Associated General Contractors of America and the American Institute of Certified Public Accountants, have urged Congress to repeal the requirement. Critics point out that:

- The 3% withholding — which applies to the total contract — will exceed many contractors' profit margins,
- The reduced cash flow will make it hard for contractors to grow their businesses and obtain bonding, and
- The cost of implementing the measure is estimated to exceed the revenue that will be raised.

A better solution, opponents say, is for the IRS to enforce existing laws that require all businesses to report their revenue and pay estimated taxes.

Stay tuned

Opponents are hoping Congress will repeal the 3% withholding requirement well before its effective date. For the latest information, contact your tax advisor. ■