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Year-end tax planning

Tax benefits available to small businesses

Companies that qualify as "small businesses" enjoy several tax benefits, including simplified tax reporting and the ability to defer taxes under certain circumstances. Your construction company's eligibility for these advantages depends on your gross receipts, including those earned by certain related entities.

Previously, the gross receipts threshold was $5 million ($10 million in some cases). But the Tax Cuts and Jobs Act (TCJA) increased the threshold to $25 million, significantly expanding the availability of these benefits.

So, now's a good time to evaluate whether you qualify as a small business and, if you do, whether it pays to change your accounting methods to take advantage of the available tax benefits. Even if you don't currently qualify, there may be planning opportunities that will enable you to do so in the future.

Perusing the pluses

The tax advantages of small business status include:

- The ability to use the cash method of accounting, which typically allows you to defer more taxable income than the accrual method,
- Relief from inventory accounting requirements,
- Exemption from the uniform capitalization rules, which may require you to capitalize rather than expense certain overhead costs,
- Exemption from the TCJA's limit on business interest expense deductions, and
- The option to use the completed contract method rather than the percentage-of-completion method to account for jobs expected to be completed within two years, allowing you to defer taxes until a job is substantially complete.

Note that companies structured as S corporations, limited liability companies or partnerships without a C corporation partner are permitted to use the cash method — even if their gross receipts exceed the threshold — unless they're required to account for inventories. Also, even if you pass the gross receipts test, you may be ineligible for small business benefits if your business is considered a "tax shelter." (See "What's a tax shelter?" on page 3.)

Small businesses are exempt from the TCJA's limit on business interest expense deductions.

Calculating gross receipts

Under current rules, your construction company is a small business if its average gross receipts for the previous three tax years (ending with the year that precedes the current year) are $25 million or less. In addition to increasing the threshold, the TCJA also provides that you need to pass only the gross receipts test in the current tax year. Under previous rules, you would fail the test if your three-year

average gross receipts exceeded $25 million in any prior year.

When applying the test, you must include gross receipts earned by certain related entities, namely members of parent-subsidiary, brother-sister or combined groups under common control. A parent-subsidiary group exists when one company owns more than 50% of one or more other companies. The group also includes other companies that are more-than-50% owned by group members.

A brother-sister group is two or more companies in which the same five or fewer persons collectively own:

1. At least 80% of each company, and
2. More than 50% of each company, considering each owner's minimum common ownership.

For example, if someone owns 15% of Company A and 25% of Company B, his or her minimum common ownership in the two companies is the lesser of the two percentages, or 15%. The table below provides an example of two companies that satisfy both the 80% and 50% tests for brother-sister group status:

Owner	Company A	Company B	Minimum common ownership
1	15%	25%	15%
2	30%	10%	10%
3	20%	5%	5%
4	15%	40%	15%
5	10%	15%	10%
Total	90%	95%	55%

A combined group exists when a parent company belongs to both a parent-subsidiary group and a brother-sister group. Under those circumstances, the two groups' gross receipts are combined. Note that, when determining a person's ownership percentage, you must include interests owned by certain family members.

What's a tax shelter?

Even if your construction company's gross receipts are less than $25 million, you may be precluded from claiming small business tax benefits if you're considered a "tax shelter." And while you may associate the term with investment vehicles designed to generate tax losses, even an ordinary business can meet the definition.

Under the Internal Revenue Code, tax shelters may include partnerships or other entities (such as S corporations or limited liability companies) in which more than 35% of their losses are allocable to "limited partners or limited entrepreneurs" who aren't actively involved in the business. Businesses structured in this way may be able to avoid tax shelter status by getting certain owners more involved in management or by reducing the amount of losses allocable to inactive owners.

Changing ownership structure

If related companies' gross receipts push your gross receipts above the $25 million threshold, it may be possible to qualify for small business status in the future by changing your ownership structure.

Suppose, for example, that Company A and Company B from the table above have gross receipts of $20 million and $10 million, respectively. Neither company qualifies for small business benefits because they're part of a brother-sister group with combined gross receipts over $25 million.

Now suppose that Owner 4 transfers 20% of Company B to an unrelated person. Doing so eliminates the brother-sister group, because no group of five or fewer persons owns at least 80% of each company. Both companies now meet the gross receipts test for small business status.

Tracking your receipts

Track your gross receipts to determine whether your construction company is — or could be — eligible for small business tax benefits. If you do qualify, evaluate the pros and cons of changing your accounting methods. Your CPA can provide valuable assistance. ■

Outsourcing employment tasks to a PEO

After reaching a certain level of success, many construction companies struggle to keep up with employment and human resources (HR) tasks such as recruiting and hiring, payroll processing, and employee benefits and workers' comp administration. One solution may be to outsource these functions to a professional employer organization (PEO).

How it works

When you partner with a PEO, a "co-employment" relationship is established. You retain control over hiring and firing decisions and management of your employees, but the PEO acts as an employer for purposes of many benefit and HR administrative functions.

This doesn't mean you're relieved of legal liability in these areas, though you may share liability with the PEO.

Benefits to consider

PEOs offer many benefits to construction businesses, including:

Fewer payroll hassles. A PEO familiar with the construction industry will competently assume the burdens associated with tracking hours, paying employees, withholding taxes, and handling other payroll administration and tax compliance matters.

More comprehensive HR services. A PEO can support your existing HR department or take over the role entirely, assisting with a variety of activities from employment verification and drug testing to preparing employee manuals to "onboarding" and training.

Better benefits. By pooling their clients' employees, PEOs can often provide access to medical, retirement and other benefits that are superior to and/or less costly than those your construction company would be able to obtain on its own.

Using a PEO doesn't relieve your firm of liability for tax and other compliance obligations.

Lower workers' comp costs. A PEO can help you with all aspects of workers' compensation, from providing insurance to resolving claims to designing safety programs. A more efficiently and properly run workers' comp program should lower costs.

Risks to consider

Using a PEO has its risks. For example, not all business owners are comfortable sharing certain decision-making responsibilities — such as selection of a benefits provider — with an outside party. Also, bringing in a third party to handle HR functions can sometimes create a culture clash with existing staff.

There may also be liability issues. For example, if a contractor hires a new worker and delays

reporting the new hire to the PEO, there may be a gap in workers' comp coverage until the worker is added to the PEO's employee list.

And, as noted above, using a PEO doesn't relieve your firm of liability for tax and other compliance obligations, so it's critical to ensure that your provider assumes contractual responsibility for these obligations and that you oversee their performance. In addition, you'll still need to track payroll-related job costs internally, which will entail some work.

Consider a certified PEO

Outsourcing payroll tax obligations can be particularly risky. You give up control over the process, but at the same time your firm's "responsible persons" — including certain owners, executives and employees — remain liable for a PEO's failure to collect and remit payroll taxes in many cases.

One way to avoid this liability is to use a certified PEO (CPEO). The CPEO was authorized by 2014 legislation and the IRS has established a process for PEOs to become certified. Unlike an ordinary PEO, a CPEO is treated as the legal employer of your workers and is solely responsible for withholding and remitting payroll taxes. The IRS provides a list of CPEOs. At IRS.gov, search for "CPEO" and then click on "CPEO Public Listings" to find "List of CPEOs."

Do your homework

When considering a PEO or CPEO, it's critical to evaluate whether a prospective provider can provide the specific kinds of employment and HR support you need. Are they a good fit for your construction company's culture? Can they grow with you? Also, be sure to check a prospective provider's client and professional references, as well as its track record of adherence to industry and legal standards.

Last, but not least, there's the question of costs. How much will you have to pay for the services and does your budget allow for it? Your CPA can help you project the costs of bringing in a PEO or CPEO and calculate whether you're likely to get a good return on investment. ■

Would you recognize an indirect cost if you saw one?

Indirect costs can have a substantial impact on a construction company's financial picture and bottom line. But they're not always the easiest things to "see." Let's zoom in to bring indirect costs better into focus.

Viewing the numbers

It helps to first define project costs in general. The Financial Accounting Standards Board recommends that construction companies treat job costs just like manufacturers treat inventory costs, calling them "the sum of the applicable expenditures and charges directly or indirectly incurred in bringing [a job] to its existing condition and location."

Which costs are indirectly incurred? Generally, there are two identifying criteria. First, an indirect cost is identified with more than one job, such as workers' compensation insurance. Second, it's a cost that's only indirectly related to the on-site construction, such as field cell phone charges.

For example, suppose liability insurance for a construction company's jobs costs $100,000 annually. So, that amount divided by 365 is $274 a day, or $8,333 a month. To follow the allocation process through to completion, you would tabulate the labor hours of each project on a monthly schedule.

Distinguishing from overhead

It's important to not include overhead costs, such as office rent, when identifying indirect costs. To prevent this, identify costs that apply to more than one job. These typically consist of benefits for field workers, workers' compensation insurance (as mentioned), jobsite liability insurance and builders' risk insurance.

Fleet-related costs can often be found here, too, such as gasoline costs, vehicle maintenance and repair expenses, and equipment depreciation. Also look at rental costs for items attributable to more than one project, as well as repairs and maintenance for an on-site warehouse, trailer or storage yard.

It's also important not to confuse costs that indirectly pertain to on-site construction with overhead costs. Common examples of these indirect costs include project manager salaries and benefits, cell phone bills, union dues, vehicle tracking and monitoring systems, and employee pension plan costs.

Using a cost driver

You can systematically allocate indirect job costs using a "cost driver." Two common cost drivers are labor hours and dollars.

Then, perhaps with your accountant's help, you could divvy up that $8,333 each month to put those dollars onto that month's active jobs pro rata. Now that $100,000 is no longer overhead — those dollars are indirect job costs.

This isn't the only approach. Many construction companies pool their indirect costs and then do the calculation and allocation instead of just doing it at the line item level. However you do it, once indirect costs are allocated and included in job reports, you and your team can discuss how to avert upcoming cash flow problems while you've still got time to make corrections.

For example, let's say you notice an unusually high allocation for vehicle costs on one of your jobs. A closer look reveals a sizable outlay for a vehicle tracking and monitoring system you're not using. In such a case, you could contact the software vendor and cancel the contract, lowering your company's indirect costs.

Keeping an eye out

It's easy to get hyper-focused on direct project costs. But indirect costs matter, too, and they can go unnoticed for much of the year. Be sure to keep an eye out. ■

Risky business: Valuation rules of thumb

Determining the market value of your construction business may be necessary or desirable for many reasons. Examples include a sale or merger, financing, succession planning, tax and estate planning, insurance claims, divorce, or setting up an employee stock ownership plan. Whatever the reason, it's important to consult an experienced valuation professional.

Some contractors use rules of thumb — such as a multiple of earnings before interest, taxes, depreciation and amortization (EBITDA) or a percentage of annual revenues plus inventory and tools — to value their business. Although these shortcuts are quick and cheap, relying on them is risky business.

Here's the problem

Rules of thumb are simple valuation formulas, typically based on industry averages or passed along by word of mouth over time. They're often based on actual sales transactions in the construction industry but, by definition, they don't account for the specific attributes that drive *your* business's value — such as management talent, location, competition, growth, costs, workforce or reputation. As a result, applying a rule of thumb is likely to undervalue or overvalue your business.

For example, let's say Contractor A and Contractor B each have EBITDA of $1.5 million. According to a widely used valuation rule of thumb in the industry, each company is worth three times EBITDA, or $4.5 million. The two contractors are nearly identical in most respects, with one critical difference: Contractor A derives 70% of his revenue from three clients, while Contractor B doesn't rely on any one client for more than 5% of her revenues. Given Contractor A's higher level of risk, it seems clear that Contractor B is worth more — even though the rule of thumb values them equally.

There are countless other factors that affect value but aren't necessarily reflected in a rule-of-thumb valuation. Perhaps one contractor has stopped investing in marketing or equipment maintenance, temporarily inflating EBITDA but placing the company's future earnings at risk, which lowers its value. Or maybe another contractor has done a better job of controlling costs, making it more profitable than the other.

A starting point

The examples above show how valuation rules of thumb often lead to inaccurate results. But that doesn't mean they're entirely irrelevant. Rules of thumb can serve as a good starting point for estimating your construction business's value, and you might use them as a "gut check" against the results of other valuation methods.

But they should never be relied on alone. Only a competent valuator familiar with the construction industry can provide the level of specificity and detail necessary for accurate results. ■

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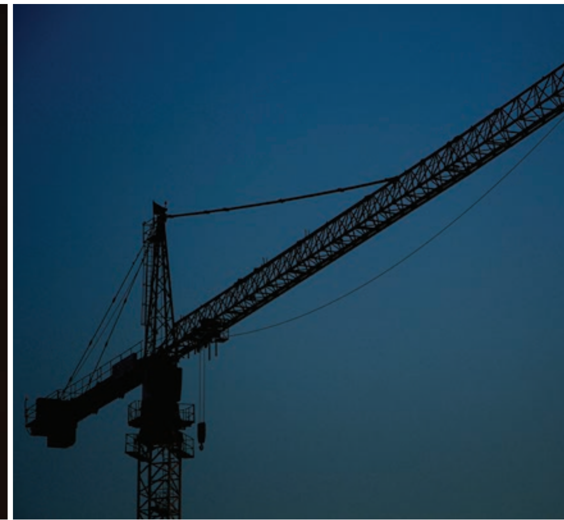

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Rapidly changing technology, market conditions, cost overruns, safety liability and high insurance costs are just a few of the challenges the construction industry faces. Whether your business tends to the residential, governmental, or commercial sectors, our qualified staff has extensive experience with tax compliance, project management, bonding, job costing, employee benefits, business succession planning and information technology. We help to reduce tax costs while remaining in compliance with federal, state, and local regulations, giving you time to focus on your business.

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