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Is it time for a change?
Tax reform has expanded availability of accounting methods

Business interruption insurance can help mitigate disaster

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Is it time for a change?

Tax reform has expanded availability of accounting methods

Almost a year ago, the Tax Cuts and Jobs Act (TCJA) was signed into law. It may be best known for slashing corporate and individual income tax rates. But another change made by the act will have a big impact on many construction companies — particularly those with gross receipts ranging from $5 million to $25 million.

Starting this year, businesses with average gross receipts in that range can take advantage of certain tax benefits available to "small contractors." As a result, more construction companies will be eligible to use the cash and completed contract accounting methods for tax purposes. Often (but not always) these methods allow businesses to improve cash flow by deferring taxes.

Overview of accounting methods

Most construction businesses use two accounting methods: one overall method and one for long-term contracts (those that span more than one tax year). Let's take a closer look at each:

1. Overall method. The two most common overall methods are cash and accrual. Under the cash method, you recognize income when payment is received and deduct expenses when they're paid. In contrast, under the accrual method, you recognize income when it's earned and deduct expenses when they're incurred, without regard to the timing of cash receipts or payments.

Before the TCJA, construction companies structured as C corporations (or as partnerships with a C corporation partner) were prohibited from using the cash method if their average gross receipts for the previous three tax years exceeded $5 million. Other entities — including S corporations, limited liability companies and partnerships without a C corporation partner — were permitted to use the cash method regardless of their gross receipts, unless they were required to account for inventories.

Businesses whose merchandise purchases were substantial in comparison to their gross receipts were required to account for inventories and use the accrual method for purchases and sales, unless their average gross receipts were $10 million or less. According to the IRS, "merchandise" includes "any item physically incorporated in a product you transfer to your customers," such as building materials. And "substantial" generally means at least 10% to 15% of gross receipts. Some companies adopt a hybrid method, using the accrual method for purchases and sales and the cash method for other items.

Watch out for the AMT

Are you considering a switch from the percentage-of-completion method to the completed contract method? (See main article.) If so, keep in mind that you're required to calculate income based on percentage of completion for purposes of the alternative minimum tax (AMT), too.

Fortunately, the Tax Cuts and Jobs Act repealed the corporate AMT and substantially increased AMT exemption amounts for individuals, so relatively few contractors will be affected. Nevertheless, if your company is structured as an S corporation, limited liability company or partnership, it's a good idea to do the math to determine whether the completed contract method would be advantageous.

The TCJA raised both the $5 million and $10 million thresholds to $25 million. That means all construction businesses with average gross receipts of $25 million or less can now use the cash method, regardless of entity type or whether they have inventories. As before, a company that doesn't have inventories, and isn't a C corporation or a partnership with a C corporation partner, can use the cash method regardless of income level.

2. Long-term contract method. Before the TCJA, construction businesses with average gross receipts over $10 million were required to use the percentage-of-completion (POC) method of accounting for all long-term contracts (with an exception for certain home construction jobs). Under this method, revenue and expenses are generally recognized according to the percentage of the contract completed during a tax year. This percentage is determined by calculating costs allocated to the contract and incurred during the year and dividing them by estimated total contract costs.

Construction companies with average gross receipts of $10 million or less were permitted to use the completed contract method for jobs expected to be completed within two years. Under this method, income generally isn't reported until the contract is substantially complete.

The TCJA raised the threshold for the POC method requirement to $25 million, significantly expanding the number of firms eligible for the completed contract method. (But see "Watch out for the AMT" at left.)

Decisions, decisions

For many construction businesses, the increased gross receipts threshold creates an opportunity to use the cash and completed contract accounting methods. But those methods aren't right for everyone, so it's important to determine whether switching methods would provide tax benefits.

If, like many companies, your accrued income (receivables) tends to be higher than your accrued expenses (payables), then switching to the cash method will likely allow you to defer income — reducing your tax bill. On the other hand, if your accrued income tends to be lower than your accrued expenses, switching to the cash method may likely accelerate income.

It's also important to consider how your tax situation may change in the future. If you expect your marginal tax rate to remain steady or decline, using the cash and completed contract methods to defer income will provide a tax advantage. But if you think you'll be in a higher tax bracket down the road, the accrual and POC methods may be the better strategy.

Many factors

An accounting method change is a major business decision involving many factors. Your tax advisor can help you determine whether your construction company would benefit from switching tax accounting methods and explain the process for doing so. ■

Business interruption insurance can help mitigate disaster

No part of the country is immune from disaster. Whether your construction company operates near water or in a desert, in the city or the suburbs, a natural calamity could stop you in your tracks and even put you out of business. For this reason, it's a good idea for every contractor to at least consider business interruption insurance.

Get to know it

Business interruption coverage is a bit like disability insurance for your company. A standard health insurance policy covers your medical expenses, but many people also opt for disability coverage to replace their lost income while they're unable to work.

In the event you need to make a claim, be sure to keep thorough, accurate, up-to-date financial records.

Similarly, basic business insurance policies cover damage to structures and equipment, but provide little if any protection against loss of income or extra expenses during a period when work on one or more projects is suspended. Without that income, few construction companies have the cash reserves they would need to pay salaries and other fixed expenses until work resumes. Business interruption insurance can fill the gap.

Ask good questions

The scope of business interruption coverage varies dramatically from policy to policy. Here

are some questions to consider as you evaluate your options:

How does the policy define "lost business income"? For reimbursement purposes, is income calculated using the cash or accrual method? Does it depend on the insured's accounting method? Does the policy cover all fixed expenses, including salaries, during an interruption? Also, must your business (or a job) shut down completely or does the policy cover partial interruptions?

What's the recovery period? Policies generally provide coverage for the time it reasonably takes to restore property to its original condition. But some policies extend the recovery period, providing coverage until the company reaches its preloss level of business.

Are contingent business interruptions covered? Is coverage limited to your facilities or equipment, or does the policy cover "contingent" interruptions — that is, losses resulting from property damage suffered by a customer or supplier? If so, are contingent losses subject to lower limits?

Is denial of access covered? In other words, does the policy cover losses attributable not to property damage, but to the authorities' denial of access to the property for safety or security reasons?

What about extra expenses? Does the policy reimburse extra expenses, such as renting a storage facility or operating out of a temporary location during a business interruption?

Be prepared

To ensure a favorable settlement in the event you need to make a claim, be sure to keep thorough, accurate, up-to-date financial records. You'll need solid documentation to establish the income your business would have earned during the interruption period and to substantiate any extra expenses you incur during the interruption.

It's often advisable to have a forensic accountant or other expert assist you in documenting and pursuing your claim. Regardless of how detailed a policy's language, there's almost always room for interpretation. An expert can help demonstrate that a certain interpretation of "business income" or other policy terms more accurately reflects your loss.

An expert can also analyze industry trends, market developments and company-specific factors that support an argument that your income would have increased during the recovery period but for the interruption.

Weigh costs vs. benefits

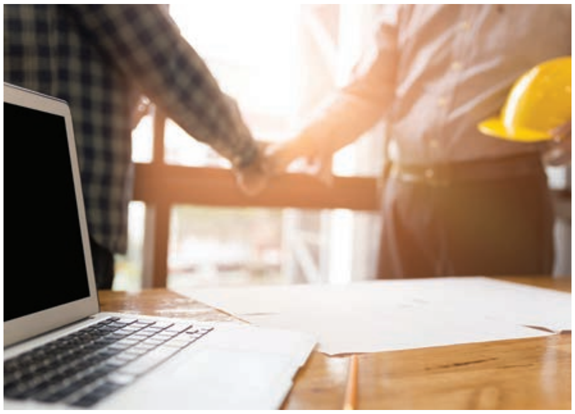
To determine whether business interruption insurance is right for you, assess your company's specific disaster risks and estimate each one's impact on your cash flow and profits. Armed with this information, you can decide whether a policy's potential benefits justify the cost. ■

Don't put off creating a well-crafted buy-sell agreement

The thought of creating a buy-sell agreement may strike a certain amount of trepidation into the hearts of some contractors. The mere suggestion of ownership change can raise delicate issues that are often avoided. But putting off the creation of a well-crafted buy-sell can put a construction company at risk if unexpected circumstances arise.

Understand the purpose

Essentially, a buy-sell sets up parameters for the transfer of ownership interests following a "triggering event." Perhaps the most common triggering event is an owner's retirement. But they can also include an owner's death or long-term disability, loss of license or other legal incapacitation, bankruptcy or divorce.



As mentioned, closely held construction businesses that fail to create a viable buy-sell agreement — or fail to create one at all — put themselves at great risk. Unlike public companies, private ones have no ready or established market on which to sell ownership shares. Also, comparable businesses may be hard to come by and buyers may simply not exist.

These points can create difficult circumstances for businesses — especially when something unexpected happens. Say an owner, in this case a man, suddenly dies. His shares may pass on to his heirs, but how much are those shares worth and to whom can his heirs sell them?

In contrast, a buy-sell will remove uncertainty by stipulating that remaining owners will buy the ownership interest at a price determined by the stated valuation method. Plus, the agreement will help to prevent an unfamiliar and perhaps unwanted owner from suddenly joining the business.

Prepare for valuation issues

The agreement will need to specify a valuation method for appraising the departing owner's interest at the appropriate time. In choosing a method, you and your fellow owners should carefully define buyout terms and specify the financial data to be used in the agreement.

For example, a sound buy-sell will spell out a required end-date for the financial statements that must be used to appraise business interests following a triggering event. Some also mandate a level of assurance (compilation, review or audit) regarding those financial statements.

In addition, every buy-sell agreement needs to pinpoint a way to accurately appraise the value of each owner's interest. Some business owners simply plug in boilerplate formulas, but doing so can lead to trouble.

For instance, Company X has a buy-sell agreement stating that the business is worth "four times annual earnings." But appraisers — and courts, if it comes to that — might argue over the definition of "earnings." One could posit that it refers to accounting net income. Meanwhile, another expert might define it as pretax earnings adjusted for items such as depreciation and amortization, interest expense, nonrecurring items, and quasi-business expenses. Ultimately, it's critical to involve a qualified valuation professional to anticipate and help defend against such conflicts.

Choose a funding method

In most cases, business owners don't have the cash readily available to buy out a departing owner. So, most buy-sells include an insurance policy to fund the agreement. And this is where several different types of agreements come into play.

Under a cross-purchase agreement, each owner buys life or disability insurance (or both) that covers the other owners. Should one owner die or become incapacitated, the other owners collect on their policies and use the proceeds to buy the deceased or incapacitated owner's shares.

Another type is a redemption agreement. Here, the company (not each owner) buys the insurance policy and acquires the deceased or incapacitated owner's shares. This approach can really help businesses with multiple owners, because fewer policies are needed.

In some cases, a company will create a hybrid buy-sell that combines aspects of the cross-purchase and redemption approaches. These agreements may stipulate that the business gets the first opportunity to redeem ownership shares. And, if the company is unable to buy the shares, the remaining owners are then responsible for buying the departing owner's interest.

Get started

Creating a buy-sell isn't easy, but it can protect your construction company from costly ownership conflicts down the road. Your CPA can help you get the process started. ■

Your contractor's license: Don't leave home without it

The notion of starting work on a project without a license may seem unthinkable. But, in their rush to win bids and start work, many contractors have run afoul of licensing issues. Here's how it can happen.

A major culprit

Out-of-state work is a major culprit. If you work on projects in other states, be sure to apply for and obtain a contractor's license as early as possible, preferably before you sign the contract.

Most states require general contractors (GCs) to obtain a license at the state or municipal level and require subcontractors in certain specialties — such as electrical, plumbing and HVAC — to be licensed. Other types of subcontractors may also need a license, but some states waive the requirement for certain trades that work under a licensed GC's supervision.

There are states that require a license only if a job's value exceeds a certain threshold, so you may be able to forgo a license in these cases.

Severe consequences

Working without a license can do serious damage to your business. In addition to incurring monetary penalties, you may have bids rejected and receive stop-work orders on current jobs. You may even lose the right to work in the state in question. You might also be prevented from collecting on the work you performed while unlicensed.

Consider the recent case of *Snider Construction v. Dickinson Elks Building, LLC*. Here, a construction company entered into a contract with a developer on December 26, 2011, to provide construction services on a North Dakota property owned by

another party. The contractor began work that same day, but didn't receive a North Dakota contractor's license until February 6, 2012. When the owner failed to pay the total bill, the contractor recorded a construction lien and filed a lawsuit to recover the value of the work performed.

At the time, North Dakota law prohibited anyone from doing business as a contractor or maintaining a lawsuit or other related claim without first obtaining a contractor's license (provided the job is valued at more than $2,000). Although the owner argued that the construction business should be barred from collecting anything, the North Dakota Supreme Court interpreted the law to preclude the contractor from collecting for any work performed before it was licensed. The court permitted the contractor to maintain the claim for work performed after it was licensed.

Due diligence

The contractor in this case was lucky. In other states, the construction company wouldn't have been able to collect *anything* for a contract entered into without a license. Be sure to do your due diligence regarding licensing when working out of state or anywhere else unfamiliar. ■