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Year-end tax planning

Explore 2017's key areas

As we approach the end of 2017, it's once again time to explore strategies for reducing your construction company's tax bill.

Because every business is different, it's important to work directly with your CPA to determine the right moves for you. Nonetheless, here are some key areas to explore when looking for savings.

Deferrals and accelerations

If you expect your tax rate to be the same or lower in 2018, you'll likely benefit by deferring income to next year and accelerating deductions into this year. There are several ways to do so, including:

- Delaying billings or prepaying expenses (for cash-basis companies),
- Postponing the performance of services until after year end or deferring taxes on qualifying advance payments (for accrual-basis companies),
- Making contributions to qualified retirement plans, and
- Deferring payment of year-end bonuses to nonowner employees. (Accrual-basis companies can deduct bonuses on their 2017 returns provided they pay them by March 15, 2018.)

On the other hand, if you expect to be in a higher tax bracket next year, you may be better off shifting some income to this year by accelerating income or deferring deductions. Keep in mind that tax reform may affect your tax rate or other tax attributes this year or next, so be sure to monitor congressional developments in the coming months. (See "How will tax reform impact year-end planning?" on page 3.)

The 10% solution

If your construction company uses the percentage-of-completion method to account for long-term contracts, consider electing the "10% method" on your 2017 return (if you haven't already done so on a previous return).

This method allows you to defer recognition of gross profits on jobs that are less-than-10% complete as of the last day of the tax year. Be aware that, once you make the election, you're required to defer profits on all eligible jobs, this year and in future years, unless you apply to the IRS for a change in accounting method.

Depreciable incentives

A good strategy for generating deductions in 2017 may be to take advantage of depreciation-related tax breaks. It's a particularly opportune time to acquire assets that qualify for "bonus depreciation." Currently, this tax break allows you to deduct 50% of the cost of certain depreciable assets, on top of regular depreciation deductions. This percentage is scheduled to drop to 40% in 2018 and to 30% in 2019, after which the deduction faces elimination.

Bonus depreciation is available for new assets that fall into one of four categories:

1. Tangible depreciable property with a recovery period of 20 years or less,

2. Water utility property,

3. Computer software, or

4. "Qualified improvement property."

Qualified improvement property includes any improvement to the interior of a nonresidential building that's placed in service after the building was first placed in service (other than elevators, escalators or internal structural framework).

Another option is Section 179 expensing, which allows you to deduct 100% of the cost of qualified depreciable assets, such as equipment and vehicles. One advantage it has over bonus depreciation is that Sec. 179 expensing is available for both new and used assets. On the other hand, there's a cap on expensing ($510,000 in 2017) and the deduction is phased out once a company's total purchases exceed a certain threshold ($2.03 million in 2017).

Tax credits

Tax credits are always a worthy area of exploration. There are a couple of noteworthy ones to look into.

First, consider the research credit (sometimes called the R&D credit). It isn't limited to pharmaceutical, biotech, software and manufacturing companies. If you commit resources to developing new construction techniques, improving business processes or other innovations, you may be eligible for the credit — which can reach as high as 6.5% of qualified research expenditures.

How will tax reform impact year-end planning?

As you review your year-end tax planning options, be sure to consider the potential impact of tax reform. As of this writing, both the White House and members of Congress have proposed reducing corporate and individual tax rates and revising a variety of deductions, credits, exemptions and other tax benefits.

If it appears that your tax rate will drop in 2018, for example, the benefits of deferring income and accelerating deductions will be even greater. On the other hand, if you believe your effective tax rate will go up next year, it may make sense to shift some income into 2017. (See main article.)

But don't assume that lower tax rates automatically translate into lower taxes. Some proposals would reduce the number of individual income tax brackets from seven to three, while reducing the top rate from 39.6% to 33%. As a result, many taxpayers would enjoy lower tax rates, but some would experience an increase. For example, taxpayers currently near the top of the 28% bracket would find themselves in the 33% bracket under the proposed tax table, an increase of 5%.

Second, don't overlook the domestic production activities deduction. It allows you to deduct up to 9% of your income from "qualified production activities," including many activities related to constructing or substantially renovating real property located in the United States.

The big tax picture

These are just a few of many year-end strategies to consider. Again, work with your CPA to develop a comprehensive strategy based on your construction company's overall situation. In addition to year-end moves, discuss longer-term strategies that may improve your tax picture. These include re-evaluating your entity choice and changing your accounting method. ■

Does your company need a controller or CFO?

The construction industry is characterized by tight profit margins and significant cash flow challenges. Your company's success depends on strong financial leadership. To meet this need, many contractors reach a point where they should either appoint or hire a controller or Chief Financial Officer (CFO). But the differences between these two roles are often misunderstood.

The primary difference between a controller and CFO is that the former tracks and reports financial performance, while the latter develops strategies to improve that performance. The controller's role is tactical, while the CFO's role is more strategic. There are many other, more minute differences as well.

Controllers: Here and now

A construction company's controller typically handles the day-to-day duties of financial management. These include:

- Performing accounting, bookkeeping and basic cash-flow tasks,
- Preparing daily, weekly or monthly financial reports,
- Overseeing payroll,
- Supervising accounts receivable and payable,
- Closing the books and preparing month-end financials, and
- Overseeing tax reporting and compliance.

Controllers may also be in charge of upholding internal controls to guard against financial misreporting and fraud, and most are the go-to expert on their companies' accounting software.

CFOs: Thinking ahead

A construction CFO is responsible for supervising the company's overall financial operations. Among other things, he or she is entrusted with:

- Preparing budgets, forecasts and complex financial projections,
- Maximizing cash flow,
- Reviewing and analyzing monthly financial statements,
- Establishing policies and procedures to ensure the integrity and accuracy of management reports,
- Understanding how finance and business operations are interrelated and harmonizing the two,
- Developing and maintaining an effective capital structure, and
- Overseeing tax planning and strategy.

A CFO may also spend time negotiating with lenders and other funding sources, and maintaining relationships with banks and sureties. In addition, he or she will help with the company's technology purchasing decisions.

The right time

So how do you know when you need a controller or CFO? Well, if your construction company currently employs neither, *someone* is fulfilling these roles. Often it's the owner, who wears several hats and barely has time to breathe. If all of this sounds too familiar, and your company is growing rapidly, you may want to look into at least adding a controller to help you out.

By the same token, if you already have a controller and he or she is struggling to keep up, it might be time to add a CFO. Controllers and owners alike can find themselves stretched too thin trying to track the company's finances *and* make strategic moves to grow the business.

If you lack the resources or don't want to bring someone in-house, outsourced controller or CFO services can be an effective solution — either permanently or until you're in a position to hire someone. You might also engage a CFO/consultant on a short-term contract to help you target a strategic direction.

Construction company owners often wear several hats and barely have time to breathe.

Critical support

Whether or not now's the time to add a controller or CFO, don't forget the value of the objective expert advice offered by your CPA and other professional advisors. They can provide critical support to you and everyone on your construction company's management team. ■

New AIA contracts emphasize insurance requirements

The construction contract documents published by the American Institute of Architects (AIA) are among the most commonly used forms on both commercial and residential projects in the United States.

Although parties are free to modify these forms to suit their needs, it's important to understand what the standard documents contain in order to negotiate appropriate changes. Even more important, in April 2017, the AIA updated its forms — making a number of significant revisions. Let's take a closer look at the changes.

Exhibit A

One of the most notable changes involves insurance. Rather than burying insurance requirements in Form A201 — "General Conditions of the Contract of Construction" — the new set of forms contains a separate Exhibit A — "Insurance and Bonds."

The exhibit provides a comprehensive menu of insurance options, allowing parties to specify insurance requirements and coverage limits by checking boxes and filling in blanks. The advantage of this approach is that it facilitates review of insurance options and encourages more thoughtful consideration of risk management.

The exhibit also spells out in detail the types of insurance that must be provided by the owner and contractor, respectively. (The two parties may opt to shift these responsibilities from one to the other.)

Additional requirements

In addition, the updated forms contain some significant changes from the insurance provisions in previous AIA documents. For example, Exhibit A:

- Provides that the contractor's required insurance must be maintained through the "correction of work" period rather than the date of final payment, as previously required,
- Requires the contractor to procure additional insurance (including professional liability, pollution liability, maritime liability, and manned or unmanned aircraft liability) if the work involves those activities, and
- Clarifies the contractor's obligation to provide additional insured coverage to the owner, architect and architect's consultants.

The last requirement is particularly significant. Previous versions of the AIA documents simply required the contractor to name the owner, architect and architect's consultants as additional insureds on their liability policies. But Exhibit A specifies: "To the extent commercially available, the additional insured coverage shall be no less than that provided by" three commonly used endorsements published by the Insurance Services Office. As a result, contractors whose liability policies don't provide this level of coverage may be liable for the difference.

Exhibit A details the types of insurance that must be provided by the owner and contractor.

Impact and risks

If you're involved in projects that use the AIA forms, be sure to review the 2017 revisions carefully. Evaluate the impact of the new forms on your insurance requirements and other obligations under the contract and request modifications if needed to mitigate your risks. ■

Reviewing retainage, in concept and practice

Even the simplest construction project involves some degree of risk. Because of this, and the obviously higher degree of risk applicable to more complex jobs, owners will always seek to protect themselves financially. One way they continue to do so is through retainage.

As you're no doubt aware, under the concept of retainage, an owner withholds a percentage of the total contract price until the project is 100% complete to that owner's standards. Many contractors' feelings about retainage range from annoyance to outrage. Yet the practice continues, so it's important to occasionally review how retainage may be affecting your construction company.

Conflict over cash

Retainage percentages vary from state to state, as do the timelines on which those funds are released. Contractors generally prefer that owners release all or a significant part of retainage when a

project is 50% complete, but many owners hold the retainage until a project is finished.

Over the years, construction associations have lobbied state legislators to limit retainage amounts. Some states responded by capping retainage at certain percentages of the contract price. In addition, there are states that now require that retainage funds be held in interest-bearing escrow accounts.

The issue of interest has been particularly contentious. Owners contend they have no obligation to pay interest on retainage, as the withheld funds are theirs until they're contractually required to release the money. Contractors, on the other hand, maintain that retainage provides zero-interest financing for projects and that, in an industry where the typical profit margin is between 2% and 5%, retention of up to 10% is quite a burden.

Alternative ideas

Some in the industry have suggested relying more on surety bonds to replace or compensate for limits in retainage. However, while bonding and retainage are financial tools designed to ensure project completion, they serve different purposes. A surety bond that would be used as a substitute for retainage wouldn't differ from traditional surety bonds. Surety bonds are more appealing to contractors because they don't involve holding back progress payments as leverage to prevent default.

Opponents counter that surety bonds don't give contractors an equal incentive to complete projects. While retainage provides readily available funds in case a contractor fails to finish a job, they contend that a surety bond isn't a sure thing if a project goes sour. In fact, a surety bond may not pay out until after extensive litigation. As a result, project completion may be long delayed.

Some have suggested increasing or improving periodic inspections of jobsites to replace retainage altogether. These enhanced inspections would help determine whether work is being completed in compliance with contract documents.

Negotiating tactics

The good news: You have some leverage in setting the ground rules for retainage and negotiating favorable contracts. For starters, try quoting two prices — one if retainage is held, the other if it's not. Doing so may help the owner better appreciate the financial burden retainage can impose.

In addition, consider stipulating that retainage be handled consistently throughout a project rather than differently at various job stages. You might also propose a fair rate of interest on all retained funds and contract language allowing interest to accrue on funds not released in a timely manner.

Think diplomatically, too. If collecting retainage is too often a problem, you might need to revise or enhance your construction company's approaches to customer relationship management. That's not to blame your business for the difficulties, but sometimes opening up better lines of communication with owners early in a project and interacting in different ways can prove helpful.

Looking for ways

It's unlikely that we'll see retainage go away completely anytime soon. Many contractors will have to deal with the practice and work around it as best they can. But this doesn't mean you shouldn't continue to look for ways to mitigate its negative impact on your construction company's financial standing. ■