Summer 2018

CONSTRUCTION INDUSTRY ADVISOR

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Should you reconsider your entity choice?

Tax reform changes the equation

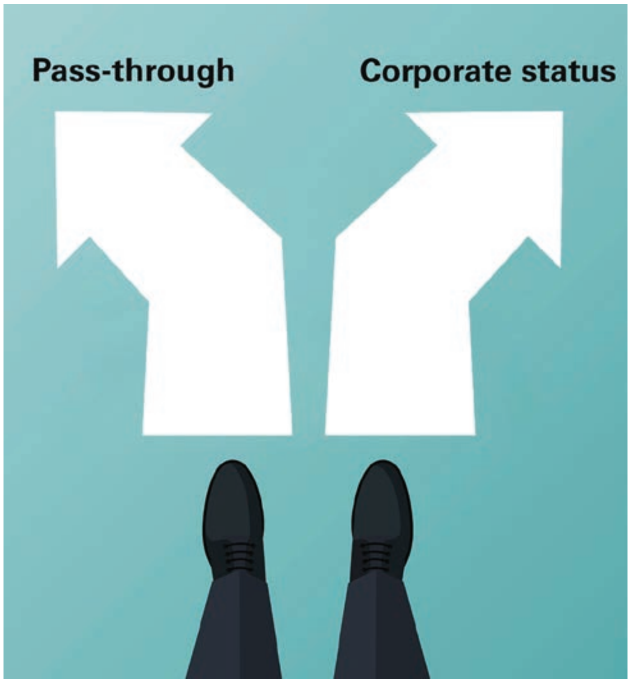
The Tax Cuts and Jobs Act (TCJA) slashed federal corporate income taxes from a top rate of 35% to a flat rate of 21%. As a result, many construction company owners organized as pass-through entities — such as S corporations, limited liability companies (LLCs) and partnerships — are rethinking their business structures.

An owner's share of pass-through income continues to be taxed at individual income tax rates as high as 37% (down from 39.6%), so converting to a C corporation may seem like a no-brainer. But while some businesses may benefit from converting, the decision isn't just a matter of comparing a 37% rate to a 21% rate. There are many factors to consider in estimating your company's net effective tax rate as a C corporation vs. its net effective rate as a pass-through entity.

The pass-through deduction is subject to two important restrictions that may reduce or eliminate its benefits.

Eligibility for the pass-through deduction

The TCJA permits certain pass-through owners (including sole proprietors) to deduct 20% of their qualified business income (QBI) from the entity. (However, the deduction may not exceed 20% of an owner's taxable income excluding net capital gains.)



QBI generally means your allocable share of the company's net income (excluding investment income), as well as reasonable compensation from an S corporation or guaranteed payments from a partnership. Assuming you're in the 37% tax bracket, receive only QBI from the company and qualify for the full deduction, your effective pass-through rate will be 29.6%. This is still higher than the corporate rate, but, given potential double taxation of corporate income (see "Distribution of profits" on page 3), it may be enough to tip the scales in favor of pass-through status.

The inquiry, however, doesn't end there. The pass-through deduction is subject to two important restrictions that may reduce or eliminate its benefits. (See "Pass-through deduction has its limits" on page 3.)

Material participation in the business

If you're a passive investor in a pass-through entity, you may be subject to an additional 3.8% of taxation under the net investment income tax (NIIT) on your share of the company's income. The tax applies to individuals with modified adjusted gross incomes (MAGIs) exceeding $200,000, or $250,000 for joint filers. (Typically, MAGI is the same as adjusted gross income.) It's equal to 3.8% of the lesser of your NII or the excess of your MAGI over the income threshold.

If you materially participate in a pass-through business, you'll avoid the NIIT. But keep in mind that material participants are generally subject to self-employment taxes on their shares of partnership or LLC income or to payroll taxes on their salaries from S corporations.

C corporation shareholders, on the other hand, are subject to the NIIT on dividends, regardless of their level of participation in the business.

Distribution of profits

If your construction company distributes its profits to the owners, a pass-through structure may be preferable. This is because C corporation distributions are exposed to double taxation: once at the corporate level at the 21% rate and again at the shareholder level at rates up to 23.8% (the 20% qualified dividend rate for high-income earners plus the 3.8% NIIT). Double taxation results in effective federal tax rates as high as 40%.

If your company reinvests its profits into growing the business, however, double taxation may not be an issue (at least until the company is sold). But watch out for the accumulated earnings tax, which applies to retained earnings that the IRS deems to be excessive.

Other factors

Even if a C corporation retains its earnings, doing so merely defers double taxation. If you sell the business, the proceeds will be taxed at the corporate level and again when distributed to shareholders. So, if you're contemplating a sale, a pass-through structure may be preferable.

Also consider the state or states in which you do business. State individual and corporate taxes significantly affect your overall effective tax rate.

What lies ahead

Weighing the tax implications of pass-through vs. corporate status is complicated — and future tax changes may alter the equation yet again. For one thing, the pass-through deduction and lower individual income tax rates are temporary. The deduction disappears and tax rates return to their previous levels in 2026.

Plus, there's nothing to prevent Congress from increasing corporate tax rates in the future. Thus, it's important to monitor legislative developments for tax changes that may affect your entity choice. Work closely with your CPA to get and stay up to speed.

Pass-through deduction has its limits

In calculating the benefits of the pass-through deduction (see main article), it's important to consider two significant limits for owners whose taxable income exceeds certain thresholds:

1. The deduction is limited to the greater of 1) 50% of the company's W-2 wages, or 2) 25% of W-2 wages plus 2.5% of the unadjusted basis of qualified property (generally, depreciable tangible property used in the business). This limit is phased in beginning when taxable income reaches $157,500 ($315,000 for joint filers) and is fully applicable once income reaches $207,500 ($415,000 for joint filers).

2. For certain service businesses, the deduction is phased out over the same income range. It's unclear whether the phaseout applies to construction businesses, but we won't know for sure until the IRS issues guidance on the subject.

Failing to properly complete Form I-9 can be costly

In recent years, the U.S. Immigration and Customs Enforcement (ICE) agency has focused its attention on construction companies and other businesses that rely heavily on foreign workers. And the agency isn't just targeting companies that employ workers who are in the country illegally. It's also penalizing businesses that fail to satisfy their employee verification paperwork requirements.

Harsh penalties

Every employer is required to inspect certain documents and to complete and maintain a Form I-9 — "Employment Eligibility Verification" — for each new hire, regardless of citizenship status or country of origin. The employee must complete and sign the form no later than the first day of employment, and the employer must complete and sign the form within three days after that.

I-9 forms may be stored electronically or on paper. If you use paper forms, it's a good idea to store them in separate files to avoid giving government auditors access to unrelated personnel information.

Penalties for mishandling Form I-9 can be harsh. In one recent case, a construction company was penalized more than $150,000 for 189 violations. Violations included missing forms, missing signatures, incomplete information and failure to check certain boxes.

Essential steps

Taking some essential compliance steps can lessen the likelihood of I-9 penalties. These include:

Formalizing your immigration policy. Create a written document that establishes procedures for ensuring compliance with immigration laws. Ask your attorney to review and approve it before you implement the policy companywide.

Providing training to HR staff and other employees. Anyone who manages employees or deals with employment issues should know your immigration policies and procedures. As examples, they should know how to 1) complete and store I-9 forms, 2) inspect documents presented to establish identity and employment eligibility, and 3) respond to ICE visits or subpoenas.

Ensuring you're using the latest version of Form I-9. As of this writing, the current version of the form was dated July 17, 2017, and indicated that it expires August 31, 2019. You can download the form at uscis.gov/i-9.

Using E-Verify. This is a free, online system that electronically confirms employment eligibility by comparing I-9 information against U.S. Department of Homeland Security and Social Security Administration records. Certain federal contractors are required to use E-Verify, but other contractors should consider using the system voluntarily. It doesn't replace the requirement to complete and store I-9 forms, but it provides evidence of good faith that can be used to reduce penalties in the event an audit uncovers any violations.

No exceptions

Remember, Form I-9 is required for all new hires. Even if you hire your spouse or a childhood friend, you must complete the form regardless of what you know or believe about his or her citizenship status, country of origin or work eligibility.

Contractor controlled insurance may suit some growing companies

Most business owners aren't content with running a small company. They want to see that operation grow and grow to become a major player — if not the dominant player — in their markets.

This certainly holds true for construction companies. Most general contractors aren't satisfied jumping from small job to small job. They want to take on bigger and bigger projects and reap the rewards that come along with them.

Naturally, the obstacles are many. Growing too fast can be just as dangerous, if not riskier, than not growing at all. Having the proper insurance coverage is critical. But insurance costs on many jobs, particularly larger ones, can be exceedingly expensive. In addition, with bigger and more complex policies usually comes a longer and more confusing claims process.

At some point, you may want to just do it all yourself. Well, you know what? You can — with a contractor controlled insurance program (CCIP).

Establishing the program

Make no mistake: A CCIP, sometimes also referred to as an "owner controlled insurance program" or "wrap-up coverage," is a big step for any general contractor. Whether it would be worthwhile depends on a variety of factors.

To establish one, you first buy a package of general liability, excess liability and workers' compensation insurance from a chosen carrier. Any subcontractors engaged for a CCIP-covered job need to enroll in the program. These subs can then remove applicable insurance costs from their contracts.

These programs are best suited for companies that have already reached a certain level of growth.

Over a specified period — typically during construction and a stated postcompletion liability phase — your program responds to claims. CCIPs are often used for public projects and larger private ones, but they can also be applied to a series of qualifying midsize jobs.

In other words, as mentioned, these programs are best suited for companies that have already reached a certain level of growth. You'll also need to have a strong backlog of projects to ensure that your cash flow will support maintaining the program.

Running the show

The primary benefit of a CCIP is controlling costs. As the provider, you'll be strongly motivated to strictly enforce claims prevention.

And therein lies an important point: General contractors with excellent safety records and good project managers tend to do the best in running these programs. If you've been struggling with accidents and injuries of late, now may not be the right time to implement a CCIP. It also helps to have some experience or at least familiarity with managing claims under a high-deductible insurance program.

When handled properly, a CCIP should increase efficiency. All claims adjustments are handled by a single insurer — your CCIP. That means you can immediately respond to claims without having to first assign fault to a given party and go through a separate insurer.

Plus, as mentioned, subcontractors will no longer need to provide their own insurance. This should lower their costs to you. Having an effective subcontractor prequalification process can help point you to subs who are comfortable with the CCIP process.

There are risks, of course. Expect to face a high deductible when buying into a CCIP. Amounts can start at $250,000 per claim, but you may encounter deductibles of $500,000 or more. Also, if you intend to use the CCIP for multiple projects, you'll likely face high minimum premiums, which could be costly if you don't have enough

jobs to justify the expense. The ability to maintain a healthy backlog is a critical criterion for contractors who intend to operate a CCIP long term.

Making the choice

Running a CCIP is, in effect, like opening a side business. If that sounds like way too much trouble off the bat, perhaps you'd be better off looking for other ways to control insurance costs. But if your construction company is ascending toward that next tier of success, a CCIP can put the often complex, contentious issue of project insurance much more under your control. ■

Attract and retain talent with equity-based compensation

Construction is a competitive industry. And contractors aren't just competing for projects; they're also competing for a dwindling supply of new management talent and other skilled workers. To combat this problem, consider incentives that can help you attract, retain and motivate quality employees.

A powerful tool

Among the most powerful tools for engaging employees and aligning their interests with those of your business is equity-based compensation. Sharing ownership — by granting stock options or restricted stock awards, for example — is a time-tested strategy for maintaining long-term relationships with employees.

Doing so may not be a viable option for closely held construction companies, however. Owners may be unwilling to dilute their ownership and control of the business. Many privately held companies have buy-sell agreements and other restrictions on their ability to transfer shares or issue new stock. Family-owned construction companies may also restrict ownership by nonfamily members.

Fortunately, there are ways to leverage the economic benefits and motivational power of equity without transferring shares to employees.

Phantom stock

Phantom stock is designed to mimic the economic benefits of a restricted stock award. Employees receive bonuses (usually in cash, though stock can be used) based on the value of a specified number of shares of the company's common stock (or other ownership unit). Some plans even permit employees to receive dividends or other benefits of ownership.

Typically, payments are made at a specified point in time or upon a specified event, such as termination of employment or sale of the business.

Stock appreciation rights

Stock appreciation rights (SARs) are like phantom stock, but they're designed to mimic the economic benefits of stock options rather than stock awards — with one significant advantage: Employees need not put up the cash to purchase shares of stock.

Rather than tie bonuses to the value of the firm's stock, SARs pay out cash awards (or, in some cases, stock) based on the appreciation in value of a set number of shares. As occurs with phantom stock, payouts are usually made at a specific time or a specified event.

Flexible planning tools

Phantom stock and SARs offer a great deal of flexibility in designing incentive compensation plans to meet a construction company's needs. Although both tools use the term "stock," they aren't just for corporations. Partnerships and LLCs can take advantage of similar tools tied to ownership "units." And unlike profit-sharing, 401(k) and employee stock ownership plans, phantom stock and SAR plans can limit participation to key employees.

You can also build in features designed to tie employees to the company long term and motivate them to improve business performance. For example, you can establish vesting schedules for phantom stock rights or SARs, or tie payouts to performance goals, such as reaching certain revenue or earnings targets. It's even possible to vary vesting schedules and performance targets on an employee-by-employee basis.

Downsides exist

Phantom stock and SARs aren't without downsides. The biggest one is that awards are usually paid in cash, which can drain a construction company's cash flow. In addition, awards are usually taxed at ordinary-income tax rates, whereas stock options and restricted stock may offer certain tax advantages for employees. If you're interested in equity-based compensation, be sure to discuss the idea with your CPA. ■

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Provisions for Estimated Contract Losses

Revenue Recognition Options

Companies with long-term fixed-priced contracts typically recognize revenue using one of two methods:

- The percentage-of-completion method, whereby income is recognized over the life of the contract, typically using cost-to-cost recognition
- The completed contract method, whereby income is recognized upon substantial fulfillment of the contract

The selection of a revenue recognition policy is typically driven by the fiscal size of the company, corporate tax strategy, level of difficulty in cost estimation, and external financial statement users.

Accounting for Losses

Regardless of the revenue recognition policy chosen, generally accepted accounting principles or GAAP requires that both options include the recognition of loss provisions in the period during which the loss becomes evident (*Financial Accounting Standards Board Accounting Standards Codification [FASB ASC] 605-35-25-46 // FASB ASC-606-10-65-1*). That is, when the current estimates of total revenue (i.e., consideration) and total contract cost remaining to fulfill the job indicate a loss, the entire value of the loss would be recorded against a loss provision (i.e., an “accrued” contract expense and a liability).

Although the wording changes slightly in the upcoming ASC 606 Revenue Recognition guidance, the concept remains the same. A company will want to make sure that it considers all direct cost types that are applicable to the contract’s performance obligations in computing the loss. Additional cost factors to consider will have updated definitions in the pending guidance, including variable consideration, non-reimbursable costs on cost-plus agreements, and costs on change orders defined as contract modifications. If a company were unable to estimate and record such loss provisions reasonably on a job-by-job basis, the company would not meet the requirements of GAAP.

Contract Combination

In general, if GAAP allows for the combination of multiple contracts for revenue recognition purposes, then these contracts could also be combined for assessing and estimating the loss provision. Conversely, if the contracts are not combined or are segmented for revenue recognition, loss provisions would be recognized for each segment. This concept generally holds true in the upcoming ASC 606 Revenue Recognition guidance, with the clarification that contracts that are not combined are analyzed for provision at the contract level.

However, with the addition of the “performance obligation” term in the upcoming guidance, loss provisions can now be computed on an individual performance obligation level, if elected in accordance with company policy. This would be applicable to all contracts, including those that have been combined per ASC 606-10-25-9. The performance obligations would have to meet the criteria defined in GAAP (*ASC 606-10-25-14 – 22*).

Presentation

If significant to the financial statements, provisions for losses are shown as a separate liability on the balance sheet. The contract provision would generally be shown as a contract cost on the income statement.

If you are interested in learning more about the provisions for estimated contract losses or the upcoming ASC 606, our Construction Industry Group members welcome the opportunity to talk to you and answer your questions.