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CONSTRUCTION INDUSTRY ADVISOR

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Sales and use taxes: An ongoing challenge

We're fast approaching the fourth anniversary of the U.S. Supreme Court's landmark decision in *South Dakota v. Wayfair*. That makes now a good time for construction business owners to review their sales and use tax obligations.

Wayfair explained

In *Wayfair*, the Court ruled that a state may require out-of-state sellers to collect and remit sales tax if they have an "economic nexus" with the state. Previously, states were limited to imposing sales tax collection obligations on sellers that had a physical presence in the state.

At first glance, one might think *Wayfair* has little impact on contractors. After all, construction companies typically have a physical presence — that is, at least one job site — in the states where they do business.

But the ruling could substantially affect your out-of-state suppliers, who may now be required to collect sales tax on the materials and equipment they sell. So, you need to manage these transactions carefully to avoid double taxation.

Nexus in a nutshell

Economic nexus laws impose sales tax collection obligations on businesses that exceed certain sales thresholds in a state, regardless of whether the seller has a physical presence. The South Dakota law upheld in *Wayfair* applied to businesses with more than $100,000 in annual sales or more than 200 separate annual transactions in the state.

Today, nearly every state with a sales tax has followed suit, though the annual sales and number-of-transaction thresholds for establishing economic nexus vary dramatically from state to state. For example, some states require sales as high as $500,000; others base nexus only on sales, regardless of the number of transactions. Still others require businesses to meet both sales and number-of-transaction thresholds.

Construction specifics

For construction businesses, managing sales and use tax can be challenging. Generally, you're treated as the consumer of materials that you use on your jobs. Thus, you either pay sales tax to your vendors or, for out-of-state vendors that don't collect sales tax, you self-assess use tax and remit it to the state. You probably don't typically collect sales tax from the owners you contract with.

As with most general rules, however, there are exceptions. For instance, some states treat contractors as retailers of certain materials. In such cases, you buy the materials tax-free under a resale exemption and collect sales tax from the owner. Examples might include:

- Appliances,
- Window treatments,
- Window air conditioning units,

Should you conduct a reverse sales-and-use tax audit?

If your construction business buys building materials, supplies, equipment and other items in several states, consider conducting a reverse sales-and-use tax audit.

You might be familiar with sales and use tax audits conducted by state or local authorities. The purpose of these audits is to uncover purchases for which sales or use tax was improperly collected and remitted to the state. A reverse audit, as the name suggests, does the opposite: It examines the sales and use tax your company has paid and identifies overpayments for which you can claim a refund.

Often, these overpayments involve taxes paid on purchases that were eligible for an exemption. Generally, it's the purchaser's obligation to claim an exemption, so mistakes are common. A reverse audit can help you spot and correct these mistakes — sometimes leading to substantial refunds.

- Carpeting, and
- Some business fixtures treated as personal rather than real property.

A few states impose sales tax on specified construction services, requiring contractors to pay sales tax on their materials and collect sales tax from customers.

In some states, the sales tax treatment depends on the type of contract. With a lump-sum contract, for example, the state treats the construction company as the consumer of materials incorporated into the real estate.

However, with time and materials contracts, in which material charges are itemized separately from labor and other charges, the state views the construction business as a retailer. This allows the builder to buy materials tax-free for resale but requires it to collect sales tax from the owner.

Another complexity involves sales tax exemptions. In many states, certain types of entities — such as schools, hospitals and nonprofits — are exempt from sales tax. In some of these states, the exemption "flows through" to the construction business. That means the contractor can buy materials tax-free under an exemption certificate for use on a project involving an eligible entity. However, in other states, the exemption is available only if the entity itself buys the materials.

Impact of *Wayfair*

Before *Wayfair*, out-of-state suppliers without a physical presence in the state in which a construction company does business typically wouldn't collect sales tax. But that's no longer the case now that most states have enacted economic nexus laws.

Therefore, it's critical for you, as a construction business owner, to understand the sales and use tax rules in the states where your company operates. You also need to provide resale or exemption certificates to your vendors — or have exempt owners buy materials directly, if necessary — to take advantage of the sales tax exemptions available.

Finally, look closely into how the contract types that your business usually operates under affect your sales and use tax obligations. Consider those obligations when developing bids.

Prevalent and complex

Given the nationwide prevalence of economic nexus laws, and the complexity of sales and use tax, regularly review your business activities to ensure that you're in compliance.

Also, consider a reverse sales-and-use tax audit to ensure you're not paying taxes that you really don't owe. (See "Should you conduct a reverse sales-and-use tax audit?" above.) Your CPA can be an invaluable resource when it comes to these matters. ■

Sizing up a public infrastructure project

Given all that's going on in the nation and the world, the federal infrastructure bill passed toward the end of last year might seem to have gotten lost in the shuffle. But, indeed, the Infrastructure Investment and Jobs Act was signed into law on November 15, 2021, and it represents a veritable mountain of opportunities for construction companies in the months and years ahead.

If your construction company has little to no history of bidding on and participating in publicly funded projects, there will be a learning curve involved. These jobs tend to come with additional rules, which can vary depending on whether you're dealing with the federal government or a state or local authority. Here are some essentials for sizing up a public infrastructure project.

Verify funding

As you would for any project, confirm that the project owner has enough funding to bankroll the job. If it's a federal project, you can obviously assume that the money is there. But you might not get paid as quickly as you'd like.

Government agencies at any level typically set aside money for infrastructure jobs, but many state and local governments have experienced substantial revenue losses during pandemic-related shutdowns. This has notably been the case in fee-based jurisdictions, such as port authorities. So, do some digging on the finances before you submit a bid.

Identify the delivery method

Publicly funded jobs don't always follow the traditional design-bid-build approach. Some infrastructure jobs have been moving away from low-bid packages toward collaborative strategies and delivery methods such as:

- Public-private partnerships,
- Design-build, and
- Integrated project delivery.

Under such methods, partners work together much earlier in the process to develop the scope, schedule and budget.

Check the supply chain

As you're likely aware, some building-material supply chains have been either strained or interrupted during the pandemic. Although, as of this writing, COVID-19 seems to be fading as a major issue, there's still the potential for bottlenecked pipelines and volatile market conditions.

Some contractors have been building up their inventory levels with critical materials and long-lead items to insulate themselves against future disruptions. It's a good strategy when financially feasible, along with diversifying your supplier base and identifying alternative suppliers who can deliver materials of similar type and quality.

Look into labor

Ensure your company can tap into a stable workforce, which might include subcontractors, to complete the project on schedule and at a high level of quality. Assess the possibility that some of your skilled workers could feel uncomfortable with the size, complexity or safety requirements of a public job. Some additional training might be in order.

Compliance and safety

Government-funded jobs mean government rules and regulations. Know what you're getting into. As mentioned, specifics will vary depending on the type of project and entity or entities involved.

Expect to see more pandemic-related requirements and responsibilities on public jobs, which could impact project timelines and costs. You might also encounter special waste-disposal and environmental requirements.

Take account of tech

Look into what technology will be used for the project. Infrastructure jobs around the world have been increasingly using building information modeling (BIM) systems. Are you and your employees experienced with BIM software? If not, will you be able to get up to speed quickly?

In addition, the pandemic has accelerated the use of videoconferencing and mobile apps enabling remote project management, as well as wearable tech and sensors alerting workers when they're too close together. You may also encounter paperless ticketing that helps limit contact during concrete and other materials deliveries.

Choose carefully

Each state will receive a specified share of the estimated $1.2 trillion allocated under the Infrastructure Investment and Jobs Act. As a project comes online, assess the factors covered here and any other elements of the job that could determine whether it's a good move for your construction company. Although it's tempting to jump at the first thing that comes along, make sure the project makes sense in terms of your capabilities and profitability. ■

Could you qualify for an energy-efficient tax deduction?

Section 179D of the tax code allows a deduction for the cost of energy-efficient improvements to new or existing commercial buildings, as well as certain residential rental buildings. Originally a temporary incentive that was renewed several times, the tax break became permanent under legislation passed in late 2020. The legislation also called for the maximum deduction amount to be adjusted for inflation — making it even more valuable.

Although the deduction targets property owners who undertake energy-efficient improvements, it can also be available to certain contractors involved in government-funded projects.

How to gain eligibility

Federal, state or local governments that make energy-efficient improvements to their new or existing buildings may allocate the deduction in

writing to the taxpayer "primarily responsible for designing" the improvements.

Usually, that means an architect, engineer, construction contractor, environmental consultant or energy consultant. IRS guidance defines "designer" in this context as one who "creates the technical specifications for installation of energy-efficient commercial building property" as distinguished from one who "merely installs, repairs, or maintains the property."

The Sec. 179D deduction is available for new construction and additions to or renovations of commercial buildings of any size.

Contractors who have significant input into the design of energy-efficient improvements — for example, those involved in design-build contracts with government entities — might be able to claim the deduction.

What improvements qualify

The Sec. 179D deduction is available for new construction as well as additions to or renovations of commercial buildings of any size. Multifamily residential rental buildings that are at least four stories above grade typically qualify, too. Building owners or designers may immediately deduct the cost of eligible energy-efficient improvements — up to a total of $1.80 multiplied by the building's square footage.

An eligible improvement is otherwise depreciable property installed as part of a building's interior lighting system, HVAC and hot water systems, or building envelope. It must be part of a plan designed to reduce annual energy and power costs by at least 50% compared with applicable industry standards. An independent contractor or licensed engineer needs to certify the plan. Partial deductions are available for building components that achieve certain lesser energy savings targets.

Previous years

If you believe your construction company was entitled to Sec. 179D deductions for projects completed in previous tax years, but you failed to claim them at the time, you may file an amended return to recover the missed tax benefits.

Keep in mind, however, that the deadline for doing so is generally three years from the date you filed the original return. Building owners have another option: file IRS Form 3115, "Application for Change in Accounting Method," and claim catch-up deductions in the current tax year. This option isn't available to designers.

Worth a look

If your construction business works on energy-efficient improvements to government buildings, and is involved in creating the improvements' technical specifications, it's worth a look to determine whether you're eligible to claim the Sec. 179D deduction.

You'll need to ask the government entity to allocate these deductions to you, and you'll have to obtain an independent certification that the improvements meet applicable energy-savings standards. But the effort could pay off in a lower tax bill. Ask your CPA for further details. ■

5 tips for avoiding profit fade

Profit fade can be a serious problem for construction companies. It's not only a red flag for sureties and lenders, but also a harbinger of doom for the overall financial performance of the business.

As the name suggests, profit fade simply means a decline in expected gross profits over the course of a project. There are many potential causes, including overly optimistic estimates, inaccurate job costs, unbillable change orders, unexpected job-site conditions and supply chain issues.

If profit fade affects only a couple projects a year, you might be able to make up the dollars lost on other jobs. But if it becomes a systemic problem, the impact on your bottom line can be devastating. Here are five tips for avoiding profit fade:

1. Create a budget. It's difficult if not impossible to identify and manage profit fade without a realistic budget for each job based on the original bid.

2. Monitor work in progress. A budget is ineffective if you simply put it on a shelf, or file it away on a hard drive, and forget about it. Monitor each job's progress closely and follow up on any discrepancies between budgeted and actual performance. Prepare regular work-in-progress reports to track:

- Contract prices,
- Amounts billed and costs incurred to date,
- Projected final costs, and
- Estimated gross profits.

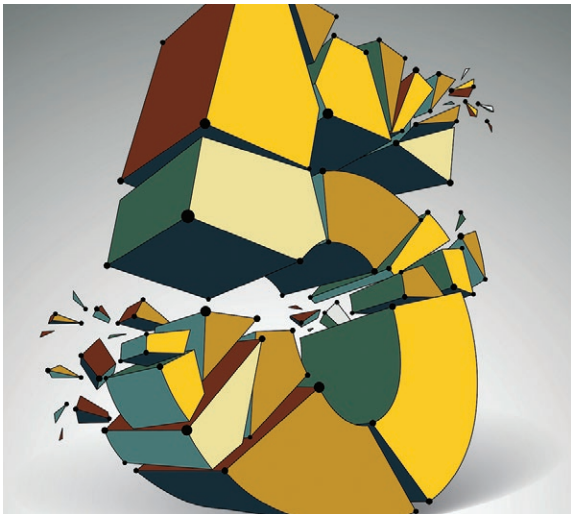
Tracking this information in real time alerts you to problems early and allows you to address them before it's too late.

3. Get a handle on job costs. Evaluate your estimating and job costing systems and processes to be sure they're accurate and complete. If profit fade is an issue, build more conservative assumptions into your estimates. Include contingent costs to provide a cushion against potential delays and other unanticipated expenses.

4. Build protections into your contracts. It's hard to avoid profit fade if your contracts are vaguely worded or make it easy for the owner to change the project's scope. To minimize unanticipated costs, double-check that your contracts clearly define the nature and scope of work and set forth straightforward change-order procedures that ensure you're compensated for extra work.

5. Learn from your completed jobs. Analyze completed jobs to look for patterns and trends. Determine whether profit fade is associated with certain types of jobs, locations, customers or personnel. If you identify a clear cause, address it immediately.

Unfortunately, in today's uncertain economy, there's no way to eliminate the risk of profit fade altogether. However, by identifying factors associated with this common problem, you can take steps to prevent it from adversely affecting your financial performance on future jobs. ■



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Transaction Advisory Services

LaPorte's Transaction Advisory Services professionals offer an integrated approach to business transactions. Our team has deep experience providing business valuation, taxation, due diligence, transaction structuring, and financial performance analysis and modeling services, to name a few. Our knowledge covers the spectrum of transactions, including mergers, acquisitions, dispositions, going-private, and others.

Qualifications to Meet Transaction Advisory Needs

Our Transaction Advisory leadership team advises companies of all sizes — from closely held family businesses to mid-market companies with diverse ownership structures. In addition, our registration with the Public Company Accounting Oversight Board allows us to serve publicly traded companies that are regulated by the Securities and Exchange Commission. Our experience includes transactions with third parties, company insiders, and next-generation leaders.

Our highly credentialed team includes certified public accountants; certified public accountants/accredited in business valuation; a certified valuation analyst; master analyst in financial forensics; certified specialist in estate planning; and master of laws in taxation.

We serve all major industries, including among others construction, energy/oil and gas, healthcare, hospitality and entertainment, nonprofit, financial services, professional services, public sector, real estate, and software.

Services

Our professionals bring proven, hands-on experience to our clients at every stage of the transaction process:

Pre-transaction Stage

- Determine value of business including potential strategic and synergistic value
- Identify tax optimization strategies
- Determine succession, generational and ownership strategies
- Prepare business for sale process, including preliminary accounting, IT, and operational assessment(s)
- Conduct preliminary quality of earnings and assets analyses
- Conduct working capital and cash flow analyses

Transaction Stage

- Develop informational memorandum
- Identify suitable candidates
- Manage due diligence process
- Formalize quality of earnings, assets, and trend analysis
- Fully develop specific deal, strategic, and synergistic value(s)
- Develop/analyze earnout scenarios
- Advise on responses/negotiating strategies
- Advise on optimizing tax implications of transaction, including purchase price allocations
- Model return on investment and payback period under multiple scenarios as well as future cash flow
- Evaluate and advise on deal terms and structuring
- Advise on/calculate working capital thresholds in transaction agreement

Post-closing Stage

- Monitor transaction terms and escrow provision(s)
- Evaluate strategies related to deferral of proceeds
- Advise on proceeds and generational transfers resulting from a sale
- Determine working capital true-up

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