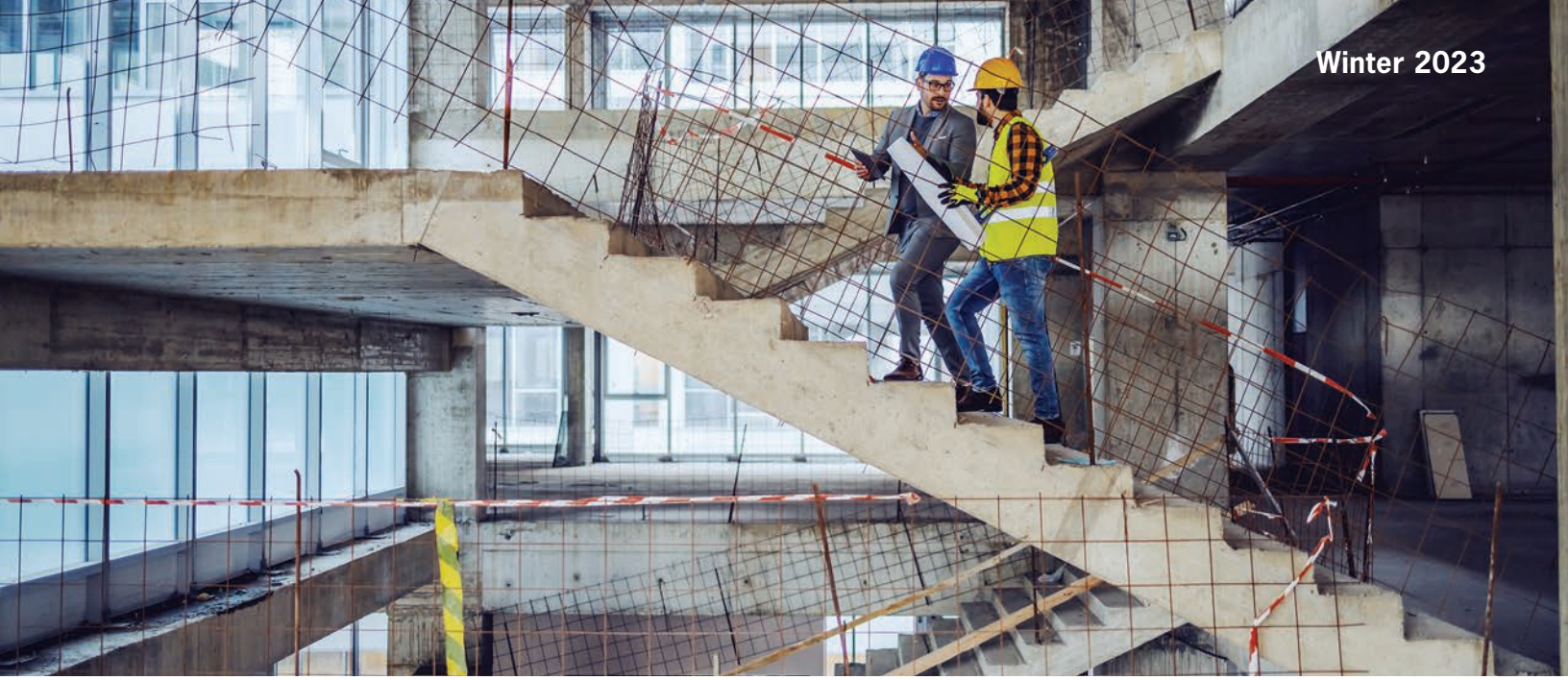

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CONSTRUCTION INDUSTRY ADVISOR

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Business interest expense: How much can you deduct?

The Tax Cuts and Jobs Act (TCJA) imposed a new limitation on deductions of business interest expense by certain companies. And the limit, found in Section 163(j) of the Internal Revenue Code, became even more restrictive in 2022 — especially for capital intensive businesses.

As a construction business owner, you should determine whether the deduction limitation applies to your company. If it does, you'll need to closely evaluate its potential impact on your tax bill and consider strategies for mitigating that impact, including potentially making an election to opt out.

Qualifying for an exemption

Sec. 163(j) doesn't apply to "small businesses," so the first step is to determine whether your construction company meets that definition. A small business is one that cannot be defined under IRS rules as a tax shelter and whose average gross receipts for the preceding three years don't exceed an inflation-adjusted threshold — $29 million in 2023.

However, even if your gross receipts are under the threshold, don't automatically assume that you're exempt. For one thing, you may need to aggregate your gross receipts with certain related businesses

in determining whether the exemption applies. Also, the definition of "tax shelter" is surprisingly broad. (For more information, see "Watch out for tax shelter status" on page 3.)

Calculating the limitation

If your construction company isn't exempt from the deduction limitation, then your business interest expense deductions in a given year cannot exceed the sum of:

1. Your company's business interest income,
2. 30% of your business's adjusted taxable income (ATI), and
3. Your company's floor plan financing interest.

Assuming your construction company doesn't have significant business interest income or floor plan financing interest expense, the deduction limitation is generally equal to 30% of ATI. Keep in mind that business interest income and expense excludes investment interest income and expense.

ATI is generally equal to your taxable income, calculated without regard to:

- Nonbusiness income, gains, deductions or losses,
- Business interest income or expense,
- Net operating loss deductions, or
- The 20% qualified business income deduction for pass-through entities and sole proprietorships.

Initially, ATI was also calculated without regard to depreciation, amortization or depletion. But, for tax years beginning after 2021, those items are

subtracted in arriving at ATI — limiting business interest expense deductions even further. Disallowed deductions generally may be carried forward and treated as business interest expense paid or accrued in the following taxable year. Special rules apply to partnerships and other pass-through entities.

Now that the CARES Act's temporary relief has ended, many more companies are affected by the business interest limitation.

Note that, to provide businesses with some relief during the onset of the COVID-19 pandemic, the CARES Act temporarily increased the deduction limit to 50% of ATI in 2019 and 2020. The act also permitted businesses to calculate the 2020 limit based on their 2019 ATI. Now that this temporary relief has ended and depreciation, amortization and depletion are excluded from ATI, many more companies are affected by the business interest limitation.

Opting out

Certain real property and farming businesses, including construction companies, are permitted to make a one-time, irrevocable election to opt out of the Sec. 163(j) limitation. Opting out can generate significant tax benefits, but it's important to weigh these benefits against the potential costs.

Companies that opt out are required to depreciate certain business assets — including nonresidential real property, residential rental property and qualified improvement property — using the alternative depreciation system (ADS). Recovery periods under the ADS are longer, resulting in lower depreciation deductions. In addition, companies that opt out aren't entitled to claim bonus depreciation on qualified improvement property, which includes many improvements to commercial buildings.

Watch out for tax shelter status

Regardless of your construction company's level of gross receipts, it won't qualify for the small business exemption from the limitation on deductions of business interest expense if it's deemed to be a tax shelter. (See main article for more details on the deduction limitation.) You might associate the term with shady tax-avoidance schemes but, as defined under the Internal Revenue Code and IRS regulations, it's broad enough to include many ordinary and perfectly legitimate businesses.

Tax shelters include entities formed for tax avoidance or evasion purposes, but they also include partnerships and other pass-through entities if more than 35% of their losses are allocable to limited partners or "limited entrepreneurs" — that is, owners who don't actively participate in management.

If your construction company is deemed a tax shelter under this definition, there may be strategies available to shed yourself of tax shelter status. For example, you could perhaps reduce the amount of losses allocated to limited partners or limited entrepreneurs to less than 35%. Alternatively, you could arrange for some of those limited partners or limited entrepreneurs to actively participate in management of the business. Contact your tax advisor for further details and professional advice.

Whether the benefits of opting out outweigh the costs depends on your construction business's particular tax situation and other circumstances.

Planning opportunities

Is your construction company affected by the business interest limitation? It's a good idea to find out. Potential planning opportunities include opting out, relying more on equity financing and less on debt, or generating interest income to offset some of your interest expense (for example, by extending credit to customers). Consult your tax advisor to identify the right strategy for your business and for help carrying it out. ■

Succession planning is a journey of many steps

Depending on where you're at in your career as a construction business owner, a succession plan might seem like something for a far-off distant future or one of those "back-burner goals" that's gradually growing in importance with each passing year.

Humans are naturally reluctant to think about their later years or death. And construction company owners are usually busy with the day-to-day details of keeping their businesses profitable. But the failure to think through succession can hurt a company's value and may lead to costly disputes and confusion down the line. That's why it's good to get started earlier rather than later.

Defining your goals

The first step is to define your succession-planning goals. Common examples include:

- Securing future financial stability for the owner, family members and the business,
- Keeping the company in the family,
- Treating children fairly whether they work for the business or not, and
- Giving valued employees an opportunity to step up and share in the company's profits.

Owners who wish to be succeeded by a child or other family member should talk to the younger generation to gauge their interest and identify their skill sets. If anyone is pressured to take over, the construction company will likely suffer. Everyone must be on the same page about future roles, responsibilities and the corresponding financial rewards.

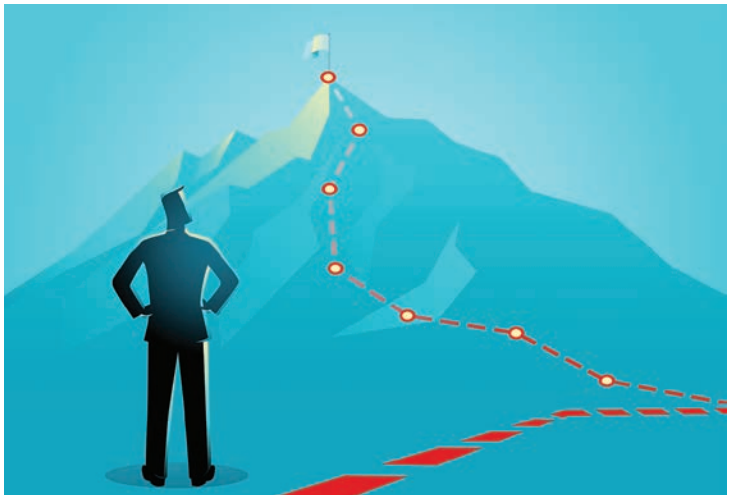
Transferring ownership shares

Many construction business owners intend to sell their businesses to family members, employees or a combination of both. Family ownership transfers are often done through a gift or sale. The right choice depends on a variety of factors, including whether the owner needs retirement funds.

Gifting can make it easier to shift responsibilities for debts or other liabilities, while also reducing the owner's taxable estate. Then again, owners who go the sale route have multiple options for structuring the deal. An installment plan, for example, could work as an annuity in retirement.

Note that a construction company's purchase price probably will be less for family members than if the business were sold to a third-party buyer. But internal transfers can avoid some of the risks that come with outside owners, such as culture change. There's also a better chance that the outgoing owner can retain some control through, for example, voting shares.

Stock redemptions are another alternative. Under these arrangements, the company buys some or all



of the owner's shares, increasing the ownership of the remaining shareholders.

For instance, if the owner has an 80% interest and his two children each have a 10% share, the owner can sell his interest, resulting in each child having a 50% interest. Redemptions must be carefully structured so the balance sheet isn't weakened, and the company doesn't fall out of compliance with any bonding or lending covenants.

A stock redemption might be required under a buy-sell agreement. Such agreements often calculate the stock's price according to an agreed-upon valuation method.

Additional transfer options include recapitalization and employee stock ownership plans. Every option has pros and cons, including tax implications. Construction business owners should consider all angles before choosing an approach.

Training the next owner

Few designated successors are ready to drop into a company's top position on a dime. Proper preparation is vital — and it's not an overnight process.

A comprehensive training program will help reassure lenders and sureties that leadership will remain competent, knowledgeable and trustworthy. Construction business owners should evaluate intended successors for gaps in skills or other qualifications, so they can address them in advance.

Everyone must be on the same page about future roles, responsibilities and the corresponding financial rewards.

The gaps might call for continuing education courses, on-the-job training, long-term mentoring and, finally, hands-on leadership experience. Responsibilities such as directing staff and interacting with lenders, customers and surety agents can then be gradually handed off.

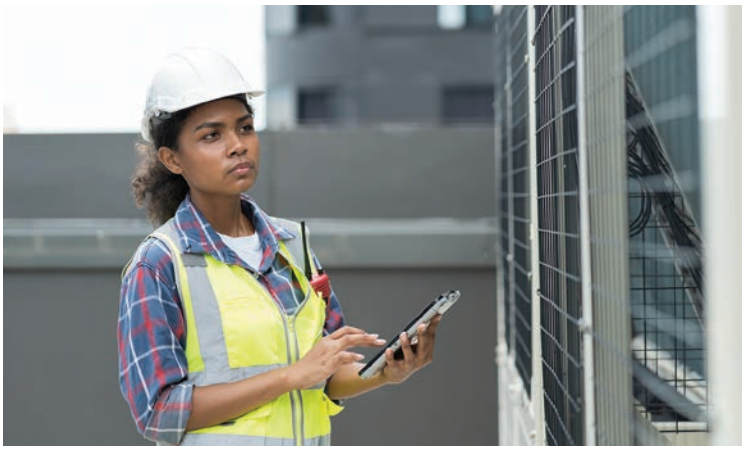
Getting started

As the old saying goes, a journey of a thousand miles begins with a single step. And so it goes with succession plans. Getting started is often the most difficult part but, once you're up and running, the ultimate destination becomes imminently reachable. Your professional advisors, including your CPA, can be invaluable travel partners. ■

The essentials of a subcontractor prequalification process

The construction business is risky business — especially in today's inflationary and supply-chain-addled environment. That's why it's critical for general contractors to take steps to mitigate their risks, which includes minimizing the likelihood of subcontractor default by ensuring that the subcontractors they work with can satisfactorily complete work.

Assuming you're a general contractor, failure to thoroughly vet subcontractors can result in delays, budget overruns and substandard work quality — all of which can diminish profits and damage



3. Reputation and performance history. Look into the background and reputation of the company, as well as its owners and management team. Have they ever been terminated from or walked off a job? Have they ever filed for bankruptcy? Do they have a history of litigation? Evaluate the subcontractor's safety plans, practices and history. What is its workers' comp experience modification rating? Does it have a history of OSHA violations?

your reputation. Among the most effective ways to reduce subcontractor risk is to implement a prequalification process.

3 areas to examine

When evaluating subcontractors, the type of information you gather and the depth of the analysis you perform will depend on the nature of your business and the size and complexity of your jobs. But here are three common areas to examine:

1. Capacity. Look at the size, skills, experience and geographical reach of the sub's workforce. Review the types of projects and volume of work the company has handled in the past, as well as its current jobs and backlog. Inquire about its equipment holdings and ability to lease assets it would need for your jobs. Ask for references from other general contractors, customers, lenders, sureties and suppliers. If possible, visit one or two of the subcontractor's jobsites to inspect work quality.

2. Financial stability. Invite subcontractors who are interested in completing your prequalification process to submit their most recent financial statements for review. Then calculate key financial statement ratios — such as the current ratio (current assets/current liabilities), return on equity and working capital turnover — to get a handle on the company's financial strength. Make sure its accounts receivable and cash flow is healthy, and that owners maintain sufficient equity in the business.

Policies and procedures

To ensure a thorough, reliable prequalification process, set formal policies and procedures. For example, create forms, questionnaires or checklists — either on paper or online — to gather relevant documents and information from prospective subcontractors. Prequalification software may be available to automate the process.

Alternatively, you could outsource the prequalification process. Some sureties will prequalify subcontractors on your behalf. An advantage to this approach is that subcontractors may be more comfortable sharing financial statements and other sensitive information with a bonding firm than with your construction company.

To encourage subcontractors to cooperate, some general contractors offer financial incentives to subcontractors who meet prequalification standards, such as accelerated payment terms.

It helps subcontractors, too

Prequalification offers significant benefits to subcontractors, too. Winning a spot on a general contractor's preferred list can provide a competitive advantage. In addition, working with general contractors that prequalify subcontractors provides some assurance that other subcontractors on the project will be qualified, reducing the risks of delays and defaults. Indeed, it's a process that can be a win-win for everyone. ■

Prepare for stricter cybersecurity on DoD contracts

Construction companies are highly vulnerable to cyberthreats because of the mobile nature of their operations. And the risk of a breach goes far beyond disclosure of confidential financial information or competitive intelligence.

Hacking a construction business could also raise serious concerns about potential personal injuries and property damage. Imagine the harm a hacker could cause by altering plans or specifications, interfering with a building's security or safety systems, or tampering with vehicles or equipment such as a drone. One entity that's well aware of these dangers: the federal government.

The CMMC program

Recently, the U.S. Department of Defense (DoD) updated its Cybersecurity Maturity Model Certification (CMMC) program. Construction companies and other entities that contract with the DoD will soon be required to comply with it.

The CMMC program requires defense contractors to comply with strict standards, practices and processes for the protection of sensitive government information. It also requires contractors to obtain a certification from a CMMC third-party assessor organization.

A comprehensive description and discussion of the CMMC program is beyond the scope of this article. Generally, it incorporates a tiered model under which cybersecurity standards become progressively more advanced, depending on the type and sensitivity of the information entrusted to a defense contractor.

The exact timeline for implementation of the CMMC program is uncertain, but the DoD expects its requirements to begin appearing in solicitations for government contracts by the middle of 2023.

A cybersecurity assessment

Construction companies that plan to bid on DoD contracts should conduct a cybersecurity assessment as soon as possible to identify the steps they'll need to take to comply with CMMC requirements. For more information on the program, you can visit dodcio.defense.gov/CMMC/.

However, even if your construction business doesn't plan to get involved with DoD projects, it's a good idea to conduct a cybersecurity assessment to evaluate the vulnerability of your systems. Take inventory of your hardware and software, as well as the mobile devices used by employees and other parties. Identify potential vulnerabilities such as:

- Outdated software,
- Lack of encryption, and
- Poor or nonexistent password protection.

Such an assessment should help you implement controls and other safeguards to reduce the risk of a data breach. It can also help you develop an incident response plan to mitigate the damage in the event a breach occurs.

Lucrative opportunities

DoD contracts can be a substantial revenue source for construction companies with the resources and skilled labor to win a bid. Just be prepared for the intensive rules that accompany public projects, which now includes tighter cybersecurity. ■

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Accounting Methods Available for the Construction Industry

Prior to the Tax Cuts and Jobs Act (TCJA), only smaller contractors were able to account for long-term projects using the completed contract method. Now, many medium- and large-capacity contractors can begin using this accounting method. This won't be the right move for all businesses, but contractors should talk to their advisors and see how it could impact their tax outlook.

Percentage-of-completion method (PCM) taxpayers recognize revenues over the life of the contract. In general, all contractors are required to use the PCM when reporting long-term contracts on their tax return unless they or their project meet one of the following exceptions:

- Their build is a home construction or residential contract.
- They perform exempt activities, such as industrial and commercial painters, engineers, architects, and construction management businesses.
- They have three-year average annual gross receipts of $27 million or less.

Should my company consider changing methods?

If contractors' average gross receipts are below the $27 million threshold, they have the option to use the completed contract method of accounting. Contractors who report long-term contract revenue under the completed contract method will not recognize contract revenues or expenses until the year in which the contract is at least 95% complete.

In most cases, contractors prefer the completed contract method because it lets them defer taxable income for longer, but there are downsides to switching from the PCM to the completed contract method.

Access to Working Capital and Cash Flow

When taxpayers use the completed contract method, the tax burden of a project will always fall into only one tax year. This could pose a problem for businesses struggling with cash flow. If a business has multiple projects that are completed within the same year, or if their taxes come due in the same year that working capital is earmarked for another project, the company's working capital may be at capacity.

Administrative Burden

The completed contract method is for tax reporting purposes only, which means that businesses must keep two sets of books: one for the IRS and one in compliance with GAAP for financial reporting purposes.

Alternative Minimum Tax (AMT)

Because the PCM is the method that must be used for alternative minimum tax calculations, taxpayers subject to the AMT may not see a tax benefit from switching to the completed contract method.

If neither completed contract method nor PCM are good fits, contractors whose average revenues fall below the $27 million threshold can also consider using either the cash method or the accrual method. Although the accrual method of accounting more closely aligns with GAAP, some contractors prefer the cash method because it is simpler to calculate and the tax liability is closer aligned with the recognition of income and expenses.

Accounting method decisions are complex. If your construction business has not discussed this tax law change, reach out to tax director and Construction Industry Group member Gretchen Ockman at gockman@laporte.com. She can help you determine if adopting one of these methods makes sense for your business.