



CONSTRUCTION INDUSTRY ADVISOR

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Beware of tax surprises when selling equipment or vehicles

Many construction businesses find themselves with equipment or vehicles they no longer need. If you're thinking about selling or trading in such assets, be sure to consider the tax consequences.

You may not expect to owe taxes when you sell a piece of equipment or vehicle for less than you paid for it, but that's what often happens with business assets — especially if they're fully depreciated. Let's first take a look at the different ways that construction companies can recover the costs of business assets. Then we'll look at the tax implications of a sale.

Cost recovery 101

Business equipment and vehicles are generally considered capital assets, the costs of which are recovered through depreciation deductions over their useful lives. In practice, however, these costs are usually recovered more quickly by using one of the following methods:

Accelerated depreciation. Under the modified accelerated cost recovery system (MACRS), most construction equipment and vehicles are classified as five-year assets. So, for example, assuming the “half-year convention” applies, 20% of the cost would be deducted in year one, 32% in year two, 19.2% in year three, 11.52% in years four and five, and 5.76% in year six.

Section 179 expensing. Internal Revenue Code Sec. 179 currently allows you to deduct, rather than depreciate, up to \$1,160,000 in equipment, vehicle and other qualifying asset costs. The deduction is phased out dollar for dollar to the extent your total investment in Sec. 179 assets for the year exceeds \$2.89 million.

Bonus depreciation. For assets placed in service after 2017 and before 2023, bonus depreciation

allows you to deduct up to 100% of the cost of equipment, vehicles and other eligible assets. However, bonus depreciation is currently being phased out. The good news is it still allows you to deduct up to 80% of the cost of assets placed in service in 2023. After this year, the percentage declines by 20% annually until bonus depreciation is scheduled for elimination after 2026.

Selling depreciated assets

When you sell or trade in a used asset, you may trigger a taxable capital gain or “recapture” of previous depreciation deductions. Recapture is generally taxable at ordinary income tax rates but, in some situations, it can be taxable at both ordinary rates and capital gains rates.

If the sale price or trade-in value is greater than your basis in the asset, then the difference is a taxable gain. If that gain is less than the amount of depreciation you've claimed on the asset, then it's considered depreciation recapture and taxed at ordinary income tax rates as high as 37%. If it exceeds your previous depreciation deductions, the gain attributable to depreciation is taxed as ordinary income and the excess is treated as a capital gain, typically taxed at 15% or 20%.

Following are three examples to illustrate how this works. To keep things simple, let's assume that:

- You're a sole proprietor in the 35% tax bracket,
- You're disposing of only one piece of equipment this year, and
- You didn't claim losses on any business property in the last five years.

When you dispose of several assets in one year, your gains and losses are netted against each other, and the tax consequences depend on whether you

have a net gain or loss and the character of that gain or loss. Also, certain deductible losses on business assets in the last five years can convert capital gains this year into ordinary income.

Example 1. Suppose you bought a midsized excavator in 2020 for \$200,000 and you deducted the entire cost that year using bonus depreciation, reducing your basis to zero. This year, you decide to buy a larger excavator and receive \$100,000 in trade-in value for the old one. The entire \$100,000 is depreciation recapture, resulting in a \$35,000 tax bill ($\$100,000 \times 35\%$).

Example 2. Apply the same facts as Example 1, except you've been depreciating the excavator pursuant to MACRS. Through 2022, you've taken \$71,200 in depreciation deductions, reducing your basis to \$128,800. Trading in the excavator for \$100,000 results in a \$28,800 loss.

Example 3. Apply the same facts as Example 2 except that, because of a severe shortage of midsized excavators, you're able to sell yours for \$218,800 — resulting in a \$90,000 gain. The amount of that gain attributable to depreciation recapture (\$71,200) generates \$24,920 in ordinary income taxes ($\$71,200 \times 35\%$). The remaining \$18,800 in gain is a long-term capital gain, resulting in \$2,820 in taxes ($\$18,800 \times 15\%$), for a total tax of \$27,740.

Selling your business? Consider an ESOP

Given the high cost of depreciation recapture (see main article), imagine the tax bill you'd receive if you were to sell your construction business! If your company owns a substantial amount of depreciated assets, the tax cost of an asset sale can be enormous. Construction businesses set up as corporations may be able to mitigate the cost by structuring the transaction as a stock sale. However, for various reasons, buyers typically insist on purchasing assets.

A potential solution is to establish an employee stock ownership plan (ESOP) and sell the company to it. An ESOP is a qualified retirement plan, similar to a 401(k), which invests primarily in the employer's stock. Business owners who sell their stock to an ESOP avoid the depreciation recapture associated with an asset sale. In addition, if certain requirements are met, business owners can defer capital gains on the sale indefinitely. Ask your CPA for further details.



No surprises

As you can see, the circumstances of a transaction involving equipment or vehicles greatly impact the tax consequences. Before committing to any deal, consult your CPA. ■

How do federal infrastructure bids work?

The Infrastructure Investment and Jobs Act was signed into law “way back” in late 2021. As expected, it's taken a while for many of the resulting jobs to come online. Nevertheless, confidence remains high that they're indeed coming. If your construction business is interested in this work, here's a look at two of

the most common bidding methods for federally funded projects.

Submitting a sealed bid

The predominant method for most federal construction work is “sealed bidding.” It begins when

the government releases an invitation for bid (IFB). The IFB provides the project specifications or statement of work, proposal instructions, and a draft contract. Bids are then opened publicly.

Sealed bidding is used when the specifications are clear, and the determining factor is price. The qualified construction company with the lowest price will win the bid — which will be a firm, fixed-price contract.

Generally, contractors who win sealed bids won't have to submit cost and pricing data. The cost principles contained in the Cost Accounting Standards (CAS), a set of standards and rules that the federal government uses to determine costs during negotiated procurement, typically don't apply. However, the Federal Acquisition Regulations (FAR) do apply to sealed bids and, indeed, to all government procurements.



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Because CAS doesn't apply, a substantial portion of the cost-accounting regulations applicable to government contracts won't come into play for most construction businesses. Nonetheless, contractors bidding these types of contracts shouldn't completely ignore the regulations because they may come into consideration if change orders are requested, the contractor submits claims for additional compensation or the government terminates the contract for its convenience.

The applicability of cost principles to fixed-price contracts is specifically addressed in FAR 31.102, "Fixed-Price Contracts." It states, in part, "The



applicable subparts of part 31 shall be used in the pricing of fixed-price contracts, subcontracts, and modifications to contracts and subcontracts whenever (a) cost analysis is performed, or (b) a fixed-price contract clause requires the determination or negotiation of costs."

Negotiating a contract

Although sealed bidding is the most popular procurement method, the federal government sometimes uses "contracting by negotiation" for multiyear construction management contracts, facilities management work and overseas contracts.

This approach typically comes into play when the construction services involved are complex, difficult to describe and include factors other than price. Unlike the sealed bidding method, which awards only fixed-price contracts, contracting by negotiation can take many forms — including cost reimbursement contracts.

The process begins when the federal government publishes a request for proposal (RFP). Like an IFB, an RFP contains the statement of work or specifications, proposal instructions, and a draft contract. Unlike proposals under sealed bidding, however, the contract proposals aren't opened publicly. Rather, the federal government evaluates the proposals against an established list of evaluation criteria addressing technical, management, past performance and cost items.

After the initial evaluation, the government selects the best proposals for inclusion in the competitive range. Then it negotiates with the offerors in the competitive range by seeking clarifications; pointing out weaknesses; suggesting improvements; and discussing terms and conditions, schedules, and other items. After completing negotiations, offerors submit a Final Proposal Revision.

Finally, the federal government awards the contract to the construction company that offers the best value, all factors considered — not necessarily the lowest bidder.

Recognizing the differences

Several factors are present in negotiated contracts that aren't found in fixed-price contracts awarded

under sealed bidding. Negotiated contracts valued above a specified dollar threshold require the contractor to submit cost and pricing data before the award is granted.

Also, with a negotiated contract, the award may be subject to an audit to determine the contractor's compliance with cost principles and the accuracy of underlying cost data used in the construction company's estimates.

Getting ready

Working on a public project is a different experience from undertaking a job in the private sector. Should you win a bid to be part of a federally funded infrastructure project, be sure your leadership team and employees are ready. ■

Seizing control of insurance coverage with a CCIP

Inurance coverage is critical on any construction project, but it also represents a substantial cost and major administrative headache. One potential solution is a contractor-controlled insurance program (CCIP).

What is it?

A CCIP is a type of “wrap-up” policy that's managed by the general contractor and covers most parties to a construction project. (Design professionals, such as architects and engineers, usually aren't covered.) Typically, these policies include general liability, workers' compensation and excess liability coverage.

There may also be an option to add other coverage, such as builder's risk, professional liability or pollution liability. Insurance for commercial vehicles and equipment generally isn't included.

What are the advantages?

Ordinarily, the general contractor and each subcontractor on a project buy their own policies. Then each subcontractor names the general contractor and owner as “additional insureds,” and each subcontract contains complex indemnity provisions. Multiple insurers and policies may lead to coverage gaps. In turn, claims can lead to costly disputes and delays as the parties sort out their respective responsibilities.

By wrapping up coverage under a single policy, a CCIP helps parties avoid coverage gaps and minimize disputes and litigation over who's at fault or responsible for damages when incidents occur. And the general contractor may be able to negotiate broader coverage, higher limits and lower premiums than the subcontractors could on their own.

Plus, by eliminating the need for subcontractors to secure their own insurance coverage, a CCIP can expand the pool of potential bidders. This can be an important advantage given today's shortage of skilled labor.

When work gets underway, the general contractor wields great control over all aspects of risk management on a project, including insurance of course. Because CCIPs are highly loss-sensitive, most general contractors are highly motivated and well advised to minimize claims through a comprehensive, centralized safety program. If a claim does arise, having only one administrator tends to accelerate the claims process and reduce the cost thereof.

And the disadvantages?

As you might expect, there are risks and costs for the general contractor setting up the CCIP. Although the program can eventually streamline insurance administration, the initial burden of finding and negotiating coverage can be daunting. In fact, given the complexity of CCIPs, many contractors find them suitable for only larger projects.

Managing subcontractor enrollment can also be an arduous task, and the subcontractors who sign up may present risks all their own. Because subcontractors aren't operating under their own insurance policies, there's less incentive for them to limit their losses.

Also, as noted, one of the advantages of a CCIP is that it's essentially a "no-fault" policy, but this can increase the risk of false claims by subcontractors.

There's also financial risk. In the unlikely event that claims exceed a CCIP's coverage limits, the general contractor might be financially responsible for the difference.

Who can help?

If you're looking to enhance project risk management, reduce insurance costs and streamline claims, consider a CCIP. Just bear in mind that we've given examples of only a few of the potential disadvantages involved; there may be others. Your professional advisors, including your CPA and an insurance expert, can help you weigh the specific pros and cons. ■



Why contractors should care about ESG

Green building, nondiscriminatory employment policies, ethical leadership — none of these are new concepts in the construction industry. However, they've begun to fall under the umbrella of an increasingly popular term: environmental, social and governance (ESG).

ESG might sound like nothing more than the latest corporate buzzword. But businesses today — including construction companies — are under increasing pressure to adopt sound ESG practices. And this pressure isn't coming from only the general public. It's coming from a variety of legit stakeholders in the construction process.

Breaking it down

Perhaps the biggest challenge in understanding ESG is identifying and addressing all the different concepts and actions that fall under its broad banner. Here are some examples:

Environmental practices. For construction companies, these include consumption of energy and other resources, efforts to lessen carbon emissions, jobsite recycling, and sourcing and usage of materials.

Social practices. These include an unbiased hiring process; fair labor policies; diversity, equity and inclusion measures; and jobsite safety procedures.

Governance practices. Under this subcategory fall things such as ethics and integrity in how business is done, anti-fraud measures, pay equity, legal compliance, and cybersecurity and other privacy measures.

Reaping the benefits

In the past, businesses had to of course follow applicable laws in these areas. (And they still do.) But, otherwise, they were largely expected to “self-regulate.” Nowadays, as mentioned, external stakeholders are becoming more and more mindful of whether companies are covering all their ESG bases.



Paying attention to ESG issues can help you mitigate risks and better control costs.



For example, in construction, project owners are considering ESG practices in determining which general contractors to solicit or accept bids from. And some will look into subcontractors and suppliers as well.



Today’s job seekers and employees — especially younger ones — are likely to consider employers’ ESG practices in deciding where to work. Solid ESG practices may enhance a construction company’s “employer brand,” granting you a competitive advantage in the ongoing skilled labor shortage and overall tight job market.

Paying attention to ESG issues can also help you mitigate risks and better control costs. For instance, by focusing on sustainability and green building techniques, you may be able to reduce fuel and energy consumption, streamline your supply chain, and minimize waste. Addressing social practices can help prevent employment litigation and curtail workers’ compensation costs. And tightening up governance can prevent costly fraud and data breaches.

Taking the next step

How big of a deal is ESG? Many of the largest and top-performing U.S. companies already include ESG updates in their financial reporting.

If you’re interested in improving your construction company’s ESG practices — and perhaps sharing progress updates with customers, employees and others — talk to your professional advisors about incorporating ESG info into your financial reports, internal communications and marketing materials. ■



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Tax Treatment of PCM Contracts in M&A Transactions

Taxpayers using percentage of completion method to account for long-term contracts should be mindful when pursuing a merger or acquisition (M&A).

During a merger, acquisition or other ownership change, the seller most likely will have in-process construction projects that will be transferred to the buyer. If the seller is using the percentage of completion method (PCM) to account for these long-term contracts, the tax treatment will depend on how the transaction is structured.

Mid-contract transfers using step-in-the-shoes rules.

If the transaction is classified as a deferred tax transaction (e.g., transfers of partnership interests; converting from a C to an S corporation; Section 351 transfers; etc.), the buyer assumes the contract from the seller. The buyer adopts the same method of accounting as the seller for that contract, even if they are using a different method of accounting for other contracts.

Mid-contract transfers using constructive completion rules.

In a transaction structured as a taxable asset transaction (including deemed asset sales), both the buyer and the seller should account for in-process contracts using the constructive completion rules. Under these rules, the seller is treated as if they have completed the contract on the date of the sale, and the buyer is treated as if they have entered into a new one.

PCM Contracts: Seek Advice

In practice, M&A transactions are rarely simple. It's important for contractors who are planning a merger or acquisition to reach out to a CPA they trust before they begin negotiations to help ensure there are no surprises regarding the tax consequences of their transaction.

If you have questions about your impending M&A transaction or about how you are accounting for your long-term construction contracts, reach out to a member of LaPorte's Construction Industry Group.