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Plus!

Construction Success Story

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Year-end tax planning

ENTITY CHOICE MAY EVOLVE WITH YOUR COMPANY

Construction companies are typically organized around the specific talents of a group of individuals. After all, the distinctive proficiencies involved with constructing, renovating, repairing and maintaining buildings aren't "entry level" skills. They're often passed down through generations, making the industry talent-centered.

Successful construction business owners know not only how pieces of building components are put together, but also how costs are incurred, paid and managed. Nevertheless, even the savviest contractors will need help making some tax and financial decisions. Case in point: entity choice.

Choosing the ideal business structure for a construction company isn't a textbook exercise or a simple decision. On the contrary, entity choice may evolve over time, essentially molding itself around the relationships that owners have with one another (if there are more than one) and with the business itself.

Two main factors

For large companies, making a choice between partnership, limited liability company (LLC), corporation or S corporation tends to affect a smaller proportion of the total number of people employed by the company. Employees are employees, whether the company is a corporation or a partnership. Two main factors to consider as year end approaches are financial risks to the owners and tax effects of executive compensation — including how the company earnings flow to the owners or members.

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In a larger company, shareholders and directors can be distinct from managers and executives. Owners or key decision makers may have a passive role and may not even be involved in day to day operations, while executive managers may have less of a stake in company earnings. When owners and directors don't manage, owners collect passive distributions and directors set policy, while executive managers are compensated with equity incentives based on their management performances.

On the other hand, smaller companies without separate owners or boards of directors to govern them may lean toward sole proprietorships, or partnerships or LLCs with small numbers of partners. This is because of the low cost and lesser amount of time required to form and maintain these business structures.

Sole proprietorships and partnerships are also exempt from standard state registration and corporate filing fees. The variegated costs and intertwined recurring tax filing deadlines of a complex corporate structure quickly may be burdensome and can hamper a small company that has only a handful of workers.

Risks to consider

As construction companies get large enough to become bonded and build, own and rent their own large structures, financial risk management becomes increasingly important in choosing the right entity type.

Corporations are attractive because the corporate veil protects owners and their growing equity stakes from risks such as accident claims or torts attacking the company's financial structure. Choosing a C or S corporation provides protection, so owners' assets aren't put on the line.

Some LLCs provide similar protections, while sole proprietorships and partnerships don't automatically offer such protection. It's also good to beware of supply houses that ask construction company owners to personally guarantee their accounts. This negates any protections the owner might have by way of corporate structure.

Without a corporate veil, a sole proprietor or partner may have his or her personal assets awarded by a court to some claimants who sue the business. This can ruin both the company and the financial standing of the owner.

Taxes and payroll

How owners get paid is a second important factor in construction company entity choice. Tailoring business structure to the owner's or owners' personal tax status is key — particularly as the business grows and expands and the company owners may incur tax exposure from multiple entities.

For example, payroll is required for corporations and S corporations, while small partnerships and LLCs don't always have payroll. It's important to analyze the tax implications of taking payroll vs. taking only profit distributions. The competing forces of payroll tax vs. self-employment tax can sway one way or another from year to year depending on tax law, the volume of your revenues and your business's profitability.

Changes under the Tax Cuts and Jobs Act (TCJA) have many business owners favoring noncorporate structures and S corporations because their qualified income can now, under certain conditions, be reduced by 20% when they figure their tax liability. In contrast, owners of C corporations are still taxed on the corporate side and then again on distributions, but the corporate income tax rate was lowered across the board. In an S corporation, a carefully chosen combination of payroll and distributions is attractive because of the deductibility of payroll and its taxes. Every business type has its positive and negative characteristics.

True priorities

As year end approaches, you'll understandably want to focus on assessing and managing your 2019 tax liability. But set aside some time to re-evaluate your entity choice, as well — especially with the TCJA adding layers of complexity to this decision. Undertake both tasks with the help of your CPA; he or she can guide you toward staying true to your personal, business and financial priorities. ■

OWN RENTAL REAL ESTATE? CONSIDER FORMING AN LLC

Many construction companies reach a point where they have the assets and opportunity to buy and manage their own rental properties. When significant rental real estate is owned, the limited liability company (LLC) structure may be the right choice.

LLCs offer a simple tax structure, while risk protection can be provided by insurance so that corporate filing fees, payroll and administration costs are minimized. Be aware, however, that rental income may be classified as passive and would then be taxed differently from construction revenues. Discuss the decision with your CPA.

A BUSY INDUSTRY: M&A ACTIVITY IS HOT IN CONSTRUCTION

The construction industry was busy last year — not only with the business of building, but also with mergers and acquisitions (M&A). A record 534 M&A transactions were announced in 2018, according to *2019 M&A Trends for Engineering and Construction*, a report issued by industry consultants FMI. That's a 26.5% increase over the 2017 results and the highest level FMI has ever recorded.

Although activity is expected to cool off somewhat by year end, there are still plenty of deals under consideration and in the works. So, it's a good idea to stay up to speed on some fundamental M&A concepts.

Time it right

Perhaps the first thing to cross any construction business owner's mind when the prospect of an M&A deal comes up is: Should I do this now? Whether you're a seller or a buyer, timing is everything.

As a seller, your retirement is obviously an ideal time for an M&A transaction. If you plan to, at least in part, live off the proceeds of the sale of your business after you retire, you'll need to start hunting for the right deal well in advance of your bon voyage party.

But that's a best-case scenario. An acute need to sell can arise at any time. Shifting market conditions, disruptive competitors or just one too many unprofitable projects may drive you to consider a merger or sale.

For buyers, timing is somewhat simpler. It's generally a matter of opportunity plus capital. But an M&A target must fit in with your strategic goals. You've got to ensure that the construction business you're buying will make you more competitive and profitable — not just briefly put your name in the news.

Due diligence is of paramount importance. That means not only fully grasping the target's finances and any legal issues involved, but also looking closely at the target's operations and culture.

Prepare for taxes

As you might expect, Uncle Sam will want a piece of any M&A transaction. But not every business sale need be immediately taxable. Some arrangements may qualify for tax-deferred treatment. Examples include transactions in which the seller receives buyer stock or certain qualifying property in exchange for their stock or assets. Corporate or partnership / limited liability company (LLC) mergers may be eligible for tax deferrals as well.

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Understandably enough, many parties to M&A deals favor the idea of a tax-deferred sale. But there are situations in which paying taxes upfront is the better way to go. For example, despite immediate taxability, cash-only sales are simpler and typically quicker to execute. Buyers typically favor a taxable sale to get a stepped-up basis in the assets, which can reduce future taxes.

If your construction company — or one you're thinking about buying — is structured as a corporation, you'll have to choose between a stock sale and an asset sale. Parties to an M&A deal often end up at odds. Sellers look to stock sales to get favorable capital gains treatment. Meanwhile, many buyers prefer asset sales to maximize future depreciation write-offs and to limit legal liability. (The buyer assumes the known and unknown liabilities in a typical stock deal.)

Many buyers also tend to frown on stock sales because they'll have to deal with the carryover basis in the assets, which may raise their future tax liability. Conversely, stock sales of C corporations appeal greatly to sellers because the departing owner(s) may avoid double taxation when they sell the assets and then distribute cash to shareholders.

Keep it in mind

Depending on the size, market and specialty of your construction business, an M&A opportunity may never come up. Then again, the chance to buy out a competitor could materialize tomorrow, or you could get a call with a buyout offer you can't refuse. Keep the possibility in mind and turn to your CPA and other professional advisors should the situation arise. ■

CONTROL JOB COSTS WITH SMARTER MATERIALS MANAGEMENT

Managing project costs can get tricky — especially in today's construction materials marketplace. Materials represent a major budget item, and their overall cost has been rising since 2017, thanks largely to trade tariffs enacted in 2018.

This year, the prices of many individual materials have become unpredictable because of ongoing trade conflicts (tempered somewhat by decreasing oil prices). Consequently, it's increasingly important for contractors to pay closer attention to smarter materials management.

Ideas for best results

The goal of materials management is to ensure that the correct quantity and quality of materials are procured at the lowest possible prices and available when and where needed. Overordering results in waste and cost overruns while underordering leads to delays and could cause higher costs if you must scramble to get needed materials. Here are some ideas on how to get the best results:

Shop around to improve cash flow. If you're less than thrilled with your current suppliers, let them know you're shopping around to encourage them to pitch a better deal. Also, review your financing. Although no one likes paying interest, creating longer payment terms by assuming new debt can be helpful if done right.

Exercise sound preconstruction. Planning and communication are key to efficient materials management. Therefore, preconstruction plays a big role. Establish realistic costs and timelines with subcontractors ahead of time, and work with suppliers and distributors to place orders and confirm delivery schedules so materials arrive on time and at the correct locations.

Order early. Speaking of deliveries, many contractors collect and submit orders daily for miscellaneous items needed the next day. But they risk work delays if those items aren't delivered before the workday begins. It may be better to schedule deliveries so materials arrive the day *before* they're required.

But don't order too early! To decrease waste during construction, make sure materials don't arrive prematurely. When items are stored until a later construction phase, they're at risk of deterioration, damage or theft. If this has been a common problem, investigate why.

Consider "kitting." Many suppliers/distributors now offer customized product kits containing just what's needed for a room, floor or other construction area. Check with your supplier to see whether kitting would be cost-effective, reduce waste, enhance efficiency and increase productivity.

Leverage tracking technology. The larger the job, the more complicated keeping tabs on assets becomes — and the more time is wasted hunting down items. Automated systems with bar codes, QR codes or radio-frequency identification tags can significantly reduce the time spent locating and moving materials and equipment.

Drones, remote-access cameras and onboard vehicle GPS systems also may give your materials management the security it needs. As an added safeguard, construction management software typically offers contractors the ability to notate on drawings the exact location of materials delivered to the jobsite.

Noticeable differences

Many construction companies get in the habit of handling materials a certain way and not deviating from those methods. If your tried-and-true approaches are working, don't feel like you must rock the boat. But slight improvements to your materials management can make noticeable differences in cutting costs and creating a healthier bottom line. ■

RELUCTANT CONTRACTOR LOOKS FOR "LIKES" ON SOCIAL MEDIA

A high-end homebuilder in a growing suburban area had been slow to adapt to social media. She didn't think much of it until she stumbled across a competitor's Facebook page and saw all the likes and comments. While visiting her CPA on other business, she mentioned her worries. He gave her five suggestions to get started:

1. Choose the right channels. Her CPA recalled a 2018 survey by the Construction Marketing Association on the topic. Pulling up the results, he pointed out that 98% of architectural/engineering/construction (AEC) professionals surveyed use LinkedIn. Close behind was Facebook with 96%. From there, 78% of respondents reported using Twitter, 61% were on YouTube and 59% were using Instagram.

These statistics indicate that LinkedIn and Facebook are generally the places to be for contractors, her CPA noted. But he urged her to research the ideal platform based on her target audience.

2. Post at least two to three times a week. Her accountant warned her that social media can eat up a lot of time. It's important to plan an adequate number of posts, but not too many. Generally, midday during the week is considered a good time to post for business purposes.

3. Be authentic. "This may sound funny coming from a CPA," her accountant said. "But don't be too serious." He urged the contractor to show the human side of her business. Post employee profiles and, as appropriate, give shout-outs to project partners. Many contractors share "pro tips" for customers. Her CPA advised keeping these brief and general, and to include a legal disclaimer.

4. Leverage cool imagery. The contractor could share photos and videos taken at carefully selected jobsites. Some construction companies post "before and after" photos of structures built or services performed. A time-lapse video of a project from start to finish can be quite breath-taking, her CPA noted. Aerial videos taken from drones are also popular.

5. Participate in the conversation. Her accountant urged the contractor not to think of social media as "blasting" information into the marketplace. Rather, it's a conversation. Using her social media account(s), she should follow industry leaders, associations, trade publications and other relevant parties. She should "like" and share posts if they're timely, from a reliable source, and would be of interest to her friends and followers.

Ultimately, the contractor decided to take her CPA's advice — along with other valuable input — and formally launch her construction company's presence on social media. The results were slow at first but, over time, her business found its voice and online community. The impact on sales was positive. ■

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- We develop **relationships with lenders and bonding agents** and understand how to present your financial picture in their preferred format.
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