CONTRACTOR

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PLANNED LIQUIDATIONS HAVE VARYING TAX CONSEQUENCES

Succession planning has long been an important issue for contractors. Sadly, one of the many tragic effects of the novel coronavirus (COVID-19) pandemic is it's forced many companies — particularly small businesses — to close sooner than anticipated.

In these circumstances, and others, the most expedient and beneficial way to end the existence of a company is sometimes through a planned liquidation. This process involves distributing assets to claimants and selling off the remainder to pay creditors and provide cash to the owner(s). The tax consequences vary depending on business structure.

Sole proprietors, partners and LLCs

Sole proprietorships and sole member limited liability companies (LLCs) can simply report the asset sales on their tax returns and check a box where it says, "This company is no longer in operation." Owners of other entity types will face more complex tax filing challenges.

If a company is operating as a partnership or multi-member LLC, each partner's interest or capital account must normally be calculated annually. This is so the proper Schedule K-1 tax form can be issued identifying the tax implications for each partner or member. A partner then keeps track of his or her own basis in the partnership as the value of any money plus whatever property he or she contributes over time.

Any assumption of partnership liabilities increases the partner's basis, as do any reported profits. Conversely, the partner's basis is decreased by distributions of cash or property or by losses reported. The adjusted basis of each partner's interest is different from any book value of capital contributed by the partner that's held on the books. The book value of capital contributed on the books is irrelevant to the tax reporting of the liquidation.

Partners' adjusted basis is likewise determined on the date of liquidation. If a partner receives money or property from the liquidation, he or she marks the new basis in any property received on his or her own books to reflect the partnership's adjusted basis less any cash received from the liquidation.

WHO ELSE WANTS TO KNOW?

When undertaking a planned liquidation, you'll obviously need to notify the IRS via the required tax filings. For example, federal quarterly payroll reports require a company to mark "final return" on the last one to indicate it's going out of business. In addition, you'll need to file an annual payroll report at year end, regardless of whether you paid any wages in the year of closing.

Various other entities need to be informed about the liquidation as well. States sometimes require annual corporate reports and/or separately reported business income tax returns. Be sure to file them and, again, mark the last one "final report" or "final return."

Some states and counties tax tangible property, such as equipment, and will follow a company year after year charging tax unless they're notified that the business is no longer operating. They may want to know how the business property was disposed of and for what price.

In some cases, a business must file a form with the U.S. Department of State notifying them that the company is no longer operating. And, finally, you must notify the construction licensing bureaus in your municipality and state that the license in question is no longer associated with the business.

Partners don't recognize any gain or loss on property received, until and unless they dispose of that property later in a sale or an exchange. This would be a capital gain.

If an item is held less than a year, it's considered a short-term gain. The IRS considers gains as long term if the partner possesses the item for over a year, including the time the partnership possessed it. If a partner was the one who contributed the item to the partnership in the first place, the amount of time he or she held the item before contributing it is also added to determine the gain status.

Corporations

An S corporation must also issue a K-1 to its shareholder or shareholders. Each shareholder's basis in stock is calculated at year end. Basis in stock is first increased by any reported profits, then reduced by any distributions of cash or property (but not below zero), and then further reduced by any expenses and deductions.

A shareholder must carefully look at his or her Schedule K-1 and compare any losses reported to his or her basis in stock of the corporation reflected in the shareholder's records. If he or she has sufficient basis in stock, the losses reported on the K-1 may be deductible on his or her personal tax return. When cash is distributed, it generally isn't taxable to the shareholder as long as, in aggregate, the cash is less than the shareholder's basis in stock. Distributions that exceed the shareholder's basis in stock are taxed as capital gains to the shareholder.

C corporations are self-contained taxpaying entities. So, when they close, the company is responsible for reporting its final year to the IRS and paying any tax itself. Assuming assets are sold off, the corporation recognizes the sales as gains or losses. After selling its assets and paying its liabilities, the business will either have cash on hand or owe money. If the latter, debts may be settled, negotiated or abandoned; whereas distributions of excess cash to owners are taxed but typically at a lower rate than ordinary income.

Many possibilities

Construction company owners usually want to pass along their businesses to carefully chosen successors. But when cash is needed quickly because of a sudden economic downturn or other circumstances, a planned liquidation might be the right move. Your CPA can help you choose the best succession planning strategy. ■

REMEMBER THE CARES ACT AS THE YEAR GOES ON

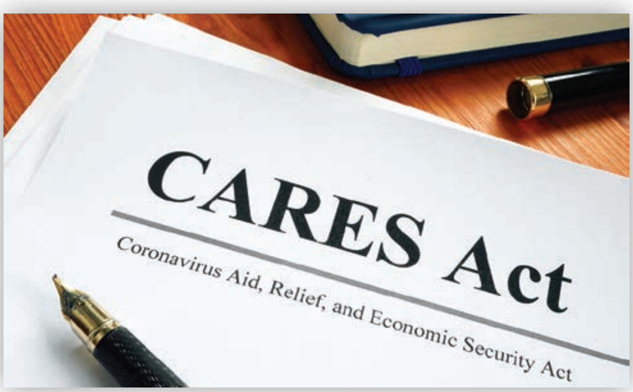
When the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law in late March 2020, it got plenty of attention. For weeks afterward, guidance was issued and business owners, contractors included, spent time learning the relevant details.

At this point, the CARES Act may seem like old news. But its tax provisions remain in effect as the year goes on and, in some cases, beyond 2020 (unless subsequent legislation changes them). Careful planning may allow construction business owners to fully benefit from the wide and varying tax relief offered.

Operating losses

A net operating loss (NOL) generally occurs when the deductible expenses of a company or trade exceed its income. Because of work stoppages and slowdowns caused by the novel coronavirus (COVID-19) crisis, many construction businesses may report NOLs for the 2020 tax year.

Before the Tax Cuts and Jobs Act (TCJA), taxpayers could carry back NOLs two years and carry them forward 20 years to offset taxable income. The TCJA limited the NOL deduction to 80% of taxable income for the year, eliminated the carryback of NOLs and removed the time limit on carryforwards.



The CARES Act allows NOLs arising in 2018, 2019 or 2020 tax years to be carried back five years. Additionally, it removes the taxable income limitation on deductions for prior-year NOLs carried forward into tax years before 2021, so that NOLs can fully offset income.

> Most businesses can now claim 100% bonus depreciation for QIP, assuming all applicable rules are followed.

Finally, it temporarily eliminates the limitation on excess business losses for sole proprietors and owners of pass-through entities. These taxpayers can now deduct excess business losses arising in 2018, 2019 and 2020 tax years.

If any of these rule changes affect you, filing an amended return for a previous tax year may allow you to claim a tax refund now that can boost cash flow.

QIP projects

For a while now, construction industry groups have been lobbying against the "retail glitch," which Congress inadvertently created while drafting the TCJA. The drafting error caused any qualified improvement property (QIP) placed in service after December 31, 2017, to be *ineligible* for 100% bonus depreciation. This typically includes upgrades to retail, restaurant and leasehold property.

The drafting error was corrected under the CARES Act. Most businesses can now claim 100% bonus depreciation for QIP, assuming all applicable rules are followed. What's more, the correction is retroactive to any QIP placed in service after December 31, 2017. (Improvements related to a building's enlargement, elevator or escalator, or internal structural framework don't qualify.)

As of this writing, it appears uncertain at best when businesses will be ready and willing to greenlight QIP projects. Nonetheless, keep an eye out for these opportunities when economic conditions improve.

Payroll credit

The CARES Act created a refundable credit against payroll tax to help employers, including contractors, retain their workforces. It's generally available to employers whose operations have been fully or partially suspended because of a governmental shutdown order related to COVID-19. Employers whose gross receipts have dropped more than 50% compared to the same quarter in the previous year (until gross receipts exceed 80% of gross receipts in the earlier quarter) are also typically eligible.

Qualifying employers whose workforces exceed 100 employees may claim the credit for employees who've been furloughed or had their hours reduced because of the reasons noted. If an employer has 100 or fewer employees, it can qualify for the credit regardless of whether it has furloughed employees or reduced employee hours.

The per-employee credit equals 50% of up to $10,000 in compensation, including health care benefits, paid to an eligible employee after March 12, 2020, through December 31, 2020. (Additional rules and limits apply, particularly regarding certain Small Business Administration loans received.)

The CARES Act also enables employers to delay payment of their share (6.2% of wages) of the Social Security payroll tax. They can pay the tax over the next two years, with the first half due by December 31, 2021, and the second half due by December 31, 2022.

The road ahead

Contractors have had to deal with unprecedented challenges because of COVID-19. Your CPA can help you navigate the road ahead. ■

RISK MANAGEMENT 2.0 FOR CONSTRUCTION COMPANIES

The novel coronavirus (COVID-19) pandemic has brought unprecedented challenges to the construction industry. We've seen site shutdowns under shelter-in-place mandates, project delays because of supply chain disruptions, increased safety precautions and, regrettably, sick personnel. As a result, construction companies have learned valuable lessons about risk management during the pandemic — call it "risk management 2.0."

Contract provisions

As you likely know, a force majeure clause is a contract provision that excuses nonperformance or extends timelines when an unforeseeable event beyond the contractor's control causes a delay. Whenever possible, specifically name infectious disease outbreaks, epidemics and pandemics under this clause, along with extreme weather events and other disasters typically named.

Two of the most widely used contract forms for construction in the United States — the American Institute of Architects (AIA) A201-2017 and ConsensusDocs 200 — don't contain a force majeure clause. Instead, they have delay provisions listing occurrences in which a contractor may be entitled to a time extension and corresponding increase in the contract price. The ConsensusDocs 200 agreement lists epidemics as a justifiable delay.

When negotiating a contract, ask for a deposit to buy and store materials before the start of construction. Also, investigate whether the contract could include a price acceleration provision that allows you to adjust the price to reflect actual costs if market prices increase.

Last, construction contracts typically require contractors to give notice of any delays, changes and additional costs incurred — and to include specific, detailed information. Clarify with owners that, while you'll make all reasonable efforts to do so, disasters involving infectious diseases are unpredictable and, in such situations, you'll measure these delays and calculate the added costs at the time. (For any matters involving contracts, an attorney's advice is helpful.)

Other steps

Beyond the contract, there are other steps you can take. For example, when bidding on a project, identify two or more alternate suppliers. Doing so will provide a contingency plan if your usual supply chain is disrupted.

> Above all, integrate outbreak preparedness measures into your overall safety program.

To the extent necessary, "upskill" yourself and your employees' ability to create detailed descriptions of project delays and to calculate the cost impact of slowdowns. Fine tune your daily logs and reports, time sheets, schedule updates, meeting minutes, and so forth.

Review insurance policies carefully; many may not cover outbreaks, epidemics or pandemics — and may even contain exclusions for them. If you're not covered, evaluate the feasibility and cost of adding such coverage or investing in a new policy.

Above all, integrate outbreak preparedness measures into your overall safety program. Such measures would:

- Promote ways of working that limit the spread of known infections,
- Communicate health-related updates and warnings to employees, and
- Facilitate decisions on whether to suspend or cancel a project because of infectious disease.

Establish protocols for project shutdowns that include cleaning and sanitizing sites and equipment, removing or locking down equipment and materials, and securing and monitoring the job site.

Anything else?

If the COVID-19 crisis has taught the construction business anything, it's to prepare for the worst and hope for the best. Consult with your trusted legal and financial advisors to create a plan to mitigate the risk of disruptive illness — or anything else. ■

COULD THE CRITICAL PATH METHOD IMPROVE YOUR SCHEDULING?

Contractors must deliver projects on schedule and within budget — or risk taking a loss. That's why many of today's project managers apply an approach that has been widely used by larger construction companies: the critical path method (CPM).

Staying on course

CPM is a scheduling technique used to calculate a project's duration and illustrate how schedules are affected when certain variables change. It identifies the "critical path," which is the longest sequence of scheduled activities that determines when a project can be completed. Any delay in the critical path slows down the job.

In many cases, some tasks won't affect other activities and can be pushed back without pushing out the planned completion date. Other tasks can be performed in parallel with the primary steps. But each job task that lies on the critical path must be completed before any later tasks can begin.

Optimizing the route

CPM analysis shows what needs to be done and when. It breaks a construction project into several manageable activities, displays them in a flow chart showing the "activity sequence" (the order in which tasks must be performed), and calculates the project timeline based on the estimated duration of each task.

For smaller jobs, this can be done with pencil and paper. The project manager draws a diagram with circles that represent activities/time durations and — where one activity cannot begin until another is completed — connecting those circles with arrows to show the necessary order of primary job tasks. The completed diagram will reveal arrow paths indicating activity sequences and how long it will take to complete them.

Using technology

For larger, more complex projects that may have multiple critical paths and overlapping, interconnected activities, creating diagrams by hand can be time consuming and difficult. CPM software makes the process faster, easier and less prone to human error. When things are constantly changing — particularly at the beginning or end of a project — these applications allow far easier updating of the analysis and production of new diagrams.

Many of today's CPM software products are moderately priced and worth considering. They can quickly identify the critical path, instantly process updates and even calculate float times for noncritical activities.

Some solutions can model the effects of schedule-compression techniques, such as fast-tracking (tackling multiple tasks simultaneously) and crashing (adding extra resources). With the software installed on mobile devices and data stored on the Internet, it's easy to share CPM charts and access them from the field.

Exploring the approach

CPM isn't a silver bullet for every scheduling problem, but it's helped many contractors. If your project managers aren't using it, consider exploring the concept and technology with them. ■

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About Wouch, Maloney & Co., LLP

Wouch, Maloney & Co., LLP is a regional certified public accounting firm with offices in Horsham and Philadelphia, Pennsylvania and Bonita Springs, Florida. The firm has provided closely held business and individual clients with a wide array of accounting services for over 30 years. Wouch, Maloney & Co.'s domestic, multi-state and international clients reflect a broad range of industries from real estate and construction to manufacturing, wholesale and professional service. The firm offers a comprehensive group of services including tax, audit and accounting, business consulting, estate planning, business valuation, litigation support and forensic accounting.

Serving the Construction Industry

Wouch, Maloney & Co., LLP prides itself on its niche practice in the construction industry. The majority of our clients are involved in construction and we are adept at recognizing and solving problems common to that industry. For over thirty years, we have represented contractors along with commercial and home builders in Pennsylvania, New Jersey and Florida.

- We develop **relationships with lenders and bonding agents** and understand how to present your financial picture in their preferred format.
- We assist you in **keeping a close eye on debt, cash flow, profit margins** and other measures of financial health.
- We prepare **contracts in progress** schedules that management can understand which clearly illustrate gross profit, job costing and over/under billings per job.
- We have highly trained staff with **expertise in construction accounting** who are detail oriented, but who do not lose sight of the larger goal which is to provide our clients with quality services to meet their many financial needs.

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