

Construction

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Accounting for long-term contracts

Understanding look-back is in your best interest

In today's economy, it's important to pay close attention to the look-back method. If you use the percentage-of-completion method (PCM) to account for long-term contracts, it's not unusual for income to be overstated for previous years. If that's the case, the IRS may owe you some interest. But income might instead be understated under PCM, in which case you may owe the IRS interest. Either way, it's important to understand the look-back rules.

Look-back in action

"Large" contractors with long-term contracts — that is, contracts performed during two or more tax years — are required to use PCM for tax reporting. A "large" contractor is one whose average gross receipts for the previous three tax years exceed \$10 million.

Certain contracts are exempt from PCM requirements, however. These include home construction contracts and contracts expected to be completed within two years by a "small" contractor (one whose average gross receipts fall below the \$10 million threshold).

When you use PCM, you report your income or loss on a job in progress based on estimates of your costs and revenues as of the end of the tax year. After the job is complete, you "look back" at the income or loss reported for the job for each tax year during which the contract was performed.

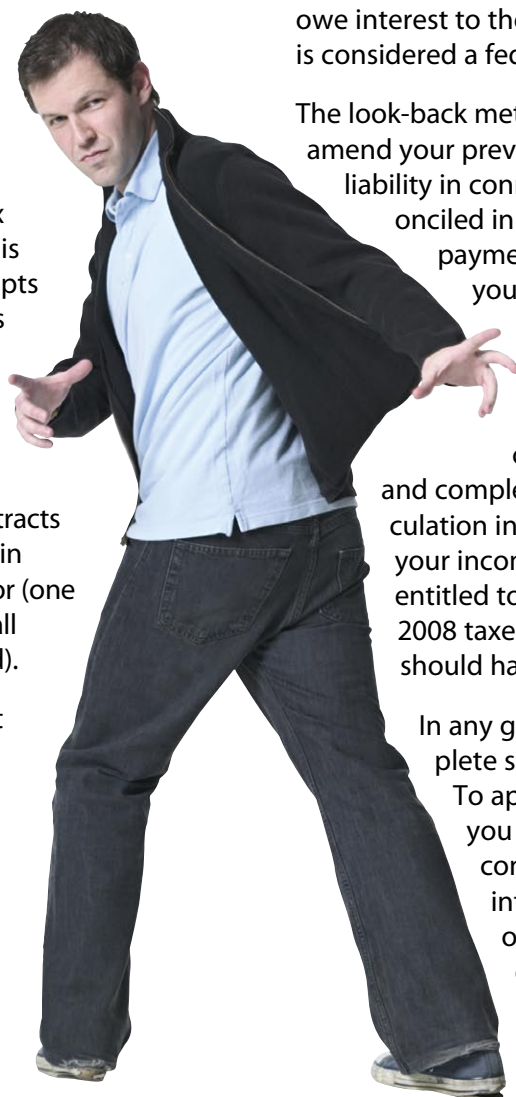
Then you must recalculate your tax liability (for both regular and alternative minimum tax purposes) based on actual results. If estimates developed in using PCM caused you to overpay taxes in a previous year, you may be entitled to an interest refund from the IRS at the applicable "overpayment rate." When you receive interest from the IRS, the amount is considered taxable income.

On the other hand, if you *underpaid*, you may owe interest to the IRS. The interest due the IRS is considered a federal tax and isn't deductible.

The look-back method doesn't require you to amend your previous returns; your overall tax liability in connection with a contract is reconciled in the year of completion. Interest payments are used to compensate you or the government for *timing* differences.

Suppose, for example, that you use PCM to account for a contract that you began in 2008 and completed in 2009. The look-back calculation indicates that you overestimated your income from the job in 2008. You're entitled to interest on the portion of your 2008 taxes that, based on actual results, should have been paid in 2009.

In any given tax year, you may complete several long-term contracts. To apply the look-back method, you must review each completed contract and calculate look-back interest that the government owes you or that you owe the government. Interest on each contract is combined and, depending on the net result,



you'll either owe a payment to the IRS or be entitled to a refund.

But then again ...

There are several exceptions to the look-back rules. Under the small contract exception, for example, the look-back method doesn't apply to a contract that 1) is completed within two years, and 2) has a gross price that doesn't exceed the lesser of \$1 million or 1% of the contractor's average annual gross receipts for the preceding three tax years.

After a job is complete, you "look back" at the income or loss reported for the job for each tax year during which the contract was performed. Then you must recalculate your tax liability based on actual results.

Also, you can elect out of the look-back method for a contract if, for each year, the amount reported is within 10% of the cumulative taxable income or loss determined using actual results.

Special rules may apply

If your company is structured as a pass-through entity — such as an S corporation, partnership or limited liability company — special rules apply. If the company isn't closely held, you should apply the look-back method at the *entity* level for any domestic contract (that is, one for which at least 95% of gross income is from U.S. sources). You're also required to use the simplified marginal impact method (SMIM) to compute look-back interest on domestic contracts. (See "Should you use the simplified method?" at right.)

For closely held companies, look-back is applied at the individual owner level. Generally, an entity is considered closely held if 50% or more of its

Should you use the simplified method?

As noted in the main article, non-closely-held pass-through entities are required to use the simplified marginal impact method (SMIM). If your company is a C corporation, sole proprietorship or closely held pass-through entity, SMIM isn't required, but you can *elect* to use it.

The advantage of SMIM is that it makes calculating look-back interest much easier. Rather than refiguring each previous year's tax liability, SMIM allows you to calculate underpayments or overpayments in a given year based on an assumed marginal tax rate — usually the top rate in effect for that year.

The downside of SMIM is that it may reduce the look-back method's benefits for your company. SMIM places a cap on the amount of refunds you can claim, but it doesn't limit the amount of interest you owe on underpayments.



value is owned, directly or indirectly, by five or fewer persons.

Worth a look

The look-back rules are complex, and this article only scratches the surface. Your tax advisor can help ensure that you're applying the look-back method correctly and maximizing any benefits available to you. ■

Long before you're ready to retire ...

... Take time to build a solid succession plan

If you're among the baby boomer generation, you know how critical it is to plan for your retirement. Equally important is setting up a succession plan that will help ensure your company's future after you've left the office for the last time. The key is to start the succession planning process sooner rather than later.

Name your successor

The most important operational question addressed in any succession plan is: Who will lead the enterprise? If yours is a family-owned operation, finding a successor can be difficult. Family members may be qualified but have no interest in taking the reins. Or they may be interested but not have sufficient experience.

To deal with such issues, take time now to encourage and develop future leaders. Identify children or other key employees you believe hold leadership potential and expose them to all aspects of running the business.

No matter whom you choose as your successor, get your CPA, lawyer, insurance advisor and a family business consultant involved.

Give them a well-defined path to find out what they need to do to become future leaders of the business. And create an environment in which they're assured that their hard work and time spent learning how to run the business will be rewarded. Finally, establish appropriate fringe benefit and deferred compensation plans, as well as incentive pay, to help retain them until you step down.



Get your family involved

It's important that you encourage the entire family, whether or not they're active in the business, to participate in the planning process and to understand the financial and personal consequences of an unsuccessful succession.

A common issue is how to equitably divide assets among heirs when only some of them will have control of or receive ownership interests in the business. If there are sufficient liquid assets, consider purchasing life insurance to provide for any children who won't be involved in the business, and give ownership interests only to those who will be involved. Or, establish a family trust to own and operate the business, so that the entire family shares the risks and benefits.

Listen to the experts

No matter whom you choose as your successor, get your CPA, lawyer, insurance advisor and a

family business consultant involved. These experts can help you assess your circumstances and create a workable succession plan.

Your plan should create a management structure that will survive your departure and keep the business on sound financial footing while ensuring adequate liquidity to fund your retirement or a buyout. Make a buy-sell agreement a part of your succession plan. It allows you to restrict transfers of ownership interests. Finally, a well-designed plan can help minimize income and estate taxes.

Drafting a succession plan that meets all those goals can be a juggling act, but, without a clear plan, all the “balls” you’ve juggled over the years to build a successful construction business can quickly fall to the ground.

Start the process now

The earlier succession planning begins, the better — even if you don’t plan to retire until years from now. Developing and grooming your successor will take time, as will preparing your employees and managers to adjust to a new ownership structure.

Alternatively, the succession planning process might lead you to determine that handing down your business to family members isn’t the best option. If that’s the case, you’ll want to consider selling it to your employees through an employee stock ownership plan (ESOP) or selling it to an outside party. Both options also require planning well in advance of your retirement.

The bottom line is that the time to start the planning process is now. ■

6 tips for boosting profitability

It’s often said that construction is a risky business, and that’s not in reference to just job safety. Construction is also highly risky from a financial perspective — thin profit margins, unpredictable site conditions, volatile costs, change orders and the use of multiple subcontractors. In addition, many construction projects are performed over long periods of time, which only magnifies these risks. Here are six ways you can minimize financial risks and maximize your profits.

1. Evaluate your estimating procedures

Do a postmortem on recently completed jobs, both profitable and unprofitable. Compare each job’s estimate to the actual figures and investigate any significant discrepancies.

Were job costs accurate? Were assumptions about productivity, labor and materials requirements, and other factors reasonable? Document your findings and refer to them when creating future estimates.

2. Have a plan

Review all project documents carefully before you begin a job and be sure that everyone involved in the job understands them. Set a realistic schedule that accounts for the possibility of unforeseen circumstances, such as unanticipated site conditions, bad weather, changes or additions.

Make sure you have procedures in place for identifying changes in the scope of work, documenting those changes and processing change orders quickly. Missing or mishandled change orders can damage your profitability and cash flow.

3. Know your indirect costs

The only way to know whether jobs are profitable — and to develop accurate estimates — is to understand their true costs. That means having a system that accurately captures, classifies and allocates direct *and* indirect costs.

Most contractors do a good job of identifying a job's direct costs, such as labor, payroll taxes, materials and subcontractor expenses. But it's equally important to allocate indirect costs — such as equipment, rent, supplies, clerical staff salaries, insurance, marketing, and legal fees — to specific jobs.

If you focus only on big-ticket items, such as labor and materials, it's easy to lose sight of gradually increasing overhead expenses, which, over time, can do serious damage to your profitability.

4. Monitor work in progress

Construction is fraught with uncertainty. No matter how well you plan, developments during a project can significantly affect your costs, profits and cash flow. Rather than wait until a project is complete to assess the damage, it's critical to prepare and monitor work-in-progress (WIP) reports to track financial performance during the project. This allows you to identify problems while there's still time to do something about them.

For example, WIP reports that indicate declining gross profits or underbillings may reveal poor estimating, inefficient project management, lax billing practices or other weaknesses.

5. Look out for overhead creep

The need to control costs, especially during tough economic times, is obvious. But if you focus only on big-ticket items, such as labor and materials, it's easy to lose sight of gradually increasing overhead expenses, which, over time, can do serious damage to your profitability.

To avoid "overhead creep," continually monitor and evaluate expenses for things such as insurance, company cars, advertising, supplies, subscriptions and travel and entertainment.

6. Build profit into your bids

Including a profit cushion in your bids helps protect your company against the risks and uncertainties inherent in the construction process. The amount of the markup depends on the nature and size of your business, the size of your projects, and other factors, such as project-related risks.

It's important to select the amount of markup carefully: If it's too high, you may lose jobs; if it's too low, you may take on too much risk. An effective strategy for adding profits to your bids is to use different markup percentages for different line items. For example, you might mark up labor, which is more uncertain, by one percentage, but use lower percentages for materials and subcontractor expenses, which generally are more predictable.

A year-round effort

The lesson here is that you should be thinking about profitability — and what you can do to improve it — starting with the bidding process and throughout the course of each project. If you wait until projects are complete or until the end of the year, you may be in for some unpleasant surprises. ■





Is your immigration program up to date?

In recent months, U.S. Immigration and Customs Enforcement (ICE) has shifted its focus from employees working in the United States illegally to the employers who hire them.

To protect your company and its management against civil fines and possible criminal charges, it's important to have an immigration compliance program that's up to date.

Reviewing your program

Here are some questions to ask:

Do you have a written immigration policy?

Whether it's part of an employee handbook or a separate document, you should have a written policy that states your company's intention to comply with the Immigration Reform and Control Act of 1986 and sets forth procedures for ensuring compliance. You also should have employees acknowledge in writing that they understand the policy and will adhere to it.

Do you provide training? Training your human resources staff and other employees on your immigration policies and procedures is critical. It minimizes the risk of fines for hiring unauthorized employees and demonstrates to ICE that you've made a good-faith effort to comply with the law.

Employees should be trained on completing and storing Form I-9 — "Employment Eligibility Verification." For example, it's advisable to store I-9 forms and supporting documentation in files separate from ordinary personnel files so that ICE auditors don't have access to unrelated personnel information.

Training also should include how to inspect documents presented to establish identity and employment eligibility, as well as how to respond to ICE visits or subpoenas.

Are you using the latest forms? Form I-9 is revised periodically, so be sure you're using the latest version. At press time, the current version had a revision date of Aug. 7, 2009 (Rev. 08/07/09) printed in the lower right-hand corner. Immigration authorities will also accept the 02/02/09 version. You can download the form from "Most Searched Forms" at uscis.gov.

Are you required to use E-Verify? Most construction firms with federal contracts are now required to participate in the E-Verify program. In addition, an increasing number of states require contractors doing government work to use E-Verify, and a few states even require large, private-sector contractors to use the program.

E-Verify is a free, Web-based system that electronically verifies the employment eligibility of newly hired employees by comparing I-9 information against the Social Security Administration's database. Even if you're not required to use E-Verify, voluntary participation can be an easy, effective way to demonstrate good-faith compliance.

Getting legal advice

Given the serious consequences of noncompliance, it's a good idea to consult your legal counsel to make sure your immigration program meets government standards. ■