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Year end tax planning for construction companies

As year end approaches, construction company owners should work with their tax advisor to review options for reducing their 2015 tax bills. There's no cookie-cutter formula for year end tax planning — the right approach depends on your particular situation — but here are several strategies to consider.

Look ahead

Although the primary goal of year end tax planning is to minimize your 2015 taxes, it's important to look ahead to 2016 as well. Generally, the best strategy is to defer income to next year and accelerate deductions into this year. But, as with most rules, there are exceptions.

Start by projecting your income and expenses and estimating your tax liability for 2015 and 2016. If you expect to be in a higher tax bracket next year, it may make sense to accelerate income into 2015 and defer deductions until 2016.

Many construction companies are structured as pass-through entities, such as S corporations or LLCs. That means owners pay tax at individual income tax rates on their shares of the company's income.

There are many ways to defer income and accelerate deductions. Cash-basis companies may have opportunities to delay billings or prepay certain expenses. Options for accrual-basis companies are more limited, but it may be possible to defer income by delaying the performance of certain services until after year end or electing to defer taxes on certain advance payments.

Both accrual- and cash-basis companies can defer income by making contributions to qualified retirement plans. Depending on the type of plan, companies may be able to deduct contributions this year so long as they're made by the extended due date of their 2015 tax return.

Accrual-basis companies may benefit by deferring the payment of year end bonuses until next year. So long as bonuses are paid by March 15, 2016, the compensation is deductible on a company's 2015 tax return. Keep in mind that bonuses paid to "related parties" — such as S corporation shareholders, partners, limited liability company (LLC) members or more-than-50% C corporation shareholders — don't qualify for this treatment.

Use 10% method

Most construction companies use the percentage-of-completion (PCM) method, which recognizes revenues and expenses as a job progresses, to account for long-term contracts. For jobs that begin late in 2015, don't overlook the "10% method," which allows you to defer recognition of gross profit on jobs that are less than 10% complete at year end. To adopt this method, file an election with your 2015 tax return. There's no need to apply for a change in accounting method.

Also, keep in mind that, if you opt to use the 10% method, the election applies to *all* jobs that

are less than 10% complete at the end of the tax year. If you decide in a later year to switch to another method, you'll need the IRS's permission.

Review entity choice

Many construction companies are structured as pass-through entities, such as S corporations or LLCs. That means owners pay tax at individual income tax rates on their shares of the company's income.

For owners subject to the top individual income tax rate (currently 39.6%), converting to a C corporation may provide a tax advantage. (The current top corporate tax rate is 35%.) But be sure to weigh the reduced rate against potential double taxation of shareholder distributions. Typically, pass-through entities offer better tax results, although a C corporation may be advantageous for companies that reinvest their earnings in the business rather than distributing them to shareholders.

Keep an eye on Congress

Several important tax breaks expired at the end of 2014, including enhanced Section 179 expensing for equipment and 50% bonus depreciation. If Congress extends these provisions retroactively to the beginning of 2015, as it has in previous years, you may have an opportunity to reduce your 2015 tax bill by acquiring depreciable assets before year end. Other expired breaks that may be revived include the research credit and the deduction for energy-efficient commercial buildings.

It's possible that some or all of these breaks could even have been extended by the time you're reading this. Check with your tax advisor for the latest information. ■

3 more tips

Here are a few more year end tax-savings ideas:

1. Evaluate accounting methods. If your company is eligible for either cash or accrual accounting, investigate whether switching accounting methods would provide a tax advantage. Usually, the cash method produces greater income deferral, but your company may be better off using the accrual method if, for example, its accrued expenses tend to be higher than its accrued income.

2. Claim the manufacturers' deduction. This deduction isn't just for manufacturers, so don't overlook it. Also commonly referred to as the "Section 199" or "domestic production activities" deduction, it allows you to deduct up to 9% of your income from "qualified production activities." These include many activities associated with constructing or substantially renovating real property located in the United States.

3. Watch out for self-charged rent. Higher-income taxpayers are subject to a 3.8% net investment income tax (NIIT) on certain net investment income, including rent. But what about construction company owners who lease real estate or equipment to the company through a related entity? This "self-charged rent" is excludable from NIIT so long as an owner "materially participates" in the construction company's business. So be sure to determine whether you're sufficiently active in the business. If you are, you don't need to deduct self-charged rent when calculating NIIT.

How to self-insure your construction business

With all of the risks inherent in a construction business, it's important that you have sufficient insurance coverage. But you also need to keep policy costs under control. Captive insurance can be a great way to do both.

The benefits

With captive insurance, you establish a subsidiary company to self-insure your business. Bigger companies may set up the arrangement independently, but a group of smaller businesses also can form a captive by banding together to buy insurance.

Because a captive serves fewer customers and is set up by the insured, it will naturally be more responsive than a large insurance company serving thousands of clients. As the insured, you may also be able to reduce the chances of future accidents by scrutinizing loss reports and being committed to follow up with managers to improve job safety.

Moreover, because you at least partially own the captive, premiums are easier to control and, in the absence of unanticipated liabilities, are likely to be lower and more stable in the long run. Plus, premiums can be determined by individual loss experience as opposed to industry group or other classifications.

Last, as the owner of the captive, you'll benefit from any investment or underwriting profits achieved. Of course, by the same token, you'll also bear the cost of any losses incurred under the program.

Tax courts have upheld a company's right to deduct premiums paid to a captive it owns if the captive writes a significant amount of insurance for customers other than the parent company.

Setting it up

A group captive may be a viable option if your construction company has at least $200,000 in annual combined premiums. But the savings generally favor businesses with annual premiums in excess of $1 million for automobile, umbrella, general liability, property and casualty, and workers' compensation insurance.

Under a group captive arrangement, companies pool financial, business and insurance risk into one self-insured retention level and buy an aggregate stop-loss policy. In buying the policy, each company commits itself to sharing a portion of the other parties' liability.

Group arrangements can vary in rules and structure. Some captives require annual combined payments of as little as $50,000. Groups normally limit their size to 80 or fewer members, with some having fewer than 10 members.

Most captives are set up for property and casualty risks, so that claims tend to be larger and less frequent. Some companies may find that letting a captive handle only

part of their risk and relying on traditional insurance for other areas makes sense. For instance, the high frequency and relatively small risks associated with health care are sometimes best managed through traditional insurance.

Tax consequences

Companies that belong to a captive can generally deduct their premiums if they don't control the captive. Tax courts have upheld a company's right to deduct premiums paid to a captive it owns if the captive writes a significant amount of insurance for customers other than the parent company.

To take the deduction, the insured must be able to prove that risk was actually transferred. Blending conventional and captive insurance into a single policy is one way to transfer risk and qualify the entire policy for deductions.

The timing of loss deductions is also critical. Contractors generally prefer to take deductions in advance for expected losses. Keep in mind, though, that the IRS doesn't want companies to deduct losses for self-insurance until claims are actually paid and the IRS can deny these deductions during an audit.

Finally, the location of a captive and the tax consequences of that location are also important to consider when choosing a captive. While many companies find locating their captive insurance companies in the United States advantageous, many group captive insurance companies are located offshore. This is because no taxes are paid on any of the members' earnings as long as the money remains offshore.

Right for you?

Captive insurance is a comprehensive alternative to traditional insurance. With expert implementation and management, a captive insurance program can provide contractors an excellent way to manage risk and control costs. ■

Cost segregation studies can benefit you *and* your clients

Construction companies seeking a competitive edge should become familiar with the mechanics of cost segregation studies and the significant tax benefits they offer. Not only can you use the study to reduce your own tax bill, but consulting on your company's studies can create a new source of revenue.

Accelerated depreciation

A cost segregation study applies engineering and tax accounting principles to identify building components and construction costs that qualify for accelerated depreciation deductions.

Commercial real property generally is depreciable over 39 years, while residential real estate is depreciable over 27½ years. But in many cases, a portion of the cost of real property is properly allocated to shorter-lived assets depreciable over five, seven or 15 years.

Such assets might include:

- Furniture and equipment,
- Electrical connections and wiring,
- Plumbing or foundations for specialized equipment or machinery,

- Paving and sidewalks, landscaping, and fences,
- Telephone systems, and
- Removable partitions, walls, and floor coverings, among other items.

Let's look at an example that illustrates the tax-saving potential of a cost segregation study.

A contractor acquired a new building for $10 million to house its offices, equipment storage and other facilities and moved into the building in January 2015. If the contractor were to depreciate the entire cost on a straight-line basis over 39 years, it would deduct roughly $250,000 per year.

The company conducts a cost segregation study, which concludes that $2 million of the purchase price is allocable to assets that are entitled to accelerated depreciation over five years. The result? The contractor increases its first-year depreciation deductions by about $650,000. Assuming that its combined federal and state income tax rate is 40%, and that it has sufficient income against which to offset its increased depreciation deductions, the company reduces its 2015 tax bill by about $260,000.

Consulting with clients

Typically, CPAs oversee cost segregation studies, but construction companies are uniquely suited to provide consulting services to their clients in connection with these studies. The best time for a study is during a project's planning phase, because the information needed to support cost classifications is most readily available. And the contractor is ideally positioned to isolate and document qualifying costs as they're incurred.

Even existing buildings are viable candidates for a cost segregation study. And if cost information is unavailable, a construction company can support a study by estimating the costs associated with various assets using standard estimation techniques.

A cost segregation study applies engineering and tax accounting principles to identify building components and construction costs that qualify for accelerated depreciation deductions.

Cost segregation studies also can be used to ensure compliance with the "repair regulations," which, among other things, distinguish between improvements, which must be capitalized, and repairs, which are currently deductible. The regulations also require building owners to recognize a loss on the removal or other disposition of certain structural components. Contractors can help their clients distinguish between repairs and improvements, segregate the costs of structural components disposed of in prior years and review the results of previous cost segregation studies for compliance with the repair regulations.

Worth a look

Contractors looking for new revenue sources should consider offering cost segregation consulting services. These services can help your clients realize significant tax savings while setting your company apart from the competition. ■

Cybersecurity: Are you prepared?

It seems that hardly a day goes by without a cyberattack making headlines. And if you think your company isn't a likely target, think again. Increasing reliance on cloud computing and mobile devices makes the construction industry particularly vulnerable to data breaches.

Risks abound

Consider the many ways construction companies are using the Internet today:

- Cloud computing to provide remote access to payroll, billing, estimating, procurement, scheduling and project management systems,
- Ability to view and edit plans, specifications and other construction data online, and
- GPS tracking systems to prevent theft and monitor usage of equipment, vehicles and other valuable assets.

While such Internet use increases efficiency and collaboration, it also increases cybersecurity risks. Hackers who gain access to these systems may be able to steal sensitive company or employee financial information. Or they might obtain valuable competitive intelligence.

They may also have the ability to interfere with a contractor's operations or even endanger the safety of people on-site by destroying data, altering plans or accessing a building's security systems. Some GPS systems allow users to shut off vehicles or equipment remotely or otherwise tamper with their operation.

Prevention is key

To prevent cyberattacks and mitigate the impact of any breaches that do occur, construction companies should have a strong cybersecurity program. Here are the steps to implementing a program:

1. Take inventory of your network, systems, hardware, software and data, identify connection points and map out the flow of data.
2. Conduct a risk assessment to pinpoint areas of vulnerability, including any bring-your-own-device (BYOD) policies and any third parties (such as vendors or service providers) with access to your network.
3. Implement internal controls and protections, such as strong passwords and other authentication procedures, encryption, firewalls, limited physical access to hardware, and segregation of duties.
4. Develop an incident response plan that establishes communication protocols and details the roles and responsibilities of management, employees and outside consultants in the event of a breach.
5. Provide training to everyone who has access to the company's information systems, handles sensitive information or plays a role in the company's incident response plan.

Once you've implemented your plan, you're not finished. You must constantly monitor your information systems for unusual activity using antivirus and antimalware software, intrusion prevention systems and other measures to ensure that breaches are detected as quickly as possible.

Closing the gaps

The level of cybersecurity you need depends on your company's particular risk profile. An IT consultant can help by examining your information systems and identifying any potential security gaps. ■

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