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# CONSTRUCTION INDUSTRY ADVISOR


Succession planning

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Succession planning

# Look at things from a surety's perspective

A well-designed succession plan is critical to the long-term survival of a construction business. In developing one, it's important to consider the objectives and needs of your company's owners as well as their family members. But it's equally important to examine your plan from the perspective of your surety.

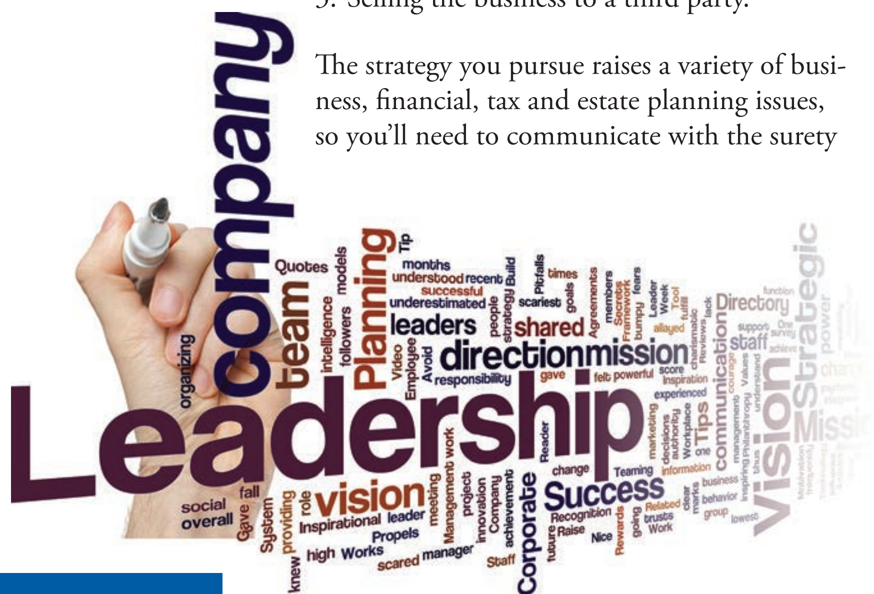
Bonding obligations typically last for several years, so it's important to maintain a strong relationship with your surety. A comprehensive succession plan will instill confidence that you'll be able to complete projects regardless of ownership or management changes. To help create or evaluate yours, let's address a few questions your surety will likely ask.

## What's your exit strategy?

Generally, there are three types of exit strategies for contractors:

1. Transferring the business to family members (by sale or gift),
2. Selling the business to employees, or
3. Selling the business to a third party.

The strategy you pursue raises a variety of business, financial, tax and estate planning issues, so you'll need to communicate with the surety regarding the potential impact of these issues on your company's continuity.




Regarding the second exit strategy type, one option to consider is an employee stock ownership plan (ESOP). This arrangement creates a market for your shares and transfers the business to employees (including family members) in a tax-efficient manner. (For more information, see "Should you consider an ESOP?" on page 3.)

*Be sure to recognize the distinction between ownership and management succession.*

If your company has multiple owners, a surety will also want to ensure that you have a well-drafted and funded buy-sell agreement in the event an owner dies or otherwise departs the company earlier than anticipated. If you haven't already established one, this is a must-have.

## Who are your successors?

It's critical to identify potential successors as early as possible — particularly for family-owned construction businesses. Even if your planned transition is several years or even decades away, your surety will want to see a contingency plan in place should an owner or key employee die, become disabled or leave the business.

To address these concerns, start developing the company's future leaders now. Identify family members or other employees with leadership potential and begin to get them involved

in company governance and strategic planning. Recommended steps include:

- Establishing various leadership roles and their objectives,
- Creating individualized development plans for each prospective leader,
- Mapping out these development paths in as much detail as possible, and
- Providing leadership training and educational opportunities.

As you consider successors, be sure to recognize the distinction between ownership and management succession. This is also particularly critical for family businesses. Children may view the business as their "birthright." But if they lack the skills, experience or desire necessary to take the reins, placing them on a management track may be a mistake.

Fortunately, there are strategies available to share the wealth without sharing control. Examples include issuing nonvoting stock and buying life insurance to create liquidity for family members who won't be involved in managing the business. Other options include using a family limited partnership, family limited liability company or trust to facilitate ownership and management.

## Will key employees stick around?

A surety will want to know that an ownership or management change — especially an unexpected one — won't compromise the company's technical and operational competence.

Provide effective incentives that tie key nonfamily employees to the company. These might include bonus plans, profit-sharing plans, stock options, ESOPs or other benefits that vest over time.

## What about cash flow?

Cash flow is the lifeblood of a construction business. Your surety will want some assurances that your succession strategies won't suddenly endanger your company's cash flow.

So, as you establish or re-evaluate your succession plan, consider the impact of future financial obligations. Compensation plans, buy-sell agreements, ESOP debt and repurchase obligations, taxes — all of these things will demand cash at some point. Be

## Should you consider an ESOP?

For construction companies structured as corporations, an Employee Stock Ownership Plan (ESOP) can be a powerful succession tool. An ESOP is a qualified retirement plan, similar in many ways to a 401(k), which invests primarily in the employer's stock.

Tax-deductible contributions are used to buy stock (typically from exiting owners) and credited to employees' accounts. When employees become eligible, distributions are made in stock or cash. These arrangements offer several attractive benefits:

- Owners can cash out and transfer ownership to employees gradually, without immediately giving up control.
- Owners can defer capital gains tax on their stock by reinvesting sale proceeds in "qualified replacement property," which includes most U.S. corporate securities. (This option is available only to C corporations and only if the ESOP owns at least 30% of the company's stock.)
- If the company borrows money to fund ESOP stock purchases, it can fully deduct contributions to cover both interest and principal on the loan.

But ESOPs have risks, as well. For example, closely held companies must conduct annual stock valuations and participants must receive a "put" option allowing them to sell stock back to the company at fair market value.

It's important to consider the potential impact of stock repurchase obligations, as well as ESOP debt, on your construction company's cash flow and bonding capacity.

prepared to explain to your surety (and yourself) from where the money will come.

### Extra motivation

You should already have plenty of motivation to create a solid succession plan. The future of your construction company depends on it, and the financial well-being of family members and heirs is affected as well. But your surety can serve as an extra motivator to help you determine just how solid your plan really is. ■

# The WIP is good: A valuable management tool

Financial statements are an indispensable tool for gauging your construction company's historical results and financial health. But relying on them alone is like driving a car by looking in the rearview mirror. To see the road ahead, you need a work-in-progress (WIP) report for every job.

Too often, contractors view these reports as a burdensome requirement imposed by sureties or lenders. But used correctly, WIP reports can be a valuable management tool.

### Creating the info

There are many ways to create WIP reports, including spreadsheet programs and accounting software add-ons. Whichever method you use, the report should track key information for each project in progress, such as:

- Contract price (including approved change orders),
- Estimated job costs,
- Estimated gross profits,
- Costs incurred to date,
- Revenues recognized,

- Percentage of completion,
- Billings to date, and
- Billings in excess of earnings or earnings in excess of billings.

Most contractors should run WIP reports at least monthly. But some companies review them every week. **Warning:** The process requires a current, complete and accurate assessment of estimated costs to complete for each project. Otherwise, the information will be incorrect and could be misleading.

### Looking for trouble

Monitoring WIP reports closely can help you recognize revenue more accurately, monitor

profitability (or lack thereof) and spot red flags. For example, say a job is 25% complete but your costs incurred to date are 40% of budget. That's not good but, thanks to your WIP report, you'll have time to investigate, make adjustments and, one hopes, get the project back on track.

WIP reports also indicate whether a job is underbilled or overbilled. Either situation is a potential red flag of financial trouble but, in many cases, there's a benign explanation.

For example, underbilling (that is, billing that fails to keep pace with a job's progress) may be attributable to cost overruns, inefficient project management or sluggish billing. Any one of these issues can portend cash flow difficulties. But underbilling may instead reflect less troublesome circumstances, such as a large number of legitimate change orders yet to be approved, or significant front-loaded costs that will be recovered over the course of the project.

Overbilling, on the other hand, is usually viewed as a good thing because it enhances cash flow. Again, it's important to examine the underlying reasons. Overbilling that reflects strong management and billing practices is a positive sign. Yet overbilling caused by substantial unrecorded costs may point to trouble down the road.

### Keeping profits sharp

WIP reports can also help you spot profit fade. This is the gradual decline in projected gross profits over the course of a job. There are several potential causes of profit fade, including inaccurate estimates, lax project management, sloppy change order practices and unanticipated job-site problems. Again, a WIP report can tip you off to project discrepancies before the job gets too far along.

### Reaching your destination

It's much easier to reach your destination efficiently and in one piece when you can see the road in front of you. That's the viewpoint a WIP report provides. Your CPA can help you set up the structure and choose the data points that are right for your construction company. ■

## Is a joint venture the right choice for your company?

They say two heads are better than one. This can sometimes be the case for construction projects when, whether because of difficult logistics or challenging technical aspects of a job, two contractors team up under a joint venture to give themselves the best odds of success.

It's an excellent solution when the circumstances are right. But sometimes you're better off *not* getting involved in a joint venture and, instead, focusing your attention on more likely sources of profitability. Let's look at some points to consider the next time one of these opportunities comes up.

### Weigh pros and cons

Joint ventures do offer advantages. They allow smaller construction businesses to take on larger projects while dividing the contractual and financial risk of such jobs between two parties. A joint venture can also enable contractors to increase their bonding capacity and learn about the newer, more sophisticated technologies that typically accompany bigger projects.

Indeed, the right joint venture can serve as a great way to get your feet wet in a new area of construction. If you can find a partner who's already

established in that area, the project can provide a great learning opportunity — assuming you can still perform the work up to standards, of course.

Despite the potential positives, however, partnering with another business can present risks. Partners who fail to clearly define the objectives and responsibilities going in can wind up legal adversaries. So you'll need to discuss the venture in depth beforehand and draw up the proper documents.

During the project, communication problems can result in confusion, delays and redundancies that undermine profitability. Of particular importance is finding a partner whose culture and communication style (and technology) are compatible with yours.

## Clarify the structure

First and foremost, be sure you have a clear objective when joining a joint venture. Construction companies generally undertake these arrangements for one specific purpose (such as to build a chemical plant or complete an infrastructure project) for a defined period of time. Partners negotiate beforehand how they'll split profits and expenses based on the time, money and labor each plans to invest.

To this end, there are various forms of joint ventures — some more complicated than others. One example: For tax purposes and personal liability protection, many joint ventures form a separate business entity — often a limited partnership or limited liability company (LLC). This is sometime referred to as an "equity" joint venture. When going this route, it's important to carefully examine the tax implications.

Another example is the contractual joint venture. As its name implies, here you and the other construction company draw up a contract outlining the joint venture and its objectives regarding the project at hand. The advantage is that this is typically a simpler and more time-efficient approach. The downside is that the contract language may expose you to liabilities from third parties.

## Consider your reputation

When considering a prospective joint venture partner, ask your CPA to perform an extensive review of its financial statements. He or she can look for red flags regarding how the company manages its money. Also, have your attorney check into the prospect's legal standing, such as whether the company is involved in any outstanding lawsuits or unsatisfied judgments.

*Partners who fail to clearly define the objectives and responsibilities going in can wind up legal adversaries.*

Last, there's the issue of ethics. Ask for references and do some media research to ensure a prospective partner doesn't have any history of questionable practices. One of the major risks of joint ventures is participating in a project that suddenly goes wrong because of bad publicity or even criminal actions. Your construction business can do everything properly and above board and still find itself suffering in the court of public opinion.

## Take great care

Joint ventures aren't all doom and gloom. Many have been carried out successfully and many more shall be. But just as you wouldn't hire a project manager without a careful vetting process, you must take great care when signing on to a joint venture. ■

# Sec. 199 deduction looking better for contractors

For many years, contractors have been advised to look into the Section 199 tax deduction for "domestic production activities." Although the deduction focuses on manufacturing, it's also available for "construction of real property performed in the United States" by companies "engaged in the active conduct of a construction trade or business."

Recently, the IRS clarified the meaning of "construction of real property" in its Technical Advice Memorandum (TAM) 201638022. TAMs don't constitute binding precedent, but they do provide insight into the agency's position on an issue. And this particular TAM makes the Sec. 199 deduction look better for contractors.

## Imposing structures

The TAM addressed a case involving a construction company that performed substantial renovation, construction or erection of various "structures." The guidance said the structures consisted of a series of large piping and ancillary equipment, including pumps, motors and heaters. The structures weighed hundreds or even thousands of tons and were attached to support columns resting on concrete foundations.

The IRS's Large Business and International (LB&I) division concluded that the construction business wasn't entitled to claim the Sec. 199 deduction. The LB&I recognized that the company met most of the requirements but found that the installed property wasn't "real property" for Sec. 199 purposes.

## Affixed to property

The IRS's Chief Counsel disagreed. According to the TAM, tax regulations define real property to include "inherently permanent structures … other than machinery." The TAM explains that inherently permanent structures and machinery are mutually exclusive categories. But if the subject properties constituted inherently permanent structures, they'd still meet the definition of real property for purposes of Sec. 199 — even if they possessed characteristics of machinery.

Inherently permanent structures include "property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time." In this case, the IRS said, the structures were affixed to the real property based on weight alone, though there was evidence that they were welded or bolted to the foundations and support columns. Although the regulations don't define "indefinite period of time," the agency found that the structures satisfied this requirement because they were expected to remain affixed to the property for the duration of their useful lives.

## A little more clarity

The Sec. 199 deduction is a potentially valuable tax break, reaching as high as 9% of qualifying income. However, the deduction might be eliminated as part of potential tax reform. (Check with your tax advisor for the latest information.) Even if it's eliminated, you might be able to file an amended return and claim the deduction for previous years. ■

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