Construction

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Retainage payable: A simple change can defer taxes

If you withhold retainages from subcontractors, you may be able to defer some of your taxable income to future years. This opportunity stems from the way retainage payable is treated under the percentage-of-completion method (PCM) of accounting.

Computing the completion factor

For tax purposes, large contractors generally use the PCM to report income on long-term contracts — that is, contracts that span two or more tax years. Large contractors are those whose average annual gross receipts for the preceding three years exceed $10 million.

Under the PCM, in a given tax year the contractor applies a "completion factor" to the contract price when calculating profits. Typically, the completion factor is the ratio of costs incurred during the tax year to total estimated contract costs. In certain circumstances, retainage can be excluded from the completion factor, which defers tax to future years.

In "The PCM in action" on page 3, Example 1 shows how the completion factor is used to calculate taxable profits for the year. Example 2 shows how excluding retainage from the numerator of the completion factor allows a contractor to defer taxable income — in this case, more than $30,000 — to future tax years. This may not seem like a significant amount, but when you multiply it across all of your jobs, the current-year tax savings can really add up.

Make sure contracts with subcontractors are clear that retainage isn't payable until the job is fully complete and accepted.

Excluding retainage

When can you exclude retainage from the PCM calculation? You can do so until it becomes a "fixed and determinable" liability and, therefore, must be treated as an incurred cost.

Under IRS rules, a liability must be recognized by an accrual-basis taxpayer when:

1. All events have occurred to establish the fact of the liability,
2. The amount of the liability can be determined with reasonable accuracy, and
3. Economic performance has occurred.

Generally, No. 3 occurs when a subcontractor completes its work or, if earlier, when it's paid. Even if a subcontractor has completed its work

or been paid, however, your liability for withheld retainage may not meet the first two parts of the test. This may be the case, if, for example, the contract provides that retainage isn't payable until full acceptance and completion of the job.

As long as there's a possibility that the sub will forfeit some or all of the retainage, your liability is not yet "fixed and determinable" and retainage should be excludable from the numerator of the completion factor.

So to take advantage of this tax-deferral strategy, make sure your contracts with subcontractors are clear that retainage isn't payable until the job is fully complete and accepted. The contracts should also spell out the circumstances under which you're entitled to withhold retainage, such as incomplete or defective work, or failure to pay suppliers or other subs.

The PCM in action

Example 1. Acme Construction won a $10 million contract to build an office building at an estimated cost of $9 million over three years, beginning construction on the first day of its tax year. At the end of the tax year, Acme has incurred costs totaling $3 million, and its original $9 million total cost estimate remains accurate.

The project's completion factor is $3 million / $9 million, or 33.33%. Acme's revenue for year one, therefore, is 33.33% of the $10 million contract price, or $3,333,000. After deducting its $3 million in costs, Acme's first-year profit on the job is $333,000.

Example 2. Assume that, of Acme's $3 million in year-one costs, $2.8 million consists of payments to subcontractors for which Acme withholds 10% retainages totaling $280,000. If Acme can exclude retainage from the numerator of the completion factor, the percentage complete is reduced to 30.22% ($2,720,000 / $9,000,000). This reduces first-year revenue to $3,022,000 and first-year profits to $302,000 ($3,022,000 - $2,720,000).

By excluding retainage, therefore, Acme reduces its taxable income in the first year by $31,000 ($333,000 - $302,000).

Acting sooner rather than later is wise

If you haven't excluded retainage payable from the PCM calculation in the past but would like to do so in the future, you'll need to apply to the IRS for permission to change your accounting method. This means filing Form 3115 — "Application for Change in Accounting Method" — together with supporting documentation that illustrates how the new method will more accurately reflect your income. The IRS will likely request copies of existing or master contracts you've entered into with subs to make sure the language is compliant with requirements.

Changing your accounting treatment of retainage payable can generate substantial tax benefits at a relatively low cost. Obtaining IRS approval to change your accounting method can take several months, however, so the earlier you apply, the better. Your tax advisors can help you determine whether such a change would benefit your company and, if so, guide you through the process. ■

Going public

Understand prevailing wage laws *before* you bid on public works projects

As the economy continues to struggle, many contractors are adding public works projects to their repertoires just to stay profitable. Public projects can be a lucrative source of new work, but they're also subject to complex federal and state requirements fraught with traps for the uninitiated. Prevailing wage laws are among the most treacherous.

What's required?

Most federal projects are subject to the Davis-Bacon Act, which requires federal contractors to pay a "prevailing wage." That is, Davis-Bacon — along with its state counterparts — requires you to pay wages on a public project that are comparable to wages for similar work in the same geographic area.

What's more, a majority of states impose similar requirements on state-funded projects. If a project is financed by both federal and state funds, the higher wage usually applies.

Prevailing wages may vary among different classifications, so it's critical to get them right.

How are wages determined?

On federal projects, the U.S. Department of Labor (DOL) sets prevailing wage rates. On state projects, the equivalent state agency sets the rates. One of the biggest challenges for contractors bidding on public projects is worker classification. Prevailing wages may vary among different classifications, so it's critical to get them right.

Complicating matters further, the DOL and state agencies may restrict the types of work that can be performed by workers in certain classifications. For example, a worker classified as a laborer may not be permitted to perform tasks traditionally associated with members of a particular trade or craft, such as plumbers or electricians.

Cash or fringe benefits?

Generally, prevailing wage rates consist of a base rate paid in cash and a fringe benefit amount. Contractors have the option of paying fringe benefits in cash or applying fringe benefit credits for contributions to "bona fide" benefit plans, such as health and life insurance, long-term disability plans, retirement plans, and vacation days or other paid time off.

Computing fringe benefit credits is complex, so you might be tempted to simply pay the fringe benefit amount in cash. But satisfying the fringe benefit obligation using bona fide benefit plans can be more cost-effective. Moreover, cash wages are subject to Social Security, Medicare and other payroll taxes, while contributions to benefit plans are generally exempt from these taxes.

Your advisors can help you determine which approach would be better for your bottom line in light of your existing compensation and benefit programs.

What record-keeping is needed?

Compliance with prevailing wage laws demands timely, accurate record-keeping. You'll need to submit certified payroll reports periodically and keep accurate internal payroll records on file. It's particularly important that you document the classification of workers and the tasks they perform.

In addition, general contractors and upper-tier subcontractors are responsible for prevailing wage violations by lower-tier subcontractors. So it's important to gather records from these subcontractors to ensure they're in compliance.

What are the penalties for noncompliance?

The penalties for prevailing wage violations can be severe. Under the Davis-Bacon Act, for example, they may include fines, contract termination or even "debarment" from future federal contracts for up to three years. And that's not all — contract payments may be withheld to cover the violator's liabilities for unpaid wages and certain other damages.

Contractors or subcontractors that falsify payroll records or demand kickbacks of wages are subject to civil and even criminal prosecution.

Plan before you bid

Compliance with prevailing wage laws is complex, so be sure you understand your obligations before you bid on a public works project. Because miscalculations can quickly wipe out any expected profits on a job, seek professional advice before you venture into this territory. ■

Build a future for your heirs ... and your business

If you're among the baby boomers marching toward retirement, it's critical that you develop a plan to transition yourself out of your leadership role in your construction company. The succession plan should cover everything from naming a successor to choosing the right method for shifting ownership to that successor and perhaps other family members.

Find the best candidate

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 lack sufficient experience. And you might have to tiptoe around sensitive family issues — especially if you have more than one family member in the business or you have children from more than one marriage.

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

Give them a well-defined path to find out what they need to do to become leaders of the business. And design appropriate fringe benefit and

deferred compensation plans, as well as incentive pay, to help retain them until you step down.

Make it a family affair

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.

Transfer ownership

The simplest way to transferring ownership of your construction company is to sell it to family members … if they want to buy it and can afford it.

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.

You can also transfer ownership by gifting interests over time, but there are potential gift tax liabilities associated with this approach — and it won't generate an income stream to carry you through retirement. If you're ready to make a larger transfer this year, however, you can take advantage of the record-high $5.12 million gift tax exemption to make tax-free gifts. The exemption is scheduled to drop to $1 million in 2013, though Congress may extend the current exemption or make other estate tax law changes.

A trust may be a better alternative for transferring ownership without creating harsh tax obligations. One option is a grantor retained annuity trust (GRAT), which will provide you with income for a term of years and then distribute the remaining assets to your beneficiaries.

The transfer of assets into the GRAT is a taxable gift, but the annuity you receive reduces the value

of the gift. Interest rates also affect the value of the gift. The current high-gift-tax-exemption / low-interest-rate environment may make a GRAT especially attractive this year. But keep in mind that, if you die before the end of the annuity period, the trust assets will be included in your estate and the tax advantages will be negated.

Get your advisors involved

No matter whom you choose as your successor, get your CPA, lawyer, insurance advisor and a family business consultant involved to help you assess your circumstances and create a workable succession plan.

Along with selecting a vehicle to transfer your assets, the plan should state to what extent you'll stay involved with the company after you leave. If you stay too involved, you may inadvertently inhibit your successors from succeeding.

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. Include a buy-sell agreement in the succession plan. It allows you to restrict transfers of ownership interests and can help minimize income and estate taxes.

Just do it

While everyone talks about the need for a succession plan, too few actually follow through with developing one. Because the person (or people) who'll eventually take over your construction business needs to be groomed into a leader, it's critical that you start the process at least several years before you plan to retire, and ideally a decade or more in advance of that target date. ■

Read the fine print in insurance policies

It's common for an owner to require the general contractor to name the owner as an "additional insured" under the general contractor's commercial general liability (CGL) policy. Likewise, a general contractor typically requires subcontractors to name it as an additional insured under their CGL policies.

Doing so helps protect the additional insured against liability in connection with activities of the "named insured" (the contractor or sub that purchased the policy). But if you haven't read the fine print of the insurance policy, you may or may *not* be covered as an additional insured to the extent you expect.

Don't rely on a certificate of insurance

To confirm that you're protected as an additional insured, obtain certified copies of the policies and endorsements that confer additional insured status. Don't rely on certificates of insurance to determine whether you're covered as an additional insured.

They generally provide little detail about the scope of coverage. Plus, they typically contain disclaimers stating that they're informational only, confer no rights upon the certificate holder, and don't expand or otherwise change coverage provided by the underlying policy. In other words, a certificate of insurance that lists you as an additional insured may be worthless if you're not properly named as such pursuant to the underlying policy.

Generally, there are two ways to name an additional insured: 1) by listing the party in a "named entity" endorsement, or 2) by using a blanket additional insured endorsement. The latter automatically confers additional insured status on a party if the named insured is contractually obligated to name that party as an additional insured. If the construction contract doesn't clearly spell out the types of policies for which the contractor or sub is required to list you as an additional insured, you may not be covered.

Check the policy language

Even if you're satisfied that you're an additional insured, examine the policy language. Often, the coverage available to additional insureds is narrower than that provided to the named insured.

For example, some policies provide coverage to additional insureds only for bodily injury or property damage for which the named insured is at least partly responsible. If the additional insured is solely responsible, coverage may be denied. Some policies exclude additional insured coverage for claims that arise after the project has been completed.

Consult a professional

The law surrounding additional insured coverage is complex and court cases in this area are often inconsistent. If you have any doubts regarding your liability protection on a project, consult an advisor to be sure you're covered. ■

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