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ElliottDavis LLC
Construction Services Group

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Buy-sell agreements: A bridge to your construction company's future

You've worked hard to build a successful construction business. But how can you ensure it will pass into capable hands when you're ready (or forced by circumstance) to leave? One good first step is creating a buy-sell agreement — a legal document that acts much like a bridge, offering your successors safe passage to your construction company's future.

Find a balance

Buy-sell agreements contractually determine what will happen to your business should specific triggering events prompt an ownership change. Triggering events may include an owner's divorce, disability, bankruptcy, termination, retirement or death, as well as a crime or scandal that could substantially harm the company.

Buy-sell agreements need to be flexible enough to balance current concerns with future needs. They should establish a method for determining a purchase price when a triggering event occurs, as well as whether triggering events will spur mandatory or optional buyouts and how the buy-sell obligation will be funded.

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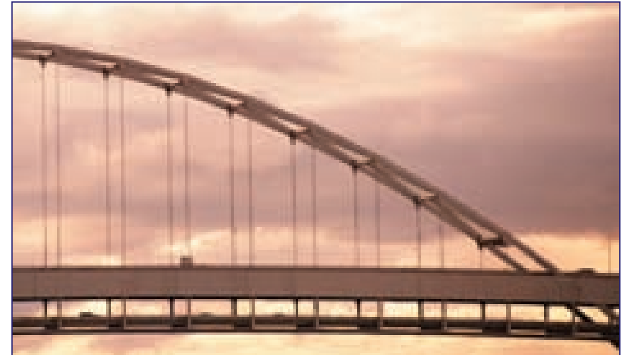
There are several types of buy-sell agreements, but the two most common are cross-purchase agreements and redemption agreements. With a cross-purchase agreement, owners agree to buy out a departing owner's interest; whereas, with a redemption agreement, the company itself buys the departing owner's share.

You may use insurance to fund either. Under a cross-purchase, each owner buys life insurance on



each of the others in an amount that will cover an equal purchase of the departing owner's share. If there are more than a few owners, this can add up to a lot of policies.

For example, with even just four owners, 12 policies would be required, because each owner would need to buy policies on the other three. Under a redemption agreement, the company buys the policies so many fewer are needed — with four owners, only four policies would be required. Sometimes a separate partnership is created to be owner and beneficiary of the insurance policies, thus solving this problem.

Weigh the benefits

Cross-purchase agreements and redemption agreements each have distinctive financial and tax advantages, and you must consider your situation carefully when deciding between the two.

One particular advantage of cross-purchase agreements is that surviving owners pay no income taxes — including the alternative minimum tax (AMT) — on any life insurance proceeds they receive as a result of another owner's death. But buying life insurance coverage on multiple owners can be tricky to administer, and not just because of the number of policies involved.

If some owners are younger and healthier than others, premiums will vary significantly and

some owners may — perhaps unfairly — have to pay more than others. In addition, if the life insurance benefit turns out to be inadequate, the remaining owners may have to pay for a portion of the deceased's shares from their after-tax income, and this may mean taking out a loan and paying interest that may not even be currently deductible.

With redemption agreements, the business must fund the buyout. If the agreement isn't fully funded and the business must borrow to meet its terms, it will be able to deduct any interest payments made. Beware that, if the business is a C corporation and is named as the life insurance beneficiary, the proceeds from the policy may trigger the AMT.

Finally, life insurance works best as a funding tool only if the exiting owner has died, because then the full face amount will be paid. If he or she leaves for other reasons, only the cash surrender value that has built up will be available and other funding may be required.

Give the gift of reassurance

To be sure you end up with a mutually — and legally — acceptable buy-sell agreement, and a means of paying for the potential buyout, work with a team of professionals to create yours, including a CPA, attorney and insurance agent.

You'll no doubt find setting up such an agreement a complex process. But, in doing so, you'll give the gift of reassurance to not only yourself, but also your employees, surety, vendors and customers that your company will endure.

Hey, look on the bright side ...

Net operating losses offer tax savings

It's no secret that a contractor's income can shift significantly from year to year. When times are particularly slow, you may not even show a profit. Fortunately, you can make the best of things, at least from a tax perspective, through the deft use of net operating losses (NOLs).

Winning losses

In simple terms, if your company is a C corporation and its allowable deductions for a certain year are greater than its gross income, you've incurred an NOL — and you may be able to deduct it. Eligible losses include those caused by a business slump as well as theft or casualty, federally declared disasters, and business property sales.

The federal tax rules regarding NOLs are complicated, but, generally, you have two choices if you incur a loss: 1) carry it back and then forward, or 2) elect to carry the entire loss forward, as long as this election is done on a timely filed return.

Note that if you operate the business as a flow-through entity (partnership, S corporation or

limited liability company), losses will flow through to owners' individual tax returns. You can also have an NOL on your individual return and the rules for its use are similar, but you will create an

NOL individually only if you have tax basis to deduct the business loss and it's large enough to offset all of your other income (such as salaries, interest, dividends and capital gains) for the year.

Backward benefits

If you choose to carry back an NOL, you must generally carry back the entire amount to each of the two tax years preceding the loss (first to the earlier year) and then carry forward any remaining amount for up to 20 years after the year in which the loss occurred — unless the loss was caused by a federal disaster or theft, fire or other casualty. In these cases, certain businesses may be able to carry back the portion of the loss attributable to those causes three years.

For instance, let's say a bumpy local building market causes you to show a $50,000 NOL in the 2005 tax year. You could carry back the entire loss to 2003, and if your 2003 net income was $5,000 you could use $5,000 of the NOL to offset this income.

Now you have a $45,000 remaining NOL to apply to the 2004 tax year, after which you'll have whatever you don't use in 2004 to apply to 2006 and beyond until you have exhausted the entire $50,000 loss.

But let's say that a fire caused $10,000 of your total $50,000 NOL. In this case, you could carry back the $10,000 fire loss to 2002 (as long as you had enough income in 2002 to absorb it) and begin using the remaining $40,000 in 2003.

Fruits of going forward

If you decide to carry forward the entire NOL, you can take up to 20 years to use it, but you must use the NOL to offset any net income each succeeding year. If the prior two years had low income and you fell into low tax brackets, you may want to save the NOL for a carryforward to subsequent years — particularly if future projections appear brighter.

You can postpone the decision by extending your tax return while you see how business is going. Carrying forward an NOL can help reduce your income in years when you may be in a higher tax bracket. A $50,000 NOL used to offset income in a 35% bracket can save $17,500, while the same loss that offsets income in a 15% bracket will save only $7,500, a $10,000 difference.

Bad news, good news

Any business loss is bad news. But the good news is that, by using the NOL rules to your advantage, you can make the best of a tough situation. Just bear in mind that the federal rules are complex, and state laws vary and may add to the complexity, so consult your tax professional before proceeding.

Watching out for the look-back rule

When managing net operating losses (NOLs), be sure to watch out for the look-back rule. It requires you to redetermine your tax liability after completing a long-term contract. If you sustain an NOL during one of the years the project was under way, the loss may "hypothetically" decrease should you carry it back.

For example, if you start a project in 2002 and complete it in 2005, you must reallocate your income from the contract for the earlier years. If you had an NOL in 2003 that you carried back and fully absorbed in 2001, the reallocation of contract income to 2003 could decrease the NOL you carried back to 2001, and your tax liability for that year could increase.

There are other caveats, too. The use of an NOL may be limited if you are carrying it forward or back to a year in which the company's ownership changed by more than 50%.

Overcome accounting challenges with savvy equipment costing

Among the biggest accounting challenges contractors face is equipment costing. Yet you can't work without equipment, so it's a challenge you simply must overcome. Regularly reassessing your costing method can help you stay on top of this critical task.

What's the real cost?

To begin, you must understand the real cost of owning each piece of your equipment. In addition to the purchase price, costs related to fuel, labor, maintenance, off-season or downtime storage, insurance, taxes and depreciation all play a role.

But knowing these expenses isn't enough; you must also allocate them — as direct and indirect costs — to each job. To do so, you'll need to match the cost of the item with its per-project use.

Establishing a consistent costing method is important for both tax and financial reporting. It's also critical in the development of claims for delays and time extensions. Generally, you can recover anything spent on recovering costs in one claim.

How is that calculated?

One option is to use internal equipment rates. Here you estimate the cost of owning and operating each machine over its life span, determine the hourly rate you'll need to charge to cover that cost, and charge each job that rate.

Another possibility is to include equipment costs in the amount you charge for the operator's labor in running the machine. Once you determine the amount of time it'll take to recoup the purchase price, you reduce the asset's cost to an hourly rate that you add to the operator's labor rate.

A third alternative: Charge for use based on rates published in equipment manuals such as the *Rental Rate Blue Book for Construction Equipment* or the U.S. Army Corps of Engineers' *Construction Equipment Ownership and Operating Expense Schedule*. Remember, however, that the rates in these publications are almost always higher than actual costs.

Regardless of how you allocate your equipment costs, you'll need to decide for tax and financial reporting purposes whether to capitalize or expense the equipment. If you don't already have a capitalization policy in place, develop one to establish the purchase price cutoff at which you'll expense or allocate equipment to indirect costs rather than depreciate it.

Last, beware of the effects of idle equipment. It can substantially alter your costing calculations and should be discussed with your financial advisor.

Do taxes play a role?

Depreciation is another key point in accounting for your equipment. Through 2007, businesses can write off up to $105,000 (the 2005 amount, which is indexed for inflation in subsequent years) on the purchase of qualifying items. If you put more than $420,000 (also indexed for inflation) of equipment into service in a single year, however, the deduction starts to phase out.

Bear in mind that depreciation methods for accounting purposes may be different from those for tax purposes. From a tax perspective, depreciation is based on a declining balance, meaning equipment is depreciated more in the earlier years, then at a given percentage of the remaining balance each year.

For accounting purposes, Generally Accepted Accounting Principles (GAAP) allow various depreciation methods. Contractors often use the straight-line approach, which involves subtracting the equipment's anticipated salvage value from the purchase price and dividing by its total estimated useful life.

But watch out: The estimated useful life of a piece of equipment may differ for tax and accounting purposes. Under GAAP, for instance, the life of a heavy truck is based on its estimated useful life, while the IRS says such a truck will last only five to six years.

Can I relax now?

Once you establish a workable costing method, don't get too comfortable. Review it regularly with your financial advisor to be sure you're getting the best results.

Futurescope: Construction Business Trends

OSHA bilingual safety initiatives target contractors

Construction companies typically hire non–English-speaking workers to fill a variety of positions. As a result of this language barrier, you may find yourself facing health and safety issues with these employees that you didn't anticipate — and that could end up costing you thousands in project delays, higher insurance premiums and hefty legal fees.

Recognizing the problem, the U.S. Department of Labor's Occupational Safety and Health Administration (OSHA) has awarded more than $10.5 million in Susan Harwood Training Grants to nonprofit organizations that provide safety and health training, or training materials, for non–English-speaking workers in industries with high fatality rates, such as construction and manufacturing.

They support training in four areas: 1) construction hazards, 2) general industry hazards, 3) ergonomics, and 4) the health care industry. The grants also bolster the development and validation of training materials in the areas of lead hazards and work-related transportation dangers.

One recent grant recipient is Texas-based Associated Builders and Contractors (ABC). It will identify residential construction training needs and develop a supervisor's manual, employee workbooks, brochures and flyers in Spanish to address those needs.

Another recipient, Boat People S.O.S of Falls Church, Va., will develop five residential construction safety training video modules in Vietnamese with Chinese and Korean subtitles. Other grantees around the country will develop materials or provide training in targeted areas such as train-the-trainer, roofing, steel, landscaping, confined spaces, and oil and gas services.

If your construction company employs non–English-speaking workers, don't wait to begin addressing their specific safety concerns. OSHA's safety initiatives offer a low cost way to protect both their well-being and your bottom line. For more information on the grant program, go to www.osha.gov.

The Contractor's Corner

Do I really need tool-tracking software?

Like many contractors, I've had quite a few small tools walk off my jobs. I'm hearing a lot about tool-tracking software and how it can help curtail this annoyance. But are these applications worth the expense and hassle?

You're hearing a lot about tool-tracking software because it does, indeed, help you keep track of your tools — whether they're inadvertently being left on job sites or not-so-inadvertently appearing in someone's personal toolbox.

Tool-tracking software allows you to keep all your tool information, including descriptions, purchase dates and maintenance schedules, in one central database that also can assign these assets an employee name, job code or other criteria.

Paying for convenience

There are a number of applications worthy of your consideration, with costs varying according to their sophistication. The best systems, which are also the most expensive, employ bar codes or radio frequency identification (RFID) chips.

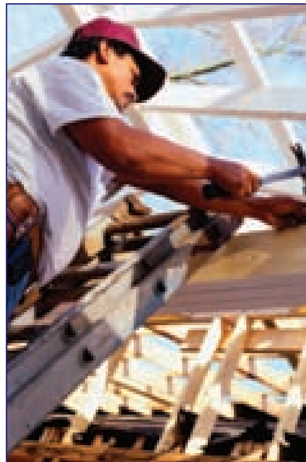
With bar coding, employees simply scan the tool when they take it out and scan it again when they bring back the item. Tools with RFID chips don't even require scanning — you can locate them anytime with a radio signal that not only finds that tool's unique identifier, but also pinpoints its location.

If a tool isn't returned, you know where to look for it. For bigger (or busier) construction companies, these systems tend to be worth the extra money and initial setup time.

Doing it yourself

A less expensive alternative is to create a tool-tracking spreadsheet with your existing software. A skilled programmer can even design a spreadsheet that provides information on billing and maintenance schedules.

If you choose this option, you'll be able to find tools easily — as long as you've entered everything consistently. Say you want to see where all your nail guns are. The search function will find them only if you've included "nail gun" in every description.



You could, of course, save even more money (though not time) with a less comprehensive tool-tracking system. Even a logbook in which you require employees to note when and where they take tools is better than no system at all. But it can be difficult to find a particular tool in the book, and there's little to stop an employee from simply walking out without making an entry at all.

However you decide to track your tools, you'll need to identify them. As mentioned, the most sophisticated way is to use bar-coding or RFID chips. A lower tech option is to use serial numbers, but they're long, difficult to type and easy to enter incorrectly. A better alternative is to paint or etch a short ID number on each tool.

Taking a closer look

At first glance, tool-tracking software may seem prohibitively expensive. But a solution may pay for itself many times over in time saved with more efficient inventory and maintenance management — plus money saved in fewer lost or stolen tools. If nothing else, this technology at least deserves a closer look.

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Meet Jim White

During his five-plus years of professional public accounting experience, Senior Accountant Jim White has provided comprehensive tax and assurance and advisory services to a broad range of construction clients. Jim also served in the private sector as controller where he gained valuable insight into standard accounting functions and processes, as well as focusing in the more specialized areas of human resource management and retirement plan administration.

"The construction industry is very dynamic," notes Jim. "Our job is to keep our clients informed about the changes that affect them, determine what their options are and help them respond accordingly."

After graduating from Clemson University with a B.S. in financial management and a minor in accounting, Jim served as staff and senior accountant with a large South Carolina CPA firm. He is a member of the American Institute of Certified Public Accountants and the South Carolina Association of Certified Public Accountants, and Jim can be reached by phone at (864) 242-3370 or by email at jwhite@elliottdavis.com.

Optimizing Cash Flow

Though maximizing cash flow is often a major issue for contractors, there is an opportunity to increase cash flow by using a tax accounting method that defers the payment of taxes by reducing the amount of revenue recognized in a taxable year. The construction industry is one of the most difficult industries to understand from a tax perspective because of the complexity of the tax rules and the many choices available to recognize revenue for tax reporting purposes. Every contractor has the opportunity for revenue deferral. Normally, a contractor will have at least two methods of accounting — an overall method of accounting and one or more methods of accounting for long-term contracts. The method of accounting for long-term contracts is determined on a contract-by-contract basis, which allows the contractor to use multiple methods in calculating its tax liability.

Generally, the "percentage of completion" method of reporting revenue is required for construction contracts unless either of two exceptions is met, then the contract may be accounted for under the contractor's "exempt" method of accounting. The first exception is for home construction contracts. The second exception is for contracts whose expected completion date is less than two years from the commencement date of the contract and the contractor's average gross receipts for the previous three years (or time in existence, if shorter) is less than $10,000,000.

Typically, "exempt" methods of accounting allow for greater revenue deferral. These "exempt" methods are cash, accrual, accrual electing to exclude retainages, completed contract and exempt percentage of completion. Note that the method chosen is required under the Internal Revenue Code to clearly reflect income and can be challenged by the IRS.

Under the cash method, revenues and expenses are recognized as cash is collected and disbursed. Although comparatively simple to use, the cash method may encourage poor business practices to receive the tax benefit. A contractor's ability to use the cash method may also be affected if the company has inventory or if the company's gross receipts reach a certain level.

The accrual method requires reporting revenue in the year in which all events have occurred fixing the right to such income and the amount of income is reasonably determinable. This method provides better matching of revenues to expenses. However, the danger in using the accrual method is that contractors typically over bill their contracts. In this case, the contractor will be reporting more revenue than has actually been earned. As with the cash method, delaying billings to reduce taxable revenue may not be considered good business practice.

Using the completed contract method, the contractor does not report any revenues or expenses from a contract until the year the contract is completed. Although this method normally achieves the maximum deferral of taxes, timing differences between the completed contract method and the percentage of completion method may trigger the alternative minimum tax. Also, income may fluctuate drastically from year to year and losses on contracts are not deductible until the contracts are completed.

Even if a contractor does not have contracts that meet either of the exceptions allowing the usage of an "exempt" method of accounting and consequently must use the percentage of completion method for all long-term contracts, some revenue may still be deferred. An election can be made to only recognize revenue on contracts after they have reached 10% completion. In the year that total costs incurred exceed 10% of total estimated costs, all costs and revenue are fully recognized based on the percentage complete.

Get To Know Elliott Davis

Since 1925, Elliott Davis has been the accounting advisor and auditor that improves the financial management of small and middle market clients by personally applying national-caliber resources to a broad range of business services. Our mission is simple — help every client achieve the highest level of success and peace of mind possible. That philosophy has helped make us one of the largest CPA firms in the Southeast, and among the Top 60 in the nation.

To learn more about Elliott Davis and how we can help you position your company for sustained profitable growth and continuing success, call us at (800) 503-4721 or visit our Web site at www.elliottdavis.com.

Firm Services

Our service mix is constantly expanding to meet the changing demands of a diverse client base. In addition to highly specialized services for the Construction industry, our broader services include:

- Accounting & Auditing
- Asset & Business Valuation
- Strategic Advisory Services
- Employee Benefits
- Information Technology
- Litigation Support
- Employee Benefits Consulting
- Tax Planning and Preparation
- Wealth Management Services

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