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HINDSIGHT IS 20/20: THE IRS UNDERSTANDS AND SO SHOULD YOU

THE LOOK-BACK METHOD HIGHLIGHTED

By Ronald F. Martino, Jr., CPA, Partner

The IRS has developed several factors in order to identify under-reported or over-reported tax liabilities stemming from the percentage-of-completion method (PCM) of contract accounting. Once a PCM job has been completed, the IRS expects that hindsight of actual costs and billings provides 20/20 vision of the percentage of gross profit that was recognized in prior years to the actual gross profit percentage earned.

The term “look-back” is derived from the taxpayer’s ability to redo the percentage-of-completion computation for each prior year of the contract, using actual total contract costs and actual contract price rather than the estimates used when filing those prior year-end returns. Although the correct amount of income tax will be paid when the contract finishes, this allows the IRS or the taxpayer to recoup interest as a result of these calculations.

Conceptually, the look-back rule was born from the concerns by many lawmakers that if estimated amounts differed significantly from the actual amounts ultimately determined, taxpayers would be paying tax on contract income either



too early or too late. This concept of retroactively validating what was once “best estimates” and adjusting the federal prior tax liabilities creates generally equitable outcomes with a significant amount of bookkeeping complexities. In general, Form 8697 is used to calculate the look-back adjustments which yield additional interest that needs to be paid to (or refunded by) the IRS on taxes paid on contract revenue that has been recognized in prior years.

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HINDSIGHT IS 20/20: THE IRS UNDERSTANDS AND SO SHOULD YOU (continued)

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Once taxable income has been redetermined from each of the prior years (of each completed contract subject to PCM), the taxpayer then must recompute both regular and alternative minimum taxable (AMT) income for each of the prior years affected by the look-back adjustments. The next step is to apply the tax rates, for each particular year, to the difference between the hypothetically redetermined regular and alternative minimum taxable incomes for the earlier years from the respective tax liabilities as originally reported. Finally, the taxpayer must determine the interest charged or credited for each of the years using the federal “overpayment” rate, the same rate being used here for both “overpayments” and “underpayments” of tax liabilities as calculated.

During these hard economic times, most contractors are optimistic about the ability to complete a job on budget, even though bids are usually much more competitive. However, under the look-back method, if gross profit was overstated in the past due to changes in estimates or margin fade, then income was overstated and tax was overpaid in the prior year, and the taxpayer is entitled to have interest refunded to them on that excess tax.

As a general rule, the look-back standards apply to long-term contracts where the percentage-of-completion method is mandated. It is also important to point out that in certain cases, the PCM and the look-back rules are mandated for AMT purposes when it may not be required for regular tax purposes. The look-back method generally does not apply to the regular taxable income from any long-term construction contract that is a home construction contract (as defined in IRC Sec. 460 (e)(6)(A)), or any construction contract that is estimated to be completed within a two-year period by a taxpayers whose average annual gross receipts for the three tax years preceding the year in which taxpayer contract is entered into do not exceed \$10 million (see IRC Sec.460 (e)).

The taxpayer should familiarize himself with the look-back method & its requirements and apply the process in combination with the job finalization estimating process and performance.

Additionally, the look-back method does not apply to any long-term contracts that are completed within two years of the contract commencement date, and have gross contract prices (as of the completion date) that do not exceed the lesser of \$1 million or 1 percent of the average annual gross receipts of the taxpayer for the three tax years preceding the tax year in which the contract is completed. For pass-through entities closely held, the look-back calculation is performed at the individual level, and for non-closely held pass-through entities the look-back calculation is done at the entity level and passes through the Schedule K-1 to the individual taxpayers (see IRC Sec.460 (4)(B)(i)).

In conclusion, the taxpayer should familiarize himself with the look-back method and its requirements and apply the process in combination with the job finalization estimating process and performance. This will enable the taxpayer to refine current estimates, prevent future margin fades and possibly receive a benefit from this process if the taxpayer has been overly optimistic on past years’ contracts as discussed above.

Please be advised that there are exceptions and various elections that relate to the look-back calculation which have not been covered within this article. If you have any questions, please contact Ronald F. Martino, Jr., CPA at 732.842.3113 or rmartino@withum.com. Ron is a Team Practice Leader of WithumSmith+Brown’s Construction Services Team.

HOME CONSTRUCTION CONTRACTORS POTENTIALLY BENEFIT FROM TAX RULE CHANGE

New proposed regulations issued by the IRS will expand the types of contracts that qualify for the home construction contract exception to the general requirement that contractors use the percentage-of-completion method (PCM) to account for long-term contracts.

Internal Revenue Code Section 460 provides the rules that must be used by contractors to account for long-term contracts. The current rules define a home construction contract as “a construction contract where 80% or more of the estimated total contract costs are reasonably expected to be attributable to the building, construction, reconstruction or rehabilitation of dwelling units contained in buildings containing four or fewer dwelling units, and to improvements to real property directly related to the dwelling units.”

Proposed rules expand the types of contracts that are eligible for the home construction contract exemption by providing that contracts for common improvements and improvements to real property directly related to and on the site of dwelling units are considered home construction contracts even if the contract is not related to any one individual dwelling unit.

The proposed rules go on to define each townhouse or rowhouse in a complex as a separate building regardless of the number of townhouses or rowhouses physically attached to each other. The proposed regulations expand the definition of a home construction contract to include an individual condominium unit as a separate building and thus eligible for homebuilder treatment. This allows each unit to be treated as a separate building for purposes of determining whether the underlying contract qualifies as a home construction contract.

Below are some examples of how the new rules affect home construction contractors and if a contract would qualify as a home construction contract:

	CURRENT RULES	NEW PROPOSED RULES
Land clearing and land development (Ex. excavation, sidewalks, sewers, and road, etc.)	Must use PCM method	Eligible for completed contract method
Single building with more than four residential dwelling units	Must use PCM method	Eligible for completed contract method
Residential development common areas (Ex. halls, swimming pools, security booths and clubhouses)	Must use PCM method	Eligible for completed contract method

FEDERAL HIGHWAY USE TAX

The federal government, along with states, imposes an annual tax on the use of highway vehicles with a taxable gross weight of 55,000 pounds or more (state eligibility varies).

Such tax is remitted with Heavy Highway Vehicle Use Tax Return (Form 2290). After such return is filed with the Internal Revenue Service (IRS), the IRS will send back Schedule 1 of the return to the taxpayer as proof of payment. By law, state governments are required to receive proof of payment of the tax as a condition of registering a vehicle for highway use. Thus, it is critical that taxpayers file the highway use tax return with the IRS.

Under current law, taxpayers that file a highway use tax return for 25 or more vehicles for any taxable period must file the return electronically. There are proposed regulations which provide that submitting a highway

use tax return for 25 or more vehicles on paper rather than electronically constitutes a failure to file for purposes of the penalty under section 6651. Additionally, if such return is filed on paper rather than electronically, the proposed regulations provide that the IRS will not send back to the taxpayer the Schedule 1 of the return, which is necessary to register the vehicle with the State.

Electronic filing can be done through any electronic return originator (ERO), transmitter and/or intermediate service provider (ISP) participating in the IRS E-file program for excise taxes.

Given the material penalties that could be incurred by a taxpayer with many vehicles, it is important to comply with the federal highway use tax rules.



CONTROLLING INSURANCE & RISK MANAGEMENT COSTS IN A FIRING INSURANCE MARKET

By Anthony Sardis, JD, LLM, President, IIAG

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A firming insurance market? Increased property and casualty costs? Can it be true? The bad news is that all indications seem to point in that direction. The good news is that you can mitigate the pressures of the insurance market by aggressively and proactively managing your company's risk management programs and exposure to risk.

Let's take a look at where we have been and where we are heading, and then discuss what you can do to position your company so that your insurance program provides you with a competitive advantage that will enable you to compete for and win more profitable work. By doing this, your insurance and risk management programs become strategic business drivers instead of organizational afterthoughts.

For approximately the last five years we have been in a soft insurance market cycle with significant capital. The soft market has produced record profits for the insurance industry, especially over the last two years. Unfortunately, underwriting and investment losses are eroding capacity which some say will lead to a firming of the insurance market. When asked about the current state of the market, James M. Hanrahan, Vice President - Major Accounts of Conner Strong Companies says, "Pricing continued to drop an average of 5-10% during the fourth quarter of 2008 and early 2009. There is clearly pressure and discussion in the market that pricing will begin to increase towards the end of 2009 and continue into 2010." Hanrahan also comments, "Contractors especially need to be aware of what is happening with the pricing of their programs well in advance of their renewal. Considering the bid cycle of many contractors, staying in front of their insurance company's pricing expectations will allow the contractor to be confident of their insurance and risk management costs while preparing their bids."

While insurance premiums will experience upward pressure at some point in 2009 or surely 2010, there are strategies that contractors can undertake now to make sure they are in control of the insurance market and their own pricing destiny. Here are a few:

SECURE INFORMATION

Make sure you know how well your insurance program is performing. This can be done by reviewing your insurance company loss runs and detail which you should be receiving on a monthly basis from your broker. Think of this information as your report card. Are you passing, just getting by or failing? Analyze and question the losses on those reports. Is your broker working with the insurance company to reduce the claims expenses? Does your company and your team have the chance to sit down with the insurance company claims staff and your broker's claims staff to discuss the legitimacy of the claims and the strategy to bring each legitimate claim to a close? This information is crucial in determining if your account is profitable to your insurance carrier. Profitability/loss ratios are one of the most important factors that the insurance company will use in their underwriting process for determining renewal premiums and parameters.

TELL YOUR STORY

Once the claims information is secured and reviewed, determine how you can improve your losses. Most of your insurance costs (about 60-70%) are a result of your actual or anticipated losses. Drive down your losses, and you drive down your costs. If you can "Tell Your Story," meaning tell the insurance company what you have done to improve your operations so that the prior claims experience will have minimal credibility in determining expected claims, you will be able to negotiate lower premiums. Make sure this information

is understood by your broker so that they can incorporate the claims detail into their marketing submission to the insurance carriers that have interest in underwriting your account.

MAKE THE IMPROVEMENTS NOW

Before the hard market gets here, make sure you have done everything you can to improve operations and safety. Partner with an insurance broker that has experience with and understands your business. "If an insurance broker claims to be an expert in the construction field, they should have an in-house construction specific service team that will enable you to control claims through the use of their claims team and safety and loss control specialists," says Hanrahan. These resources will help you establish, execute and monitor the programs your company needs to be considered "best-in-class" by the insurance underwriters. The best-in-class risks will secure

the most favorable and aggressive pricing from the insurance market.

While the anticipated firming of the insurance market is inevitable, the resulting havoc that the insurance market will have on your company is not. By staying ahead of the market and improving your company's risk management programs, you will be able to stay ahead of your peers and competitors while winning more profitable work. ■

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Insurance & Investment Advisory Group ("IIAG") is an affiliated company of WS+B providing insurance and investment solutions for the affluent and business markets. Anthony Sardis is President of IIAG and an active member of WS+B's Construction Services Team.

UPDATE ON TAX RULES FOR MEALS

Most business are aware of the tax rule that disallows 50% of their otherwise allowable deductions for business meals. What is not widely known is that there are several exceptions to this rule and when one of these rules apply, your business generally can get 100% deduction for meal expenses. Here is a run down of some of the major exceptions to the disallowance rule:

Office Coffee Bar. Employers can deduct 100% of the cost of providing employers with free snacks or beverages consumed on the business premises.

Employee Parties. Employers can deduct the cost of providing food and beverages at recreational, social or entertainment gatherings, primarily for the benefit of rank and file employees, as opposed to highly compensated employees.

Meals Served on the Employer's Premises. Employers may provide meals at work and claim a full deduction. The key is the meals have to be provided for a valid business reason, on or near the business' premises, and primarily for the convenience of the employer, not for the purpose of added fringe benefit for employees.

Items Available to the Public. Expenses incurred for meals available to the general public are 100% deductible. Examples include free food at concerts hosted by a shopping mall, free wine and food at an exhibition sponsored by a liquor dealer, and free cookies furnished by a realtor at an open house.

Amounts Billed to Clients. When services are provided as an independent contractor, the service provider can deduct 100% of job-related meal expenses by billing the client separately for these costs. The client then deals with the 50% disallowance rule. If separate billing doesn't occur, the 50% disallowance rule applies to the service provider.

Charity Sporting Event. The allowable deduction for the cost of a ticket to a qualifying charity sporting event isn't reduced by the 50% meal disallowance rule even when meals are included. The ticket package must include admission to the event, but it can also include meals and refreshments. To qualify, the charitable event must give 100% of its net proceeds to a charity and use volunteers to do almost all the work. The classic example is a charity golf tournament with a meal included in the deal.

Hours of Service Limitations. In lieu of the regular 50% disallowance, individuals whose work is subject to the hours of service limitations of the Department of Transportation (e.g., interstate truck drivers, certain railroad employees) can deduct 80% of their business food and beverage expenses in 2008. As you can see, there are enough exceptions to the 50% disallowance rule that most businesses can meet at least one, if not more of them. To the extent your business qualifies for any of them, it's important that the qualifying expenses be tracked separately (typically by charging them to a separate account in your accounting records so that a full deduction can be claimed).



WHY YOU WANT TO KNOW WHAT YOUR CONSTRUCTION BUSINESS IS REALLY WORTH

By Laurence G. Thoma, JD, CFE, CPA/ABV/CFF, DABFA, Partner

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Why would anyone want to spend the money to value their construction industry business when they are not ready to sell it? Well, in addition to selling one's business, there are a number of reasons for valuing it on a periodic basis that can lead to valuable opportunities. These planning opportunities include the following:

- Gifting for Succession Planning
- Buy-In/Buy-Out Opportunities
- Mergers and Acquisitions
- Business Split-Ups/Shareholder Disputes
- Divorce Planning
- Planning for an Outright Sale

We will discuss all of these briefly, but first, one needs a general understanding of what considerations go into a business valuation and the various terminologies that one will encounter.

BUSINESS CYCLE OF A CONSTRUCTION BUSINESS

The valuation of a construction industry business may vary depending upon where it is in its business cycle. The construction industry fluctuates between highs and lows, typically over periods of between five to ten years. This cycle may be different for commercial, residential and infrastructure

construction businesses. Therefore, construction industry companies in different business sectors may have values that fluctuate during different periods of their business cycle depending on that sector's current business cycle.

PREMISES OF VALUE

There are basically two premises of value: "Going Concern" and "In Liquidation." "In Liquidation" is when a business' tangible assets are worth more if sold individually in the market place. In today's economy, we might encounter a liquidation premise more frequently than in prior years. A "Going Concern" premise (more typical for a business valuation) applies when the business is being valued at any given point in a business cycle, and there is reason to believe the company will continue to operate into the future.

VALUATION METHODS

Asset Methods. Asset methods combine the FMVs of all the various tangible assets of a business into a total sum net of liabilities.

Income Methods. Income methods consider historic, current and forecasted future earnings and cash flow, which are then capitalized at a risk-factored rate of return which equates to a multiple of earnings or cash flow.

Fair Market Value (FMV) is the estimate of value determined "as if" the transaction will occur between a willing buyer and a willing seller in the open market with each having knowledge of the market. It also assumes the price paid will be in cash, and the business would have been exposed in the marketplace for a reasonable period of time. This standard also includes the consideration of discounts for lack of control (minority ownership) and marketability.

Fair Value (FV) is a value determined for shareholder disputes and for divorce situations. In New Jersey, it is, in simple terms, the fair market or entity value before one considers any discounts to value. It is also known as "value to the holder." It is typically a higher value than FMV. However, in certain limited circumstances, discounts may also apply.

Synergistic Value (SV) in valuation terminology, is a value which may be even higher than "fair value" and which can be calculated, after determining various synergies (i.e. reduced overhead, elimination of competition, etc.) which would be created between a specific buyer and a targeted acquisition candidate.

WS+B NEWSFLASH: Paul Kuhl, CPA, Team Practice Leader of WS+B's Construction Services Team, has recently been elected to the Board of Directors for the New Jersey Chapter of the Construction Financial Management Association (CFMA).

Market Methods. Market methods generate a value by equating equity in the company to sales prices of comparable businesses that have recently sold.

Hybrid Methods. These methods typically combine an asset and income approach as necessary to assure all the tangible and intangible value is accounted for.

Rules of Thumb. These methods should not be used to value a company, as they merely represent an average range of many values for multiple companies in that industry.

During low points in one's cycle, a capital intensive construction business may be valued utilizing an asset method because it may be operating less profitably than at other points in their business cycle. Whereas in good times, an income or hybrid valuation method may reflect not only the value of the underlying assets, but also the intangible value of the earnings and repeat business. There is also another intangible known as "Going Concern" value. This intangible represents the costs to put all aspects of an operating business in place. This intangible value is frequently combined with an asset method valuation. Typically, income methods will try to incorporate income trends over a period of years to aid in the determination of the forecasted earnings or cash flow that will be capitalized.

PLANNING OPPORTUNITIES

Gifting for Succession Planning. If an owner has an eye toward retirement and/or the business is at a low point in its cycle, this may be an opportunity to consider gifting stock to one's successors. This can save considerable income, gift and estate taxes.

Buy-In/Buy-Out. A low point in one's cycle may provide an opportunity to buyout other equity holders for less than would normally be the case or to bring someone on board at a low cost who will add future value. If at a higher point in the cycle, one may wish to sell or be bought out for retirement or other purposes.

Mergers and Acquisitions. During a low point in one's business cycle, one may consider acquiring a competitor who may not make it through the cycle. The acquiree and acquirer may both come out stronger as a combined entity. Also, one might consider an upstream merger with another entity at a time in the business cycle where the value of one's company could secure a necessary amount of value or retirement funding.

Business Split-Ups/Shareholder Disputes. When continuing friction is occurring within a business between multiple owners, knowing the value of the business provides an estimate for any potential litigation. This information may be critical and may even help decide if any litigation is worthwhile. Having a good shareholder/partnership agreement would also be important at this time.

Divorce. A valuation is typically required at or about the date of the filing of a divorce complaint for the purpose of determining equitable distribution. Sometimes, a value at more than one point of time is required, especially if the business was premarital or gifted. In New Jersey, FV is the standard utilized by the divorce courts.

Outright Sale. Lastly, if you are contemplating a sale of your business at any time in the near future, a calculation of value is recommended to help set an appropriate asking price and/or a bottom-line selling price.

CONCLUSION

As is apparent from the above, obtaining an understanding of the value of your construction industry business and how that value has been created is likely money well spent. Once a valuation is done, you will also have a benchmark for future points in time along your business cycle, were you to value your company again. ■

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Larry Thoma is the Director of Firm Litigation/Valuation/Forensic Accounting Services. He is also an active member of the Construction Services Team and is involved in all aspects of construction industry valuation, litigation and related forensic accounting services.



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WS+B CELEBRATES 35 YEARS OF SUCCESS

WithumSmith+Brown, PC is proud to celebrate 35 years in business. With revenue growth every year since inception in 1974, WS+B is most proud of its talented team of professionals, as well as the valuable relationships it has formed with clients and community organizations over the past 35 years.

Since the time it was incorporated, WS+B has grown from six employees in one small office to the sixth largest accounting firm in New Jersey and 34th largest in the nation. The Firm has enjoyed a long-standing reputation for honesty, integrity and professionalism.

In addition to offering traditional accounting, tax and consulting services to a variety of industries, WS+B specializes in serving the needs of the construction industry through its Construction Services Team (CST). The CST has been assisting the construction community for over 30 years and has become synonymous with teamwork and quality client service.

As testament to its dedication to staff and clients, WS+B was recognized in 2008 as "Business of the Year" by *NJBIZ* and as a "Best Accounting Firm to Work for" in America. For the past five years, the Firm has been listed as one of the "Best Places to Work in New Jersey," and has also been named "Best of the Best" by *INSIDE Public Accounting* for ten out of the last 13 years for client service and firm management.

For more information on how the Construction Services Team can help your business, please contact:

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