

# CONTRACTOR

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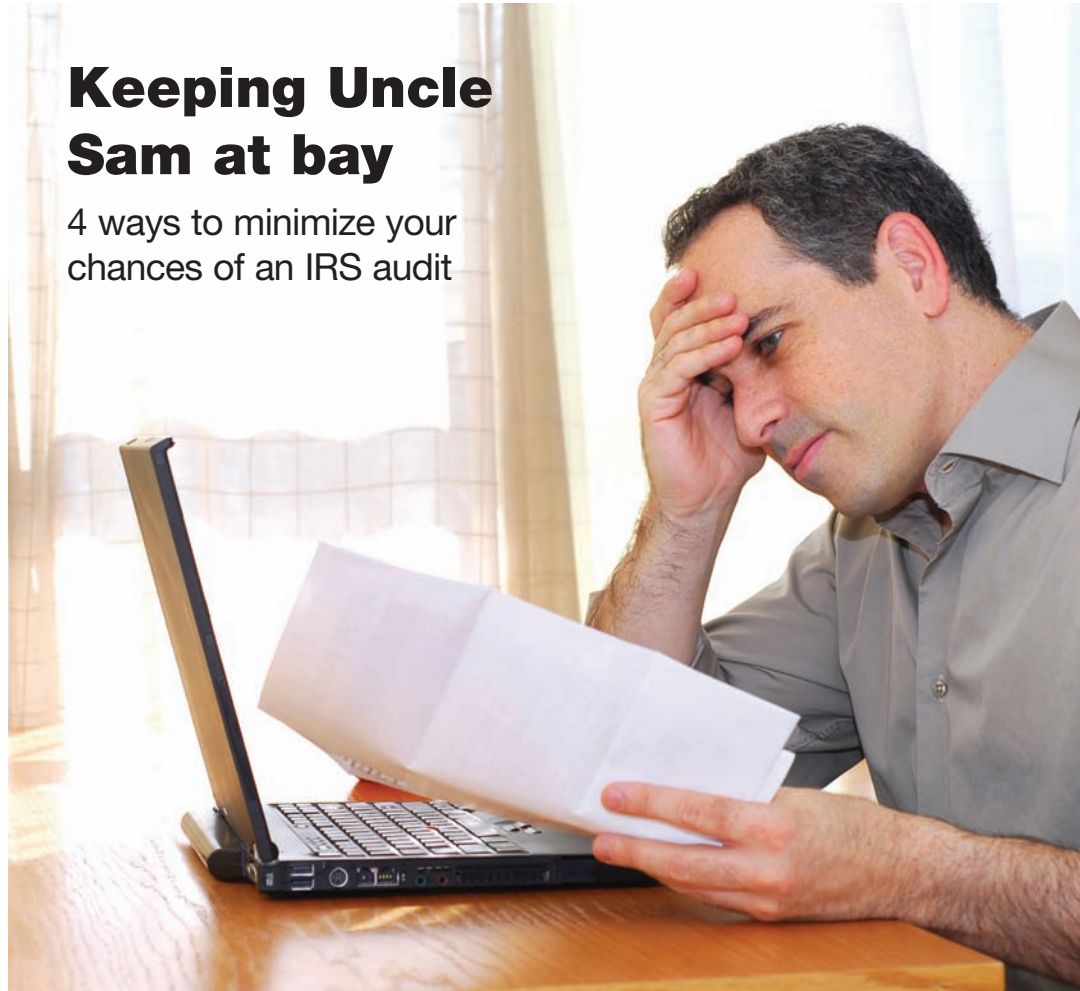
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Track your tools  
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stop the nickel-and-diming

**Plus!**  
Construction Success Story  
Contractor divides company  
into multiple entities

## Keeping Uncle Sam at bay

4 ways to minimize your  
chances of an IRS audit



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# Keeping Uncle Sam at bay

## 4 ways to minimize your chances of an IRS audit

**T**hanks to a variety of industry quirks, construction companies are especially vulnerable to IRS audits. But by avoiding some common audit triggers, you can keep the guy with the white beard and funny hat at bay. Here are four ways to do so.

### 1. Consider the accrual method

It's no secret that many contractors prefer cash accounting to accrual accounting, which can be more complex and sometimes require you to pay taxes on income you haven't yet received. The IRS, on the other hand, isn't a big fan of cash accounting because it can delay tax payments.

Generally, the IRS allows contractors with less than \$10 million in annual sales to use the cash method. But, the *accrual method is required* for C corporations with more than \$5 million in annual sales and for contractors who spend generally 10% to 15% of their gross income on substantial purchases of materials, such as



inventory or lumber — even if annual sales are less than the otherwise applicable \$5 million or \$10 million threshold.

**Contractors who own LLCs are six times more likely to be audited than those with S corporations, a recent IRS study shows.**

If you're audited and you've been using the cash method when you should have been using the accrual method, you may be forced to postpone deductions and pay penalties. Even if you aren't required to use the accrual method, be aware that using the cash method may invite IRS scrutiny.

### 2. Mind your independent contractors

Independent contractors are a big part of the construction industry. But if your business uses them, proceed with caution. The IRS has long believed that a significant percentage of employers misclassify employees as independent contractors.

In fact, the agency began a three-year crack-down in 2010 on such employers in an effort to recoup any taxes those organizations should have paid. To avoid becoming one of the crack-down's targets, make sure that your workers meet the criteria for independent contractors and that you issue 1099 forms to them.

### 3. Keep long-term contracts legit

As you may know, contracts that span over two calendar years are considered long-term. What you may not know is that the IRS watches these carefully to make sure contractors pay their taxes on the monies involved in a timely manner.

Many long-term contracts are subject to the percentage-of-completion method, which requires contractors to pay taxes each year on the portion

## Already facing an audit? Don't fret

If you're already facing an IRS audit, follow these tips on getting through the process with sanity intact:

**Get professional help.** Your CPA can work directly with the IRS examiner, who may be more comfortable dealing with someone familiar with the tax system. If the IRS wants to conduct the audit at your office, ask whether it's possible to use your CPA's office instead. Choosing a neutral location limits the IRS's interaction with your customers and employees, keeping business disruptions to a minimum.

**Compile and clean up your documentation.** Collect all of your pertinent records and fill in any necessary blanks, such as missing receipts or mileage logs. Any unsubstantiated deductions or other omissions you can't back up may further heat up the hot water you're already in. If the IRS had audited you specifically because of your tax return, sending documentation to the agency ahead of time may help to narrow the audit's scope.

**Keep an appeal in your back pocket.** If you anticipate that you'll disagree with the examiner's final assessment, remember that all is not lost. You can appeal the audit findings to the IRS Appeals Division and even all the way to the U.S. Tax Court.



of the contracts that were finished in that year. Some smaller contractors are allowed to use the completed-contract method, though, which lets them put off paying taxes until projects are done.

If you're using the completed-contract method, keep in mind that the IRS may look into such contracts to make sure you're not unnecessarily dragging out the terms. A couple of potential audit triggers: 1) a delay in completion of a contract that's almost done to the next tax year, and 2) a contract that contains separate projects that could be treated as separate contracts, such as identical apartment units.

### 4. Consider an "S" election

In certain cases, operating an S corporation can help shield you from an audit more effectively than a single-member limited liability company (LLC) or a sole proprietorship.

Contractors who own LLCs are six times more likely to be audited than those with

S corporations, a recent IRS study shows. Although you shouldn't change your business structure just to minimize IRS scrutiny, it's a factor worth considering when reviewing how your construction company is set up.

### No magic bullet

The IRS audited 11% more returns in 2010 than in 2009, according to agency statistics. And with a growing federal deficit to plug, the government has hinted that taxpayers should expect more audit crackdowns this year. Even if you have nothing to hide, an audit can be an expensive process, draining valuable time and resources from your business.

There's no magic formula for keeping the IRS away from your door. But taking the right precautions should at least reduce your risk of getting stuck with an audit. And that increases the likelihood that you'll have more time to focus on what's important — running a successful construction company. ■

# Preparation is key for contractors seeking credit

**B**ank lines of credit are life-lines for many contractors.

But, as you may be all too aware, convincing a bank to provide or renegotiate a line of credit is no small feat in today's economy.

Although the financing market remains tight, it's still possible to prevail in a search for credit. By building your case beforehand and knowing all of the available options, you'll have a better shot at getting the dollars you need.

## **Crunch the numbers**

Before you set foot inside a bank, analyze your projected balance sheets and projected future earnings thoroughly. Many lenders are looking for increasingly sophisticated number crunching on the applicant's part, including up to 36 months of cash forecasting and financial contingency plans.

**When you approach a lender, be open about your financial situation, including any typically slow work and cash-flow periods.**

You'll also need to realistically assess how large of a line of credit you'll need. Lines of credit are meant to be a short-term cash solution while you're waiting for accounts receivable to come in, and being fully extended on your line of credit can make it harder to obtain



surety bonding. Plan to use the funds for basic operational items — not capital purchases, such as construction equipment.

## **Choose the right lender**

When choosing an institution for a line of credit, it pays to think like Goldilocks: not too big, not too small, but just right. Depending on your needs, you may fare better with a community bank, which typically prioritizes lending to small to midsize businesses. On the other hand, a national bank often has more funds to lend.

When you approach your chosen lender, be open about your financial situation, including any typically slow work and cash-flow periods. This will help your lender target the right credit solution for you, and you'll be able to learn about any impending personal guarantee issues.

## **Consider the alternatives**

If you're shut out of traditional lending altogether, alternatives are available. Many contractors

negotiate payment due dates with their vendors to get themselves out of short-term cash binds.

Other options include factoring, whereby a company buys your invoices and advances you a percentage of the invoice amount. There's also asset-based financing, whereby you pledge inventory or equipment as collateral for a loan. One caveat: The fees and interest rates in these

arrangements are typically higher than those in traditional lending.

#### **Tap into it**

While the flow of credit has slowed in recent years, savvy contractors can still tap into needed amounts under the right circumstances. Plan carefully and approach the marketplace with an open mind. ■

## Track your tools

### **Technology can help you stop the nickel-and-diming**

In an economy where cash flow is more important than ever and operational efficiency is critical, it can be easy to lose track of the little things. Literally. Losses of small tools, whether to carelessness or outright theft, can slowly but surely nickel-and-dime you into a disadvantageous financial position. Fortunately, technology offers a variety of tools for coping with this problem.

#### **Bar-code systems**

Think of tools as miniature assets that can be coded and tracked just as easily as a 17,000-pound backhoe. For example, electronic bar-code systems easily and efficiently label, coordinate, trace and catalog tools in real time. These systems usually involve, as you may have guessed, bar codes displayed on polyurethane labels on each tool. These labels are designed to hold up under repeated on-the-job wear and tear.

The systems also come with hand scanners, which project or equipment managers use to scan the bar codes when assigning tools and accepting returns. Tracking software sends the pertinent information to a database that you can also use for browsing, billing and running reports. In addition, the program records repair histories and maintenance schedules.

The cost of bar-code technology varies, depending on the number of features included in a given

system configuration. How complex a system you'll need will, of course, depend on the number of tools you're looking to track as well as the number of job sites you typically maintain.

#### **Reduced budget and liability risks**

This technology also improves management efficiency. How? You can let managers know



that, if the system doesn't show tools as coming back from job sites at completion, you'll charge the project for them. Thus, managers will more closely monitor and protect these items to avoid going overbudget.

Bar-code technology may also reduce your legal liability. Federal regulations often require workers to wear safety gear such as goggles, hard hats and respirators. And these systems enable you to show that you issued employees the proper equipment, which could in turn limit your accident liability.

### Accounting integration

To take a tool-tracking system to the next level, integrate it into your accounting system. Doing so can boost the value of your tool-related data and streamline procurement of these assets.

For instance, you might create a "live" (constantly updated) list of tool information, such as descriptions, warranties, purchase dates, costs and maintenance schedules. You can then generate a report of employees or job sites responsible for each of the small tools on the list.

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An integrated system may also enable you to assign tools by employee name, job code, project number, date, time, location or other criteria. This can give you some valuable insights into how that tool is being used and prevent it from being left lying around unused on a job site.

In turn, you'll foster an atmosphere of accountability by making managers and employees more responsible for these assets. There's no better way to drive home a point about wasted assets or money than to sit down with employees and show them, in dollars and cents, how a tool is being misused.



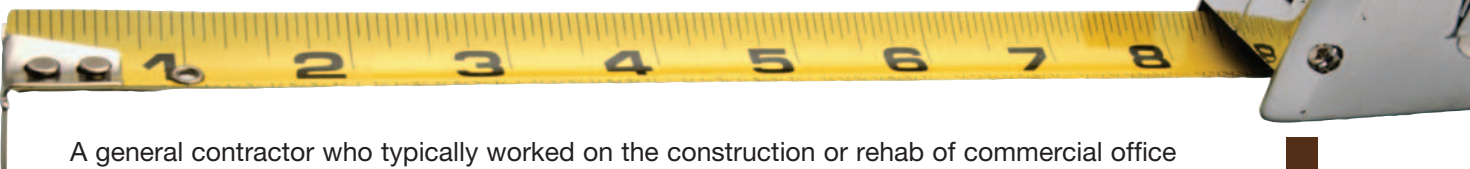
### More for you

If you're already using some type of tool-tracking software, but you're still struggling to track and leverage the use of these small assets, it's probably time for an upgrade. At the very least, undertake an intensive review of the system and its use to see what's going wrong.

And if you're still managing your tools the old-fashioned way, whether through paper checklists or the honor system, now is likely a good time to step up to a higher level of tool management. Although you'll need to invest some time and money upfront in choosing and implementing the right software — and training your staff on how to use it — the end result will probably be more nickels, dimes and dollars for you. ■

## Construction Success Story

### Contractor divides company into multiple entities



A general contractor who typically worked on the construction or rehab of commercial office buildings was interested in taking on some state and federal projects. But he knew such jobs could be tricky and worried about his company's lack of experience.

For some advice, he sat down with his financial advisor. Multiple business entities, the advisor suggested, could provide one way to safeguard his established company's reputation while offering potential legal and tax benefits as well.

#### **Breaking it up**

The advisor suggested that the contractor form a holding company that would own the major assets of his business, including construction equipment. The holding company would own two operating entities: one for the contractor's main operations and another for his new line of public projects. Both subsidiary companies would maintain minimum balances of working capital and equity, and the contractor would have full ownership of all three businesses.

Creating separate entities for the contractor's assets and operations meant that anyone who filed a claim related to the contractor's work couldn't access the bulk of his worth. The arrangement would also shield the contractor's main (commercial office building) operations from risks on any government projects.

In addition, the new structure could offer tax benefits. For example, if the contractor qualified for the manufacturers' deduction (also known as the domestic production activities deduction or the Section 199 deduction), he might be able to maximize the tax break by forming a separate entity to perform projects and claim the deduction.

#### **Minding the details**

Although the proposed entities would be closely related, the advisor emphasized that the contractor would need to operate each one independently.

If one business borrowed money from another, the loan would have to be documented. And when the company that held the assets leased construction equipment to the operating businesses, the rental would have to be at a fair market price. If the businesses weren't run separately, the advisor cautioned, it could create a legal issue that might result in the businesses having to combine.

In addition, Generally Accepted Accounting Principles (GAAP) require that, under certain circumstances, business owners consolidate so-called "variable interest entities" on their financial statements. The rules here are complex, so the financial advisor stressed that they would need to discuss this matter in greater detail at a later date.

#### **Taking the plunge**

Although splitting into multiple entities required considerable time and paperwork, the contractor took the plunge (with the help of his financial advisor and an attorney). Once the new entities were in place, he was able to start bidding on the government projects with a little less worry on his mind. ■

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- Succession and estate planning
- Financing assistance / growth management
- Project management and accounting systems
- Litigation and claims support

As specialists in the construction industry, Smith & Gesteland has developed the expertise needed to help contractors address and meet their many challenges. We would welcome the opportunity to help you build your success.

To find out what we can do for you, or for more information about the ideas presented in this newsletter, please contact John Folsom or Steve Pullara at (608) 836-7500 or [mail@sgcpa.com](mailto:mail@sgcpa.com). We look forward to talking with you.