

FALL 16

# ONSITE

CONSTRUCTION INDUSTRY PERSPECTIVES

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## DEFINING “REASONABLE” COMPENSATION

You probably assume as the owner of a construction firm that your compensation is nobody’s business but yours. However, since salaries and bonuses are deductible by the corporation, the IRS has an interest in the size of your annual compensation. And, if the service considers your compensation to be “unreasonable,” it may seek to reclassify the excess payment as a dividend. That’s not the best outcome, since dividends are generally nondeductible by the corporation and taxable to the recipient.

This process played out in a recent Tax Court\* case addressing the reasonableness of the compensation paid by a family-owned concrete contracting company to two brothers, who were also officers and substantial shareholders. Together, they received total compensation (including bonuses) of \$4,025,039 in 2003 and \$7,300,916 in 2004. In addition to deducting these payments, the company deducted a \$500,000 administration fee paid to a related company to ensure a reliable supply of concrete.

### THE IRS SAYS “NO”

The IRS argued both that the compensation was “unreasonable” and that the \$500,000 administration fee was not an “ordinary and necessary” business expense. The IRS therefore issued a notice of deficiency of \$877,440 and \$2,087,678 for 2003 and 2004, respectively. The company disputed the IRS’s notice of deficiency, and the case ended up in Tax Court.

The Tax Court applied a multifactor test to determine whether the compensation was “reasonable.” The court considered:

- ▶ the employees’ roles in the company
- ▶ the compensation paid by similar companies for similar services
- ▶ the character and condition of the company
- ▶ potential conflicts of interest — specifically, whether a hypothetical independent investor would receive a

reasonable return on equity after payment of the compensation

- ▶ the internal consistency of the compensation arrangement

“... the IRS has an interest in the size of your annual compensation.”

### THE COURT’S FINDINGS

The court ruled that the compensation paid to the brothers was reasonable. It noted that the brothers were integral to the company’s growth in revenues, assets, and gross profit margins leading up to and including 2003 and 2004. The return on equity that the corporation generated for each year after payment of the brothers’ compensation was in line with and closely approximated the return generated by the companies most comparable to it and therefore would have satisfied an independent investor. Additionally, the court found that the corporation consistently adhered to its officer bonus formula from its inception in 1991.

The court ruled also that the \$500,000 payment was an “ordinary and necessary” expense. It noted that it was normal and necessary for a concrete contractor to spend money to ensure a reliable supply of concrete at favorable prices during times of shortage.

\* *H.W. Johnson, Inc. v. Comm’r*, T.C. Memo 2016-95

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# NEW OVERTIME RULES

Contractors with office staff will likely be affected by a recently issued rule from the U.S. Department of Labor that increases the salary threshold under which most salaried workers are eligible for overtime pay when they work more than 40 hours a week. The new rule is expected to extend overtime protections to an additional 4.2 million employees and boost employee wages by \$12 billion over the next 10 years, according to the White House.

The new rule raises the threshold from \$23,660 annually (\$455 per week) to \$47,476 (\$913 per week). In addition, the new rule changes the total annual compensation level above which most white-collar workers will be ineligible for overtime. The highly compensated employee (HCE) salary level rises to \$134,004 from the current \$100,000. The rule will take effect on December 1, 2016.

“The new rule raises the threshold from \$23,660 annually (\$455 per week) to \$47,476 (\$913 per week).”

## OTHER DETAILS

The new rule will also:

- ▶ Automatically update the salary threshold every three years, beginning January 1, 2020. Each update will raise the standard threshold to the 40th percentile of full-time salaried workers in the lowest wage Census region, estimated to be \$51,168 in 2020. The HCE threshold will increase to the 90th percentile of full-time salaried workers nationally, estimated to be \$147,524 in 2020.
- ▶ Permit employers to count non-discretionary bonuses, incentive pay, or commissions toward as much as 10% of the salary threshold for non-HCE workers provided these payments are made on at least a quarterly basis.
- ▶ Retain the “duties test” that determines whether white-collar salaried workers earning more than the salary threshold are ineligible for overtime pay.

## WHAT YOU CAN DO

You have some flexibility in how you comply with the new rule. Permissible

methods of compliance include raising salaries of primarily executive, administrative, or professional workers to at least the new threshold, paying

overtime for hours worked in excess of 40 hours per week, or reducing overtime hours.

## PROS AND CONS OF RENTING EQUIPMENT

Careful management of equipment needs is critical if contractors are to remain profitable and competitive. Part of that process involves deciding whether to buy or rent construction equipment. Before making a decision, you may wish to consider the following factors.

### LOOK AT THE COSTS OF BUYING EQUIPMENT

The health of your cash flow should be a major consideration before you buy equipment. Since buying equipment involves dipping into your cash reserves or line of credit, you’ll want to analyze your company’s upcoming cash needs and financing options before committing to a purchase. You’ll also need to consider other costs of ownership, such as paying for maintenance and for storage space for your purchased equipment. It’s important to recognize also that many expensive pieces of construction equipment may sit idle for long periods between projects. Also, the value of construction-related equipment can depreciate quickly, and its trade-in or resale value can fall in tandem.

### WEIGH THE BENEFITS OF SHORT-TERM RENTALS

Renting particular pieces of equipment as they are needed for a specific job may make sense from

a financial and logistical perspective. With a rental, you do not have to make a large, up-front payment and erode your cash reserves. Since maintenance is included in the price of the rental, you won’t face the costs related to keeping the equipment in working order. Typically, the rental company will pay for needed repairs and replace the equipment if it breaks down. In addition, you won’t have to pay to store rental equipment nor will you incur any expenses transporting the equipment since it is usually delivered straight to your jobsites.

Renting gives you a degree of flexibility that you might not enjoy with a purchase. For example, you rent equipment only when you need it for a particular job. Moreover, renting may allow you to bid on a broader range of jobs because you are not limited by the equipment you own. And since you know up front the cost of renting a particular piece of equipment for a specific job, you can add some or all of the cost of the rental to your job quote.

# SUCCESSION PLANNING IS CRITICAL

As the owner of a construction firm, you have probably thought about retiring at some point and handing off the business to a family member or a partner or even selling out to another company. Whether you think about retirement a lot or a little, it makes sense to start planning for that eventuality now. And a key component of your planning has to be a succession plan.

A succession plan can help ensure that the business will continue to thrive after you are no longer involved in the company and will also help facilitate a smooth transition to the new leaders. From a financial perspective, it should also help maximize the value of the company and the financial legacy that is passed on to your heirs.

## THE GOALS OF A SUCCESSION PLAN

While no two situations are exactly alike, most well-designed succession plans should be crafted with these objectives in mind:

- ▶ Protect the company's value and ability to compete
- ▶ Minimize conflicts among family members
- ▶ Reduce gift and estate taxes
- ▶ Achieve the owner's retirement goals

## THE ELEMENTS OF A SUCCESSION PLAN

It is important to be proactive with your succession planning. It has to be a deliberative process carried out long before you intend to retire. Focus on these elements of succession planning:

**Establish a Value.** It's likely that the business accounts for the majority of your net worth and cash flow. However, if you don't know what your business is worth, it can be impossible to plan for your retirement and the transfer of your wealth. You will need professional assistance to establish a value for your business. In general, its value will consist of assets such as buildings, equipment, bank balances,

investments, and accounts receivable. Your company's value will also be represented by your expertise, relationships, and reputation.

Establishing a value can also help you to identify what factors are driving the growth of your business. The sooner you identify these value drivers, the more time you'll have to focus on them and help boost the long-term worth of your business. Determining your company's value can also help you plan for the most tax-efficient way to transfer wealth to your heirs.

## Prepare the Next Generation of Leaders.

If you want your business to prosper after you've retired, it's important to identify and prepare those individuals who will take leadership roles in your company early in the process. A formal succession plan can help attract and retain those individuals who have the skills and abilities to take your firm to the next level. If you intend for family members to eventually take control of your business, your succession plan will have to spell out specifically who you want to succeed you, their responsibilities, and what roles, if any, other family members will play in the business and its decision-making. Family business experts stress that regular, open communication with all family members is critical in this process.

**Have a Buy-sell Agreement.** A buy-sell agreement is a contract between the owners of a business — or between the owners and the business itself — that outlines what will happen to each

owner's interest in the business should an owner die, become disabled, or retire. A buy-sell agreement can ensure that your family or other beneficiaries will receive a fair price for your business interest. It can also help with an orderly transition and management of your firm, create a market for closely held stock, and establish the value of a business interest for federal estate tax purposes.

## WE CAN HELP

We would be happy to work with you and your attorney to develop an effective succession plan that will meet your goals for the future of your company.

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## DEVELOPMENTS IN TAX AND BUSINESS

### CONSTRUCTION SALARY SURVEY RESULTS

The *2015 Construction Craft Salary Survey* conducted by the National Center for Construction Education and Research found that project managers earned an average annual salary of \$88,675, while project supervisors earned \$77,917. Average annual salaries for commercial carpenters, commercial electricians, and masons were \$53,664, \$57,741, and \$54,860, respectively.

### DANGEROUS ROADS

Thirty-nine percent of highway contractors reported that motor vehicles crashed into their construction work

zones during the past year, according to a study conducted by the Associated General Contractors of America. The study further noted that 18% of work zone crashes injured workers on the site, and 6% of these crashes resulted in worker fatalities.

### DATES SET FOR IMPLEMENTATION OF FINAL SILICA RULE

The Occupational Safety and Health Administration has set June 23, 2017, as the day when covered employers must comply with the standards outlined in its final rule on occupational exposure to respirable crystalline silica. The rule

drops the permissible exposure limit from the existing 250 micrograms of respirable crystalline silica per cubic meter of air averaged over an eight-hour day to 50 micrograms.

### CAN WE SERVE YOU?

Our firm provides a broad range of accounting, auditing, tax, employee benefit, and management consulting services to contractors.

The general information provided in this publication is not intended to be nor should it be treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your particular situation.