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IRS offers truce in worker classification battle

Among the most long-standing battles between the IRS and employers is the classification of employees vs. independent contractors. On one side you have the agency, which where possible would prefer to view workers as bona fide employees because, at least in part, doing so simplifies tax collection. On the other side you have employers, which often engage independent contractors to ease administrative burdens, payroll taxes and benefits costs.

Although many people might think of the technology sector when it comes to these skirmishes, the construction industry is also a prime battleground. After all, subcontractors and consultants typically play key roles in many projects. The good news is that, last fall, the IRS offered what could be considered a truce in this continuing conflict.

Opposing interests

When you pay an independent contractor, you don't need to bother with payroll or income tax withholding. Nor do you need to remit the employer share of FICA or Medicare taxes. Unemployment and workers' compensation insurance, both of which represent a huge issue on construction jobs, also don't enter the picture. And independent contractors aren't entitled to the benefits employers provide to employees. For businesses, it's indeed a cost-effective arrangement under the right circumstances.

The IRS, however, believes that perhaps billions of dollars are lost annually to the practice because, even though independent contractors are subject to self-employment and income taxes, they tend to underreport their income.

Plus, they don't pay into unemployment and workers' compensation programs. So there's also pressure at the state level to address worker misclassification. After all, many states are struggling with massive budget shortfalls and need every dollar they can get.

Taxes, penalties and interest

So the battle is on. You engage a qualified person to handle a specific task (or set of tasks) without actually hiring that individual. And the IRS says you hired an employee. (See "3 major factors of worker classification" on page 3.)

Should the IRS prevail in such a confrontation, you may be liable for back taxes that you should have paid as well as payroll and income taxes that you should have withheld. The agency may assess interest and penalties, too.

The penalties in question often come into play when the IRS finds that an employer intentionally disregarded its tax obligations. Sometimes "responsible parties" — such as company officers, partners or managers — may even be held personally liable for uncollected taxes.

But keep in mind that, even if the misclassification was entirely unintentional, the IRS may assess penalties. And don't forget those state governments we mentioned; they may come swooping in as well.

A whitish flag

So about that truce we mentioned: It's called the Voluntary Classification Settlement Program (VCSP) and, as it originates from the IRS, we're not exactly talking about a full and unconditional surrender here. But, if you're concerned that a hefty bill for back taxes and penalties may be out there with your construction company's name on it, the VCSP is worth exploring.

Under the program, an organization that currently treats its workers (or a class or group of those workers) as independent contractors or other nonemployees may voluntarily reclassify the workers as employees, rather than independent contractors, for future tax periods.

To qualify, you must have consistently treated the workers as nonemployees and have filed the required Forms 1099 for the preceding three years. You cannot currently be under an audit by the IRS, the Department of Labor or a state governmental agency. (Additional eligibility requirements may apply.)

If you do qualify, your liability for past payroll obligations will be reduced to 10% of the employment tax liability that may have been due on compensation paid to the workers in question for the most recent tax year as determined under Section 3509 of the Internal Revenue Code.

3 major factors of worker classification

On what grounds might the IRS attempt to reclassify an independent contractor as an actual employee? Generally, the agency looks at three major factors:

1. Behavioral control. The IRS examines how, where and when a job task or tasks are accomplished. If you require a worker to perform the function on your job site or at your office at a set time and per your processes or by using your equipment, it may spell trouble.

2. Financial control. In short, employees typically get paid whether a company makes money or doesn't, whereas independent contractors are responsible for their own profits and losses. If a worker markets his or her services to others and incurs ongoing and nonreimbursable expenses (tools and equipment, for example), he or she is much less likely to be considered an employee by the IRS.

3. Nature of relationship. Consider closely the relationship you've established with anyone you consider an independent contractor. Do you have a current contract that defines the time frame, scope and desired results of his or her work? If not, and you've been paying the worker wages over a substantial period, the IRS could seek to define this individual as an employee.

But there are other factors to consider as well. For example, reclassifying independent contractors as employees could subject you to claims by the reclassified workers for past employee benefits they didn't receive.

Serious business

Worker classification is serious business in the construction industry. More than 2 million workers (about 20% of the industry) are considered independent contractors, according to the Coalition for Independent Contractor Freedom. Your financial advisor can help you determine whether you're on safe ground regarding your use of independent contractors and whether you should consider applying for the VCSP. ☒

Business valuations are for contractors, too

You may associate the term "business valuation" with the sale of a professional sports team or the unfortunate task of handling a deceased owner's affairs. But there are many reasons to work with your financial advisor and a qualified appraiser to estimate the current value of your construction company.

Asking why

Although it's true that contractors often decide to obtain a valuation because of an anticipated change in ownership, valuations also can be crucial in determining:

- How much you can borrow,
- Whether it's smart to make a bold strategic move, and
- If your estate plan needs updating.

Moreover, a valuation can help you understand the drivers that affect the value of your construction business. Many factors affect your company's value, such as bonding capacity, internal controls, leadership expertise, bidding success rates, stability of earnings and overall performance.

Your company may also have a distinctive level of specialization or skills that can boost its market value. For example, a contractor renowned for renovating historic buildings or one that has staff certified in green building might be worth more than one that doesn't have such talent.

Taking the right approach

Generally, appraisers use one or more of three primary approaches when conducting a business valuation.

First, there's the income approach. It's typically used when valuing small and midsize closely held businesses, typical of most construction companies. Value is based on projected future sales, earnings and cash flow.

One common valuation method used under the income approach is the capitalization of earnings (or cash flow) method, in which a valuator determines the capitalization rate (a rate of return required based on the risk associated with that business) and then divides earnings by that rate. Another income approach is the discounted earnings method, in which the valuator determines the present value of projected future earnings, and then divides it by an appropriate discount rate.

Second, there's the asset-based approach. It's generally used in conjunction with capital-intensive enterprises reporting weak earnings (or losses). Construction companies may fall into this category because of their heavy investment in equipment and their patterns of one-time projects. And niche contractors, such as excavators, are especially well suited to asset-based valuation.

In an asset-based valuation, the valuator adjusts assets and liabilities to their fair market value equivalents. The sum of a company's adjusted assets less its adjusted liabilities yields its fair market value.

Last, there's the market approach. It measures value using ratios or factors derived from the earnings, sales and assets of similar businesses. For reliable results, the companies must share certain characteristics and risk factors. An appraiser may consider public companies as guidelines and may use private transactional databases to find comparable companies.

Making the sale

If a sale of your construction company is in the offing, getting a business valuation now is particularly important. But it's not the only financial task that must be done. In addition, buyers generally want at least five years of financial statements, and you'll need time to determine how much you need to boost your earnings or cash flow if your goal is to raise the asking price.

Professionally prepared statements and supporting documents can make a better impression but, if you did them yourself, it won't be a deal-breaker. Whatever you do, don't try to hide anything. Prospective buyers will scrutinize your business in excruciating detail. If they learn you've not been completely forthcoming, they might walk.

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They'll also want to review legal paperwork such as vendor contracts, permits, leases and articles of incorporation. Make sure everything is current and in order. A little due diligence goes a long way toward impressing prospective buyers.

Getting it done

How often should contractors get a business valuation done? Ideally, once a year. But every two to three years may be more realistic. And, of course, in the event of a business sale or other major ownership change, the answer is "right away."

Protecting your construction company's mobile technology

Like many contractors, you may rely on mobile technology — laptops, tablets and smart phones — to generate estimates, review job plans and store important documents. This is valuable data that can easily fall into the hands of a thief or a competitor. Because of such dangers, you must ensure your company's mobile technology is protected.

Keep it safe

Often the simplest policies are the ones that get overlooked. Consider establishing a rule that anyone who carries a laptop must: a) keep the machine in his or her possession at all times, and b) store it in a locked location when not using it.

Next, establish and enforce rules regarding the length and complexity of your passwords — and how often they should be changed. Be sure passwords are used to access every laptop's desktop and consider using them for accessing important documents such as bids and payroll info.

If you've lost laptops or data because of poor password security, consider a fingerprint reader. These are relatively easy to install and make logging in much easier. Also, be sure your units feature full-disk encryption, which codes everything on the system drive (operating system, applications, data) so it's unreadable to unauthorized users.

Get it back

Unfortunately, even if you take all the steps mentioned above and more, a laptop may still get misplaced or stolen. To safeguard against such instances, consider purchasing laptop-tracking software — it's usually well worth the investment.

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These apps use Internet protocol addresses to pinpoint a stolen laptop's location as soon as the thief connects to the Internet; the app then sends you an e-mail alert. Examples include Flipcode Ltd.'s Hidden, ActiveTrak's GadgetTrak, Absolute Software's LoJack for Laptops, and Prey by Fork Ltd.

Some also offer GPS tracking in case the thief is savvy enough not to connect to the Internet. Additional features may include audible alarms, warning messages that notify thieves the unit is under surveillance, and disk "lock" and "wipe" functions that either secure your data or delete it entirely.

Last, assuming you don't lease your technology assets, imprint your construction company's name and phone number on each unit so, if an honest person finds it, he or she can return it. (If you do lease, record and track serial numbers carefully.)

Move ahead

For the purposes of this article, we focused mainly on laptops. But just about all of the tips discussed apply to tablets (such as the iPad®) and even smart phones (such as a BlackBerry® phone or an iPhone®). Make sure that, as your construction business moves ahead with its technology, it does so safely and securely.

The Contractor's Corner

Should we throw our hardhat into the disaster recovery ring?

I own a homebuilding company in an outlying suburban market. Over the past year or two, jobs have been hard to come by. We've also been hit by a number of severe storms that have damaged many homes and businesses. While driving past the clean-up sites, I can't help but think that our crews could be installing windows and clearing debris just as well as anyone. Should we throw our hardhat into the disaster recovery ring?

Disaster recovery jobs offer an enticing promise of work that not only brings in some additional revenue, but also helps out those struggling to return their lives to normal after a catastrophe. But making a formal move into this niche calls for some careful risk management.

Questions of practicality

First, look into just how practical the move would be. If the recent spate of storms was a relative rarity, you may not want to go through the time and expense of building your knowledge base in this area, creating procedures and policies for these projects, training your employees, and marketing your business.

Also consider the level of competition. Are there already dedicated disaster recovery contractors in your market? Again, think about whether the time, expense and energy required to win some of their market share would be worth your while.

Last, look at your workforce. Determine how much training your crews would need in order to work effectively in this niche. Consider how quickly they could mobilize as well. These projects, like the disasters that spur them, tend to develop overnight.

Money matters

There are, of course, financial considerations, too. First and foremost is cash flow. You may gain the opportunity to play a big role in one or more of these jobs. But that could mean expenses and labor costs that thin your ready supply of dollars to the breaking point.

Then there's the workers' comp conundrum. Your workers will, after all, be literally walking into a disaster area. The number and severity of safety hazards may be far beyond what they're accustomed to dealing with and that could mean costly claims for you. You'll need to check with your insurer regarding how your coverage may change for such projects.

Many things to consider

We hope this discussion of risk management hasn't scared you away from the notion of moving into the disaster recovery niche. It can be a lucrative or at least financially helpful line of work under the right circumstances. But, as you can see, there are many things to consider before tossing that hardhat.