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Gelman LLP
Certified Public Accountants
& Business Advisors

1 Park Plaza STE 950
Irvine, CA 92614
Phone 714-667-2600
Fax 714-667-2636
www.gelmanllp.com

Tax planning: C corporation owners may face IRS scrutiny

Construction is a high-risk industry. Many contractors convert their businesses to C corporations to avoid personal liability for financial claims against their companies. Although doing so makes sense from a risk management perspective, it can put construction business owners (shareholder-employees) in a precarious tax position regarding their compensation.

Crux of the issue

Generally, C corporations pay shareholder-employees some combination of compensation and dividends. They usually want to pay these parties more in compensation than in dividends because compensation is tax deductible, while dividends aren't. What's worse, dividends are subject to "double taxation" — that is, they're taxed once at the corporate level and again on the recipients' individual tax returns.

Enter the IRS. If it believes a C corporation is paying shareholder-employees "excessive" compensation, the agency may challenge the company's approach as providing dividends in disguise. Such challenges typically begin with an audit and can go as far as the U.S. Tax Court.

The issue of excessive compensation springs from Internal Revenue Code Section 162. It allows corporations to deduct only "a reasonable allowance for salaries or other compensation for personal services actually rendered." In other words, compensation must be based on work performed and not, for example, a shareholder-employee's percentage of ownership in the business.

If the IRS can prove that a shareholder-employee's compensation was excessive for the work performed, it may recharacterize all or part of it as dividends. This will likely result in higher taxes and could trigger penalties and interest for underpayment.

Reasonableness factors

Disputes over the proper characterization of compensation to C corporation shareholder-employees have led to much litigation over the years. The resulting case law identifies several factors relevant to evaluating whether compensation is reasonable and not excessive. These include:

The shareholder-employee's role. How important is the individual to the company? This factor includes the shareholder-employee's qualifications, expertise, hours worked and duties performed. It also considers whether the person handles multiple functions for a single salary and was substantially underpaid in the past — for instance, while the business was getting off the ground.

Compensation at comparable businesses. In an industry context, this factor would examine payments to owners of similar construction companies in similar executive positions. A court might look to benchmarking data, surveys, job listings or formal studies. This factor may not be relevant, though, if the shareholder-employee fills a unique role for which "comps" aren't available.

Business characteristics. The company's "size" in terms of sales, net income or value plays a role in the reasonableness determination. Is the business in good financial condition and growing steadily? How does it compare to similar construction companies? Strong operational performance can help justify an ostensibly excessive salary. General economic conditions and the complexities of the specific business are relevant, too.

Internal compensation consistency. Courts have looked for evidence of internal inconsistencies in how a company compensates employees, whether shareholders or not. For example, bonuses awarded to shareholder-employees that are inconsistent with an established compensation program may indicate excessive compensation. Courts will also likely question salaries paid to shareholder-employees that seem to be a function of ownership rather than management responsibility.

Conflicts of interest. This factor may come into play when the individual in question is the sole owner or controlling shareholder. For instance, providing large bonuses or distributions of all or most of a company's pretax earnings to a shareholder-employee, but not non-shareholder-employees (such as managers), may indicate an attempt to distribute income through excessive compensation.

Conflicts of interest have become such an important factor that they've given rise to the "independent investor" test. This test asks whether a hypothetical (nonemployee) investor would be satisfied with the return on equity after shareholder-employee compensation is paid. If the remaining return is unreasonably low, it suggests that some compensation may be excessive and represent a disguised, nondeductible dividend rather than reasonable pay for services rendered.

Help is available

If your construction business is structured as a C corporation, stay vigilant regarding the issue of excessive compensation. And if you're considering converting to a C corporation, assess the risk of IRS challenges in your due diligence. In either case, your CPA can help you design and maintain a compensation plan that's likely to withstand scrutiny. ■

S corporations: The other side of the compensation coin

Construction business owners who run C corporations must beware of paying themselves excessive compensation in the eyes of the IRS. (See main article.) Those who run S corporations face the other side of the coin.

Generally, S corporations pay shareholder-employees some combination of compensation and profit distributions. These business owners usually want to receive less compensation and more distributions because of the 15.3% federal payroll tax on compensation. IRS rules, however, require S corporations to pay shareholder-employees "reasonable" compensation for their services before allowing nonwage distributions.

To determine whether compensation for an S corporation shareholder-employee is reasonable, the IRS assesses the main source of the company's gross receipts, which may be:

- Shareholder-employee services,
- Non-shareholder-employee services, or
- Capital equipment.

To the degree that gross receipts come from the work of non-shareholder-employees and capital equipment, payments to a shareholder-employee are rightly characterized as nonwage distributions. These payments aren't subject to payroll tax.

However, if shareholder-employees are the primary driver of gross receipts, their payments will probably be classified as wages. The IRS also typically considers compensation for administrative work performed by a shareholder-employee to be wages.

How the OBBBA changes the depreciation game

Like most construction businesses, yours probably invests in physical assets regularly. These may include equipment, vehicles, and computing devices and software. If so, you've probably been keeping an eye on two key depreciation-related tax breaks: bonus depreciation and Section 179 expensing.

The good news is that both get a substantial boost from the One, Big, Beautiful Bill Act (OBBBA). And this could have a significant impact on your asset investment and year-end tax planning strategies.

Rocky landscape

Before the OBBBA, the tax landscape was set to become decidedly rockier for construction companies looking to make capital investments.

Let's start with bonus depreciation. It allows businesses to immediately deduct a percentage of the cost of eligible new or used property in the year the asset is placed in service. Doing so is usually preferable to spreading out smaller write-offs over several years under regular depreciation rules. However, under the Tax Cuts and Jobs Act (TCJA), the bonus depreciation deductible percentage — which was initially 100% — began to drop by 20 percentage points annually and was 40% for 2025. It was scheduled to vanish after 2026.

Then there's Sec. 179 expensing. This deduction allows you to expense the full cost of qualifying assets up to a dollar limit, also in the year they're placed into service. The limit begins to phase out dollar for dollar when asset acquisitions for the year exceed an annual threshold. These amounts were increasing modestly, as adjusted for inflation. The previously scheduled 2025 limit was $1.25 million with a phaseout threshold of $3.13 million.

Generous changes

The OBBBA brings generous changes to both tax breaks. First, it permanently restores 100% bonus depreciation, effective for assets purchased and placed in service after January 19, 2025. For assets acquired on January 19 or earlier but not placed in service until after that date, the pre-OBBBA depreciation percentages for the actual placed-in-service-year generally apply. For example, if an asset was purchased on January 10, 2025, and placed in service on February 10, 2025, 40% bonus depreciation would apply.

Second, the law raises the Sec. 179 expensing limit for 2025 to $2.5 million with a higher phaseout threshold of $4 million. (These amounts will be adjusted for inflation annually.) Compare those numbers to the previously scheduled ones under the TCJA.

Careful planning

Enhanced bonus depreciation and Sec. 179 expensing offer generous tax benefits under the right circumstances. However, taking advantage of them calls for careful planning. You don't want to rush out and buy a costly piece of equipment just for a tax break.

Then again, if you're ready to acquire an asset, bear in mind that eligible property must be purchased and put into service *before* year end if you want to claim the break on this year's tax return. Manufacturer backlogs or slow delivery times could upend your plans if you wait too long.

Much depends on your current financial position. For example, let's say you expect to finish a few big projects in 2025 and report a high amount of taxable income. In such a case, investing in pricey equipment before year end may help reduce your tax liability while supporting next year's operations.

Both tax breaks remain available to businesses that finance their purchases — as long as the assets in question are placed in service during the tax year. So, if you're buying expensive heavy-duty machinery or specialized tools, such as an excavator or wheel loader, you can still set up a payment plan to help you manage cash flow while claiming the full deduction.

Considerable impact

The OBBBA makes a considerable impact on more than just depreciation-related tax breaks. It contains many other provisions that will likely interest construction business owners and leadership. Examples include making the qualified business income deduction permanent, creating a 100% deduction for "qualified production property" (which may spur commercial projects) and eliminating tax credits related to clean energy. Work closely with your CPA to leverage the law to your advantage. ■

Exploring an ESOP for your construction business

Every company is a team effort, but construction businesses *really* depend on teamwork. Everyone must come together to win profitable jobs, complete them to the highest quality and quickly move on to the next project.

Construction company owners may electrify engagement and enhance their succession plans by implementing an employee stock ownership plan (ESOP). However, there are also potential risks to consider.

What's the big idea?

ESOPs are a type of qualified retirement plan, somewhat similar to a 401(k). But instead of investing mostly in mutual funds, an ESOP primarily invests in the employer-sponsor's stock.

Because of this, only businesses structured as C or S corporations can offer ESOPs.

To establish one, your construction company first sets up a trust. It then contributes ownership shares to the trust or uses cash to buy and contribute shares. Over time, the plan allocates shares to eligible participants, typically based on compensation level and years of service.

Why should we consider it?

Under the right circumstances, ESOPs offer several potential advantages. First, as noncontrolling owners of the business, participants tend to be much more motivated. After all, they literally have a stake in the company's long-term success. Engagement and productivity often improve as a result.

There are also tax advantages. Your construction business's contributions to the plan are generally tax deductible. Meanwhile, participants face no immediate tax on stock allocations and favorable tax treatment on distributions. Other tax benefits may be available depending on whether your company is structured as a C or S corporation.

An ESOP can help construction business owners with succession planning, too. It creates a built-in market for company shares, which can be highly beneficial in an industry where finding an outside buyer or passing ownership to a family member isn't always feasible. Plus, you and any other owners can gradually exit the business in a tax-advantaged manner while leaving the company in the hands of plan participants committed to its success.

And the risks?

ESOPs present certain risks — and these can be especially acute for construction businesses. First, the plan requires the employer-sponsor to buy back shares from departing employees under a process called a "repurchase obligation." Thus, strong cash flow is critical. Unfortunately, construction companies tend to struggle in this department because of seasonality, slow-paying owners and project delays.

You'll also need to deal with business valuations. ESOPs generally require an annual independent valuation of the employer-sponsor's stock. Because construction companies often report uneven revenue and face customer concentration risks, valuations can produce unpredictable results. Moreover, you'll have to commit time and resources to getting them performed.

Your construction business's contributions to the plan are generally tax deductible.

Finally, ESOPs come with a notable amount of administrative and regulatory complexity and costs. As mentioned, they're qualified plans, which means they're subject to the Employee Retirement Income Security Act. The IRS and U.S. Department of Labor will be watching closely.

Who can help?

An ESOP can be a powerful motivational and succession planning tool for a construction business in a suitable financial position with leadership committed to the concept. However, these plans are anything but "do-it-yourself." If interested, contact your CPA for help deciding whether an ESOP is right for your company. ■

5 essential social media practices for contractors

Social media has become a key component of virtually every business's marketing strategy, and that includes construction companies. However, establishing and maintaining an appropriate online presence isn't easy. Posting too often could become a distraction or even a liability. Doing too little can generate scant return on investment, if any at all. Here are five essential practices:

1. Focus on the right channels. As you're likely aware, there are many different options. The most popular include Facebook, Instagram, LinkedIn, YouTube and TikTok. There's even an app called Houzz that enables residential contractors to network with other like companies and prospective customers.

Don't spread yourself too thin by trying to post on them all. Choose two or three that are most likely to resonate with your target audience. For example, LinkedIn can be a good place for commercial construction businesses to do "B2B" networking. But if you're using social media mainly to recruit on-site workers, you probably won't find many of them on LinkedIn.

2. Set up a consistent posting schedule. Social media can eat up substantial time. Aim to generate an adequate number of posts, but not too many. Work with your leadership team, and perhaps a marketing consultant, to develop a coherent strategy for the types of content you'll share, as well as how often and when you'll post.

3. Show them who you are. Construction businesses should usually take a professional tone in marketing communications. However, you can showcase your company's human side on social media. You might post employee profiles and, as appropriate, give shout-outs to project owners or partners. Some contractors share "pro tips" about basic property maintenance and minor repairs.

4. Think (and post) visually. One advantage contractors have on social media is that construction is a visual industry. Many construction businesses post "before and after" photos of project deliverables (with the owner's permission). Video is particularly powerful. You could take a time-lapse video of a job from start to finish or film aerial footage using a drone.

5. Be an active participant. Social media is conversational. Follow industry leaders, influencers, trade associations and other relevant parties. "Like," share and comment positively on posts you find timely, reliable and of interest to your followers.

On the flip side, establish sound policies for responding to engagement. React to complaints or criticism carefully. It's generally best to resolve disputes privately. Avoid heated arguments and be prepared to block anyone you believe is acting in bad faith. On a more positive note, reply to questions quickly and show plenty of gratitude for compliments. ■

Gelman LLP
Certified Public Accountants
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1 Park Plaza STE 950
Irvine, CA 92614
Phone 714-667-2600
Fax 714-667-2636
www.gelmanllp.com

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