

CONTRACTOR

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Construction projects can involve many parties. If your company has engaged independent contractors, be they technology consultants, specialists in a given area of building or laborers, you need to exercise caution — the IRS is watching.

If it deems that you've misclassified a bona fide employee as an independent contractor, you could suffer a number of costly fates. Fortunately, there are ways to control your destiny and, if you do inadvertently fall afoul of the rules, potentially mitigate the damage.

Billions lost

The IRS believes that perhaps billions of dollars are lost to employee misclassification annually because, 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.

If the IRS does reclassify one of your independent contractors as an actual employee, you may be liable for back taxes that you should have paid.

State governments are increasingly taking on the matter as well. Some have created laws that impose even stricter penalties on companies that misclassify workers. In assessing your risk of employee misclassification, determine whether your home state, or any state in which your construction company operates, has specific laws addressing this issue.

3 primary categories

The IRS looks at three primary categories when determining whether a worker is properly classified. Here are those categories and some key questions to ask yourself about each:

- 1. Behavioral.** Does your construction company control what the individual in question does on a day-to-day basis, and did you train this person to perform tasks in a specific way?
- 2. Financial.** Does this individual work exclusively with your construction business, not marketing his or her services to others, and do you reimburse the person in question for tools and equipment?
- 3. Type of relationship.** Does the individual receive any type of benefits from your construction company (for instance, insurance or vacation pay), and is the relationship open-ended without a defined scope?

4 ways to avoid inadvertently misclassifying workers

1. Create a standard contract and check your wording. In consultation with your attorney, draft an agreement that defines your intention to establish an independent contractor relationship with the individual and states the terms of that relationship. Make sure to put a new agreement in place if you continue engaging the contractor after the initial agreement expires.

2. Keep job descriptions current. Job descriptions are often the first thing the Department of Labor and other government bodies will review if they audit your company for proper employee classification. Be sure these descriptions are clearly distinct from your independent contractor agreement.

3. Pay attention to the paper trail. Is your company complying with various tax reporting requirements for independent contractors, namely issuing 1099 forms? Are you also following federal and state tax and labor requirements for all employees? This includes issuing W-2 forms, filing Forms 940 and 941, and more.

4. Provide training. Everyone involved with hiring as well as directing the actions of workers needs to know the worker classification rules. Sometimes a construction company owner may properly engage an independent contractor, but a project manager on a job site may start directing the individual's work activities in violation of those rules.

If you answered “yes” to any or all of these questions, you may be in trouble. Or you may not be. The IRS doesn't provide a magic formula that fits every situation. Instead, it typically takes a broad overview of the entire relationship, reviews documentation and weighs various factors differently on a case-by-case basis.

If the IRS does reclassify one of your construction company's independent contractors as an actual employee, you may be liable for back taxes that you should have paid as well as payroll and income taxes that you should have withheld. In some cases, the agency levies interest and penalties on offenders as well.

Source of relief

If you've inadvertently misclassified an employee as an independent contractor, you may be able to mitigate the consequences. The IRS's Voluntary Classification Settlement Program (VCSP) allows eligible employers to obtain some relief from federal payroll taxes they may owe — as long as they're willing to treat reclassified workers as bona fide employees going forward.

Under the VCSP, you can change workers' statuses from independent contractors to employees for future tax periods and receive more attractive terms for back taxes owed. You also won't incur penalties or interest. To apply, you'll

need to complete Form 8952 and submit it 60 days before the desired date of “employee designation” (the date when you want the individual in question to be reclassified as an employee).

To be eligible, you must have consistently treated the workers in question as nonemployees, including filing all required 1099 forms for the previous three years. In addition, you cannot be currently under audit by the IRS, the Department of Labor or a state agency concerning worker classification.

Be advised that your payroll practices will come under scrutiny. You'll need to review payroll records dating back up to six years to ensure that everything is in order. And you should be prepared to verify that you have filed payroll deposits and tax returns on time. (For information on outsourcing your payroll administration, see “Construction Success Story” on page 7.)

Any concern whatsoever

In the construction industry, worker classification can be tricky. An independent contractor engaged for one job can move on to other jobs of yours, quickly blurring the line between non-employee and employee. If this topic touches off any concern whatsoever, work with your financial advisor and attorney to ascertain your risk and determine the best response. ■

Track costs, cut spending with fleet management software

Whether you have a fleet of five vehicles or 50, fuel costs and productivity levels can be tricky to manage. That's why many contractors are turning to fleet management software. This technology allows you to gather a variety of vehicle-related data, enabling you to track costs and cut spending in this often expensive area of a construction business.

Collecting data

Among the most popular features of fleet management software is its ability to track and organize vehicles in the field via global positioning system (GPS) technology. A centrally located dispatcher can use the application to send drivers to the closest appointments and create schedules that minimize fuel costs and maximize efficiency.

Most types of fleet management software also use GPS capabilities to direct drivers to job sites via turn-by-turn directions. Doing so can further cut fuel costs and reveal expensive habits such as unnecessary idling and speeding.

Proper maintenance is also critical for an effective construction fleet. To this end, the software sends reminders when vehicles hit maintenance milestones and records incidents that may accelerate repair needs. Such data can also help you decide whether to buy certain vehicles outright or lease them.

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Fighting fraud

In addition to cutting wasteful spending, GPS-enabled functionality can allow you to catch fraudsters in the act of taking and using company vehicles for personal purposes or making unauthorized fuel purchases.



What's more, letting employees know you've installed and are operating fleet management software can promote accountability and deter fraudulent vehicle usage and fuel spending. To prevent unauthorized use of the software itself, you may assign permissions that regulate which users are able to access different levels of the system.

Improving job costing

How much is each project phase really costing you?



That's a question you probably ask yourself all of the time. Fleet management software can help here, too, by integrating with your accounting system to give you a truer picture of how vehicle-related expenses are affecting job costs.

This information not only helps current projects, but also contributes to more accurate future bids and budgets. You can flag unexpected costs, extra hours and other factors that may affect an ongoing or prospective project's outcome.

Hitting the gas

Naturally, the right fleet management software package will require an upfront investment and come with a learning curve, the steepness of which will depend on your company's adaptability to new technology. But the benefits are there if you're willing to hit the gas. ■

Is the manufacturers' deduction a worthy construction project?

Some tax breaks are relatively easy to claim. The manufacturers' deduction — also known as the “Section 199 deduction” or “the domestic production activities deduction” — isn't always one of them. Like one of your construction projects, it calls for a solid foundation (of documentation) and an intricate infrastructure (of calculations). But the effort may be well worth it.

Putting in the work

Don't let the name fool you: Although it does indeed apply to manufacturing businesses, among the primary qualifying activities of the so-called manufacturers' deduction is “construction of real property performed in the United States” by a taxpayer “engaged in the active conduct of a construction trade or business.”

The deduction applies to domestic production gross receipts (DPGR) derived from constructing or erecting buildings or other real property, as well as from substantial renovations of real



property. There are various examples of qualified production activities that may lead to DPGR.

For instance, activities “typically performed by a general contractor,” such as management and oversight, periodic inspections and required job modifications, are generally eligible. So is the construction or installation of building components (HVAC systems, elevators and plumbing) and infrastructure (roads, power lines, wiring, water systems and sewers).

Certain land improvements that aren't capitalizable to the land (such as landscaping) may qualify. Other activities that physically transform the land (grading, demolition, clearing and excavating if performed in connection with building construction) may also fit the bill.

The construction or installation of building components (HVAC systems, elevators and plumbing) and infrastructure (roads, power lines, wiring, water systems and sewers) is generally eligible for the manufacturers' deduction.

If your construction company provides tangential services (such as hauling debris or delivering materials), you may be able to claim them — but only if you perform the services while constructing or substantially renovating the property in question. Yet another example is administrative support services (billing or secretarial services) incidental and necessary to construction activities in which you're engaged.

DPGR doesn't include receipts from the sale of land or tangible personal property, though receipts attributable to materials and supplies consumed in the construction process are included.

Crunching the numbers

In practice, the manufacturers' deduction calculation can be a bit complicated. So it's best to have your tax advisor do the math.

He or she must first determine your construction company's DPGR and then subtract expenses, losses and deductions (other than the manufacturers' deduction itself) that are properly allocable to DPGR to arrive at your qualified production activities income (QPAI). From there, your advisor will compare your QPAI to your taxable income for the year and multiply the lower of QPAI or taxable income by 9%.

The result is your tentative manufacturers' deduction. The deduction is limited to 50% of your QPAI-related W-2 wages for the year, so your tentative deduction will need to be reduced if it exceeds the wage threshold.

Construction businesses that rely heavily on independent contractors may be able to enhance their manufacturers' deduction by converting some of these workers into W-2 employees. (Of course, there are many other factors to consider before doing this, such as the cost of employment taxes and employee benefits for these workers. See "The IRS is watching: How contractors can cope with employee misclassification" on page 2 for more on independent contractors vs. employees.)

Refining the data

Allocating revenues, expenses and other items between construction activities and nonconstruction activities can be challenging. So, the regulations outline several allocation methods, including a simplified method for taxpayers with average annual gross receipts of \$100 million or less or total assets of \$10 million or less.

Under this method, you can allocate costs based on the percentage of your total receipts that qualify as DPGR. In addition, a "land safe harbor" allows you to use a formula to allocate gross receipts between land and real property other than land.



There's also a de minimis exception: If less than 5% of your total gross receipts from a construction project (excluding receipts allocated to land sales) are derived from nonconstruction activities, you can treat all of your gross receipts as DPGR from construction.

Establishing a process

As you can see, the manufacturers' deduction isn't exactly simple. But establishing a process for claiming this break now could lower your tax bill not only this year, but for many years to come. ■

Construction Success Story

Contractor considers sending payroll packing



A general contractor who specializes in multifamily housing units noticed he was spending a large amount of time on one thing: payroll. Although he had office staff to help him out, the contractor still found it to be time-consuming, complicated and tedious work.

During a recent industry event, a fellow construction company owner mentioned that she'd solved her payroll problems by outsourcing this function to a third-party payroll service. This sounded appealing to the contractor, so he contacted his financial advisor to discuss the idea further.

Quite a challenge

The financial advisor agreed that payroll for his or most any other construction company is challenging. Contractors often deal with multistate and local taxes, more-prevalent workers' compensation claims, work crews that vary in size and shifting pay rates. In addition, some workers don't receive a paycheck every two weeks because of project scarcity and down times. The uncertain economy has exacerbated this challenge in recent years for many construction businesses.

Key questions

The advisor stressed that any payroll service the contractor seriously considers must understand these nuances and, preferably, have experience working with contractors. A few key questions include:

- Is the service able to prepare certified payroll reports instantly?
- Does it know the applicable payroll laws and regulations in any state where the contractor might have jobs?
- Is it familiar with the reporting differences between union and nonunion workers?
- Can it compile job cost reporting? (Lack of ability to do so is often a deal-breaker.)

If the answer to any of these questions is "no," the contractor should probably move on. After all, the payroll service will assume the responsibility (though not the legal liability) for completing virtually all payroll-related paperwork and ensuring taxes are paid on time.

A good one will, therefore, help his construction company avoid tax and regulatory pitfalls and, in turn, the negative financial consequences that come with these threats. Finding a savvy, trustworthy partner with the latest technology is of the utmost importance. Last but not least, the contractor needs to compare the costs (including conditional fees) of several prospective services. He needs to further compare the cost of each to what he's currently paying his staff to handle payroll matters.

Tough call

After speaking with his financial advisor, the contractor admitted outsourcing his payroll was a tougher call than he'd anticipated. Ultimately, however, he decided to go for it. After a relatively lengthy bidding process and some minor implementation bumps, he's now enjoying some noticeable relief from the burdens of construction payroll. ■