CONTRACTOR

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Plus!
Construction Success Story
Contractor damps down deluge of app downloads

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2215 Olan Mills Drive | jhmcpa.com | 423.756.0052
Chattanooga, TN | 37421 | fax 423.267.5945

TAX BREAK: ACTIVATED

Don’t overlook the Section 199 deduction

It goes by many names. You might hear it called the “domestic production activities deduction” or the “manufacturer’s deduction” or, as we’ll call it, the “Section 199 deduction.” About 10 years ago, this provision of the Internal Revenue Code was adopted to encourage domestic job growth.

Like many contractors, you still may not fully realize that your company could qualify for the Sec. 199 deduction. And you should, because it could allow your construction business to deduct from its taxable income as much as 9% of taxable income derived from qualifying activities.

Determining eligibility

Although one of its names suggests the deduction applies only to manufacturing companies, it’s available to many types of businesses. Most apropos to our purposes, the Sec. 199 deduction can be claimed by businesses involved in the construction or renovation of residential, commercial and institutional buildings, as well as many infrastructure projects. It can also be used by companies that provide architectural and engineering services for construction work — including consultation, planning, design, evaluation and supervision.

> Once you’ve determined that your construction business is eligible, you need to track the income that serves as the basis for the deduction.

In all of these cases, the deduction applies only to “real property” construction projects performed in the United States. Real property doesn’t include

machinery unless it’s a structural component. For work on existing structures, the tax break’s rules distinguish between substantial renovation (which fits within the eligible category) and maintenance (which is ineligible). To qualify as substantial renovation, a project should materially increase the value of the property, substantially prolong its useful life, or adapt it to a new or different use.

Identifying your activities

Once you’ve determined that your construction business is eligible, you need to track the income that serves as the basis for the deduction. Sec. 199 refers to this figure as qualified production activities income (QPAI) and defines it as the taxpayer’s domestic production gross receipts (DPGR) less the sum of:

- The costs of goods sold that can be allocated to those receipts, and
- Other expenses, losses and deductions that can be allocated to those receipts.

Taxpayers have to determine whether receipts qualify on a reasonable item-by-item basis — not on another basis such as corporate division, product line or transaction. But de minimis rules allow you to treat total gross receipts as DPGR if less than 5% of your total gross receipts are non-DPGR.

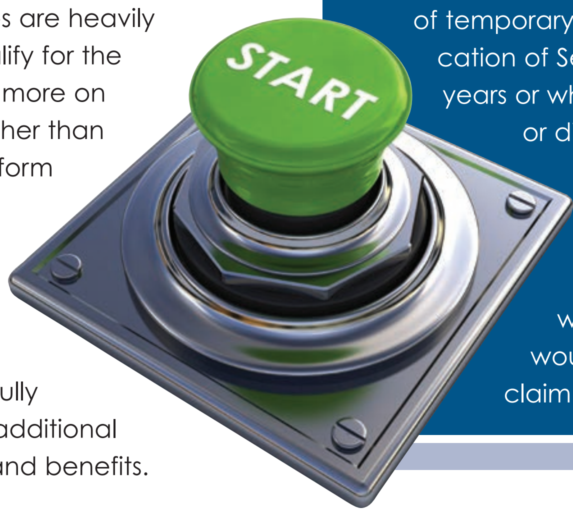
Calculating the deduction

In concept, once you know your DPGR and QPAI, calculating the Section 199 deduction appears relatively simple. In practice, however, you'll probably encounter some significant challenges in arriving at those numbers and then determining which limitations apply under the tax code. So it's a good idea to work closely with your tax advisor when attempting to claim the deduction. Together, you'll have to essentially follow four steps:

1. Determine your construction company's DPGR,
2. Subtract expenses, losses and deductions (other than the Sec. 199 deduction) that can properly be allocated to DPGR to arrive at your QPAI,
3. Compare your QPAI to your taxable income for the year, and
4. Multiply the lower of QPAI or taxable income by 9%.

The result will be your *tentative* Sec. 199 deduction. The maximum deduction you can actually take is limited to 50% of your QPAI-related W-2 wages for the year, so you may need to reduce the amount of the deduction if it exceeds the wage threshold.

Some construction businesses are heavily involved in projects that qualify for the Sec. 199 deduction, but rely more on independent contractors rather than bona fide employees to perform the work. If you're in this situation, converting some of these workers to employees could help you maximize the deduction. But you'll need to very carefully weigh doing so against the additional costs of employment taxes and benefits.



Justifying the effort

The Sec. 199 deduction entails meticulous recordkeeping and, as mentioned, some fairly complicated calculations. But, potentially, the tax savings could justify the time and effort involved. If you're unsure whether it's for you, some recent IRS regulations may help put the tax break in somewhat clearer perspective. (See "IRS issues regulations to clarify Section 199 requirements" below.) ■

IRS ISSUES REGULATIONS TO CLARIFY SECTION 199 REQUIREMENTS

In September 2015, the IRS proposed regulations to clarify various aspects of the Section 199 deduction, including how to determine domestic production gross receipts (DPGR). In large part, the new regulations address issues related to manufactured products, oil-related activities and film production. But certain provisions also address issues related to construction.

For example, the proposed regulations clarify that a taxpayer's construction activities must include more than the approval or authorization of payments for that taxpayer's activities to be considered those typically performed by a general contractor. The proposed regs also revise the definition of substantial renovation to include requirements on how renovation costs must be capitalized.

At the same time, the IRS issued another set of temporary regulations on the allocation of Sec. 199 wages in short tax years or where the taxpayer acquires or disposes of a major business unit during a tax year. If either of these situations might pertain to you, ask your tax advisor about whether and how the regs would affect your capacity to claim the deduction.

BUILD AN ADVISORY BOARD TO BENEFIT YOUR BUSINESS

Running a construction company entails a broad range of skills. You no doubt already bring many of these to the table as the boss. For others, you probably rely on capable employees or engage professional advisors. There is, however, another source of leadership assistance that many business owners draw on: an advisory board made up of outside experts. Here's how to get started.

The right people

When forming an *outside* advisory board, you need to first look *internally*. That is, consider your own leadership strengths and weaknesses to help you determine what you most need from the board.

For example, many contractors struggle with getting out the word about their companies. Adding someone with marketing expertise could help you differentiate your business from the competition. Or maybe you need help separating the signal from the noise when it comes to technology. You might look for an IT expert who would enjoy the challenge of assessing the latest construction hardware and software.

Above all, you want advisors who'll tell you the truth as they see it — even if you might initially disagree. At the same time, you want trustworthy advisors you can work with comfortably. Think twice before calling on close friends or family members. Invite them to serve only if you're sure your relationship can withstand honest disagreements.

Ground rules

It's a good idea to start small, with a group of three to five advisors. Once you've identified an adequate number of candidates, spend some time with each to gauge their interest and commitment.

Ask them to commit to a specified term of service, so that you both can reassess participation at regular intervals. In addition, request that members sign nondisclosure agreements, as you'll likely be sharing confidential information about your current projects, backlog, strategic plans, intellectual property and even trade secrets. Last, spell out the duties and responsibilities you want advisors to fulfill, so expectations are clear.

Best practices

When the board is up and running, respect everyone's time and attention. Set up a reasonable meeting schedule: maybe bimonthly to start and less frequently once the board is well established. Be prepared to compensate your advisors by covering travel costs, if necessary, and providing snacks or meals and beverages. In some cases, you may need to pay a small stipend for their service.

Before each meeting, email members an agenda and any useful briefing materials to help them prepare. Run the session itself as you would any professional meeting, following it up with an action plan on the items discussed. When meeting in person isn't practical, hold a conference call or Web-based meeting. For continuity's sake, it's important to gather regularly.

Between meetings, keep members informed of pertinent company developments. Also feel free to communicate with advisors individually on issues specifically related to each one's field of expertise. Finally, remember that it's your prerogative to immediately fire an ineffective or disruptive board member.

Time and resources

A well-built advisory board can help contractors solve problems, explore opportunities and minimize risk. But, should you decide to assemble one, make sure you're ready to dedicate the time and resources to form it and meaningfully participate in its activities. ■

CRACKING DOWN ON PROJECT FRAUD

Going into a job, every contractor's objective should be to arrange everything to maximize the chances of turning a healthy profit. But the sad fact is that you can do that and still lose money if just one unscrupulous employee commits fraud. And you can probably imagine the damage of multiple parties conspiring to defraud you.

For this reason, you've got to stay cognizant and proactive about how construction project fraud can happen. Let's review some of the most common points of vulnerability.

Know what everyone's up to

Historically, the construction industry's reputation has struggled because of the prevalence of fraud schemes involving kickbacks and bid rigging. These schemes, which are hardly extinct, usually involve payments to employees to secure a bid or, later in the process, get a change order approved.

> Cross-check your employees' respective home addresses with those of subcontractors, vendors and co-workers.

If your company is suddenly winning bids that you've typically had trouble securing, make sure this success isn't too good to be true. Verify that all of your usual bid processes have been followed and the appropriate documentation is present.

Remember that kickbacks and bid-rig payouts don't always involve cash. As mentioned, a corrupt employee might be disguising them as change orders. So limit the number of staff members authorized to approve change orders and, if possible, validate each one yourself. Specifically, check to make sure the costs of a given change order weren't included in the original bid, so you don't pay multiple times for the same item.

Beyond that, be afraid of ghosts. It's not unusual for a construction company employee to create a ghost employee whose paycheck is directed to an address or bank account where the fraudster can get to it. An employee could also "punch in" his pal on the time clock when the friend isn't there to do it himself.

Scrutinize vendor payouts

As materials move from storage locations to projects, bad things can happen. For example, a dishonest employee may order more materials than are necessary for the project. He or she can then report the excess as scrap and sell it — or use it on another, "privately arranged" job. An employee also might steal equipment or report it as broken and then sell it or use it personally.

Another common scheme is for an employee to make duplicate payments to a legitimate supplier for a legitimate invoice related to the project. One check goes to the supplier, but the employee cashes the other check. Sometimes the employee is in collusion with the supplier and they share the duplicate payment. Require several levels of verification to set up a new vendor.

Do your office work

The job site may seem like a natural place to catch project-related fraud. But your office may actually be the better setting for establishing your defenses.

For starters, gather your financial statements and sit down with your CPA to reconcile items such as estimated vs. actual costs for labor, materials and equipment. Consider both the number of hours on the job and the unit rates applied to those hours. Your accountant also can perform regular reconciliations of material requisitions and deliveries, tying them to the estimate for the job and investigating any significant differences.

Next, meet with your HR staff or advisor to perhaps recast some of your job descriptions. For instance,

ensure accounting-related duties are properly segregated. Different individuals should be charged with reviewing invoices and issuing payments. Ordering, receiving, delivery and payment duties also should be segregated.

Additionally, run regular background checks on subcontractors, suppliers and others involved in your project. Beware of any personal relationships between employees and subcontractors or suppliers. Cross-check your employees' respective home addresses with those of subcontractors, vendors and co-workers.

Take a positive approach

Above all, create a construction company culture that not only conveys zero tolerance for unethical behavior, but also promotes principled business practices. Although punitive measures are important, so are positive actions demonstrating good behavior. ■

CONTRACTOR DAMPS DOWN DELUGE OF APP DOWNLOADS

Like many contractors, the owner of a growing suburban homebuilding company wanted to take advantage of the many mobile construction apps now available for smartphones, tablets and laptops. Trouble was, she couldn't tell which ones were worth downloading and which ones were just cluttering up her employees' devices while nickel-and-diming her technology budget. So she asked her financial advisor a simple question: "How do I choose the right apps?"

The advisor replied that it isn't so much the cost of the apps that's the problem. Rather, a deluge of different app downloads can create confusion, cause delays and errors, and inhibit the smooth integration of data into her accounting and project management systems.

Picking the categories

The solution, the advisor suggested, was to create a list of preferred apps in various categories for her employees to download only as needed. Examples include:

Labor-tracking apps. These typically use GPS capabilities to let project managers know that crew members are where they're supposed to be. The apps can automatically log employee work hours to specific job names or numbers, so workers don't need to fill out time cards and managers don't have to review them. (Examples: Labor Sync and ClockShark.)

Drafting apps. A variety of apps allow users to view, edit and share building drawings directly from their mobile devices. This technology can eliminate the need to bring printed copies into the field and allow easier commenting and revisions. (Examples: AutoCAD 360 and FingerCAD HD.)

Specialized tool apps and calculators. Field personnel need to quickly measure surfaces and solve tough construction-math problems. These apps turn a mobile device into a virtual hand tool, saving time and space. (Examples: Construction Master Pro, HandyMan Sidekick, QuadLevel and iHandy Carpenter.)

Creating and updating the list

It will take some upfront time and effort, the advisor warned, to compile her preferred app list. He urged the contractor to seek input from her staff and perhaps network with other contractors about their most beloved and despised apps.

A particularly tech-savvy staff member can champion the task of initially compiling the list, which also might be a great opportunity to create an internship. Once created, the list will need to be reviewed and updated regularly.

Standardizing your approach

Ultimately, this contractor followed her financial advisor's suggestions. She and her office manager curated a list of preferred apps, which they then presented with an explanation to staff. Ever since, her construction company has saved both time and money with a more standardized approach to its technology. ■

JHM KNOWS THE CONSTRUCTION INDUSTRY – FROM THE GROUND UP

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- and other special consultations
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