# Construction
## Industry Advisor

Fall 2013

# Year end tax strategies for contractors

As 2013 winds down, it's time to think about year end tax planning. Planning is particularly important this year because 1) individual income tax rates are higher, 2) several tax breaks are scheduled to expire at the end of this year, and 3) new taxes, especially the 3.8% Medicare surtax on net investment income, require special attention.

With those items in mind, here are several strategies for lowering your tax bill and boosting your cash flow.

## Mind your tax rate

As always, a good place to start is by projecting your income and estimating your tax liability for this year and next year. Many construction businesses are structured as pass-through entities, such as S corporations, partnerships or LLCs, which means owners pay tax at individual income tax rates on their shares of the company's income.

Starting in 2013, the top individual rate is 39.6% for single filers with income over $400,000 and joint filers with income over $450,000. The top tax rate for long-term capital gains and qualified dividends is now 20% (up from 15%) for taxpayers in the 39.6% bracket.

Typically, deferring income to next year and accelerating deductions into this year is an effective way to reduce your tax burden. But if you anticipate a *higher* marginal rate next year, it may make sense to reverse this approach.

If your company is structured as a pass-through entity, you may want to consider converting it to a C corporation. (See "Should you convert to a C corporation?" on page 3.)

## Take advantage of expiring tax breaks

The American Taxpayer Relief Act of 2012 (ATRA) extended several valuable tax credits and deductions through the end of 2013. There's no guarantee that Congress will extend these tax breaks after they expire, so it's a good idea to make the most of them *now*. They include:

**Section 179 expensing.** If you need equipment, machinery, vehicles or other qualifying assets, acquiring them this year may generate significant tax deductions. Enhanced Sec. 179 expensing limits allow you to deduct (rather than depreciate) up to $500,000 in qualified purchases (up to $250,000 in qualified real property) of new or used assets this year. The deduction begins to phase out once your total investment in qualified assets tops $2 million.

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Unless Congress changes the law, the Sec. 179 limit will drop to a measly $25,000 in 2014, with an investment limit of $200,000.

**Bonus depreciation.** ATRA extended 50% bonus depreciation through 2013, for *new* equipment or other assets with a recovery period of 20 years or less. This provision allows you to immediately deduct up to 50% of qualified asset costs in the first year. And, unlike regular depreciation, construction companies that use the percentage-of-completion method of accounting can take advantage of bonus depreciation even for certain qualified assets used on projects that won't be completed this year.

**Deduction for energy-efficient public projects.** Construction businesses involved in the *design* of energy-efficient, publicly funded projects may qualify for deductions up to $1.80 per square foot. This deduction is scheduled to expire at the end of 2013, but lawmakers have proposed making it permanent and increasing the limit to as high as $3.00 per square foot.

Other expiring tax breaks include the research tax credit, the Work Opportunity Tax Credit, Empowerment Zone tax incentives, and the energy-efficient tax credit for new homes.

## Don't overlook the DPAD

Find out whether you qualify for the Domestic Production Activities Deduction (DPAD). The DPAD allows you to deduct up to 9% of the lesser of your income from "qualified production activities" or taxable income. These include many activities associated with constructing or substantially renovating U.S. real property.

## Plan for the Medicare surtax

Starting this year, taxpayers whose modified adjusted gross income (MAGI) exceeds $200,000 ($250,000 for joint filers) are subject to a 3.8% Medicare tax on the lesser of 1) their net investment income or 2) the amount by which their MAGI exceeds the threshold. This net investment income tax (NIIT) includes dividends, taxable interest and capital gains (less allocable expenses). It also includes passive income, such as income from rental activities that don't constitute a "trade or business."

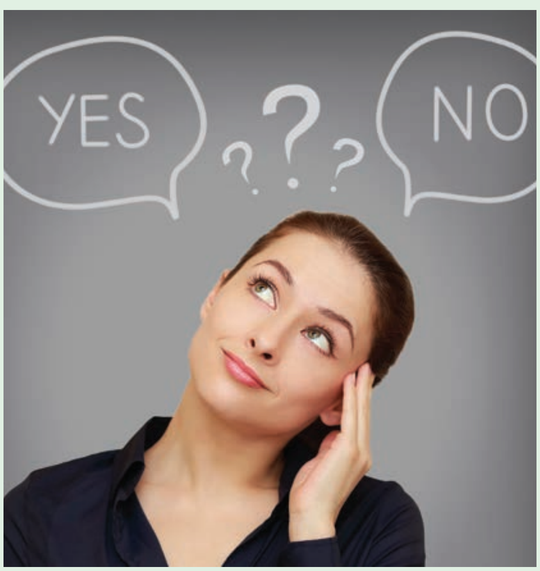
If you're subject to the NIIT, consider strategies for minimizing or eliminating it. For example, you might defer income to bring your MAGI below the threshold or reduce your NIIT by selling investments at a loss to offset any gains.

Also consider the impact of the NIIT on any rental properties you own, particularly if you rent property to your construction business through a related entity. There may be opportunities to restructure your rental activities to avoid the 3.8% tax.


## Review your situation

To begin the year end tax planning process, sit down with your tax advisors to review your current tax structure and project your income for 2013 and 2014. Doing so will help you identify potential tax-saving opportunities.

## Should you convert to a C corporation?




At 35%, the corporate tax rate is lower than the top individual rate. For some construction companies, converting to a C corporation may reduce their tax bills.

But keep in mind that C corporations are subject to "double taxation." If you distribute earnings to shareholders or sell the company's assets, the income is taxed twice: once at the corporate level and again when it's received by the shareholders. The maximum combined corporate and individual tax rate on earnings distributed to shareholders is more than 50%.

In light of double taxation, pass-through entities continue to provide a tax advantage over C corporations in most cases. However, a C corporation structure may be beneficial for companies that retain their net earnings and reinvest them in the business.

# Is employee fraud hurting your bottom line?

The average business loses 5% of its annual revenues to occupational fraud, according to estimates by participants in an Association of Certified Fraud Examiners (ACFE) survey. But for the construction industry, losses pertaining to jobsites, plant sites and job management are more common than accounting and financial fraud.

And while you may think you're losing the battle against fraud and theft, there are ways you can beef up your controls to fight back against fraudsters.

## Enforce the rules

Add a chapter to your employee manual describing your company's policies on employee theft and fraud. Be specific, too. If a worker were to steal company office or construction supplies for personal use, spell out the consequences. The most commonly stolen items besides labor are cash, fuel, minor parts (such as batteries, oil filters, tires) and construction materials (such as lumber, copper and steel).

Make sure your policy also explains that all violators will be terminated and prosecuted, if the crime deserves it. In addition, inform employees that they need to be aware of what is going on around them and to alert a supervisor if they believe foul play is going on.

## Establish a hotline

Telling employees to report any wrongdoing is one thing. But you also need to protect those who do. Provide a confidential mechanism, such as a toll-free hotline, through which a worker can communicate concerns or "blow the whistle" on perpetrators. Taking this step increases the likelihood that fraud will be exposed before it seriously harms your company.

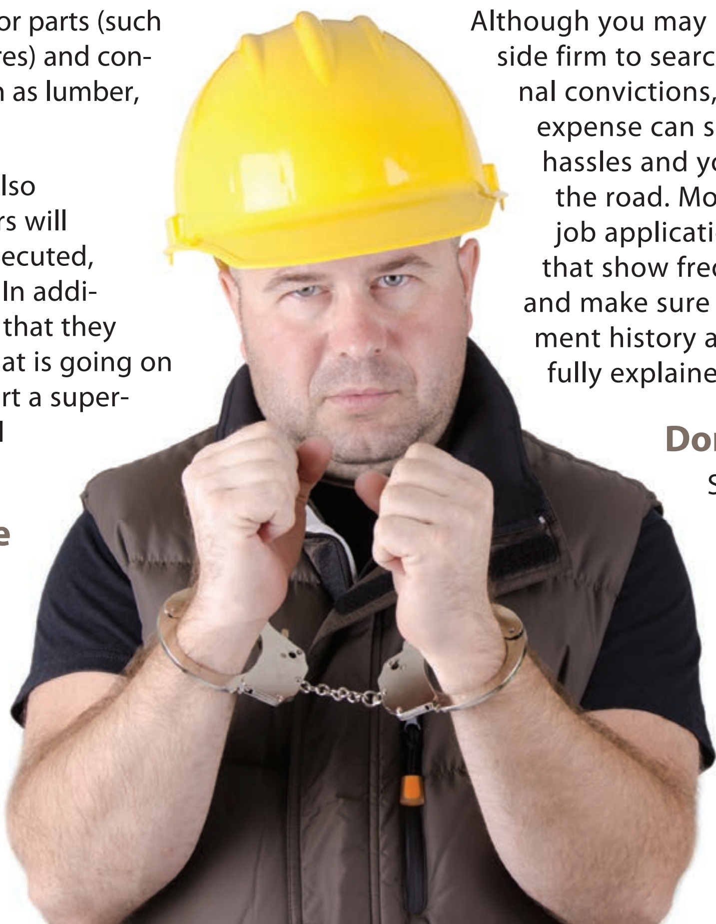
## Weed out the crooks

The best way to prevent fraud and theft is to pinpoint the wrongdoers *before* they start working for you. So, make sure you conduct thorough background checks on prospective candidates — even those who come highly recommended from a trusted source. The most common behavioral red flag among fraudsters is that they live beyond their means. Other indicators include gambling, drinking and drug issues. Consider the advantages of individual fidelity bonding for certain classes of employees as opposed to blanket bonding.

Although you may need to hire an outside firm to search for previous criminal convictions, this extra up-front expense can save you money, hassles and your reputation down the road. Moreover, be wary of job applications and resumés that show frequent job changes, and make sure any gaps in employment history are reasonable and fully explained.

## Don't invite fraud

Smaller contractors may rely on one or two employees to handle several critical duties. For example, one person may be responsible for both accounts receivable and accounts payable.



However, personnel responsible for billing and receivable functions should never come into contact with receipts or deposits.

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To make it harder for workers to dip into the till, divide accounting and finance-related responsibilities among several employees. For example, have someone independent of the purchasing or vendor payment functions review all new supplier entries.

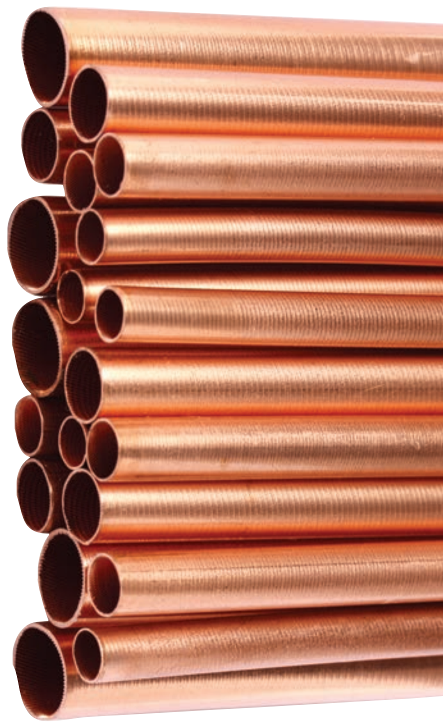
### Do random audits

Your CPA is a good resource for uncovering fraud and embezzlement. For example, he or she can make random, unannounced audits to help identify potentially dangerous gaps in your controls and procedures. A CPA can also help create an effective internal control environment and monitor bookkeeping records, invoices, bank statements, payments, journal entries, financial reports and other documents with an eye toward identifying red flags.

### Be on the up and up

It's important to be a good example to your employees. Don't fall into traps such as failing to report income, padding expense accounts or taking home office supplies for your kids.

If workers see such behavior at top levels, they may develop a sense of entitlement that could lead them down the slippery slope to occupational fraud.



Rather, promote an honest, positive work environment. Encourage employees to be ethical and to act in the best interests of the company.

### Fight to the end

Fraud is likely here to stay. But that doesn't mean you have to tolerate it in your construction business. By implementing the steps noted above, you'll have a fighting chance to combat thieves. If you'd like to learn more about how to tackle internal fraud, contact your CPA. ■

# Goodwill matters when valuing a construction business

For many construction companies, a significant portion of their value consists of goodwill, both business and personal. And the type of goodwill can have a big impact on the value derived from a sale of the business.

### Goodwill defined

The *International Glossary of Business Valuation Terms* defines goodwill as an "intangible asset arising as a result of name, reputation, customer


loyalty, location, products and similar factors not separately identified."

Often, goodwill value is expressed as the excess of a business's total fair market value over the fair market value of its net tangible assets and specifically identifiable intangible assets, such as patents or trademarks.

## Personal vs. business goodwill

Goodwill can be broken down into two components: personal and business. Personal goodwill is associated with an individual owner's education, experience, skills, reputation and relationships. Business goodwill, on the other hand, is attributable to the company's ability to attract business apart from any specific owner. It's derived from characteristics such as a construction business's name, reputation, location, workforce, technology and work quality.

## Why it matters

The distinction between personal and business goodwill can be critical in the context of a business sale. C corporations that sell their assets are subject to double taxation on the proceeds (once at the corporate level and again when the proceeds are distributed to shareholders). S corporations that began as C corporations are also subject to double taxation on built-in gains — unrealized appreciation on assets owned at the time of the conversion — if those assets, sold in 2013, are sold within the recognition period of five years after electing S status. However, this temporary reduction in the recognition period will revert to 10 years beginning in 2014 as the temporary provision expires.

Whether your construction business is a C corporation or an S corporation with built-in gains tax exposure, the impact of double taxation is reduced to the extent the company's value is attributable to personal goodwill. Why? Because personal goodwill is considered the property of the individual owners, not the company, so it escapes taxation at the corporate level.

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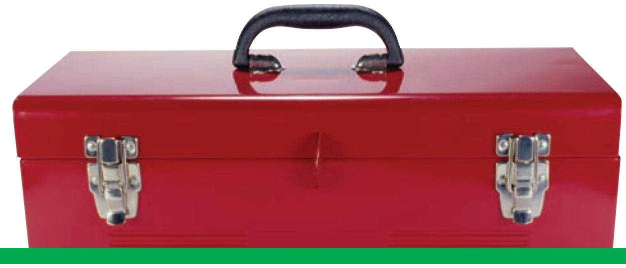
The value attributable to personal goodwill varies from company to company. Generally, the more a business relies on its owners' talents, knowledge, reputation and relationships, the greater the value of personal goodwill. Keep in mind that, if owners sign employment or noncompete agreements, they may be deemed to have transferred their personal goodwill to the company, exposing it to corporate tax.

## Setting your price

If you're thinking about selling your construction business, ask your advisors to estimate the value of personal goodwill. Knowing the amount allocable to personal goodwill will give you a better idea of the tax cost of a sale, making it easier to set a fair price. ■



# Tablets on the jobsite? Do your homework first

Contractors, superintendents, project managers and other employees often use tablet computers at jobsites or on the road. Tablets not only offer portability, but they also provide some advantages over laptops, such as touch screens that allow users to zoom in and out when viewing shop drawings, specifications or other construction documents.

Tablets can be used to track time and materials; connect to the company's estimating, bidding and project management systems; and view and share AutoCAD drawings, among other tasks. They can also be used to hold videoconferences and share real-time jobsite information with others.

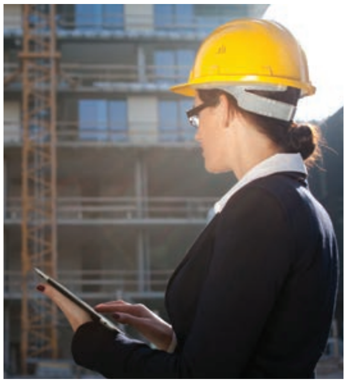
But, before you buy tablets for your employees — or allow them to use their own — make sure the devices meet your needs. Here are three questions to ask:

## 1. Should we use consumer tablets or industry-specific devices?

Consumer tablets, such as the Apple iPad® and the Samsung Galaxy Tab®, are fairly inexpensive. But specialized tablets offer certain advantages, such as tougher construction to withstand drops and extreme weather conditions, antiglare screens that can be viewed in bright sunlight, and longer battery life. Some even have built-in barcode, fingerprint or radio frequency identification (RFID) readers.

## 2. Will tablets work with our existing systems?

Tablets are ideal for cloud-based systems that run software via a Web browser. Systems that aren't designed for the cloud — even if they're "hosted" in the cloud — may have specific hardware or software requirements that are incompatible with tablets or other mobile devices.



## 3. Should we allow employees to use their personal tablets?

It's easy to enable employees to connect to your company's intranet or other resources on their own tablets or smartphones. If you go this route, however, develop a bring-your-own-device (BYOD) policy to address acceptable use and security concerns. The policy should:

- Define *how* and *where* devices may or may not be used on company time,
- Consider acceptable-use policies as they relate to personal tablets,
- Provide a list of approved devices and operating systems,
- Require employees to password-protect their devices and implement other security measures,
- Give the company the right to use mobile device management software to monitor usage and remotely lock, disable or erase a device that's lost or stolen,
- Specify whether and how the company will reimburse employees for usage fees, and
- Set forth the parties' relative liability for any loss of data.

With proper planning, tablets can be powerful tools for enhancing productivity, efficiency and customer satisfaction.