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Fall 2013

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Year end tax planning

Getting all you can from equipment purchases

You read it every year end. As the months wind down, construction company owners are reminded to consider buying new equipment sooner rather than later so they can take advantage of the current depreciation-related tax rules.

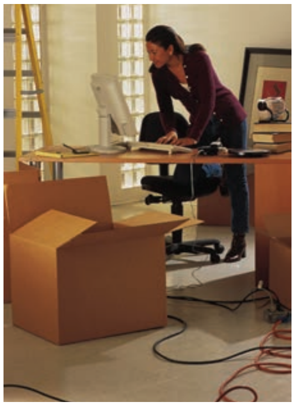
Well, guess what? This year is no different. The American Taxpayer Relief Act didn't just keep us from tumbling over the "fiscal cliff" — it temporarily extended the two primary depreciation breaks. But time is running out to claim both in their existing, high-value formats.

Bag the bonus

Let's start with 50% "bonus" depreciation. If you buy and place into service qualified *new* assets for your construction business before Dec. 31, 2013, the special depreciation amount you can deduct is equal to 50% of the assets' adjusted basis. And there is no monetary limit on the amount of equipment that businesses may purchase.

Assets that qualify for 50% bonus depreciation include tangible personal property, such as passenger-type business vehicles (limited to $25,000 per vehicle) with a gross vehicle weight of more than 6,000 pounds, computers and office machinery, manufacturing and production equipment, and unmodified consumer computer software. (No limitation applies to passenger-type business vehicles weighing more than 14,000 pounds.)

Bear in mind that, to be eligible, tangible assets must also have a modified accelerated cost recovery system (MACRS) recovery period of 20 years or less. (Under MACRS, qualified assets are divided into classes that dictate the number of years over which an asset's cost can be recovered.)



Take the break

The other prime tax break extended in its more valuable form is the Section 179 small-business expensing limit. The expensing limit on qualifying *new and used* assets bought and placed in service in calendar 2013 is a noteworthy $500,000. Qualified assets include tangible personal property, off-the-shelf computer software, and certain other costs.

This tax break begins to phase out dollar-for-dollar when your construction company's total asset acquisitions for the tax year exceed $2 million. Also note that you may claim the Sec. 179 election only to offset net income, not to reduce it below zero to create a net operating loss.

Claim them both

What's better than claiming either the 50% bonus depreciation break or the Sec. 179 expensing deduction? Claiming them both.

You may be able to combine the two by filing one form: IRS Form 4562. It allows for varying recovery periods and categorizes assets according to when you placed them in service during the year. The half-year convention, which treats your property as though it had been put into use halfway through the year, is applied to most depreciable property.

For example, if your construction firm spends $800,000 on a new piece of heavy equipment in 2013, you can expense $500,000 under Sec. 179, resulting in a depreciable base of $300,000. Then, by applying the bonus depreciation, you're eligible to deduct 50% of the depreciable basis, or $150,000, leaving you with only $150,000 of that purchase to depreciate.

On top of that, you can deduct standard first-year depreciation. In this case, that would be 20% for property with a five-year recovery period (using the half-year convention), or $30,000. This leaves you with an even lower $120,000 to depreciate over future years.

Think it over

As of this writing, the 50% bonus depreciation amount has not yet been extended to 2014. Similarly, the Sec. 179 expensing limit and phaseout threshold are scheduled to drop to $25,000 and $200,000, respectively, in 2014, unless Congress acts to extend them.

To be clear, you certainly shouldn't splurge on buying construction equipment just to claim a tax break — or even two. But if you have any asset purchases in mind anyway, time is of the essence here. Ask your CPA whether you should buy now to procure some helpful tax relief.

Ownership costs vs. operating costs

Perhaps you are strongly considering buying equipment — both to fill a critical need of your construction business and garner a tax break or two. (See main article.) If so, now is a good time to review some key distinctions between the cost of *owning* an asset and the expense of *operating* it.

Ownership costs. The expense of owning a piece of equipment mounts whether it's in use on one of your job sites or not. To calculate ownership cost, you generally start with the piece's initial price and calculate an annual, monthly and even hourly depreciation charge.

One way to do so is to take the equipment's actual cost, subtract the expected salvage value at the projected end of its estimated useful life and divide the result over that useful life estimation. Other factors, however, will affect total expense of ownership. These include capital equipment costs and insurance premiums.

Properly managing ownership costs depends largely on how adept you are at budgeting. Your construction company's budget should include line items for each piece of equipment that let you know where every asset stands in terms of life cycle.

Operating costs. These accrue only as you use the piece of equipment in question. Examples include:

- Scheduled and unscheduled maintenance,
- Supplies and fuel,
- Repairs, and
- Regulatory compliance costs.

The key to controlling equipment costs is to recover expenses through accurate rental rates. A common approach is to play the role of a third-party lessor and allocate equipment usage costs to specific projects. Careful record keeping is essential here. The data you track should help you review and modify rental rates appropriately over time.

Fraud alert: How contractors can stay on guard

Every type of company is vulnerable to fraud. But contractors have it particularly bad. You've got the money coming into the office. You've got the equipment, tools and supplies on the job site. And, often, you've got operations spread out over several locations. For these reasons, construction company owners must always be on guard for fraudulent activity.

Where are you vulnerable?

The best question to regularly ask yourself is: "Where are we vulnerable?" The answer can change as your company grows or takes on different types of jobs.

For example, say you have a project that results in an abundance of scrap metal. This material is a valuable commodity, especially during periods of economic uncertainty. An unscrupulous employee, acting in collusion with an accomplice in the scrap or junkyard business, can order more metal (copper is particularly in demand) than you need. He can then hide the cost in job reports and sell the excess to the accomplice for cash.

To prevent this type of fraud, make sure no one person is responsible for both ordering materials and approving their costs. Additionally, someone other than the person who orders materials should check them in when they arrive at job sites.

Another example pertains to contractors who have moved into the maintenance and repair sector. In this scam, an outside mechanic submits phony maintenance and repair invoices. An employee then approves them and splits the payment with the mechanic.

Again, oversight is the key to preventing such schemes. Someone other than the employee who approves maintenance costs should review invoices. If a cost seems off-base, the reviewer should check with equipment operators to see when — or whether — the work was done.

Is your office safe?

Of course, fraud doesn't threaten only the job site. As always, you must keep your office staff alert to external scams of all sorts.

One example that may seem shockingly simple but sometimes succeeds is the "dead vendor" trick. Someone sends you invoices bearing the logo and letterhead of an apparently legitimate vendor. What you don't know is that the company in question is either closed or about to close because the owner has recently died or retired. Before you're aware the company is "dead," you've paid the bogus charges and the fraudster is off to another scam.

To prevent this one, be sure to always pay close attention to invoices. Consider setting up an approved vendor list, and train your staff to double-check any unfamiliar vendors or unusual orders.

Are you in control?

In addition to the frauds we've mentioned, construction companies are unfortunately subject to the same internal rip-offs that all businesses must guard against. To protect yourself, be proactive.

Establish internal controls that make it difficult for fraudsters to succeed, and adopt a "zero-tolerance" policy toward any type of unethical behavior. Make background checks a routine part of your hiring procedures, and incorporate the basics of fraud deterrence in your employee training programs. (Your CPA can coach you on exactly what these basics are.)

Among the most common ways fraudsters get caught is when someone sees something and tips off management. So invest in a third-party tipline and make sure all workers know their responsibilities in reporting suspicious behavior.

Beyond that, work with your site supervisors, financial advisors and office administrators to identify and address weaknesses in your operations that could lead to fraud.

If the same person who pays the bills also approves purchase orders and reconciles the accounts, for example, it would be easy for that person to write fraudulent checks undetected. Assign the job of reconciling the accounts to someone else, and fraud becomes much more difficult.

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Did you see that?

No contractor can see everything that goes on at his or her construction company. But by always being alert to the latest fraud threats, you can increase the likelihood that you'll deter those who try to steal from you and catch those who do.

Six Sigma for construction companies

You might see the term "Six Sigma" and assume it refers to a hot new suite of software or perhaps a little known college fraternity. In reality, it's a rigorous set of business-improvement practices originally intended for manufacturers and refined by tech giant Motorola in the 1980s. Since then, Six Sigma has been applied to a wide variety of industries — including construction.

Greeting the concept

Six Sigma is all about identifying and eliminating "defects" in the name of customer service. The word "defect" doesn't refer only to mistakes but to any result that fails to meet customer specifications or could lead to a process likely to dissatisfy customers.

Companies that implement Six Sigma should expect to undertake continuous efforts to achieve stable and predictable process results. For contractors, these efforts will apply to both your on-site operations *and* in-house financial management.

Like so many of today's business-improvement models, the practice is also heavily focused on statistics. Six Sigma believes every company's processes have characteristics that can be measured, analyzed, improved and controlled. Accomplishing this objective, however, will call for a total organizational commitment — particularly from you, the owner, and other top-level managers.

Navigating the methodology

Businesses that undertake a Six Sigma program generally must choose from two primary methodologies. For improving an existing business process, you'll navigate "DMAIC," an acronym for define, measure, analyze, implement and control. For creating a new product or process, you'll deal with "DMADV," an acronym for define, measure, analyze, design and verify.

Because most contractors are likely looking to improve an established process, let's focus on DMAIC. It will ask you to:

***Define* the problem you're trying to solve.** Don't just look at it from your own perspective. You'll need to "speak in the voice" of your customers and point to specific goals.

***Measure* key aspects of the process.** Target metrics that will enable you to measure progress toward the stated goal, by collecting the relevant data.

***Analyze* the data, looking for cause-and-effect relationships.** Here, you'll put on your investigator's hat and look for the root of the defect you're seeking to eliminate.

***Improve* the current process.** Six Sigma will recommend data analysis techniques for using the

information gathered and reconfiguring the process in question. You can then set up tests to establish whether the improvement is real.

***Control* the process going forward.** You'll be guided through steps to set up systems for monitoring the improved process once you've implemented it.

Reaping the benefits

A carefully executed Six Sigma program should provide very specific answers about what you can do to better serve customers. Eliminating defects means you'll spend less time putting out fires and more time completing quality work. In turn, you'll be able to stay within your cost estimates and, thereby, greatly improve your odds of getting more referrals and repeat business.

Plus, Six Sigma's "control" phase often allows contractors to tighten their financial management procedures. These could enable you to free up cash flow and better leverage the growth value of your existing customer relationships.

Getting to the next level

Is Six Sigma for every construction company? Probably not. As mentioned, it requires a total commitment from management and will entail much detailed digging into how your business operates and what specific changes could improve it. But if you find yourself longing for a way to get to that next level of success, Six Sigma may provide the structure you're looking for.

The Contractor's Corner

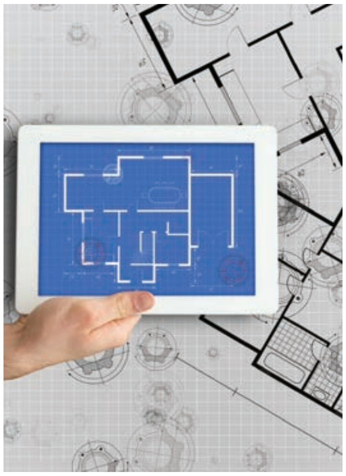
How can I trim plan distribution costs?

I run a relatively small but growing general contracting company. I noticed recently that we spend a surprising amount of money on distributing building plans. There's not only the hard cost of the initial printing, but also the expense of revising the plans, overnighting specs to project participants and using a courier service during the job itself. Is there any way to reduce these costs?

Although it comes with expenses all its own, today's technology does offer a solution: reprographics. This catch-all term refers to the practice of reproducing both physical and digital content via means such as scanning, photography, xerography and digital printing.

Welcome to the planroom

The most basic service a reprographics firm offers contractors is the simple electronic reproduction of building plans, which either the provider or the construction company can then e-mail to project stakeholders. But many vendors have upped the ante and created online "planrooms" where contractors can post building plans for viewing via a Web browser.



Planrooms can be customized in various ways. You can set one up for the more limited participation of a privately funded project or for the more expansive needs of a public job. A simple one might display only the building plans while others could include subcontractor orders, contract addenda and other items. Many planrooms allow you to notify participants when a revision or update has been posted.

From plan to project

A few reprographics firms have moved on from simply reproducing construction plans and offering planrooms to engineering full-fledged software packages. Such applications aren't just about *distributing* plans, but project management as a whole.

Typically, these solutions will post the initial plans to a secure website while providing you with a "dashboard" that enables you to monitor job progress, coordinate and share changes, and push real-time updates to stakeholders.

One example of this type of software is MySmartPlans from Marathon Digital Services. It even offers a tablet version of the app and a Project Information Manager to help you maximize the application's functionality.

The next level

Many larger construction companies have been using reprographics for a while. For a small to midsize business like yours, the decision should hinge on a cost vs. benefits analysis. The nickel-and-diming you're suffering could be minimized, if not eliminated, with the right service.

But planrooms and particularly software packages come with upfront costs and learning curves that could lead to initial confusion. So you'll need to vet providers carefully and really consider whether eliminating hard-copy plans and going all-electronic suits your company and your projects' typical participants.

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