Construction
Industry Advisor

SUMMER 2011

Manufacturers' deduction offers contractors valuable tax savings

Do you have a financial health plan?
If not, it's time to establish one

5 tips for showing you're "bond worthy"

CONTRACTOR'S TOOLBOX
The "no damages for delay" clause: Handle with care

HB

HEINOLD-BANWART, LTD.

Certified Public Accountants

2400 North Main Street • East Peoria, IL 61611
Phone: (309) 694-4251 • Fax: (309) 694-4202
www.hbcpas.com

Manufacturers' deduction offers contractors valuable tax savings

Unfortunately, many contractors overlook the manufacturers' deduction because it sounds like it applies only to manufacturing companies. Not so — many construction businesses, as well as architectural and engineering firms, can avail themselves of the deduction's valuable tax savings.

Also known as the "Section 199 deduction" or "the domestic production activities deduction," this tax break reached its top level in 2010. This means you can now take a deduction amounting to as much as 9% of your company's income from "qualified production activities."

Which activities qualify?

One of the activities the manufacturers' deduction is available for 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. (See "Renovation or maintenance?" on page 3.)

Some examples of qualified production activities that may lead to DPGR include:

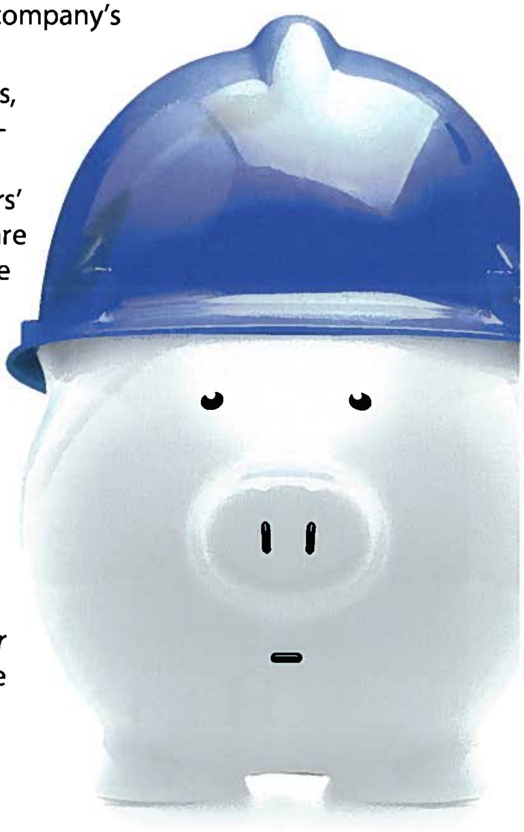
- Activities "typically performed by a general contractor," such as management and oversight, periodic inspections and required job modifications,
- Certain land improvements that are not capitalizable to the land (such as landscaping) and other activities that physically transform the land (grading, demolition, clearing and excavating if performed in connection with building construction — even if by different taxpayers),
- Construction or installation of building components (HVAC systems, elevators and plumbing) and infrastructure (roads, power lines, wiring, water systems and sewers),
- Tangential services (hauling debris or delivering materials — but only if performed by the same taxpayer that constructs or substantially renovates the property), and
- Administrative support services (billing or secretarial services) performed by a taxpayer engaged in construction activities and that are incidental and necessary to the construction project.

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.

How is the deduction calculated?

Conceptually, the Sec. 199 deduction calculation is simple. But in practice, the calculation can be a bit complicated. So it's best to have your CPA do the math, which requires him or her to:

1. Determine your company's DPGR,
2. Subtract expenses, losses and deductions (other than the manufacturers' deduction) that are properly allocable to DPGR to arrive at your qualified production activities income (QPAI),
3. Compare your QPAI to your taxable income for the year, and
4. Multiply the *lower* of QPAI or taxable income by 9%.



Renovation or maintenance?

For purposes of claiming the manufacturers' deduction (see main article), the distinction between substantial renovation and maintenance is critical. The former constitutes "construction of real property" that qualifies for the deduction, while the latter doesn't.

Tax regulations define "substantial renovation" as "the renovation of a major component or substantial structural part of real property that materially increases the value of the property, substantially prolongs the useful life of the property, or adapts the property to a new or different use."

Recently, the U.S. Tax Court decided its first case interpreting the manufacturers' deduction, *Gibson & Associates, Inc. v. Commissioner*. The case involved an engineering and heavy construction company that erects or rehabilitates streets, bridges and airport runways. The court ruled that Gibson's work rehabilitating bridges and other real property that had suffered significant casualty damages or become dilapidated qualified for the manufacturers' deduction.

This conclusion was based on expert testimony that rehabilitation work increased the value of the property and substantially prolonged its useful life. The Tax Court rejected the IRS expert's opinion that "the useful life of a structure as a whole does not change if work is performed on only part of the structure."

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 may 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.)

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 also is 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.

Boosting your cash flow

Calculating the manufacturers' deduction calls for a considerable amount of administrative work. But, for many contractors, the eventual tax benefits justify the time and energy invested. If your construction company qualifies, you can boost your cash flow by claiming the deduction for work you're already doing. ■

Do you have a financial health plan?

If not, it's time to establish one

Having a financial health plan is critical for any construction business, but it's especially helpful during a lackluster economy. By taking your company's "pulse" on a regular basis, you can ward off a number of financial maladies before your bottom line develops a serious ailment. Here's how.

A prescription for success

Taking your blood pressure alone tells you little about your overall health. Likewise, no single financial indicator tells the whole story about your construction company's well-being.

There are many ratios and other metrics you can use, but it's important to select a manageable number of indicators that make sense for your business and measure its performance in various areas. A good source of such benchmarking information is the Construction Financial Management Association's (CFMA's) *Construction Industry Annual Financial Survey.*

Although profitability is every company's ultimate goal, *liquidity* is critical — especially in today's economic environment. A construction business may appear highly profitable on paper but still fail because of inadequate cash flow.

Leverage and efficiency also are important concerns. Even if your company seems to be thriving now, too much debt or inefficient use of capital or assets can signal trouble down the road.

Plus, loan agreements often require contractors to maintain their debt-to-equity or other financial ratios at certain levels. And today's lenders generally remain quite strict about compliance.

Key financial ratios to note

Your return on equity, also known as profitability, is a key ratio. Generally, the higher this ratio (net earnings / total net worth), the better. But, in some cases, a high ratio may indicate that your company is undercapitalized or has too much debt.

8.62, Ma
1500
1200
Sept.
Oct.
Nov.

One of the most popular ratios is the "current" ratio (current assets / current liabilities). It measures a contractor's ability to satisfy his or her short-term liabilities with cash and other relatively liquid assets.

The working capital turnover ratio (revenue / working capital) measures your liquidity — that is, the amount of revenue supported by each dollar of net working capital used. A higher ratio may signal a need for additional working capital to support future growth.

Another helpful tool is the debt-to-equity ratio (total debt / net worth), which measures the degree of leverage you use. A higher ratio allows you to earn more on invested equity, but also exposes you to greater risk.

Last, but certainly not least, is the months in backlog ratio. This ratio — backlog / (revenue/12) — measures efficiency, indicating the number of months it will take to complete all signed or committed work. A lower ratio may mean your company needs some new contracts to maintain constant revenue in the future.

Monitoring these and other financial ratios allows you to compare your company's performance to its past results as well as those of other construction businesses in your industry sector and region. By watching for changes in your financial ratios over time, you can spot negative trends and identify opportunities for improvement.

KPIs, WIP reports help, too

Financial ratios are really just a subset of key performance indicators (KPIs), which include other financial measures, such as:

- Unapproved change orders,
- Underbilling,
- Profit fade, and
- Overhead creep.

KPIs can also assess nonfinancial issues such as employee morale, schedule variances and customer satisfaction.

In addition, work-in-process (WIP) reports are valuable. They not only reveal potential problems, but also help identify strategies for dealing with them.

Suppose, for example, that an analysis of your WIP reports shows a pattern of gross profits that shrink over time ("profit fade") or that gross profits on current jobs are consistently lower than on completed jobs. There are several possible reasons for this, including poor estimating or ineffective project management.

Numbers provide guidance

Like many construction companies, yours may be struggling to stay competitive while trying not to overextend its financial commitments. The right numbers can help guide you down the safest path. ■

5 tips for showing you're "bond worthy"

In today's economy, risk-averse project owners are more likely to require bonds. At the same time, cautious sureties have become more rigorous in their evaluation and approval of bond requests. So, it's critical for contractors to show that they're "bond worthy." Here are five tips for doing just that.

1. Make a strong statement

Your company may be financially healthy. But, if you can't demonstrate this to your surety, obtaining bonds will be a challenge.

Make sure your financial statements are complete, accurate and timely, and provide other documentation as needed, such as owners' personal financial statements. Also, minimize year end adjustments by preparing high-quality interim financial statements.

2. Manage profits and net worth

A critical indicator for a surety is your company's profitability. So manage the factors that affect profitability, such as overhead costs and bonuses.

Your net worth provides evidence of your ability to absorb losses. But sureties also look "behind" this number at the quality of the underlying assets. They may discount the value of riskier assets, such as aged receivables and inventory.

Cleaning up your balance sheet by removing risky assets and reinvesting profits in the business can help boost your bonding capacity.

3. Work your working capital

Sureties want to see strong working capital, which is defined as current assets minus current liabilities. Current assets include cash and assets readily converted into cash, such as short-term receivables and certain inventory. In contrast, illiquid assets may include your facilities and equipment.

> *Sureties want to see strong working capital, which is defined as current assets minus current liabilities.*

In measuring working capital, sureties typically discount riskier assets, such as aged or related-party receivables or prepaid expenses. So, to improve your working capital, consider accelerating collection of receivables, deferring payment of year end bonuses or other expenses, or refinancing short-term debt with long-term debt.

4. Track your progress

"Profit fade" (where a contractor's gross profits shrink over the course of a project) will undermine a surety's confidence in your financial strength. It can signal a number of weaknesses, including inaccurate estimating and sloppy project management. Even profit *gain* can cast doubt on your estimating abilities.

Sureties also look at underbillings (billings that lag behind a job's progress), which may point to cost overruns, inefficient management or lax billing practices. Overbilling can reflect effective cash management, but it can also be a sign of "job borrowing" — that is, overbilling on some projects to compensate for fading profits on others.

To instill confidence in your surety, prepare timely, accurate work-in-progress reports to help you stay on top of your estimating and project management processes and correct problems as early as possible.

5. Prevent surprises

For sureties, there's one thing that's worse than bad financial news, and that's bad financial news that they weren't expecting. For instance, what if an owner or key employee dies, becomes disabled or suddenly retires? Make sure you have a well-designed succession plan to provide assurance that your long-term prospects are strong.

In addition, to increase your surety's comfort level, maintain ongoing communication regarding any developments that are affecting your financial performance. Doing so not only helps demonstrate your good intentions, but also gives you an opportunity to explain any financial difficulties and outline your plans for turning things around.

Beyond bonding

Along with boosting your bonding capacity, these strategies can produce other significant business benefits — including making your construction company more attractive to lenders and investors. Work with your CPA to discover other ways to build your surety's confidence in your business. ■

The "no damages for delay" clause: Handle with care

In the construction industry, delays are a fact of life. They can be caused by any number of factors — severe weather, differing site conditions, equipment problems, construction errors, or interference by the owner or other contractors.

Because delays can be costly, contractors often seek damages for delays caused by the owner or, in the case of a subcontractor, by the general contractor. An important contract clause can help you mitigate the financial ramifications of such delays.

What it does and doesn't do

To reduce the risk of delay claims, many owners and general contractors include a "no damages for delay" clause in their contracts. The wording and scope of the clause varies by project but, essentially, it denies a contractor's right to recover monetary damages for some or all delays, limiting its remedies to an extension of time to complete the work.

Although the consequences of no damages for delay clauses can be harsh, they're legally valid and enforceable in most states — so long as their language is clear and unambiguous. The existence of the clause in a contract, however, doesn't necessarily preclude a contractor from recovering delay damages under all circumstances.

For one thing, not all clauses are created equal. Some, for example, bar claims for delays within the contractor's control or beyond the control of both parties, but allow claims for delays within the owner's control.

Exceptions may vary

Depending on state law, you might be allowed to recover damages, in spite of a no damages for delay clause, for delays that are:

- Caused by the other party's bad faith or willful, malicious or grossly negligent conduct,
- Caused by the other party's active interference in the project,
- Caused by the other party's breach of a contractual obligation,
- Not contemplated by the parties (some states limit enforcement of the clause to delays specifically listed in the contract), or
- So unreasonable they constitute abandonment of the contract by the other party.

Most states recognize exceptions to enforcement of no damages for delay clauses, but the specific exceptions vary from state to state.

Documentation is key

Be sure to review the no damages for delay clause in your contracts with your attorney to ensure you understand its scope and how it affects your rights under state law. In addition, documenting any delays attributable to the conduct of others or to uncontemplated events may increase your chances of recovery under a contractual or state-law exception. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. *© 2011 CIAsu11*

Heinold-Banwart, Ltd. is a full service accounting firm with a team of professionals who specialize in providing quality and timely services to the construction industry.

Based in East Peoria, Illinois, our Firm is the largest locally owned accounting firm in the region with over 50 people on staff to serve your diverse needs. Our local presence allows us to be responsive and accessible.

You know the construction industry. It's your business. Your CPA should be skilled in your industry too.

We are a proud member of The Construction Industry CPAs/Consultants Association (CICPAC). CICPAC is a national association of CPA firms recognized for providing quality financial and consulting services to the construction industry.

In addition, we hold the exclusive designation of Certified Construction Industry Financial Professional (CCIFP) and membership in the Construction Financial Management Association (CFMA).

These designations provide contractors the individual attention of an accomplished firm, combined with the unparalleled knowledge and resources of a nationwide network and nationally recognized construction industry specialists.

CICPAC
CONSTRUCTION INDUSTRY
CPAs/CONSULTANTS ASSOCIATION

Heinold-Banwart, Ltd. provides a wide range of financial services to our clients

Audit and Assurance Services

Tax Planning & Preparation

Business Consulting and Accounting Services

Business Valuation, Litigation, and Forensics

Pension Administration

We welcome the opportunity to discuss your needs! Visit our web site at www.hbcpas.com or contact Scott Carr at 309.694.4251 or scarr@hbcpas.com

Heinold-Banwart, Ltd.
Certified Public Accountants
2400 North Main Street • East Peoria, IL 61611
Phone: (309) 694-4251 • Fax: (309) 694-4202
www.hbcpas.com

Return Service Requested