Construction

Industry Advisor

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Boning up on the new repair regs

IRS guidance can help you and your clients reduce taxes

In December 2011, the IRS issued temporary regulations entitled *Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property*. Commonly referred to as the "repair regs," the new guidelines address the tax treatment of expenditures made to acquire, produce or improve tangible property. This includes buildings and building components, land, machinery, and equipment, as well as furniture and fixtures.

Contractors should familiarize themselves with the regs because: 1) they affect the tax treatment of investments in their own buildings, and 2) they may provide opportunities to help clients reduce their tax bills.

Capitalize or deduct

Generally, the regs require taxpayers to capitalize (rather than deduct) amounts paid to:

- Acquire a new building,
- Create permanent improvements or betterments to property,

- Restore property, or
- Adapt property to a new or different use.

Betterment involves eliminating a pre-existing material condition or defect, as well as material additions or improvements that increase a property's capacity, productivity, efficiency, strength or quality. Restoration includes work that restores property to like-new condition at the end of its useful life, returns property to efficient operating condition from a state of disrepair, or replaces a major component or substantial structural part.

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Property owners are permitted to deduct expenses for maintenance or repairs that keep property in efficient operating condition.

Property shrinkage

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In fact, the final regs omitted a proposal that would have defined "major component" or "substantial structural part" based on a 50% cost or size threshold in relation to the relevant unit of property. Thus, the determination is made on a case-by-case basis according to a taxpayer's particular facts and circumstances.

One of the most significant provisions of the repair regs changes the way the rules apply to buildings.

The regs continue to treat a building and its structural components as a single unit of property, but they also require owners to capitalize expenses for betterments or restoration of the building structure or of any of these specified building systems: 1) HVAC, 2) plumbing, 3) electrical, 4) escalators, 5) elevators, 6) fire protection and alarm, 7) security, and 8) gas distribution. This change shrinks the unit of property, increasing the chances that expenses must be capitalized.

Suppose that an owner has substantial repair work done on a building's HVAC systems. Under the old rules, the expense would have been deductible if it didn't result in a betterment or restoration of the building as a whole. But the same expense would have to be capitalized under the new rules if it results in a betterment or restoration of the *HVAC system*.

Routine maintenance safe harbor

The regs contain several special rules, including a safe harbor for "routine maintenance." Maintenance is considered routine if, at the time the unit of property is placed in service, the owner reasonably expects to perform it more than once during the unit of property's useful life.

The safe harbor doesn't apply to buildings, though. Otherwise, owners could deduct the expense of major maintenance projects, such as roof replacements, simply because they expect to perform them more than once over the building's life. The safe harbor might apply, however, to maintenance performed more than once during the life of the *roof*.

Assist your clients

Familiarity with the repair regs provides an opportunity to help clients lower their tax bills. For example, providing clients with itemized bills makes it easier for them to separate deductible expenses (such as routine maintenance) from capitalized expenses. In some cases, the choices you and your clients make (such as the types of materials used) can have significant tax implications. (See "Repair or improvement?" below.)

The repair regs are heavily fact-driven, so it's critical to review the many examples included in the regs and to consult a tax professional. ■

Repair or improvement?

Often, there are several solutions to a construction problem, and the solution you choose can make a big difference on your client's tax bill. Consider this example from the repair regs:

A storm damages the roof of a small retail shop, displacing many wooden shingles. The owner hires a contractor to replace all of the shingles on the roof with new wooden shingles. The expense is deductible. The work doesn't result in a betterment, because it doesn't result in a material addition or increase the building structure's capacity, productivity, efficiency, strength or quality. The result would be the same if it were impractical to use new wooden shingles, causing the contractor to replace all of the wooden shingles with comparable (albeit stronger) asphalt shingles.

The result is different, however, if the contractor replaces the wooden shingles with shingles made of lightweight composite materials that are maintenance-free, don't absorb moisture, and have a 50-year warranty and a Class A fire rating. In that case, the work would result in a betterment, because the new shingles materially increase the quality of the building structure. Therefore, the expense must be capitalized.

Ready to jump into new waters?

Look into all of the details of an out-of-state job

The uncertain economic recovery continues to give contractors fits in many markets. If this holds true for your construction company, you may consider pursuing jobs out of your home state. It could be a good idea, but, before you jump into those new waters, look into *all* of the details.

Tax issues

Tax laws differ from state to state. Most states levy *sales* taxes on building materials purchased in the state and *use* taxes on materials brought in from outside the state.

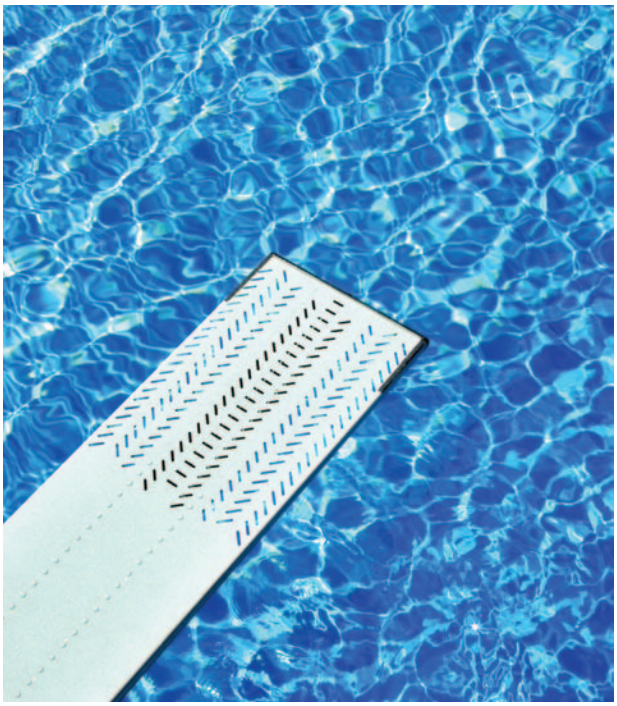
Some states, however, may levy a flat tax on all commercial construction rather than charging sales and use taxes. Others could require out-of-state contractors to obtain use tax permits if they do more than one project in the state. Before taking a job in another state, ask your CPA for help in understanding the state and local tax laws.

Insurance matters

The first thing you should know about insurance is whether yours is valid in other states. Check with your carrier to see what limitations your general and workers' compensation coverage may have — and how much it will cost to change them, if necessary.

If you're going to work in more than one state, a one-size-fits-all contract won't do you much good.

Check, too, to be sure you'll be paying workers' compensation premiums only once. In some cases, contractors must pay premiums in their home states as well as the states in which they do



business. Neighboring states often have reciprocal agreements to prevent such double payments.

Licensing rules

In most states, out-of-state contractors must be licensed or registered to do business in that state. Licensing requirements vary, with some states requiring examinations as well as proof of insurance and evidence of financial solvency. In states that don't require a license, contractors often must register with appropriate state offices.

In either case, state rules regarding the timing of licensure and registration will vary. Furthermore, in some states, only licensed contractors may bid on jobs; in others, unlicensed contractors can bid, but projects may be awarded only to licensed construction companies. Know the rules before you venture too far afield.

Bonding requirements

Most states require out-of-state contractors to post bonds before they do business in the state.

The type and amount of bonds required fluctuate vastly, depending on the type of license sought and the amount of work anticipated.

In some states, all contractors must post bonds or cash. In others, only specific types of contractors or only those working on public projects must provide bonds.

Labor relations

You can save yourself a great deal of trouble by learning about the labor relations and union issues in the states you're thinking of expanding into. If you're considering a public project, you'll probably be subject to prevailing wage laws, meaning you must pay whatever rate is common for similar work in other areas of the state.

Regardless of the type of jobs you're interested in, determine up front whether there's a strong union presence in the area. If so, be ready to deal with union issues whether you have a labor contract or not.

Contract language

If you're going to work in more than one state, a one-size-fits-all contract won't do you much good. State laws governing construction are even more complicated and more divergent than their licensing and bonding requirements.

For example, the pay-if-paid construction contract clause is a contentious issue for many out-of-state contractors. Courts are often divided on whether such clauses are enforceable when contracts are governed by the laws of another state. Try to avoid this clause or, if you must include one, work with your attorney to ensure it's applicable wherever you're working.

Risky leap

Working across state lines may seem like a relatively easy way to expand your market. But it can be risky. For the best outcomes, make sure you understand every potential risk. Your financial and legal advisors can help you determine just how deep the waters are before you jump. ■

The agree-to-agree clause: Handle with care

In the construction industry, change may be the only constant. That's why construction contracts typically authorize an owner or general contractor (GC) to change the scope of a project and negotiate a price for the additional work. If the two parties in question can't agree on a price, the GC or subcontractor typically must be compensated according to an agreed-upon method, such as time and materials.

But what happens if a contract's change provision is nothing more than an "agree-to-agree" clause? That is, what if the contract requires parties to negotiate the price of additional work in good faith, but is silent as to what happens if they can't reach an agreement through negotiation?

Case in point

A recent California case — *Ted Jacob Engineering Group, Inc. v. The Ratcliff Architects* — is instructive. In that case, the defendant architecture firm contracted with a county for a hospital renovation and expansion project and then subcontracted with the plaintiff for mechanical and electrical engineering services.

Here are the facts of the case: The plaintiff, Ted Jacob Engineering Group (TJEG), entered into a contract with the defendant, Ratcliff Architects, that contained an agree-to-agree clause. The scope of the work increased substantially and TJEG performed the work as requested, presenting Ratcliff with timely claims for additional fees. Ultimately, Ratcliff terminated its contracts with the county and TJEG, the parties never having agreed on adjusted fees. The plaintiff sued the architect to obtain a judicial determination of its claims.

TJEG's total claim was nearly $1.2 million. The jury awarded TJEG $1.1 million, and the trial court awarded some $1.3 million in prejudgment interest and more than $2.2 million in attorneys' fees.

The appellate court upheld the award, finding that, absent an agreement on adjusted fees, TJEG was entitled to be paid the reasonable value of the extra work it performed. The court held that, under California law, if changes in the work are minor, a contractor must continue working and ask a court to decide on the price of the changes. If the changes are significant, however, a contractor isn't required to continue performance absent an agreement on the price.

But that doesn't mean, as Ratcliff argued, that the contractor *has to stop working*. "To the extent that negotiations were unsuccessful and Ratcliff nevertheless directed TJEG to perform the work," the court said, "TJEG was entitled to compensation for the fair and reasonable value of the additional work it performed pursuant to that direction."

The court also rejected Ratcliff's assertion that it was excused from paying TJEG's claims by a contract provision requiring prior written authorization for additional services. "Ratcliff's conduct of accepting services without complaint in the absence of written authorization," the court explained, "would justify TJEG in believing the written authorization condition had been waived."

Little choice

Although TJEG prevailed, it still went through a long, expensive trial and appeal. Ultimately, the firm recovered most of its claims plus interest and attorneys' fees. But it could have avoided a lot of headaches if the contract had spelled out a pricing mechanism for extra work.

Thus, as a general rule, it's best to avoid agree-to-agree clauses. They create uncertainty and, in the event the parties can't agree on a price for additional services, they leave little choice but to seek a judicial determination of the value of the work.

The plaintiff could have avoided a lot of headaches if the contract had spelled out a pricing mechanism for extra work.

If you're subject to an agree-to-agree clause, protect yourself by thoroughly documenting any changes and communicating this information to the owner or GC early and often. Also, to avoid the expense and time commitment of litigation, consider discontinuing performance until an agreement on price can be reached.

Options available

A caveat: The TJEG case involved California law. If you find yourself in this situation, it's a good idea to consult an attorney in your jurisdiction to discuss the options available under applicable law. ■

How JPM helps measure productivity in real time

In the construction industry, productivity can make the difference between success and failure. Unfortunately, traditional measures of productivity are after-the-fact accounting measures of *production*. They do nothing to help contractors monitor productivity during a job and respond to negative trends or other issues.

Increasingly, contractors are turning to Job Productivity Measurement (JPM). The standard was adopted in 2010 by ASTM International (formerly, the American Society for Testing and Materials). JPM measures productivity in real time by tracking work performed compared to construction put in place (CPIP).

Quality, not quantity

The key to measuring productivity in a meaningful way is to determine the quality of construction *outcomes*.

Traditional productivity measures are based on *outputs*, such as hours worked or quantity installed. The problem with this approach is that it masks unproductive activities, such as repairs, rework, out-of-sequence work and other inefficiencies. The fact that a certain amount of effort has been expended or that a certain amount of material has been installed doesn't necessarily translate into a satisfactory outcome. If the quality is poor, additional hours and materials may be needed to complete the work.

According to ASTM International, JPM focuses on outcome quality by measuring "observed completion of the project as accepted by the customer." Relying on regular reports from workers in the field, JPM tracks the observed percent complete of all activities involved in producing a completed project. It also distinguishes tasks that offer value to the customer from those that are unproductive or wasteful.

Early warning system

In addition, JPM provides ongoing feedback on errors, repairs and rework. By doing so, it serves as an early warning system for productivity problems and creates opportunities to make adjustments or corrections during a job. Along with improving productivity, JPM often shortens the duration of end-of-job inspections.

Another significant benefit of JPM is that, by relying on CPIP rather than costs incurred or efforts expended, it provides more accurate percentage-of-completion calculations. This enables contractors to better match progress billing to actual value transferred to the customer, and it allows the contractor to bill for this value regardless of costs incurred, which can improve its cash flow.

To manage it, measure it

They say you can't manage what you don't measure. When it comes to productivity, measuring performance after completion offers little opportunity for improvement. JPM monitors productivity during a job and identifies problems while there's still time to do something about them. ■