Construction

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IRS employment exams

Will your construction company pass the test?

Recently, the IRS launched an audit program that focuses on employment tax issues. As part of a National Research Project (NRP), the IRS will randomly select approximately 6,000 employers over the next three years for detailed employment tax examinations.

The program is designed to gauge compliance with employment tax law and related reporting requirements, and to gather information that will help the IRS select and audit future returns with the greatest compliance risk. The IRS offers few details about the specific issues it plans to probe, but it's a safe bet that auditors will be scrutinizing areas that have led to audit adjustments in the past.

Targeted areas

For construction companies, the Service's *Construction Industry Audit Technique Guide* (ATG) provides clues to what auditors will be looking for. Here are some of the main employment tax issues NRP audits will target:

Worker classification. The employee vs. independent contractor issue is a significant one in the construction industry. The ATG warns agents that "the use of subcontractors is common within the construction industry. Many taxpayers treat employees as subcontractors to avoid paying employment taxes. The agent may need to seek guidance from an employment tax specialist when confronted with potential employment tax issues."

It seems unlikely that many contractors deliberately misclassify employees as independent contractors to avoid employment taxes. But even inadvertent misclassification can have serious consequences, including back taxes, penalties and interest; additional employee benefit obligations; and liability for overtime pay. To avoid these costs and ensure you can support your tax

position, review your employment practices and procedures, relationships with independent contractors, and written contracts.

Officer compensation. The IRS will likely focus on two issues involving owner-employees: 1) C corporations that pay unreasonably high salaries, which are really disguised dividends, and 2) S corporation shareholders who receive unreasonably low compensation to reduce employment taxes. To avoid unpleasant tax surprises, be sure to maintain documentation that supports the reasonableness of owner salaries.

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Reimbursed expenses. Agents will be looking for employee expense reimbursements that aren't paid through an "accountable plan" and, therefore, should be included in income and subject to employment taxes. Payments under a nonaccountable plan, while they may be deductible by the employer, are usually taxable income to the employee. Your plan is accountable if it's in writing and requires:

1. Reimbursed expenses to have a business connection,
2. Employees to adequately substantiate expenses in writing within a reasonable time, and
3. Employees to return any excess reimbursements or advances within a reasonable time.

Keep in mind that reimbursement of employees through an accountable plan won't convert otherwise nondeductible expenses into deductible ones.

Avoid getting fried by Davis-Bacon

The combination of a struggling economy, a depressed real estate market and the stimulus law's creation of new infrastructure projects has led many contractors to bid on public works projects for the first time.

If you're new to government contracting, become familiar with the Davis-Bacon Act, a federal law that requires you to pay a "prevailing wage" on most federal projects. Prevailing wage rates typically consist of a minimum basic hourly rate and, if appropriate, a fringe benefit amount. In addition to the federal law, most states have "mini" Davis-Bacon acts that impose prevailing wage requirements on state-funded projects.

Essentially, Davis-Bacon and its state counterparts require you to pay wages on a public project that are comparable to wages paid for similar work in the area where the project is located. Penalties for disregarding the prevailing wage include monetary damages, contract termination and even debarment from future contracts.

Contractors often pay the basic rate and fringe benefit amounts in cash. But in many cases, it's more cost effective to satisfy the fringe benefit requirements through benefit plans, such as qualified retirement plans, health plans or even paid time off.

Be prepared

The chances of being selected for an NRP audit may be slim, but the same issues are likely to be raised in ordinary audits, too. In light of renewed IRS interest in employment tax issues, work with your attorney and CPA to review your employment practices, procedures and records to be sure they meet the agency's standards.

While you're at it, if you have or plan to bid on any public works projects, you should also review your compensation practices for compliance with prevailing wage requirements. (See "Avoid getting fried by Davis-Bacon" above.) ■

Putting the WOTC to work for you

Even in good times, profit margins in the construction industry are notoriously thin. So it's critical for contractors to take advantage of every financial tool at their disposal. One tool that's often overlooked is the Work Opportunity Tax Credit (WOTC) — a tax break available to companies that hire workers from certain disadvantaged groups.

The WOTC has been around for years, but last year's stimulus legislation expanded the list of targeted groups to include "unemployed veterans" and "disconnected youth." To claim the credit, you must take certain steps *before* you make a job offer, so you should screen all applicants for eligibility.

How much is the credit?

For most targeted groups, the maximum credit is 40% of up to $6,000 in qualified first-year wages, or $2,400 per hire. "Qualified wages" generally means wages subject to FUTA taxes. In addition to the two categories mentioned above, eligible workers include:

- Food stamp, supplemental security income and short-term welfare recipients,
- Some ex-felons,
- 18- to 39-year-old residents of empowerment zones or other designated communities, and
- Disabled workers referred by a qualified vocational rehabilitation program.

The maximum credit for disabled veterans is $4,800 (40% of up to $12,000 in qualified first-year wages). And you can claim a credit of up to $1,200 (40% of qualified first-year wages up to $3,000) for hiring a "summer youth employee," defined as a worker who's 16 or 17 years old, lives in a designated community, and works 90 days or more between May 1 and Sept. 15.

The WOTC also includes the welfare-to-work credit, which is available to companies that hire long-term welfare recipients.

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A new break for hiring — and retaining — workers

Under the Hiring Incentives to Restore Employment (HIRE) Act of 2010, signed into law March 18, payroll tax forgiveness can exempt you from having to pay Social Security taxes (6.2%) on certain new hires through the end of 2010. Additionally, a tax credit for retaining such new hires can provide you future tax savings of up to $1,000 per qualified worker.

Many rules and limits apply, however, so it's important to work closely with your tax advisor before acting. Also be aware that you generally can't take both payroll tax forgiveness and the Work Opportunity Tax Credit (WOTC) for the same employee for the same year. You can, however, elect to pay the Social Security tax so that you can take the WOTC if, for example, the WOTC would provide a greater tax benefit.

Through the end of 2010, the $2,400 credit is extended to include unemployed veterans and disconnected youth. Unemployed veterans are those who were discharged or released from active duty within five years before the hire date and received unemployment compensation for at least four weeks during the one-year period ending on the hire date. Disconnected youths are workers age 16 to 24 who aren't "readily employable" and weren't regularly employed or attending school during the six-month period ending on the hire date.

The maximum credits are available for eligible employees who work at least 400 hours during their first year. Partial credits (25% of qualified wages) are available for eligible employees who work at least 120 hours but less than 400.

How do you apply?

The WOTC is intended as an incentive to hire disadvantaged workers, so it's not available for existing employees. To qualify for the credit, you must fill out IRS Form 8850, "Pre-Screening Notice and Certification Request for the Work Opportunity Credit," before you make the job offer, and have the new hire sign the form. You must also complete one of two U.S. Department of Labor (DOL) forms: Form 9061, which identifies the characteristics that qualify the worker for the WOTC, or Form 9062, which indicates that the worker has been conditionally certified by the state.

The IRS and DOL forms must be filed with your state workforce agency (SWA) within 28 days after the new hire's start date. Once the SWA has certified that an employee is eligible for the WOTC and has worked the required number of hours, you can claim the credit by attaching Form 5884 to your income tax return for the year (or years) in which qualified wages are paid.

Are you up to the task?

As you can see, there are specific conditions to qualifying for the WOTC, so make sure you work with your CPA to ensure you cross every "t" and dot all the "i's." And, keep in mind that the expanded credit for unemployed veterans and disconnected youth is limited to workers hired by the end of 2010 and that the WOTC is currently set to expire at the end of August 2011 (though Congress may extend it). ■

Don't throw in the towel

How to get your groove back after the recession

After several years of this tough economy, many contractors may be ready to throw in the towel. But don't give up the fight. Instead, get back in the groove by harnessing cash flow and actively managing your company's finances. Once you've got your groove back, you'll likely not only emerge from the recession on your feet, but also be better prepared to take on new opportunities.

Harness cash flow

If you feel you've lost control of your cash flow, now's the time to get it back on track. Companies that don't come out of a recession alive are usually those that have been too slow to react to the harsher business reality. Every contractor should have three- to six-month cash flow projections. If your costs are approaching or exceeding your revenues, cut costs *now* — not after your business is damaged.

Hard times usually mean an increase in collection problems. Keep on top of your accounts by getting your bills out on time and following up with clients once their payment deadlines have passed. Don't let debts mount: If a client has a serious problem, it's best to find out early and negotiate the best possible outcome. Nobody likes making collection calls. But it's better than getting only pennies on the dollar in a bankruptcy court.

Stay on top of financial matters

In a slowly recovering economy, it's always good to take a fresh look at your financing arrangements. Reconsider how you structure your contracts. Try to front-load payments so that you don't have to finance early project costs.

This is also a good time to look at capitalization, accounting practices and other financial management issues. If you're financing equipment through short-term debt, you may be hampering your bonding capacity and exacerbating cash flow problems.

Does your accounting system provide the information you need to make effective bids, accurately track costs and otherwise understand your financial picture? Leaving 5% on the table when times are good may just mean lower profits. Leaving it on the table when times are bad may mean closing down.

Last, don't ignore marketing. Although you may be tempted to cut marketing costs to save a buck, remember: If you cut your marketing expenses too heavily, you'll end up without the new contracts you need to survive. If you have a valuable employee you would otherwise have to let go, give him or her a crack at drumming up business.

Find new opportunities

Now is the perfect time to reflect on new market segments that you haven't tapped into yet. Keep in mind, though, that new markets mean new lessons. For example, government contracts usually come with increased paperwork and management demands. They also typically have lower margins than contracts with private developers. But public jobs are still worth checking out.

No matter what types of jobs you choose, lean on your CPA's financial expertise to get back in the groove of financial stability and ensure your construction company stays there. ■

Debt relief also brings tax implications

As the economy continues to struggle, many contractors are asking their lenders for debt relief. Often, restructuring debt is in the best interest of both borrower and lender. The borrower can hang on to its property, which can help ease cash flow pressures, while the lender avoids the expense of foreclosure or other collection efforts.

But if you're discussing workout options with your lender, be sure to consider the tax implications. Even if your property has declined in value, a foreclosure or debt workout can result in taxable income.

Recourse vs. nonrecourse

Say you have a $650,000 balance on a recourse loan secured by real property with a fair market value of $500,000 and a tax basis of $400,000. If your lender forecloses (or accepts a deed in lieu of foreclosure), the transaction is treated as if you'd sold the property for its fair market value, resulting in a $100,000 capital gain ($500,000 "sale" price less $400,000 basis). If the lender forgives the $150,000 shortfall, that amount is treated as cancellation of debt (COD) income, which is taxable as ordinary income.

If the debt is *nonrecourse*, which means you're not liable for the shortfall, there's no COD income. Instead, the excess of the unpaid loan balance over your basis — in this case $250,000 — is treated as capital gain.

Restructuring the debt

If you and your lender agree to restructure the debt, you won't recognize any gain or loss, but you may have COD income. If the lender reduces the principal, for example, the portion of the loan that's forgiven may trigger COD income.

Similarly, you may have COD income if the lender reduces the interest rate or modifies other loan terms to reduce your monthly payments.

You can avoid (or at least defer) COD income if:

- The debt is discharged in bankruptcy,
- You're insolvent, or
- The debt is "qualified real property business indebtedness" that meets certain requirements.

Even if COD income is unavoidable, last year's stimulus act may help soften the blow. It allows you to defer tax payments for certain business-related COD income realized in 2009 and 2010 and pay the tax in installments over five years beginning in 2014.

Complex rules

The rules regarding COD income are complex, and this brief article is intended only as an introduction. If your construction company is structured as a pass-through entity — such as an S corporation or limited liability company (LLC) — the issues become even more complicated. To avoid unpleasant tax surprises, consult your tax advisor before you discuss debt relief options with your lender. ■