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Extend your reach

Cost segregation studies offer a profit-building opportunity

In a business climate of shrinking margins and increased competition, landing new construction contracts is more challenging than ever. But one way you can nail down more business is to contribute your services to a cost segregation study.

What is cost segregation?

Cost segregation is a tax strategy that allows building owners to maximize their current tax depreciation deductions by using shorter lives and faster depreciation rates for qualifying parts of their properties. The study is appropriate for property owners who are going to construct, expand or remodel a facility — or who have recently completed such a project or purchased a property.

Property that qualifies for faster write-offs (such as decorative fixtures, security equipment, cabinets and shelves, and carpeting) is often lumped in as part of the building and depreciated over 27½ years for residential property or 39 years for commercial property. That's a very long time for the owner to write off the full value of the building on his or her tax return.

The ideal time to perform a cost segregation study is when plans are being drafted to construct, expand or remodel a building.

A cost segregation study, however, identifies structural components that owners can deduct much faster — typically over 15 years for land improvements and five to seven years for most equipment and furnishings. This process may save owners thousands of dollars. For example, if $400,000 of assets were reclassified as seven-year vs. 39-year property, the owner's depreciation deduction in the first year would increase as much as 10 times, or about $50,000.

At this point, you may be asking why *you* should care about cost segregation studies. The answer is simple: By helping to show owners how they can pay less income tax and, thus, increase their cash flows, you can get your construction company's name in the forefront of more owners' minds and perhaps turn these one-time opportunities into additional business.

Who's involved?

A team of experienced professionals — including engineers, estimators, contractors, project coordinators and a CPA — usually performs a cost segregation study. This team examines a building's walls, floors, ceilings and plumbing, as well as its electrical lighting,

telecommunications, heating and cooling systems, to identify the components that will qualify for accelerated write-off periods.

Computer cable, for example, can be depreciated over five years rather than 39 years. Land improvements, such as landscaping and fencing, qualify for a 15-year write-off period.

What do you need to do?

Encourage owners to initiate cost segregation studies sooner rather than later. The ideal time is when plans are being drafted to construct, expand or remodel a building. By tracking costs early, it's much easier for the owner to gather needed data when a project is completed.

Some owners, however, may want to conduct the study *after* their buildings are completed and occupied. This means that you and the cost segregation team will need to dig into archived files. Owners who start late in the game will still be eligible for identified tax benefits, assuming you can access the documentation they need. Detailed costs are vital to the accuracy of cost segregation studies.

Who can say no?

Over the past several years, contractors have realized that cost segregation studies are an important service to project owners. Your contributions to this process can improve a project's overall financial picture by boosting an owner's cash flow. And who can say no to saving money?

Paying for personal safety equipment is now law

Get ready: A new OSHA rule requiring contractors and other employers to buy their employees' personal safety equipment takes effect May 15, 2008. According to the rule, you must now provide the equipment at no cost to your employees. Any employer who violates the rule faces stiff fines — up to $10,000 per violation and up to $70,000 for each subsequent violation.

The rule applies to any equipment that's required to meet OSHA safety standards, such as hard hats, respirators, gloves and fall protection harnesses. You aren't required to pay for safety-toed footwear, logging boots, ordinary prescription safety eyewear, ordinary clothing and weather-related gear, however.

But the rule does require you to pay for replacement equipment under established wear-and-tear standards. You won't have to replace equipment that employees lose or intentionally damage, however. Employee deposits on equipment are acceptable, and employees can pay for protective equipment, so long as you reimburse them in full.

You also may need to amend existing or negotiate new collective bargaining agreements. Such agreements often include provisions about personal safety equipment. OSHA advises employers to make sure any changes to collective bargaining agreements don't conflict with the new rule.

The agency noted that, when employers take full responsibility for employees' safety equipment, they're more likely to make sure equipment is adequate for the job, that it's in good condition, and that the employees are protected against workplace hazards. OSHA estimates the new rule will save more than $200 million per year in costs, including medical and insurance bills.

It's time for your financial checkup

From the time you win a bid until the last punch list has been signed off, you probably know exactly where you stand on every project budget. But can you say the same about your construction company's finances?

If you haven't taken your business's financial pulse in more than a year, it's time for a thorough checkup. Financial performance measures are valuable analytical tools that provide a high-level view of the overall health of your business and enable you to make meaningful comparisons with industry averages and benchmarks.

In short, by identifying emerging problems and uncovering potential opportunities for increased profit, you can improve your construction company's bottom line and make business decisions that will bolster its financial health.

5 key metrics

One way to find out whether your construction company is as healthy as the one down the street is to compare apples to apples. The Construction Financial Management Association (CFMA) publishes its *Construction Industry Annual Financial Survey* each year. Following are some of the "apples," or metrics, it uses to rate the financial status of construction companies across the nation:

1. Return on assets (ROA). Some contractors are so busy working, they don't see how their investment of time, effort and money has grown. A good first step is to determine your ROA, an indicator of how profitable your company is relative to its total assets. To get ROA, divide net income by total assets. The higher the ROA, the better, because it shows you're earning more money on less assets.

For example, a highway contractor has a net income of $1 million and total assets of $5 million, for an ROA of 20%. A competing company earns the same net income but has total assets of $10 million for an ROA of 10%. Thus, the first company is better at converting assets into profit. Best-in-class construction companies had an average ROA of 21.6% vs. 7.7% for all construction companies surveyed, according to the CFMA survey.

2. Return on equity (ROE). Calculate ROE to learn how much profit your company generated with money your shareholders invested. Divide net income by shareholders' equity. (Shareholders' equity is the difference between total assets and total liabilities.)

For example, if you're a general contractor with a shareholders' equity of $10 million, and you made $3 million in profit, you would have a 30% return on your equity. In the 2007 CFMA survey, ROE was 47.4% for the top construction companies vs. 26.2% for all construction businesses surveyed.

3. Fixed assets ratio. Determine this ratio by dividing total fixed assets (construction equipment and company computers, for example) by total assets. A high result could indicate that a disproportionate amount of your company's funds is tied up in fixed assets. And this, in turn, could mean your business may lack the liquidity needed to fund current operations.

A low figure suggests that you may need to invest some money in fixed assets. However, off-balance-sheet financing of equipment may offset this apparent positive indication. Best-in-class companies had an average fixed asset ratio of 33.4% vs. 36% for all companies in the survey.

4. Debt-to-equity ratio. Measure your company's ability to borrow and repay money by dividing total liabilities by shareholders' equity. Ideally, the debt-to-equity ratio shouldn't exceed 3.0 without a plan to bring it back within this limit, according to CFMA.

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Outstanding companies had an average debt-to-equity ratio of 1.2, compared with 2.4 for all companies in the CFMA survey. Lenders look closely at this number because a high ratio may jeopardize loan repayments. Sureties will also look at debt to equity when making bonding decisions.

5. Working capital turnover ratio. Working capital refers to current excess assets over current liabilities. To calculate the turnover ratio — the revenue being generated from each dollar of working capital available — divide sales by your working capital. Generally, the higher your working capital turnover, the better, because it means your business is generating a lot of sales compared with the money it uses to fund the sales. Too high a ratio, however, may indicate that the company is overextended and may have difficulty paying its bills from time to time.

Best-in-class companies turned over their working capital an average of 8.4 times — 5.6 times less than the typical company. Although these companies didn't use their working capital to generate sales as efficiently as the typical company, their performance in other areas impressed CFMA enough to still cite them as having best-in-class status for their working capital.

An apple a day ...

With numbers such as the ones mentioned here in hand, you can compare your business with other, similar construction companies and set realistic profit and performance goals for the future. Just be sure to ask your CPA for help obtaining and interpreting all the data. And for more information on the CFMA survey referenced in this article, go to www.cfma.org.

Dateline 2008: Contractors need — and find — solutions to rising costs

Just as consumers are paying more for gasoline and groceries, contractors are feeling the pinch of escalating material and fuel costs. With little relief in sight, price escalations are forcing contractors to pass on these higher costs to owners and look for other ways to ease the pain.

Challenging times

Strong demand for construction materials overseas (particularly in China, which is in the midst of a building boom) is straining building supplies. Basic economics dictate that, in an open market, prices rise when demand increases or when supply decreases. At the same time, higher energy costs are putting contractors' costs in the fast lane because fuel plays a role in nearly every part of the construction process.

Since 2003, the cost of steel has risen 61%, asphalt 49% and concrete 32%, according to the Associated General Contractors of America (AGC). By the end of 2008, such costs are expected to rise by another 6% to 8%, according to the trade group. While modest decreases were recently seen in the costs of wallboard, steel, copper and lumber, the AGC expects the decreases to be short-lived in light of higher fuel costs.

Considering these increasing costs and the fact that projects often have slim profit margins, contractors face tough situations in which they either make no profit or lose money on their jobs. Projects that take a year or more to complete are particularly vulnerable to volatile market conditions because materials and fuel prices may surge repeatedly.

Finding solutions

Given today's economic climate, re-examine the way you bid for jobs. Contractors who may have honored their quotes for six months are now limiting that time to 30 days.

You can also guard against losses by including a price escalation clause when hammering out contracts. A typical escalation clause allows you to pass price increases on to the owner during the course of projects.

The clause should identify the specific building materials you believe are at risk for price fluctuations and explain that, if those costs increase, the total job price will increase accordingly. The clause should also explain how you will notify the owner of price increases, and when and how often the escalation clause can be triggered during the job. (Be sure to work with your attorney to generate the appropriate contract language.)

Containing costs

Of course, there are ways to contain material costs as well. And many are less complicated than you might think. Holding down expenses may be as simple as:

Placing material orders well in advance. If site conditions allow, order as much steel or other materials as early in the project as possible and then store them on site. Then if prices jump or supplies run low because of a bump in worldwide demand, you may have enough on hand to complete the project.

Negotiating with suppliers to lock in prices for set times. In the same way that owners establish prices with you, try to nail down construction material prices with your suppliers.

Buying in bulk. You may be able to earn discounts by buying large amounts of materials for multiple projects at the same time.

Identifying value-engineering opportunities. Work with the owner and architect to redesign parts of a project to include less expensive components that don't detract from the overall aesthetics. For example, suggest going with less expensive light fixtures and wall and floor coverings rather than high-end, top-of-the-line products.

Reusing materials. Cabinets, fixtures, hardware and appliances that are no longer suitable for one building may be just right for another. Many basic building components can be reused, including wood beams, sheetrock, bricks and tile, insulation, and pipes.

Living in a material world

Construction material costs are expected to remain high, which means you may be living with higher construction costs for some time. Take proactive steps now to lessen the blow and prepare for riding out the challenges and changes.

Time for a reality check

When was the last time you raised your rates? If you can't remember, it's time for a reality check. You might not be able to pass along every cost increase, but you can share some of the burden with your customers.

Look at it this way: Material suppliers are passing their costs to you, and you're paying more to attract skilled workers in a shrinking labor pool. Insurance and taxes are also on the rise. Your competitors have most likely raised their prices to remain viable. Where does that leave you?

Don't let the fear of losing customers hold you back. There may be some who are unwilling to pay more, but most will respect your decision if you give them plenty of notice and explain the reasons behind your decision. If the idea still makes you too nervous, consider raising prices for only new customers or for your least profitable ones.

Contractor's toolbox

Can your salaries stand up to IRS scrutiny?

If your construction company is an S corporation, the IRS is likely to examine your 2007 tax return closely. That's because it's on the lookout for S corporations that fail to pay "reasonable compensation" to shareholders who work for the business.

Why it matters

Generally, S corporations don't pay income taxes. Instead, the corporation's income or losses are divided among and passed through to shareholders, who report the income or losses on their individual income tax returns. Employment taxes are imposed on employees' wages but not on distributions to shareholders.

If a company earns a profit, its shareholder-employees must pay themselves "reasonable compensation." The IRS contends that S corporations typically underreport salaries of shareholder-employees to minimize the employment taxes that would be due on those wages.

Suppose, for example, a roofing contractor operating as an S corporation pays its three officers $10,000 each in salary and $50,000 each as distribution of profit. After learning that all three officers have worked full time in the business and that contractors in comparable lines of work typically earn $50,000 or more a year, the IRS may assert that each officer should have received $50,000 in salary and $10,000 as distribution of profit.

Such a reclassification would create a payroll tax liability on an additional $40,000 per officer. The IRS also could impose penalties and interest for the unpaid tax liabilities.

Reasonable compensation

The basic rule of thumb is that shareholder-employees should pay themselves what they would pay others to do the same jobs.

To make sure you're paying your shareholder-employees a reasonable salary, your CPA can offer information for reasonable salaries in your locale. But you may also want to research salaries using Internet salary calculators from www.salary.com, www.careerbuilder.com and www.salaryexpert.com. You can also buy construction-specific wage surveys at www.constructionexecutive.com and www.wageaccess.com/ncs/construction.asp.

Various approaches

If you can't find salary data for the work your particular shareholder-employees perform, consider using the "60-40" approach. In other words, take 60% as salary and 40% as distributions. Some CPAs use the treatment as a general guide to help prevent triggering an audit.

Another option is to make the shareholder-employee's salary a percentage of your net business income — before taking the salary deduction into account.

Although using such approaches can help guide you in determining appropriate salaries, they aren't foolproof. Therefore, it's critical that you work with your CPA when setting up a salary structure.

Facts and circumstances

There are no hard-and-fast rules for determining adequate shareholder-employee salaries. The IRS weighs the facts and circumstances in each case and may also consider your company's size and region, among other factors.

In any case, given the increased IRS scrutiny, construction companies operating as S corporations should ensure that their shareholder-employees are, indeed, drawing reasonable salaries. They may have the IRS breathing down their necks if they don't.