Construction

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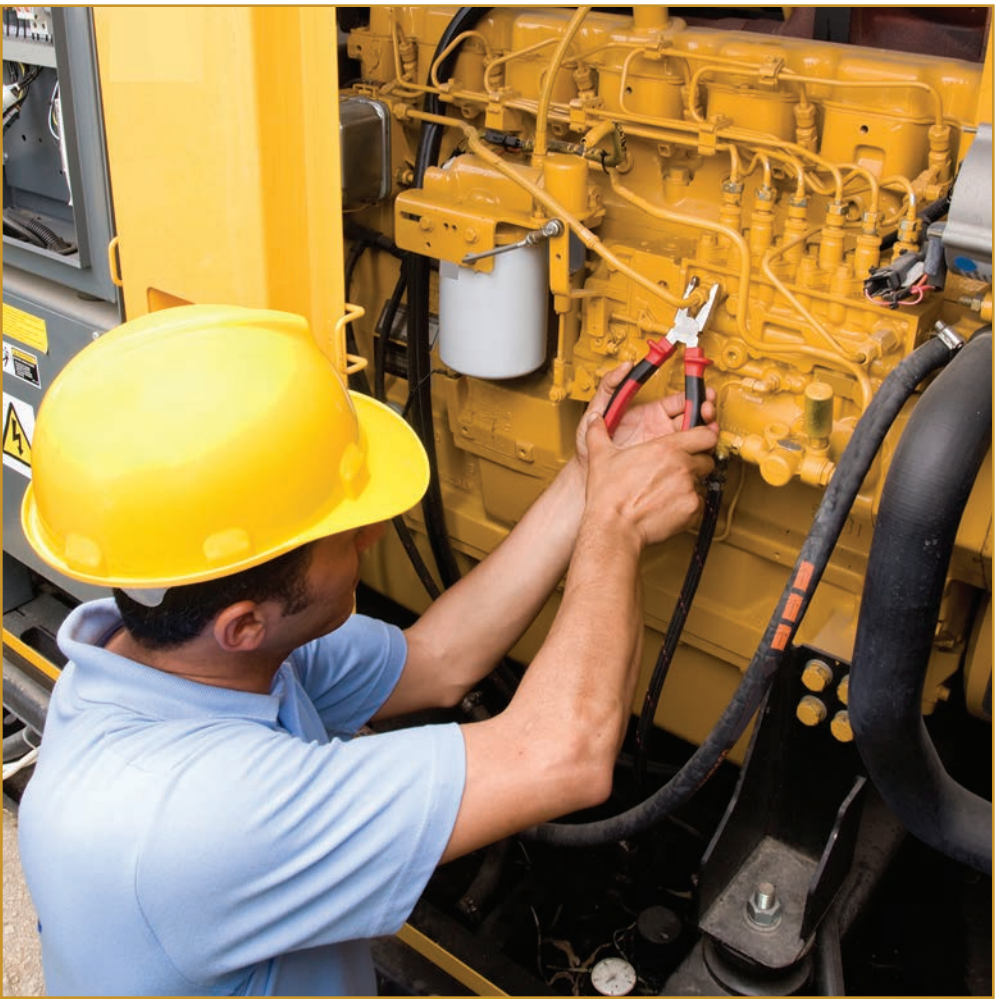

Expense or capitalize?

New repair regulations offer guidance for contractors

For years, contractors have struggled to determine whether certain costs may be expensed for tax purposes (that is, deducted currently) or if they must be capitalized and depreciated. Recently, the IRS issued long-awaited final regulations on this subject, known as the "Repair Regs."

A full discussion of the 222-page final regulations is beyond the scope of this publication. So, this article will review some of the highlights.

Improvements vs. repairs

Under the final regulations, businesses are required to capitalize amounts paid to acquire, produce or improve tangible property. This includes buildings, machinery and equipment, vehicles, and other real and personal property. Certain incidental expenses, such as repairs and maintenance, are deductible.

Improvements include activities such as enhancing a property's quality, strength, productivity or efficiency, or restoring a major component or substantial structural part of a property. Distinguishing between improvements and deductible repairs or maintenance isn't always easy. For example, if a contractor maintains a fleet of specialized vehicles or equipment, is replacing an engine or other major part deductible *maintenance* or is it a nondeductible *improvement*?

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To simplify these decisions, the Repair Regs contain a safe harbor for routine maintenance. It allows businesses to deduct expenses for recurring activities — inspecting, cleaning, and testing of property and replacement of damaged or worn parts — that result from their use of the property and keep the property in efficient operating condition. An activity is considered "routine" if, at the time a piece of equipment or other property is placed in service, the business reasonably expects to perform it more than once during the property's class life (for example, more than once every 10 years for a building).

Materials and supplies

These are deductible if they aren't inventory and are:

- Components acquired to maintain, repair or improve a unit of tangible property,
- Fuel, lubricants, water or similar items reasonably expected to be consumed in 12 months or less,
- Units of property with a useful life of 12 months or less,
- Units of property with an acquisition or production cost of $200 or less, or
- Property identified as materials or supplies in published guidance from the IRS.

The timing of the deduction depends on the type of property. Incidentals, such as office and cleaning supplies, are deductible when purchased. Nonincidental materials and supplies — such as small engine parts, fuel, motor oil, drill bits and saw blades — are generally deductible when first used or consumed.

Rotable (regularly maintained), temporary or standby emergency spare parts generally aren't deductible until they're used or consumed. But a business can elect to capitalize and depreciate these parts.

Buildings

To determine whether an expense is for an improvement or repair, it's critical to identify the relevant "unit of property" (UOP). The Repair Regs treat a building and its structural components as a single UOP, but they also treat a major component or substantial structural part of property — including HVAC, plumbing, electrical, escalators, elevators and fire protection — as a separate UOP.

So, for example, if work done on a building's HVAC system constitutes an improvement to that system, the costs must be capitalized — even if the work doesn't rise to the level of a betterment with respect to the building as a whole.

Providing added value to customers

Construction companies that understand the Repair Regs (see main article) can help customers reduce their tax bills. Suppose, for example, that a building contains asbestos insulation that has begun to deteriorate, thus creating a health risk.

The owner hires a contractor to replace the insulation. Assuming that the customer meets the requirements under the small business safe harbor rule (see "Buildings" section in main article), the contractor gives the customer a choice:

1. Install new insulation that's comparable in quality to the old insulation, which would likely be considered a deductible repair, or
2. Use higher quality insulation, which would likely be considered an improvement, which must be capitalized.

Option No. 1 would give the customer an immediate deduction, lowering tax liability and strengthening cash flow. Meanwhile, Option No. 2 would yield far less tax relief — at least in the short term.

The final regulations also contain a small business safe harbor. Businesses with gross receipts of $10 million or less may elect to deduct rather than capitalize expenditures for repairs, maintenance, improvements and similar activities so long as: 1) the building's initial cost is $1 million or less, and 2) total expenditures for the tax year don't exceed the lesser of $10,000 or 2% of the building's unadjusted basis.

Know the rules

It's important to familiarize yourself with the Repair Regs in order to understand the tax treatment of the work you do on your own buildings, equipment, machinery and vehicles, as well as work you do for customers. (See "Providing added value to customers" above.)

In light of the new rules, review your existing accounting policies and procedures and modify them if necessary. You may need to apply for a change in accounting method to ensure that you're treating expenditures properly for tax purposes. ■

How your contracts can help strengthen cash flow

All businesses experience the ebbs and tides of cash flow at some time or another. But it can be particularly hard if your construction company is experiencing hard times. Fortunately, the very document you sign when starting a job can help you turn that tide around.

Pinpointing payment terms

Payment terms have an enormous impact on cash flow. A contract that calls for payment on completion of specified phases of the project, for example, creates uncertainty — making cash flow forecasting difficult. A contract that requires payment in equal installments over the course of a project provides greater predictability but may not correspond to your expenditures on the job.

It's not unusual for a construction project to involve significant upfront costs. If possible, negotiate a "front-loaded" billing schedule that reflects your greater cash needs in a project's early stages. You might also ask for accelerated payment methods, such as wire transfers or electronic checks.

If your contracts don't have change order terms, your payments may be delayed for additional work. Or, even worse, you might lose out on those payments altogether.

Before you even start a job, assess the financial strength and creditworthiness of the owner as well as other contractors, suppliers and vendors involved. Doing so can give you a better idea of whether the payment terms are realistic. Furthermore, rather than waiting until a payment is past due, develop working relationships with the customer's accounts payable personnel to

ensure payments are on schedule and consistent with the terms.

In addition, many contractors find it helpful to prepare project-specific cash flow forecasts to get a better idea of how the payment terms will affect their overall financial positions going forward. This way, they can be prepared to make adjustments during the course of the job.

Negotiating retainage

A 5% or 10% retainage can easily defer your entire gross profit on a job until after completion. To reduce the impact on your cash flow, try to negotiate a lower percentage or ask for retainage to be phased out over the course of the project. For example, the contract might provide for 10% retainage, reduced to 5% when the job is 50% complete and eliminated when it's 75% complete.

Other options include limiting retainage to certain job costs, such as the labor component, or eliminating it through the use of letters of credit, performance bonds or other security.

Clarifying change orders

Change orders are an inevitable part of most construction jobs. It's critical that your contracts establish clear terms and procedures for approving and paying them. Train your staff to identify changes in the scope of work and to promptly

prepare and document change orders in accordance with contract terms.

If your contracts don't have such terms, your payments may be delayed for additional work. Or, even worse, you might lose out on those payments altogether.

Avoiding disasters

Contracts often disallow requisitions for materials until the materials have been installed. To avoid cash flow disasters, try to negotiate requisition terms that allow you to request payment once materials have been delivered to the job site.

Remember that cash flows in two directions, and outflow is just as important as inflow. If feasible, don't make payments to contractors, suppliers or vendors earlier than required unless you're entitled to a discount for doing so. Try to negotiate payment terms that, to the extent possible, match your cash outlays with your receipts from the owner or general contractor.

For example, include retainage provisions in your subcontracts that have terms similar to those in your contract with the owner. If you're a subcontractor and your contract with the general contractor contains a "pay-when-paid" or "pay-if-paid" clause, your contracts with sub-subcontractors should contain parallel provisions. That way, you won't be forced to pay subs until you collect from the general.

Reading the fine print

When entering into a contract, it's essential that you read every word — especially the fine print — and clarify any ambiguous terms. Your financial advisor can help you apply these and other ways to ensure your contracts strengthen, rather than weaken, your cash flow. ■

Sales and use taxes

Evaluate your exposure *before* you bid

If you do business across state lines, don't assume that other jurisdictions will tax your business the same way it's taxed at home. Just one misstep can quickly turn a potentially profitable job into a money loser.

Material differences

Most states treat contractors as the ultimate consumers of building materials they incorporate into a construction project. In other words, the contractor pays sales or use taxes on its material purchases and treats those taxes as a cost of doing business. These costs are reflected in the contractor's bids and are then passed on to its customers. Typically, it's the supplier's responsibility to collect the tax and remit it to the state. The contractor doesn't have to charge, collect or remit sales or use taxes.

In some states, however, the rules are different. A few, for example, treat contractors as retailers of the materials they install. The contractor buys the materials tax-free (usually by presenting a resale certificate to the supplier) and then collects sales tax from the customer, who is treated as the ultimate consumer of the materials.

In some of these states, the tax treatment differs depending on whether the installation is in residential or nonresidential property. Other states make a distinction between "capital improvements" and "repair, maintenance or installation," requiring the contractor to collect sales tax from the customer for the latter, but not for the former.

Tax treatment in some states depends on the form of the contract. For example, a contractor might be required to collect sales tax from its customers if materials are separately itemized and priced in the contract, but would be treated as the consumer of materials under a lump sum contract. In these states, there may be an opportunity to "shape" the tax treatment by using a certain type of contract.

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What if a construction company buys materials in its home state and takes them to an out-of-state job? Conceivably, the business could be charged sales tax in its home state and required to pay use tax or collect sales tax in the other state. Some states allow contractors to buy materials on a tax-exempt basis by certifying that the materials will be used out-of-state. And many states offer a credit against sales or use taxes for taxes paid in another state.

Tax-exempt customers

When it comes to projects involving nonprofit organizations or government entities, the sales and use tax treatment will also vary from state to state. The federal government is generally exempt from sales and use taxes, as are many state and local government entities and nonprofits.

Some states allow contractors to use a customer's exemption to buy materials tax-free for a job. In other states, materials are exempt from sales and use taxes only if the tax-exempt entity purchases them directly. In those states, contractors have an opportunity to avoid sales and use taxes altogether by having the customer procure the materials for the job.

Obligations and exemptions

Work with your tax advisor to be sure you understand and account for the impact of sales and use taxes on your jobs. The only way to develop accurate estimates is to understand the tax regimes in the states where you work, ascertain your obligation to pay or collect these taxes, and determine whether there are steps you can take to qualify for exemptions. ■

SBA offers bond guarantees for small contractors

Do you own a small construction company that's struggling to obtain surety bonds? If so, consider taking advantage of the U.S. Small Business Administration (SBA) Surety Bond Guarantee Program.

Do you qualify?

To qualify for an SBA guarantee, your annual receipts for the previous three years don't exceed a specified threshold.

For general and heavy construction contractors, the threshold ranges from $13.5 million to $17 million, depending on the type of construction. Specialty trade contractors must meet a $7 million threshold.

What are the benefits?

The SBA doesn't issue bonds. Rather, it guarantees bonds issued by participating sureties on contracts up to $6.5 million ($10 million for federal projects if a federal contracting officer certifies that an SBA guarantee is necessary for your construction company to obtain a bond).

The amount of the guarantee depends on which of the two programs is selected as well as the nature of your business. Under the Prior Approval Program, the SBA guarantees 90% of a surety's losses on: 1) contracts up to $100,000, and 2) contracts awarded to the following types of businesses:

- Socially and economically disadvantaged small businesses,
- Historically Underutilized Business Zones (HUBZone) Program small businesses,
- 8(a) Business Development Program small businesses, or
- Veteran-Owned or Service-Disabled-Veteran-Owned small businesses.

For all other contracts, the guarantee rate is 80%. As the name indicates, the SBA reviews and approves each surety bond under this program. For contracts valued at $250,000 or less, the agency offers a streamlined Quick Bond Guarantee Application and Agreement, which combines the contractor's application with the guarantee agreement between the SBA and the surety.

Under the Preferred Program, participating sureties can issue, monitor and service bonds without prior SBA approval. The guarantee rate for this program is 70%.

How do you apply?

The first step is to select a participating surety or a bonding agent who represents a participating surety. Next, you'll need to complete the surety's application and provide it with information on the "three Cs" (capital, capacity and character).

If the surety determines that an SBA guarantee is required before it will issue a bond, you'll need to complete and submit the necessary SBA forms for the relevant program (Prior Approval or Preferred).

Who needs it?

Obtaining surety bonds can be a challenge for any contractor. But doing so is particularly difficult for smaller companies on the rebound from financial trouble or for new businesses that have a limited track record or little working capital. An SBA guarantee could mean the difference between winning and losing a contract. ■