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CONSTRUCTION INDUSTRY ADVISOR

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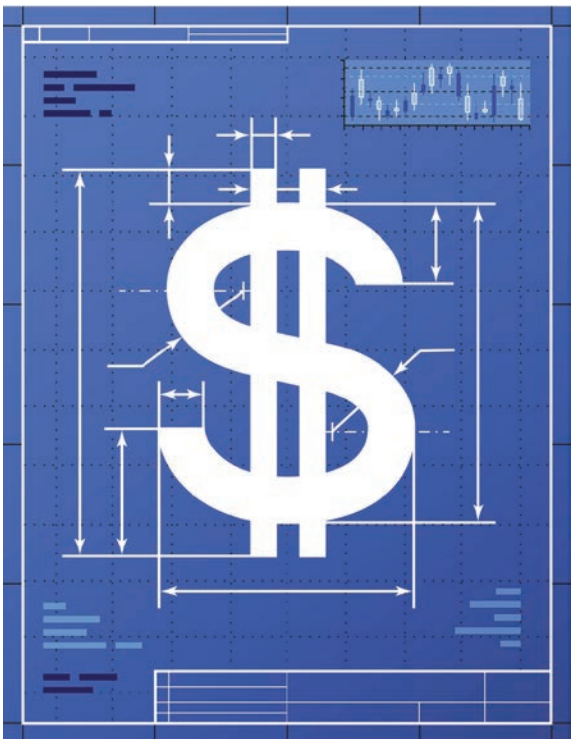
Are you getting all that you deserve?

Don't overlook the research credit

Construction businesses are often surprised to learn that they may be eligible for the research tax credit, often referred to as the "research and development," "R&D" or "research and experimentation" credit. Too often, they assume that this tax break is for only large pharmaceutical, biotechnology, software and aerospace companies, so they don't bother to investigate whether any of their activities qualify.

But if your company commits resources to developing new construction techniques, improving processes, experimenting with alternative materials or devising other innovations, it pays to explore the potential tax benefits. And even if you've looked into the research credit before, *now* is an ideal time to revisit the subject. Late last year, Congress made the credit permanent and enhanced its benefits for smaller businesses. (See "New and improved research credit benefits smaller companies" on page 3.)



Potential benefits

The tax benefits of the research credit are significant: a dollar-for-dollar, nonrefundable credit of up to 6.5% of qualified research expenditures (QREs). QREs include wages and supplies related to qualified research activities, computing costs and 65% of research fees paid to certain contractors.

"Nonrefundable" means the credit can't exceed your tax liability for the year. So you can't use it to generate a loss and claim a refund. But unused credits may be carried back one year or forward up to 20 years to offset your tax liability in those years.

It's important to understand that simply conducting research isn't enough to qualify for the credit. Rather, it's designed as an incentive for companies to *increase* their research activities. Calculating the credit is complex, and there are several methods for doing so, but, essentially, it's equal to a percentage of the amount by which your current-year QREs exceed a base amount.

Qualifying activities

Generally, to qualify for the research credit, a research activity must: 1) be related to development or improvement of a "business component," such as a product, process, technique or software program, 2) strive to eliminate uncertainty over how (and whether) the business component can be developed or improved, 3) involve a "process of experimentation," using techniques such as modeling, simulation or systematic trial and error, and 4) be technological in nature — that is, it must rely on "hard science," such as engineering, computer science, physics, chemistry or biology.

An inherently uncertain business, construction often requires architects, engineers and contractors to use innovation and experimentation to meet the technical challenges associated with a

New and improved research credit benefits smaller companies

The Protecting Americans from Tax Hikes Act of 2015 made the research credit permanent after decades of short-term renewals. It also made two important changes that expand the benefits of the credit for smaller businesses.

First, beginning in 2016, the act allows businesses with average gross receipts for the previous three years of $50 million or less to claim the credit against the alternative minimum tax (AMT). This is good news for taxpayers, particularly owners of partnerships and S corporations, whose ability to use the credit is limited or eliminated by the AMT.

Second, also beginning in 2016, start-ups — generally, companies in operation for less than five years with less than $5 million in gross receipts — may use the research credit to offset up to $250,000 in employer-paid FICA taxes. This is a big advantage for companies that incur substantial research expenditures but can't otherwise use the credit because they're not yet generating any taxable income.

project. Here are a few examples of activities that may qualify for the research credit:

- Developing more efficient, more effective, and safer construction techniques and methods,
- Evaluating alternative materials or combinations of materials,
- Developing new or improved construction equipment,
- Designing more efficient HVAC, electrical, plumbing or lighting systems,
- Developing innovative foundation designs to accommodate unusual site conditions,
- Developing innovative mechanical or electrical systems to accommodate unusual structures,
- Creating new or improved estimating software or building information modeling systems, and
- Designing buildings, features or systems that improve energy efficiency or help achieve LEED certification.

Generally, firms that perform engineering, architecture or design work in-house — such as design-build or engineer-procure-construct firms — have the most significant research credit opportunities. But any construction company that invests in these types of technological innovations may be eligible.

Review your contracts

To determine whether otherwise qualified research is eligible for the research credit, it's important to review your contracts carefully. To claim the credit, you must bear the financial risk associated with the research *and* enjoy substantial rights to the results. Otherwise, it will be considered "funded research," which is ineligible for the credit.

Generally, research performed pursuant to a fixed-price contract is eligible for the credit because the contractor bears the financial risk (provided the contractor also retains the rights to the results of the research). But research performed under a cost-plus or time and materials contract will likely be considered funded (and therefore ineligible) because the financial risk lies with the customer.

Don't leave money on the table

If your business invests time and money into developing or improving construction processes, techniques, products or designs, talk to your tax advisor about whether these activities qualify for the research credit. Too often, contractors leave money on the table by failing to take advantage of this valuable tax break. ■

Maximizing the Section 199 deduction

As a construction business, your company may be eligible for the Section 199 deduction for "domestic production activities." This tax break is known by several names, including the "domestic production activities deduction" and the "manufacturers' deduction."

In fact, many contractors overlook the Sec. 199 deduction because they believe it's only for manufacturers. But it's also available for "construction of real property performed in the United States" by a taxpayer "engaged in the active conduct of a construction trade or business."

Claiming the deduction

The Sec. 199 deduction is equal to 9% of the *lesser* of: 1) your qualified production activities income (QPAI) for the year, or 2) your taxable income (before taking the deduction). For individual taxpayers, adjusted gross income is used instead of taxable income. The deduction is capped at 50% of your company's W-2 wages attributable to qualified production activities.

Determining your QPAI can be complicated but, generally, it's your *net* income from constructing or substantially renovating buildings or other real property. It may also include net income from certain construction-related activities, such as management, land improvements, installing building components (such as HVAC systems or plumbing), delivering materials, hauling debris or providing administrative support.

QPAI doesn't include income from construction activities outside the United States, sales of land or tangible personal property (other than certain construction materials and supplies), real property rentals, repairs or cosmetic work.

Note that, for pass-through entities such as S corporations and partnerships, the Sec. 199 deduction is determined at the shareholder or partner level.

Boosting your benefit

Depending on the nature of your construction business, you may have opportunities to boost the benefit of the deduction. Here are some strategies to consider:

Evaluate your accounting system. It can be challenging to distinguish between qualifying and nonqualifying construction activities and then allocate revenues, expenses, deductions and losses between them. Ensure that your accounting system has the ability to track this information.

Increase W-2 wages. Because the Sec. 199 deduction is limited to 50% of W-2 wages, you can boost your deduction by increasing those wages. There are several ways to do this, including:

- Hiring more employees,
- Converting independent contractors into employees, or
- Paying bonuses to employees involved in qualified production activities.

If you're a sole proprietor with no employees, consider incorporating your business and paying yourself a salary.

Use separate entities. If your business is involved in both qualified and nonqualified production activities, consider using a separate entity for qualified activities. This makes it easier to segregate the revenues, wages and other expenses attributable to qualified activities and can help increase your Sec. 199 deduction.

Restructure your compensation. Consider this example: George is the sole shareholder of a construction business organized as an S corporation. The company's net income is $600,000, all of which is QPAI, and it has W-2 wages of $800,000, including George's $300,000 salary. His taxable income before the deduction is $900,000 ($300,000 in wages plus $600,000 in pass-through income). Thus, the Sec. 199 deduction is $54,000 (9% of $600,000), reducing his taxable income to $846,000.

Now suppose George reduces his salary to $100,000 and receives a $200,000 distribution. This increases his company's QPAI to $800,000. His taxable income before the deduction is still $900,000 ($100,000 in wages plus $800,000 in pass-through income). But the Sec. 199 deduction is increased to $72,000 (9% of $800,000), and George's taxable income drops to $828,000.

Ensure that your accounting system has the ability to track all of the pertinent information.

In addition to increasing the value of the deduction, reducing George's salary also lowers the company's payroll taxes. (This assumes his new salary is considered reasonable. Work with your tax advisor to establish such an amount.)

Doing your homework

As you can see, the Sec. 199 deduction's benefits can be significant. So, as a contractor, it pays for you to do a little homework to determine whether you qualify and, if so, how you can get the most from it. ■

Enhance your operations with benchmarking

Benchmarking is the process of comparing one's business processes and performance metrics with your own historical data or those of other, similar companies. Through this process, you can identify the "best in class" business practices in the construction industry, or in another industry where similar processes exist, and compare these approaches and results with your own. In doing so, you'll hopefully learn how to enhance your operations.

Look within

The first thing to know about benchmarking is that it's an effective management tool. Benchmarking tells you how your company is performing and shows you where you can improve.

Internal benchmarking, or tracking your own performance, is your guide to weaknesses and opportunities within your operation. If, for example, your long-term debt-to-equity ratio

(an indicator of your ability to pay long-term debt) is rising, benchmarking will alert you early on so you can determine why it's happening and bring it back into proper alignment. Similarly, if your repeat business percentage is declining, benchmarking can give you a heads-up so you can identify and correct the problem.

External benchmarking helps you understand how other construction companies like yours have performed. For instance, how does your time to completion compare with those of similar businesses? Industry organizations, such as trade associations, can be a good source of information, though they tend to have a regional focus.

Indeed, be wary of the source and content of any benchmarking studies you review. National benchmarking, while informative, may not be useful for a locally or regionally focused contractor, because construction practices vary widely across the country. Similarly, a contractor with national reach would likely find local or regional data to be less helpful or even misleading.

Pick your data points

The specific benchmarks you use should be those that have the most effect on your company. A plumbing contractor, for example, is unlikely to be as concerned with capital equipment costs as an excavator will be.

In deciding which benchmarks would be best for you, pick your data points carefully. For example, a comparison of estimates to historical averages using a three- to five-year period typically creates a representative sample size.

You might also look at how gross profit in backlog compares to historical averages or how profit recognized to date compares to historical averages. You're also likely to examine labor costs (including overtime), overhead, materials and equipment costs, and other metrics.

In addition, surety information — how your bonding compares to that of your peers — is valuable. Your bonding company is likely to be one of the most important users of your financial statement, and any benchmarks you establish in that area can only help your capacity, especially if you can demonstrate that you're working to improve.

Gather complete information

Once you've established your benchmarks, you'll need to assemble the data you need to measure them. Make sure you're working with complete information that's relevant to what you're measuring. A single financial statement from five years ago won't provide an accurate representation of what you were doing back then, and a marketing summary that confidently predicts you're going to double your gross revenues next year isn't a reliable guide to the future.

Last, when you've collected all the information, keep it together — benchmarking should become a regular part of your financial operations. If you report financial information every quarter, benchmark every quarter, too.

Move forward

Benchmarking can help you move forward at a risk-reduced, carefully measured pace. For best results, work with your financial advisor. He or she can help you choose and calculate the optimal performance metrics. ■

Drones on the job site

These days, one probably wouldn't be surprised to see an unmanned aerial vehicle (UAV), commonly referred to as a "drone," hovering over a job site. These vehicles hold great promise for the construction industry.

But before you run down to the local hobby store to pick one up, be sure to familiarize yourself with the regulatory issues surrounding their use. As drone use increases, the Federal Aviation Administration (FAA) is looking at them more closely, and the regulatory framework that governs their operation is in a state of flux.

A powerful tool

A drone with high-quality video and still photography capabilities could serve as a powerful tool for contractors. Potential uses include:

Site surveys. Drones can fly over a job site and transmit images to a mapping software program. This can be a cost-effective solution for aerial mapping needs that traditionally required a larger aircraft, such as a helicopter.

Drones are indeed a promising tool for contractors, but be mindful of potential regulatory issues.

Job monitoring. Using a drone can be a great way to monitor progress, keep projects on schedule, ensure work is meeting your quality standards and update clients with informative — even spectacular — imagery.

Inspections. A drone allows you to inspect work at high elevations or difficult-to-reach places

without the cost and safety concerns associated with human inspections.

Marketing. High quality aerial video footage of a job site can be an impactful tool for showing your work to clients and prospects.

Materials and equipment transport. Eventually, it may be possible to use drones to move certain materials and equipment to or on a job site.

Security. Drones can help detect and prevent theft or trespassing on job sites or at storage facilities.

A cautious agency

Drones are indeed a promising tool for contractors, but be mindful of potential regulatory issues. Currently, the FAA permits recreational use of drones weighing up to 55 pounds, so long as users register their aircraft and comply with federal safety guidelines. These include flying no higher than 400 feet, staying away from airports and avoiding interference with air traffic.

The bottom line

As of this writing, the FAA is developing regulations for commercial drone use. For now, permission is granted on a case-by-case basis to users who obtain a "Section 333 exemption." To avoid significant penalties (as much as seven figures in extreme cases), contractors who wish to use drones should apply for a Sec. 333 exemption (a potentially costly, time-consuming process) or hire a drone operator who already has a valid exemption. ■

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Analyzing and Managing Cash Flow

Maintaining strong cash flow can be critical – and challenging – for contractors, subcontractors, and construction companies. The majority of cash inflow comes from projects currently underway, which involve covering spending for project completion while relying on customer payments to cover payroll, vendor expenses, and other business expenses.

Many construction companies don't realize their cash flow balance is misaligned until it's too late. Monthly balance sheets or income reports may not provide advance warning of a problem.

How to assess the strength of cash flow

While cash flow can be defined as the amount of payments received minus payments made over a set period, maintaining a healthy cash flow involves more complex calculations. Analyzing cash flow involves several key indicators. These may include:

- Working capital percentage (funds available after debts and expenses are settled)
- Liquidity and the company's ability to meet financial obligations
- Cash demand and ratios such as working capital turnover and the average number of days to settle outstanding accounts

Why cash flow is important

In addition to allowing a business to cover its expenses, cash flow management can impact the relationship a company or contractor has with sureties or other lenders.

Borrowing funds is often necessary because purchasing and labor frequently precede customer payments. Equally important, lenders will analyze a borrower's ability to maintain sound financial practices and a healthy cash flow.

A surety underwriter will examine several factors when deciding if a borrower is a strong candidate for a loan or bond such as:

- Debt-to-equity ratio
- Timely bill payments
- Accurate in-house financial tracking
- Existing borrowing or overbilling

Best practices for cash flow management

There are several ways to strengthen cash flow:

- Setting up progress payments with a schedule of values
- Setting up a standardized billing and collection policy
- Negotiating better contract terms
- Factoring some portion of accounts receivable

The LaPorte Construction Industry Group has more than five decades of experience providing accounting services to the industry. For more information on establishing practices to strengthen cash flow and enhance financial flexibility, contact Directors Tracy Tufts at ttufts@laporte.com or Frank Sharp at fsharp@laporte.com.