

PERSPECTIVES ON THE CONSTRUCTION INDUSTRY

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Court Rejects Homebuilder's Deduction of Employee Compensation

In a recent case, a builder of custom and speculative homes was required to capitalize — rather than deduct — certain employee salaries and year-end bonuses, including \$1,318,000 in total compensation paid to the company's founder and CEO.* The decision affirmed an earlier Tax Court decision that the company's deduction of these and other related expenses violated the tax law's uniform capitalization (UNICAP) rules.

Background

The UNICAP rules require producers of real property to capitalize their production costs, including both "direct" and "indirect" costs. Direct costs that must be capitalized include direct material and direct labor costs. Indirect costs are allocated between production and nonproduction activities, and the portion allocated to property produced is capitalized.

Indirect costs also include service costs, which must be allocated among capitalizable, deductible, or mixed service costs. Because mixed service costs are only partially allocable to production, they must be capitalized based on a "reasonable allocation method" as described in the tax regulations. The primary issue in the case was whether the construction company's payments of employee salaries

and bonuses in 2005 — a mixed service cost — were deductible.

The Issues

First, the appeals court agreed that the homebuilder — as the designer, builder, and seller of both custom and speculative homes — was engaged in "production" activities and therefore was subject to the UNICAP rules. As the Tax Court observed, speculative homebuilding is the classic production activity to which the UNICAP rules apply.

The homebuilder asserted that, as a *custom* homebuilder, its activities were exempt from the UNICAP rules because its business model centered on sales and marketing rather than on production-related services. In making this argument, the homebuilder placed particular emphasis on its use of subcontractors for completion of the actual construction. However, the homebuilder's use of subcontractors for the physical home construction was not enough to exempt it from the UNICAP rules. In the court's view, the creative design of custom homes is as much a part of a development project as digging a foundation or completing a structure's frame.

The CEO asserted that most of his time had been spent on deductible services rather than on specific production

activities. However, he had kept no contemporaneous time records to substantiate his claims, and the evidence submitted consisted entirely of his uncorroborated testimony. The appeals court concluded that the Tax Court's ruling was not "clearly erroneous" because the existing evidence indicated that a substantial proportion of the CEO's activities directly benefited, or were incurred by reason of, production.

Contact Us

This case illustrates the importance of properly accounting for a firm's production and non-production activities. If you would like us to help you set up appropriate procedures for the proper allocation of these costs, please get in touch with us at your earliest convenience. ✓

* *Frontier Custom Builders, Inc. v. Comm'r*, CA-5, 9/16/2015

In This Issue . . .

Payroll Taxes:	
Who's Responsible?	2
Avoiding Problems with	
Receivables	2
Safety Is a Bottom-line Issue	3
Developments	4

Payroll Taxes: Who's Responsible?

Any business with employees must withhold money from its employees' paychecks for income and employment taxes, including Social Security and Medicare (FICA) taxes, and forward that money to the government. A business that knowingly or unknowingly fails to remit these withheld taxes in a timely manner will find itself in trouble with the IRS.

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The IRS may levy a penalty, known as the trust fund recovery penalty, on individuals classified as "responsible persons." The penalty is equal to 100% of the unpaid federal income and FICA taxes withheld from employees' pay.

Who's a Responsible Person?

Any person who is responsible for collecting, accounting for, and paying over withheld taxes and who willfully fails to remit those taxes to the IRS is a responsible person who can be liable for the trust fund recovery penalty. A company's officers and employees in charge of accounting functions could fall into this category. However, the IRS will take the facts and circumstances of each individual case into consideration.

The IRS states that a responsible person may be:

- ✓ An officer or an employee of a corporation
- ✓ A member or employee of a partnership

- ✓ A corporate director or shareholder
- ✓ Another person with authority and control over funds to direct their disbursement
- ✓ Another corporation or third party payer
- ✓ Payroll service providers

The IRS will target any person who has significant influence over whether certain bills or creditors should be paid or is responsible for day-to-day financial management.

Working with the IRS

If your responsibilities make you a "responsible person," then you must make certain that all payroll taxes are being correctly withheld and remitted in a timely manner. Talk to us if you need to know more about the requirements. We can also help you analyze your business's cash flow so you'll be in a better position to meet your obligations to the IRS. ✓

Avoiding Problems with Receivables

It's predictable that some of your company's invoices will become collection problems. However, by implementing several simple procedures, you can greatly increase your chances of collecting payment for work you have completed.

Be Clear on the Payment Terms

Before beginning work on any project, communicate in writing your payment terms and when payment is expected. You may want to consider charging clients interest on overdue receivables, but be sure to consult with your legal advisor first regarding the terms.

Set a Goal of Zero-defect Invoices

To help speed up the payment process,

make sure your invoices are correct and easy to understand. When you inaccurately describe the work you've performed, your customer then has to contact your company for clarification and, more than likely, you'll have to resubmit the invoice.

Establish a Tight Invoicing Sequence

Any delay in preparing and mailing invoices will also delay payment. It's best to set and stick to a tight invoicing sequence. If at all possible, agree with your customers on terms that make partially completed work billable.

Stay on Top of Things

Establish a system for tracking and following up with your customers after invoices

are mailed. Keep an aging schedule of your receivables and begin an automatic collection effort after a predetermined period, such as 30 days. ✓

"To help speed up the payment process, make sure your invoices are correct and easy to understand."

Safety Is a Bottom-line Issue

It's estimated that employers in the U.S. pay almost \$1 billion per week for direct workers' compensation costs, according to the Occupational Safety & Health Administration (OSHA). Direct costs include workers' compensation payments, medical expenses, and costs of legal services. In addition, employers incur significant indirect costs for such things as training replacement employees, accident investigations, lost productivity, implementation of corrective measures, and lower employee morale and absenteeism.

The Impact on Construction

The construction industry remains one of the most dangerous industries. Out of 4,251 worker fatalities in the private sector in 2014, 874 (one in five) were in construction.* The four leading causes of worker deaths were:

- ✓ Falls – 349 (39.9%)
- ✓ Electrocutions – 74 (8.5%)
- ✓ Struck by object – 73 (8.4%)
- ✓ Caught-in/between (pinched in a small space and crushed, often in trenches) – 12 (1.4%)

Prioritizing Safety on the Worksite

As a contractor, you need to ensure that employee safety on the worksite is a top priority. A comprehensive and workable safety program that educates all employees on safe worksite practices and procedures can save lives. Moreover, addressing safety and health issues can add value to your business through:

- ✓ Lower workers' compensation insurance costs
- ✓ Reduced medical expenditures
- ✓ Fewer quality issues
- ✓ Increased productivity

- ✓ Reduced turnover
- ✓ Better morale

Here are some key areas your company safety program should address.

Scaffolding

Scaffolding safety should be a priority since numerous accidents are caused by unsecure, unsafe scaffolding. According to OSHA, scaffolding should be sound, rigid, and sufficient to carry its own weight plus four times the maximum intended load without settling or displacement. It must be erected on solid footing and unstable objects cannot be used to support scaffolds or planks. Scaffolds must be equipped with guardrails, mid-rails, and toe boards. Moreover, scaffolds cannot be erected, moved, dismantled, or altered except under the supervision of a competent person.

Fall Protection

Falls are the number one cause of fatalities in construction. Make sure your safety program emphasizes the use of safety nets, guardrails, and fall arrest systems or body harnesses whenever employees work high above the ground. OSHA recommends using guardrail systems with toe boards and warning lines to protect workers near the edges of floors and roofs. In addition, you could consider using aerial lifts or elevated platforms to provide safer elevated working surfaces.

Trenching

Trench collapses are a potentially deadly event for construction workers. OSHA

recommends that protective systems be used in and around trenches and that these protective systems be designed by a registered engineer when trenches are 20-feet deep or greater. Protective systems can consist of trench boxes or other types of supports to prevent soil cave-ins. In addition, you should ensure that ladders, stairways, ramps, and other means for exiting a trench require no more than 25 feet of lateral travel for employees in the trench. And always have a competent person inspect trenches before employees enter and after any event that may present a hazard, such as a rainstorm, vibration, or excessive surcharge load.

Safety Equipment

The law requires you to provide certain types of protective clothing and equipment to employees. Required personal protective equipment (PPE) may include:

- ✓ Eye protection
- ✓ Hard hats
- ✓ Hearing protection
- ✓ Respiratory protection
- ✓ Goggles
- ✓ Face shields
- ✓ Fall protection
- ✓ Ladder safety device belts
- ✓ Reflective work vests

If you are interested in instituting a formal safety program in your company, OSHA has checklists and other helpful resources on its website (www.osha.gov). ✓

* OSHA Statistics

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The general information provided in this publication is not intended to be nor should it be treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your particular situation.

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Developments in Tax and Business

New Online Tool from the Census Bureau

Contractors looking to expand their business have a new tool to help them make data-driven decisions. The Census Business Builder: *Small Business Edition* is an online tool from the U.S. Census Bureau that provides a comprehensive range of helpful key demographic and economic data. It includes an interactive map that allows users to select a specific area to explore for business opportunities. The tool also provides dynamically generated, downloadable, and printable county- and city-level reports.

Shortage of Skilled Construction Workers

A shortage of skilled construction workers has hampered the construction industry since the recession. The shortfall, though, has become more acute as of late. A recent survey of 1,358 construction firms by the Associated General Contractors of America found that 86% of firms had difficulty filling jobs for hourly craft workers and salaried supervisors and specialists. Respondents reported the hardest positions to hire for were carpenters (73%), sheet metal workers (65%), concrete workers (63%), and electricians (60%). ✓

Can We Serve You?

Our firm provides a broad range of accounting, auditing, tax, employee benefit, and management consulting services to contractors.

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