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Nonqualified deferred compensation plans

**Reward, retain
key employees
with these
arrangements**



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Nonqualified deferred compensation plans

Reward, retain key employees with these arrangements

Do a few key employees play a critical role in your construction company's success? Do you want to reward them for their hard work while increasing the likelihood that they won't jump ship to the competition or strike out on their own? If so, a nonqualified deferred compensation (NQDC) plan may be just what you're looking for.

Give to the very best

In a nutshell, NQDC plans allow you to give your very best employees an extra, tax-deferred retirement reward that you can structure in a variety of ways.

NQDC plans generally aren't subject to the Employee Retirement Income Security Act (ERISA) or IRS regulations that govern "qualified" plans, such as 401(k)s. (To receive advantageous tax treatment, a qualified plan must cover a large percentage of employees and be subject to limits on contributions and benefits.)



NQDC plans don't provide as many tax benefits as qualified plans do, but they're more attractive in other ways. These arrangements are essentially contracts drawn up between your company and its select employees to pay them later for work they do today.

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As such, NQDC plans allow you to play favorites. You can give one person more than you give another, and you don't have to follow quite as many rules as you do for qualified plans. The vesting schedule can also be whatever you say it is, and contributions can be whatever you want them to be as well.

Funded vs. unfunded

Generally, NQDC plans fall into two categories — funded and unfunded. Funded plans are those in which a third party, such as a trust or escrow account, holds assets for the NQDC.

A funded plan's assets can't be touched by creditors, but they're also out of your reach — once you put money in the account, you can't access it even in an emergency. The designated employee or group of employees is guaranteed to get it.

The downside to funded plans, and the reason they're not commonly used, is that they provide only limited tax benefits and *may* be subject to ERISA requirements. (See "The tax picture" on page 3.)

If your employees fear you'll go bankrupt or sell your construction company, a funded plan could serve as a valuable retention tool because participants are guaranteed to get their NQDC payout as long as they remain with the company until they become fully vested. Otherwise, in most cases, everyone will be better off with an unfunded plan.



With an unfunded plan, you don't set aside the money you'll use to pay the benefits. Instead, you pay out of your cash flow or through property such as a corporate-owned life insurance policy. You can also set up a so-called "rabbi trust" to hold the plan assets but, if you go bankrupt or become insolvent, assets in such a trust will be subject to creditors' claims.

The tax picture

If your NQDC plan is unfunded and maintained solely for the benefit of a select group of highly compensated employees, you'll win on two fronts: You'll be able to claim a tax deduction when participants are taxed on their benefits *and* you'll avoid most ERISA regulations.

Funded plans are a little more complex. Although you'll still be able to claim a deduction for your contributions when participants are taxed on their benefits, ERISA rules, as mentioned, may apply in some cases. (Ask your CPA for details.)

In addition, as soon as employees are vested in a funded plan, they generally must include NQDC contributions in their income — and pay taxes on them. This may affect their willingness to participate in the plan.

And whether a plan is funded or unfunded, new regulations require that you still include any deferred compensation amounts on participants' W-2 forms.

Likely candidates

NQDC plans will most likely benefit a financially sound, closely held construction company that anticipates generating healthy profits for years to come — particularly if it's a C corporation.

Deferred comp deadline nears

If you already offer a nonqualified deferred compensation (NQDC) plan to any of your construction company's key employees, you have until Dec. 31, 2008, to make sure that the plan complies with recently amended IRS regulations.

Specifically, Internal Revenue Code Section 409A applies to NQDC plans (as well as certain stock option plans, bonus plans and other longer-term deferred compensation plans) and requires that:

- Employees elect to defer compensation before the year in which they perform the services for which the compensation is earned,
- Benefit payments be made according to a fixed schedule or after a specific event (such as death, disability or separation from service), and
- Payments not be accelerated (with limited exceptions).

Penalties for noncompliance can be harsh. They may include immediate taxation of vested benefits, a 20% penalty tax and interest charges.

Why a C corporation? Because, if your company is an S corporation, limited liability company partnership or sole proprietorship, neither you nor anyone else with an ownership interest can defer taxes on his or her share of business income. The plan can be used as a benefit for only nonowner employees and, even in that case, the deferred income tax deduction resulting from the plan could increase the business income taxable to the owners.

Also bear in mind that, no matter what your business structure, your construction company will have to accrue an expense for the NQDC plan and the accrual will be a liability on your books. Such a liability could impair your bonding capability.

The right way

Done the right way, an NQDC plan can be an effective retirement funding vehicle for your key employees and an effective employee retention tool for you. Yet there are risks as well, so be sure to work with your CPA to determine whether one of these arrangements is a good fit for your construction company. ■

PPE should be on employers' dime, OSHA says

It's a decision the Occupational Safety and Health Administration (OSHA) says could prevent thousands of work-related injuries each year. That is, the agency now requires employers to provide employees with virtually all of their personal protective equipment (PPE), such as hard hats and nonprescription safety goggles.

If you buy PPE, OSHA says, employees are more likely to have the right gear in good condition, and they'll be more inclined to use it.

What's the deal?

The new rule is intended to add consistency regarding PPE across both companies and industries. But the rule doesn't really change what PPE you must provide; it just requires that you pay for the PPE you use to comply with OSHA regulations.

There are some exceptions: You aren't required to pay for steel-toed boots, prescription safety glasses or clothing used solely for weather protection (such as winter coats) or to protect against dirt (for example, overalls).

The rule also gives you some leeway in how you provide the PPE. Your options include:

- Buying and distributing the equipment yourself,
- Giving employees pay advances to buy their own equipment,
- Reimbursing employees for the cost of equipment after they buy it, or
- Negotiating with a supplier to accept vouchers in lieu of cash (and bill you later).



There are advantages to each approach, but vouchers may be the most convenient administratively, and they keep cash out of the cycle. If you choose to give employees advances, be sure they return any excess money. Otherwise, you'll have to report the overages as wages.

Anything else?

One issue of particular concern to contractors is employee mobility. Construction workers often move among job sites — not to mention among jobs.

You aren't required to replace PPE if an employee loses or intentionally damages it, but you are required to make sure every employee starts out with the proper equipment. And that includes transitory, temporary and part-time workers.

You can require employees to turn in their PPE when they leave the company. After all, if they don't, you'll have to buy more for the next person. You may even take steps to retrieve missing equipment or require the departing employee to pay for it.



For accounting purposes, PPE is a business expense that you'll include in your overhead. As with any expense, how you recognize it depends on the accounting method you use. If you use the cash method, you may recognize expenses as you incur them.

If, like most contractors, you use the accrual method, how you recognize expenses will depend on whether yours is a small or large business, whether your projects are short- or long-term, and whether your projects are home construction or general construction. If you're not sure which method is right for you, consult your CPA.

Has anything really changed?

As OSHA notes, most contractors already pay for PPE most of the time. If this is true for your company, nothing has really changed. Nonetheless, the final rule became effective on Feb. 13, 2008, and companies were due to implement it by May 15. So, if you're not in compliance, take steps to abide by the rule immediately. ■

Worth a look: Web-based project management software

Many construction company owners have their own distinctive means of managing jobs, be it a simple spreadsheet or a more advanced tool. If you're pleased with your approach to project management, great; but one upgrade that's well worth looking into is Web-based project management software.

Information where you need it

Simply put, Web-based project management software lets everyone — from the owner to the architect to the general contractor to subcontractors and suppliers — log on to a project-specific Web site to gather information and communicate with one another. (Typically, the main purchasers of these systems are general contractors/construction managers.)

Perhaps more important than upfront cost is whether the software will do what you want it to do.

If, for example, a change order requires approval from the architect, the owner and a subcontractor, each of them can go online to review and approve the order in minutes. Participants can also review job progress, converse on message boards or in chat rooms, and even view the job site in real time via a Webcam.

Perhaps best of all, you don't have to install special software on every relevant computer. Any user with an Internet connection — and the proper security credentials — can access the virtual job site.

Price isn't everything

When shopping for this type of software, remember that price, though important, is still just one consideration. Perhaps more important than upfront cost is whether the software will do what you want it to do. After all, your return on investment should, eventually, recoup the money you spend.

Before you buy, you'll want to pinpoint your "mission critical" requirements. For instance, if you're frustrated with slow response times from subcontractors, you can graphically highlight tasks

with approaching deadlines. Some systems even send the affected users an e-mail of changed or new items, so those parties don't have to log in to the project Web site to get updates.

Generally, a Web-based project management system will replace your existing project management software. These solutions, however, usually don't integrate with accounts payable or job costing systems.

Tax savings included

For a limited time only, there's also a tax benefit to obtaining a project management solution. As part of the Economic Stimulus Act of 2008, businesses may claim an immediate 50% deduction for depreciable property — including off-the-shelf computer software — placed in service before Jan. 1, 2009.

Better yet, for this tax year, you can also deduct, rather than depreciate, up to \$250,000 in asset expenses under Internal Revenue Code Section 179. The phaseout has been increased as well: You can spend up to \$800,000 before the dollar-for-dollar reduction in your Sec. 179 deduction kicks in.

Because these are one-year benefits, you need to act quickly to take advantage of them.

Know what matters

Web-based construction management software can improve your key processes and boost productivity — along with your bottom line. Just be sure you do your homework so the application you buy truly meets your needs and those of other stakeholders. ■



Do you know how much worker turnover is costing you?

Every time an employee leaves your construction company, it costs you money in terms of lost knowledge and time and lower employee morale. And if many workers leave annually, you're losing a lot of money. Plus, with the ongoing labor shortage in the construction industry, finding qualified replacements isn't likely to be easy.

Estimates on the cost of turnover vary widely but, however you crunch the numbers, it's expensive. And that's precisely why you need to figure out how much turnover is costing your construction business.

Run the numbers

You can get a rough estimate of turnover costs by, first, calculating 30% of a departing employee's salary for benefits and taxes. Then, to estimate the cost of hiring, training and integrating a replacement, add the 30% figure to that person's salary and multiply the total by 0.25.



Let's say a craftsman makes \$50,000 per year, and you pay another \$15,000 (30% of \$50,000) in benefits and taxes. Your total cost for that employee is \$65,000 per year.

Now let's say the employee quits. By the time you hire and train a replacement, set up benefits, and provide orientation and any required equipment, you may have spent \$16,250 (25% of \$65,000). Multiply that by 10 employees, and you've spent six figures before a hammer ever hits a nail. And that estimate may be conservative.

Consider other factors

You'll also need to factor in a drop in productivity while your remaining employees try to fill the gap, which could trigger a decline in quality, timeliness and customer service, causing the cost to skyrocket even more.

Some turnover is, of course, inevitable. Baby boomers are retiring in larger numbers annually, and sometimes you have no choice but to fire a worker. You can, and should, budget for that. The real problem is unplanned turnover.

When the economy is booming, your employees may have their choice of jobs, and they may choose to move to greener pastures. When the economy is less robust, you may have more workers from which to choose, but your competitors may be working harder to lure your best employees away.

Of course, as mentioned, the labor shortage in the construction industry may leave the job market in employees' favor — even during slower economic periods.

Revisit your hiring process

In either case, it's in your best interests to reduce unplanned turnover. How? Start by calculating what your turnover rate is now.

There are many possible variations in calculating turnover rate, but it essentially involves taking your average number of workers who leave each year, and dividing by your total number of employees. So if you have 100 employees and 20 of them, on average, quit, retire or get fired every year, your turnover rate is 20%. That may be good or bad

compared to other contractors in your area, but it can be improved — and it may not take much money to do it.

First, look at who's leaving and why. If you're firing a fair number of people, it may be time to review your hiring practices. Are you writing job descriptions that accurately convey the skills and attributes you require? Do you perform reference and background checks on every candidate?

Next look at the other reasons people quit. Compensation is always a primary factor, but

it isn't the only one. Lack of employer recognition, inadequate training, disagreeable management style and little room for advancement can all play a role in an employee's decision to leave.

Be the best you can be

Ultimately, if you respect your employees, establish realistic performance expectations, and pay them fairly, they'll be less likely to move on. At the same time, while asking your workers to be the best they can be, you should expect the same of yourself and your management team. ■



Construction Success Story

Cost segregation study gives one contractor a competitive edge

A commercial contractor, whose company typically builds office buildings, wanted to expand his market base by bidding on a proposed medical clinic. He knew his team could do the job, but one of his competitors had more experience in the construction of health care facilities.

He mentioned his concern to his financial advisor, who came up with an idea that would give him a competitive edge: As part of his bid proposal, the contractor could suggest organizing a cost segregation study.

The advisor explained that a cost segregation study's purpose is to identify property components that have shorter depreciation lives and, thus, qualify for faster depreciation rates. By breaking down the components in this manner, the property owner could maximize its current depreciation deductions and, thereby, boost cash flow. (However, note that, while a cost segregation study can accelerate deductions for depreciation, it does not increase the total amount of tax deductions over an asset's life.)

For example, the proposed clinic's plumbing, wiring, and heating and air conditioning vents and lines may be eligible for shorter lives if they're specifically required for equipment that has a shorter life, such as wiring for a security system. The owners may also be able to depreciate the allocated portion of certain capitalized indirect or overhead costs — such as architectural fees.

Cost segregation studies are generally led by a CPA and include other parties such as architects and engineers. For contractors, participation can help differentiate a construction company from its competitors and add considerable value to an owner's project. The trick is to initiate the cost segregation study as early in the construction process as possible — ideally, during the design phase, when depreciable assets are easier to identify.

In this case, the cost segregation study offer, coupled with a savvy bid, won the contractor the project. And besides getting an excellent new facility, the physician owners were able to reclassify 25% of the project's costs under accelerated depreciation schedules, boosting their projected cash flow by generating some tax savings through larger deductions as they opened the clinic. (Bear in mind, however, that depreciation is a noncash expense, so cash flow isn't directly affected by depreciation expense.)

As for the contractor, he's now winning bids on other health care facilities — and earning a little extra on the side as a cost segregation consultant.

The expertise you need, the service you want.

At Smith & Gesteland, LLP we know that running a successful construction company these days requires more than just dedication and hard work. It takes the assistance of experts who understand the industry and the challenges contractors face, and who have the specialized knowledge, hands-on experience and service commitment it takes to help them achieve their business goals.

Our Construction Industry Services Group consists of experienced professionals focused on increasing the success of companies like yours. For more than 50 years, our firm has served individuals and businesses throughout south central Wisconsin. We are delighted to currently work with more than 100 contractors and to have recently been voted Madison's Number 1 accounting firm. We are ready to assist you with a broad range of services tailored specifically to your needs, including:

- Profitability improvement
- Cash flow projections
- Quality and productivity enhancement
- Estimating/bidding improvement
- Bonding capacity maximization
- Lease vs. purchase analyses
- Tax reduction strategies
- Business valuations
- Succession and estate planning
- Financing assistance / growth management
- Project management and accounting systems
- Litigation and claims support

As specialists in the construction industry, Smith & Gesteland has developed the expertise needed to help contractors address and meet their many challenges. We would welcome the opportunity to help you build your success.

To find out what we can do for you, or for more information about the ideas presented in this newsletter, please contact John Folsom or Steve Pullara at (608) 836-7500 or mail@sgcpa.com. We look forward to talking with you.

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