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A CPA's Report for the Construction Industry

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Cost Segregation Studies

Benefits to Building Owners and Contractors Alike

In recent years, a growing number of commercial property owners have been able to improve after-tax cash flow by accelerating their depreciation deductions for certain building components. The key to achieving these benefits is the completion of a cost segregation study, which identifies certain building systems and components that qualify for accelerated deductions.

The use of cost segregation studies began increasing in the late 1990s, following several prominent tax court cases and related IRS rulings. Interest intensified further after 2013, when the IRS issued new tangible property regulations governing the capitalization and depreciation of certain capital expenditures.

Contractors who own their office, warehouse or shop facilities have an obvious interest in having a cost segregation study performed. It could help them defer taxes, reduce their current tax burden, free up capital, and ultimately improve their return on investment.

But even contractors who do not own commercial property directly can benefit by understanding what cost segregation studies do and recognizing how they can be used to benefit their customers.

How Building Owners Can Benefit

Commercial property typically is depreciated over 39 years, while residential rental property, including multifamily housing projects, is generally depreciated over 27.5 years. But certain building components and systems — electrical installations, plumbing, mechanical systems and finish components, for example — qualify for shorter depreciation recovery periods of five, seven or 15 years.

Cost segregation studies identify construction-related costs that can be depreciated over these shorter time spans. By accelerating depreciation schedules, the building owner can reduce current tax obligations and increase cash flow.

While cost segregation studies can be particularly helpful in improving the cash flow on new construction, they can also provide tax and cash flow benefits for existing structures. In fact, virtually every taxpayer who owns, constructs, renovates or acquires a commercial real estate structure could potentially benefit from a cost segregation study.

For example, under the tangible property regulations issued in 2013, certain repair and maintenance expenditures can be expensed immediately while other expenditures must be capitalized and depreciated over a period of years. Cost segregation studies help define the specific costs related to these various building components so that building owners can apply the proper tax treatment.

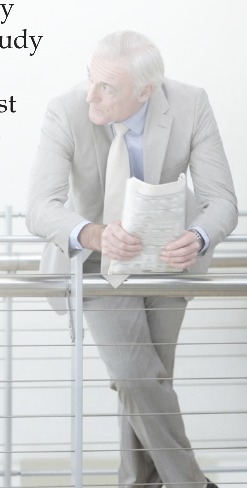
Added Opportunities

Beyond offering potential tax benefits to building owners, cost segregation studies can also give contractors a way to provide added value to their customers, thus strengthening and deepening customer relationships.

In its *Cost Segregation Audit Techniques Guide*, the IRS says, "Preparation of cost segregation studies requires knowledge of both the construction process and the tax law involving property classifications for depreciation purposes." As a practical matter, this generally means the study is a joint effort involving both construction engineers and CPAs, but building contractors also have an important role to play. Many contractors have qualified construction engineers and cost estimators on staff who can support the effort.

Even if they don't play a direct role, however, contractors can help streamline the process by coordinating with the study team and providing the detailed construction cost data that's needed, organized in a way that helps the team complete the study accurately and quickly. This means an astute building contractor will want to understand

Continued on page 3



Managing Risk

Fraud Deterrence Is Always a Priority

As the construction industry continues to rebound, it's easy for contractors to become complacent about the risk of fraud and the need to maintain strong internal controls. After all, new jobs and new opportunities are demanding more and more attention, leaving less time for owners and managers to monitor potential risks.

Unfortunately, as the pace of business quickens, the risk of fraud also increases. In busy times, fraud deterrence actually becomes *more* important — not less.

Increased cash flows and distracted owners mean there are more opportunities for employees to commit fraud. In addition, as employees struggle with greater volumes of work, some might also find it easier to rationalize fraudulent activities by convincing themselves that they're entitled to more compensation.

Expect the Unexpected

Every two years, the Association of Certified Fraud Examiners (ACFE) issues its "Report to the Nations on Occupational Fraud and Abuse." The report tracks trends in the growth and detection of various internal fraud schemes such as embezzlement, misappropriation of funds, phony expenses, bribes and kickbacks.

The most recent ACFE study, completed in 2014, found that nearly half (46.5 percent) of the reported fraud cases in the construction industry involved some form of corruption, such as purchasing schemes, invoice kickbacks or bid rigging. Other fraud categories that posed high risks to contractors included billing schemes, check tampering, phony expense reimbursements and payroll fraud.

Many of these ploys have a long history in the construction industry. Yet fraudsters are resourceful and inventive, consistently devising ingenious new schemes to avoid detection.

For example, in one recent case of payroll fraud, a company controller awarded herself bonuses amounting to thousands of dollars. But rather than writing large checks to herself — which almost certainly would have been noticed — she applied all of her bonuses to her payroll tax withholding account.

As a result, she was due a very large refund on her income taxes — in effect, using the IRS to launder her stolen funds. Because the business was growing and adding employees, and the owner failed to regularly review payroll records, the larger payroll tax deposits attracted no attention and the scheme went undetected for some time.

Important Internal Controls

As this example illustrates, fraudsters can be patient and clever, and no system of internal controls is foolproof. Nevertheless, certain internal controls can minimize the opportunities for fraud and deter all but the most determined thief. Here are some effective steps you can take to reduce fraud risk:

- Segregate financial duties. No single employee should handle all the steps of any transaction or all the activity in any account.
- Limit access to assets. Just as you lock up tools, materials and vehicles, you should also protect financial and electronic assets — for example, through strong password requirements.
- Make purchases only with prenumbered purchase orders. Also check receiving reports against invoices before payment is made.
- Prepare financial statements monthly and compare them against general ledger entries, bank statements, loan schedules and other supporting documents.
- Compare cash receipts to accounts receivable every month. Be alert for unusual credit memos on receivables, which could mask a diversion of funds.
- Open every bank statement yourself instead of delegating this to an employee.
- Monitor company credit card statements carefully to spot possible personal charges.
- Review the employee payroll list regularly, looking for duplicate or missing Social Security numbers, addresses or phone numbers. These could indicate a phantom employee or overlapping payments to an employee.
- Maintain personnel records independently of payroll and timekeeping functions. The payroll bank account should be reconciled by an employee who is not involved in preparing, authorizing or distributing paychecks or automatic deposits.
- Periodically compare payroll with personnel records to make sure terminated employees are removed.
- Always compare reported payroll tax withholdings to deposited withholdings.
- Be inquisitive and unpredictable. For example, ask about expenditures you've never asked about before, and focus on something different every time you review a financial statement.

This is not a complete list of all the internal controls you should have in place, and even sophisticated controls may not stop a truly determined thief. But extra vigilance and a systematic approach to basic internal controls can make your company less vulnerable. ■

Please call us to schedule a review of your internal controls and other strategies to reduce fraud risk.

Smart Hiring

Take Care When Using Background Checks

Last December, the U.S. Bureau of Labor Statistics issued a study projecting that the construction industry will add more than 790,000 new jobs by 2024. It seems the competition for qualified construction employees is going to remain intense for some time to come.

Despite the tightening labor market, it's important not to take shortcuts when recruiting, screening and hiring new employees. Careful screening can help ensure a safe and productive working environment while also reducing the risks of fraud, theft or other problems.

Regulatory Limitations

Unfortunately, properly screening applicants is not a simple process. Local, state and federal laws limit what types of background checks you can conduct, as well as how the information uncovered can be used in making hiring decisions.

For example, in 2012 the U.S. Equal Employment Opportunity Commission (EEOC) issued extensive guidance on the use of arrest and conviction records in employment decisions. Construction company owners, human resources teams and others with hiring responsibilities should review this guidance carefully to be sure that policies and procedures regarding criminal background checks are in compliance.

Five Important Principles

Always consult with qualified legal counsel to verify that your screening and hiring practices comply with applicable federal, local and state regulations. With that precaution in mind, here are five useful principles that can guide your review, particularly as it relates to the use of criminal background checks:

1. Treat all applicants equitably. If you check criminal backgrounds on some applicants, you should check them on all applicants. Be particularly careful not to single out certain nationalities, races or religions. This can happen inadvertently if you use criminal background checks for only certain positions that might attract more applicants from protected groups.

2. Document everything. Maintain detailed written policies and procedures for screening applicants and employees, identifying the specific types of checks that will be performed. These could include drug tests, criminal background checks, credit checks and social media searches, among others.

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The documentation should also identify critical job requirements for various positions. In addition, it should include a statement of specific offenses that might demonstrate a candidate's unfitness for a particular job.

3. Exercise judgment. According to the EEOC, a blanket policy that denies employment to all applicants with criminal records is a violation of Title VII of the 1964 Civil Rights Act. Instead, use a targeted screening process that takes into account the nature and severity of the crime, the amount of time that has passed since the offense was committed, and whether or not the particular violation is relevant to the job being filled.

And remember: You may not exclude an applicant based solely on an arrest record. An arrest, unlike a conviction, does not establish that any law was broken.

4. Give proper notice. If you plan to obtain information from a credit bureau or a criminal background check, you are required to notify applicants in advance. It's good practice to get candidates' agreement to this in writing as part of the application.

If you choose to ask candidates directly about past criminal convictions — a practice the EEOC strongly discourages — you must also include language informing them that their admission of a prior conviction will not, by itself, disqualify them.

5. Be discreet and professional. It's best to have background checks performed by qualified professionals — either internal HR staff with adequate training or outside firms that specialize in this area. Naturally, you must keep any background information you obtain confidential. Managers and others with hiring authority should be well-trained regarding the appropriate use of such information.

Background checks can be an effective risk management tool, but they must be conducted carefully. Be sure to consult with qualified legal counsel to ensure that all your hiring policies and procedures are in compliance with applicable laws and regulations. ■

If you have other questions about hiring and administrative issues, please call us to schedule a consultation.

Cost Segregation Studies

Continued from page 1

and recognize the various asset class life designations for the relevant building systems and components.

Ultimately, by helping building owners accelerate their tax deductions and improve cash flow, a cost segregation study can make funding of new construction or improvements more feasible — a situation that benefits building owner and contractor alike. ■

We would be happy to discuss the use of cost segregation studies with you in more detail. Please call us for an appointment.

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Maintain Up-to-Date Corporate Minutes

Large, publicly traded construc-tion companies often employ teams of in-house professionals to make sure they're complying with the various legal and financial reporting requirements that apply to large corporations. In privately held corporations, though, regulatory compliance is often an added responsibility that majority shareholders handle themselves — which means it can easily get overlooked.

One such requirement is the need to hold regular shareholder meetings and maintain accurate corporate minutes. These are not only required by law, but they also can be helpful in defending against third-party legal actions that might seek to shift liability away from the corporation to individual shareholders.

Corporate minutes can also be useful in the event of audits or tax disputes, and they can help resolve future shareholder disputes by providing a written record of agreements among the owners.

The required timing and other details will vary depending upon the state in which your business is incorporated, so consult with legal counsel for specific annual meeting requirements. Typical meeting agenda items include:

- Election of officers and approval of compensation.
- Ratification of financial statements and tax returns.
- Approval of equity transactions such as the issuance of new stock or redemption of shares.
- Review of shareholder loans or other related-party transactions.
- Review of real estate transactions and any significant financing, long-term debt or lease agreements.
- Approval of mergers, acquisitions or joint ventures.
- Approval of senior management salaries and bonuses.
- Changes to employee benefits or retirement plans.
- Renewal of professional contracts with banks, attorneys, accountants, auditors, sureties and insurance brokers.

Annual meetings and corporate minutes do not have to be burdensome. Generally, the previous year's minutes will provide a good template for the current year's requirements. ■