Mueller Prost PC
CPAs + Business Advisors

DIMENSIONS

REGULATORY COMPLIANCE

Understanding Federal DBE Requirements

If you're a contractor seeking to work on projects that are funded either wholly or in part by the U.S. Department of Transportation, it is important to understand the department's Disadvantaged Business Enterprises (DBE) requirements. Title 49, Part 26 of the Code of Federal Regulations provides that, except under limited circumstances, at least 10 percent of the authorized construction funds disbursed by the DOT must be spent with DBEs.

The practical effect of this policy is that virtually every highway or heavy construction contractor must show it is complying with the DBE program requirements.

What's more, since the federal DOT's requirements are mirrored by many state and local governments, any contractor working on government-funded projects should understand how to demonstrate compliance.

What Is a DBE?

The statute defines a DBE as a for-profit small business that meets two criteria:

1. It is at least 51 percent owned by one or more individuals who are both socially and economically disadvantaged — that is, they are members of designated racial minorities, women or members of other groups specified by the department.

2. Its management and daily business operations are controlled by one or more of the socially and economically disadvantaged individuals who own it. In other words, a qualified DBE can't be a mere shell.

The statute uses Small Business Administration (SBA) standards to define a "small business." There are a number of specific qualifications, but in general terms this means a company that is not dominant in its local market, with annual receipts totaling less than the prescribed maximum for the particular type of construction it performs.

For general building and heavy construction contractors, the maximum size is usually $33.5 million in average annual receipts; for specialty trade contractors, the maximum is usually $14 million. These maximums are different from those used to determine eligibility for SBA loans.

What Contractors Must Do to Comply

Contractors that do not qualify as DBEs themselves must establish and document their own goals for awarding contracts or subcontracts to DBEs. Contractors can ask for exemptions or waivers if it becomes impractical to comply, but such exemptions are getting more difficult to obtain.

Once its goal is established, the contractor must either meet the goal or demonstrate that it made a good faith effort to do so by taking steps such as:

- Soliciting DBE participation through all reasonable and available means, such as pre-bid meetings, advertising and written notices to capable DBEs.
- Selecting portions of work to be performed by DBEs, even if the contractor would normally prefer to work on those items itself.
- Providing DBEs with adequate and timely information about plans, specifications and requirements.
- Negotiating in good faith with DBEs.
- Not rejecting DBEs as unqualified without sound reasons.
- Assisting DBEs with bonding, lines of credit or insurance.

REGULATORY COMPLIANCE
Understanding Federal DBE Requirements, Cont'd.

Documentation and Other Requirements

In addition to these good faith efforts, participating contractors must also have a designated DBE liaison officer with direct access to the CEO, establish written policies and procedures to document their efforts, and take steps to ensure payment is made to DBEs within 30 days of completion of work. These and the other regulatory requirements are available online at http://www.fhwa.dot.gov/hep/49cfr26.htm.

These days, federally funded infrastructure projects play a significant role in many contractors' growth strategies. Any contractor seeking to participate in this growing area of business should be careful to comply with DBE requirements.

Call us with questions about qualifying or complying with various federal guidelines.

HANDLING CHANGE ORDERS:
Discipline and Knowledge Can Help Avert Problems

One lesson many contractors learn very early in their careers is that the original scope of work spelled out in a contract is hardly ever the final word — there are changes on virtually every job. How you handle these changes can mean the difference between a profitable project and a money-loser.

Know Your Contract

The first requirement for handling change orders is to fully understand the change-order process spelled out in your contract. The language should be clear about who on the project owner's team has the authority to assign additional work. It should also spell out how and when your request for a change order is to be submitted and processed. If anything is unclear, insist that the project owner give you written notification of who is authorized to commit to change-order work.

When additional out-of-scope work is assigned, make sure you follow the contract procedure to the letter — every time. If your request for a change order is denied and you decide to pursue a formal claim or litigation, the first thing you will need to do is show that you complied with the notification terms in the contract.

There is also a less obvious reason for strict adherence to contract terms: It can affect how the costs associated with change order-related work are reported and accounted for. This means it can directly affect your company's bottom line.

Change Order Accounting

According to Generally Accepted Accounting Principles (GAAP), you can recognize revenue from work that is billed to a change order only after the change order is actually approved. This is straightforward enough since without an approved change order, you are not likely to receive payment anyway.

What's more complicated, however, is how you account for the costs associated with change order work. It is very common to begin incurring costs for out-of-scope work even before a change order is approved. How well you adhere to contract terms will affect how these costs are accounted for while you are awaiting approval.

HANDLING CHANGE ORDERS:
Discipline and Knowledge Can Help Avert Problems, Cont'd.

When you start to incur costs related to work that you think should be covered by a change order, GAAP rules allow you to record those costs as a prepaid expense — that is, as an asset on the balance sheet — provided you have met certain conditions:

- Your contract spells out a process for applying for change orders.
- You have met the criteria for applying for a change order, such as submitting proper notice, and are complying with other terms of the contract.
- Your company has a generally good track record for getting approvals on the change orders it requests.

If these conditions are met, the costs associated with pending change order work can be separately reported as a prepaid expense on the balance sheet. In the case of large contracts that extend over more than a single reporting period, this can make a significant difference to your financial statements.

You must have a good cost identification system in place in order to segregate these costs into a separate account, rather than just charging them to the general job costs. In addition, everyone involved in charging or reporting costs should be informed when they are doing change order-related work.

Change Orders Are Everyone's Concern

The principles that apply to general contractors submitting change order requests to project owners also apply when subcontractors submit their change order requests to the GC. In addition, subcontractors should go one step further and follow how the general contractor passes on such requests to the owner.

Even if a subcontractor follows its contract procedures to the letter, the "paid-if-paid" clause that is found in most contracts means it may not get paid for change order work if the general contractor drops the ball. For this reason, subcontractors should always verify that their GC has complied with contract terms to ensure successful handling of the change order. If there is any reason for doubt, subs should insist on getting copies of all relevant change order requests the GC submits to the project owner.

A Disciplined Approach

Finally, always remember to get change orders approved and processed immediately — do not allow them to accumulate. Often, a project manager is under considerable pressure to "just get it done" and save the paperwork for later. But letting change orders accumulate until the end of a project inevitably means you will settle for less.

It can be difficult to maintain the discipline needed to get change orders processed promptly. But the alternative — not getting paid for legitimate work — is worse.

Call us today at 314.862.2070 with any questions about change order processing or accounting.

COMPENSATION STRATEGIES

"Reasonable" Subchapter S Compensation Is a Must

Many construction contractors operate as Subchapter S corporations. This form of ownership offers a number of tax advantages, but it can also lead to complications which, if not handled properly, can result in significant tax penalties.

One area of particular interest to the IRS is the issue of "reasonable compensation" for S corporation officers. S corporations report corporate income or losses on their shareholders' personal tax returns, but these earnings are not subject to Social Security, Medicare or Federal Unemployment Tax.

Because of this, S corporation officers may be tempted to reduce their payroll tax liability by paying themselves only a nominal salary, and taking most of their earnings in the form of shareholder distributions instead. This practice has come under increased IRS scrutiny recently.

What Is "Reasonable"?

The Internal Revenue Code (IRC) establishes that any officer of a corporation is an employee for federal employment tax purposes, and should be paid reasonable compensation. The challenge is how to define the word "reasonable."

In a 2009 report on the question, the Government Accountability Office pointed out that the IRS provides only "limited guidance" on the question, and the IRC offers no specific guidelines for what is considered reasonable. From various court rulings, however, the IRS has developed a list of nine specific factors that tax courts have considered in adjudicating cases where officers' compensation was questioned:

1. The duties and responsibilities of the shareholder.
2. The time and effort the shareholder devotes to the business.
3. The shareholder's training and experience.
4. Payments the company provides to non shareholder employees.
5. The timing and manner in which the corporation pays bonuses.
6. The company's dividend history.
7. What comparable businesses in the industry pay for similar services.
8. The existence of written compensation agreements.
9. Any documented formulas the company uses to determine compensation.

The more of these factors you can use to argue in your favor, the better your chances of convincing the IRS or a tax court that your officers' salaries are reasonable and you are not trying to illegally avoid paying Social Security or Medicare taxes.

The IRS is also interested in fringe benefits paid to shareholders as compensation. For example, health insurance premiums the corporation pays on behalf of shareholders are reportable as wages for income tax withholding purposes on the shareholder's Form W-2. They are not subject to Social Security, Medicare or Federal Unemployment Tax, however.

The Risk of Under-Compensating

The consequences of failing an audit for reasonable officer compensation can be quite costly, since the IRS will likely decide that all K-1 distributions should be considered wages. Such a determination would generate a substantial payroll tax liability, along with penalties and interest that could greatly exceed what would have been due originally. Contractors that are structured as S corporations should take extra care that the salaries they pay themselves and other active shareholders will stand up to scrutiny.

Contractors that are structured as S corps should take extra care that the salaries they pay themselves and other active shareholders will stand up to scrutiny.

Are You Prepared for the New Medicare Surtax?

Starting on January 1, 2013, the Patient Protection and Affordable Care Act will begin imposing an additional 3.8 percent surtax on high-income taxpayers in order to cover rising Medicare costs.

The surtax applies to individuals whose modified adjusted gross income (MAGI) exceeds specific thresholds — $250,000 for married couples filing jointly, $200,000 for single taxpayers, or $125,000 for married couples filing separately.

The surtax is computed on the lesser of two figures:

- Net investment income for the tax year, or
- The amount by which MAGI exceeds the threshold for a taxpayer's filing status.

For purposes of the surtax, net investment income is defined as interest, dividends, royalties, rents, capital gains and other passive income. It does not include self-employment income, income from an active business, IRA distributions, or income from tax-exempt municipal bonds. It also does not include gain from the sale of a principal residence, unless that gain exceeds the normal Section 121 exclusions ($250,00 for single taxpayers and $500,000 for joint filers).

MAGI is basically adjusted gross income minus certain deductions, such as IRA contributions, Roth IRA conversions or rollovers, student loan interest, tuition and fees. In other words, it's the last number at the bottom of page 1 of Form 1040.

It's important to emphasize that the surtax is imposed on the lesser of these two figures. So it is possible to reduce the surtax by rebalancing a portfolio to reduce either MAGI or net investment income. Among the strategies to do this are Roth IRA conversions, shifting some investments into tax-exempt bonds or tax-deferred annuities, adjusting the timing of the sale of a personal residence, and using installment sales to spread investment income over a period of years.

Call us today if you would like to explore these or other strategies that could reduce your Medicare surtax obligation.

Mueller Prost PC offers practical solutions and insightful advice to individuals, businesses and non-profit organizations, providing a full range of audit, tax, accounting and business advisory services. The experience of our more than 80 accountants, engineers, operations leaders and former business owners gives us a unique and comprehensive perspective to address the needs of growing organizations. In addition, we leverage our membership in PKF North America (an association of more than 100 legally independent accounting and consulting firms) to enhance our national and international capabilities. For more information, visit **www.muellerprost.com**.

The firm offers a full range of professional tax, audit, accounting and management advisory services to the construction industry.

For more information, please contact **Tony Smith, CPA, CIT** or **Teri Samples, CPA** at 314.862.2070 or tsmith@muellerprost.com or tsamples@muellerprost.com.