Blueprint

Building Profits for Construction & Real Estate

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Managing fraud risk: what you don't know could hurt you

by Jeff Roberts, jroberts@bkd.com

Many contractors spend significant time and energy thinking about projects and the problems that could inevitably arise. Concerns about competition, project profitability and customer satisfaction are important. However, a major and costly risk area many owners and managers overlook is the possibility a trusted employee will commit fraud within the company.

Employee-perpetrated fraud can be devastating: According to the Association of Certified Fraud Examiners' (ACFE) **2006 Report to the Nation**, the median loss for construction companies victimized by employee fraud is $500,000. Of the 19 industries the report profiles, only mining and wholesale trade suffer heavier losses.

I don't hire criminals!

Never assume an employee won't steal from you. Of those who perpetrate fraud and are caught, only 10% have a criminal background; most have never received anything more serious than a speeding ticket. In fact, the typical "fraudster" is generally a long-term employee who has built trust over years of service to the company and is often the kind of person colleagues go to for advice.

With time, such employees can earn an owner's confidence. They may be allowed to make unquestioned decisions and often have access to company assets. An alarming finding of the **2006 Report to the Nation** shows a direct correlation between fraud loss amounts and the fraudster's length of employment: Longer lengths of employment equal higher fraud loss amounts.

Unique fraud risks

When it comes to employee fraud schemes, contractors are as vulnerable as companies in other industries. However, complex, multi-phase projects on multiple work sites is unique to construction, making it an easier target for certain types of fraud.

Without procedures to help prevent fraud, the following schemes can be easy for construction industry employees to perpetrate:

Bonuses and Incentives – Carefully monitor employee bonuses or incentive arrangements. Shifting costs away from projects that start to look less profitable (or even falsifying job profitability reports) can be very tempting for some employees, particularly if their compensation is strongly tied to project profitability.

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Section 199: real estate developers, stake your claim

by Tom Pretti, tpretti@bkd.com

There's been a lot of buzz in recent years about Internal Revenue Code Section 199 (Section 199), the *Domestic Production Activities Deduction*. Thousands of taxpayers have realized significant benefits with the deduction, from business owners in the construction industry to those with businesses ranging from manufacturing to filmmaking.

Compared to many other Section 199 business calculations, calculations for real estate developers are not as easy to perform. However, the recent real estate development "gold rush" has lead many domestic developers to their best-ever profits, and Section 199 can provide some relief from the steep tax bill that follows successful investments.

Staking your claim

Developers can currently realize a 1% rate reduction, rising to a 3% tax rate reduction when fully implemented. Just as in your daily business, it will take detailed preparation to mine the value of the deduction.

Planning early in the year can help you overcome the technical nuances, the accounting/documentation requirements and the annual preparation challenges to claim the Section 199 deduction.

The following suggestions may help you stake your claim to the Section 199 deduction:

Understand the basic calculation – Taxpayers may claim a deduction equal to a percentage of the lesser of their "qualifying net income" or taxable income. Qualifying net income equals revenues earned from specific activities performed within the U.S. less the cost of goods sold and other allocable expenses.

The applicable deduction percentage for

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2005 to 2006 is 3% and 6% for 2007 to 2009. For 2010 and after it peaks at 9%. The deduction is further limited to 50% of W-2 wages.

For the construction and real estate development industries, there are three primary requirements for qualifying revenue-generating activities:

- ✓ You must currently conduct construction activities on a regular, ongoing basis. Land subdivision and construction management qualify, though construction does not have to be your only or your primary line of business.
- ✓ Your construction activities must involve real property in the U.S., defined as substantial renovation or erection of real property. Infrastructure improvements qualify and include roads, water systems, sewers, sidewalks, etc. Sales of tangible personal property are specifically excluded.
- ✓ You must derive "qualifying revenues" from your activities, *i.e.*, revenues earned performing construction services on real property. Sales of land by itself generally do not qualify. Other service revenues (materials delivery, debris removal, grading, demolition, painting or landscaping) may qualify if they are part of a larger project. General contractor activities like project management and oversight also qualify.

Select your guiding authority – For 2005 and 2006, taxpayers must choose between using the Internal Revenue Service's (IRS's) initial guidance or applying Section 199 final regulations to calculate their deduction. This is an important decision that could impact construction material revenues, gain on land and the definition of qualifying construction activities. Generally, the final regulations are more favorable to the construction industry.

Apply *de minimis* exceptions and safe harbors correctly – For taxpayers whose nonqualifying receipts equal less than 5% of total receipts (*de minimis)*, the IRS deems 100% of the receipts qualify. In addition, the final regulations allow a similar 5% *de minimis* exception based on total project revenue.

Vitally important to real estate developers is the land safe harbor. Land itself does not generate qualifying receipts. With the land safe harbor, taxpayers can calculate their land receipts by identifying land costs plus an estimated appreciation percentage.

The safe harbor percentages are 5% if land is held less than 60 months, 10% if held 60 months to 120 months and 15% if held 120 months to 180 months. The safe harbor eliminates the need to perform an appraisal to determine the land value.

Consider your wages – To claim the deduction, taxpayers must have W-2 wages. For example, sole proprietors with no employees (thus, no wages) will not benefit from Section 199.

Taxpayers who use professional employee organizations, employee leasing companies or multipartied, multitiered partnerships may have trouble proving or identifying their wages. However, wages could be allocated via common-law employer rules in these situations.

Also, for years beginning after May 17, 2006, Congress has implemented changes to the wage limitation calculation.

Identify your business's differences – The real estate industry's evolution has lead to myriad business structures and employee relationships. These business "quirks" could cause significant issues when you prepare your Section 199 deduction so note the following:

- ✓ If you are a taxpayer within a larger group where ownership relationships are greater than 50%, you may need additional consideration to determine your allocable Section 199 deduction.
- ✓ If your business is a pass-through entity, you must report specific information for your partners/shareholders to claim the deduction.
- ✓ You may claim a Section 199 deduction even if you trigger the alternative minimum tax; however, the calculation's income limitation is adjusted.

Develop your processes – Develop your processes and documentation to consistently identify, aggregate and calculate the proper data for your Section 199 calculation:

- ✓ Review your financial reports and accounting policies with your tax advisor.
- ✓ Educate accounting system users of the importance of capturing the appropriate data.
- ✓ Plan early in the year because it's difficult to remember your activities and data after year end.

In the event of an IRS audit, consistent calculation procedures will help you demonstrate a good-faith effort in performing an accurate calculation.

* * *

Many real estate developers use the domestic production activities deduction to significantly lower their tax on profits and increase cash flows, but it is key to understand deduction fundamentals and to plan early. Contact your BKD advisor to discuss your business's characteristics and how to lessen your risks and increase your deduction. ■

Managing fraud

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To prevent this type of fraud, don't allow project employees to assign costs to jobs if their compensation depends on meeting project profitability targets.

Kickbacks – Long-term employees often develop friendly relations with materials suppliers and subcontractors. In fact, some project managers may even agree to artificially inflate pricing in exchange for gifts or cash under the table.

To mitigate this risk, require your project managers to obtain competitive bids for materials or subcontractors over a specified amount, then periodically verify bids were obtained. A knowledgeable employee other than the project manager should also review

Before starting a retirement plan, know your objectives, benefits & costs

by Vicki Graft, vgraft@bkd.com

If you're a small contractor or real estate developer, starting a retirement plan can be daunting. How do you know which plan is right for you?

Is your objective to attract and retain employees and help them save for the future, or is it to obtain tax savings or deductions for your business? The benefits of your retirement plan—and its costs—will depend on the type of plan you select.

For most small businesses, a 401(k) plan is the most widely accepted. Employees can choose to defer a portion of their salaries on a pre-tax basis (up to $15,500 in 2007), and employees 50 years of age or older can defer an additional $5,000.

Because 401(k) plans can vary significantly in their complexity, the following may help narrow your selection.

Traditional 401(k) plans are subject to anti-discrimination testing, which may restrict the amount deferred to the plan by highly compensated employees (HCEs), including the company's owners. Most 401(k) plans offer a discretionary employer-matching contribution to encourage employee participation.

Safe harbor 401(k) plans are similar to the traditional 401(k) but require a fully vested employer contribution—either a 3% nonelective to all eligible participants or a matching contribution that equals approximately 4% of a participant's pay.

The mandatory employer contribution eliminates the anti-discrimination tests, making this plan ideal for businesses with HCEs whose contributions would otherwise be limited in a traditional plan.

However, the fully vested employer contribution—especially for relatively new employees—can be a tough pill to swallow for small business owners.

Automatic enrollment 401(k) plans automatically enroll employees in the plan with a

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risk: what you don't know . . .

supplier and subcontractor invoices.

Fictitious suppliers and subcontractors – Fictitious suppliers and subcontractors are common and often take the form of suspicious-looking services. For example, an employee might create fictitious invoices at home for "project consulting" services and submit them for payment to an unsuspecting bookkeeper. Checks are cut and mailed to a P.O. box (or home address) that the fraud perpetrator controls.

If you are an owner or manager, sign *all* checks and review supporting invoices for suspicious suppliers or subcontractors. In addition, always require approval for new suppliers or subcontractors to help prevent this type of fraud.

Fraud shows symptoms

Like a disease, fraud often has symptoms that are noticed long before it's ultimately uncovered and exposed. Many companies could have uncovered fraud had they noticed the warning signs along the way, including the following red flags:

- ✓ Employees who refuse to take vacations or are very protective of their work
- ✓ Long delays in receiving regular financial reports or job profitability reports
- ✓ Bank accounts that go unreconciled for several months
- ✓ Employees who begin to work odd hours when fewer co-workers will be around
- ✓ Employees who improve or maintain their lifestyle despite personal hardships

Stopping fraud in its tracks

Whether you operate a large company or a small one, there are things you can do to reduce your company's chances of being the victim of fraud. Following are a few basic fraud prevention tips you may have overlooked:

Establish an ethical culture – The foundation of fraud prevention is a company culture where ethics and integrity are highly valued. Without it, few other fraud prevention strategies will work.

Use anonymous reporting hotlines – Provide employees, suppliers and subcontractors an anonymous hotline to report fraud and abuse. This has proved to be one of the most effective methods of combating fraud, and a number of companies now offer hotline services.

Separate duties – No single employee should perform *every* accounting-related duty. Many frauds involve long-time bookkeepers whose work is rarely reviewed or questioned.

Make vacations mandatory – Because fraud is often discovered during an employee's absence, require employees to take at least one full week of vacation and have another employee perform their duties.

Receive bank statements at home – Owners of smaller companies should consider having company bank statements sent to their home address. Review the statements and ask your accounting staff questions about various transactions. Potential fraudsters are less likely to commit fraud if they believe an owner or manager reviews their activities

No one strategy is foolproof, but the more fraud prevention elements you introduce into your company, the better your chances are of stopping fraud before it starts. ■

Before starting a retirement plan, know your objectives. . .

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fixed salary deferral (generally 3% of pay) once the employee is eligible to participate (usually on date of hire). An employee must "opt out" of the plan if he/she elects not to participate.

In addition, there are several low-cost, low-maintenance government plans specifically targeted to the small employer.

Profit-sharing plans provide discretionary employer contributions to all eligible employees. Business owners can decide to make yearly contributions, which provides flexibility for companies with cash flow or profits that fluctuate.

A set formula based on compensation determines the amount allocated to an employee and may also be designed to reward HCEs or specific classes of employees by skewing the contributions toward those employees.

Most profit-sharing plans are combined with a 401(k) feature to motivate employees to save for retirement. Employer contributions are generally subject to a vesting schedule to reward long-term employment.

Other options

There are other types of plans to consider, including:

Defined benefit (DB) plans, which provide participants a fixed benefit. Under this plan, employees often receive a higher benefit at retirement than with other types of plans; however, DB plans are more complex, making them more costly to establish and maintain.

Employee stock ownership plans (ESOPs) are unique because they are designed to provide employees an ownership stake in the company by investing in the sponsoring employer's stock.

Further, S corporation ESOPs are currently tax-exempt, which makes a 100% ESOP-owned S company an attractive businesses entity. Often used for succession planning, ESOPs are powerful, flexible plans that motivate employee performance.

In addition, there are several low-cost, low-maintenance government plans specifically targeted to the small employer. The plans don't require formal documents and can be established by completing a one- or two-page Internal Revenue Service (IRS) form or annual administration. These are low-cost plans, but they offer little, if any, flexibility.

Simplified employee pensions (SEPs) are similar to a profit-sharing plan. A uniform percentage of pay for each employee is contributed by an employer at his/her discretion.

Employee contributions are not allowed; however, SEPs are the only plans that can be established following a company's year end and until the due date of the corporate tax return, including extensions.

Savings Incentive Match Plans for Employees (SIMPLE) 401(k) or IRA plans are available only to employers with 100 or fewer employees. Employees can contribute a portion of their salary (up to $10,500 for 2007 plus an additional $2,500 for those age 50 or older). Employers must contribute either a 3% matching contribution to those who defer or a 2% profit-sharing contribution to all eligible employees.

All contributions are 100% vested, and no additional contributions are allowed. SIMPLE plans do not provide flexibility in plan design or in contributions, but they are great "starter plans" for small businesses.

* * *

Contact your BKD advisor for help selecting, establishing and operating a retirement plan for your small construction, contracting or real estate business. ■

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