Construction

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Expand your comfort zone

Use a joint venture to mitigate the risks

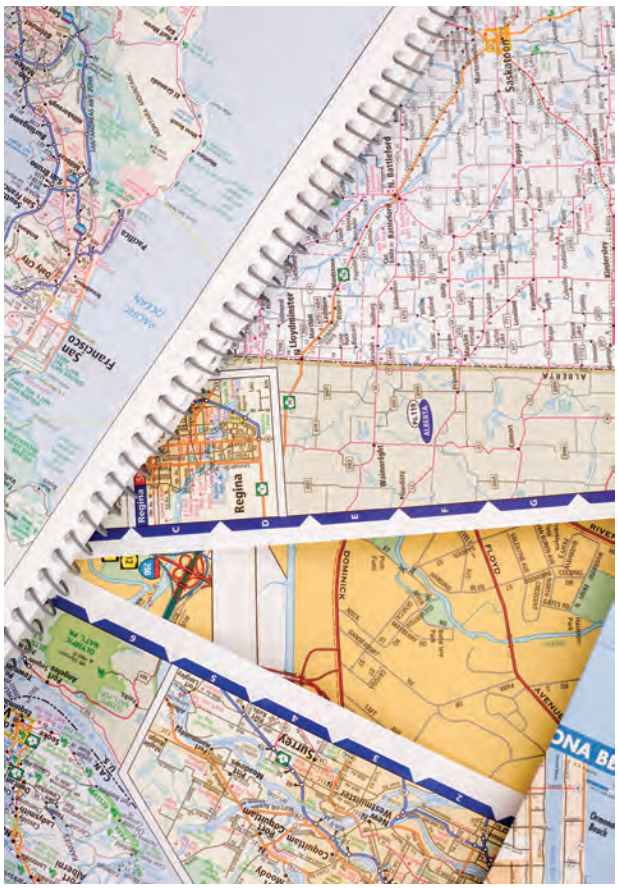
As the economy continues to struggle in some parts of the United States, many contractors are looking for ways to gain a competitive edge. One effective strategy is to branch out into new types of work, new geographical areas and larger, more complex projects.

Although venturing into unfamiliar territory can help you compete, doing so may also expose you to additional dangers. One way to mitigate the risks is to enter into a joint venture with another construction business.

Consider the benefits

Joint ventures provide potential benefits, including:

Broader geographical reach. Partnering with businesses in other locations gives you access to markets that would be hard to enter on your own. Your partners' relationships with suppliers and other businesses, access to equipment, and knowledge about local market conditions can provide huge advantages in bidding, labor relations, and other areas.



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Pooled resources. A joint venture instantly boosts the partners' working capital, manpower, equipment, specialized expertise or skills, and other resources — enabling them to bid on larger, more complex projects than an individual contractor would be able to handle alone. This is advantageous given current economic conditions, in which raising capital and attracting qualified personnel can be a challenge.

Reduced risk. By spreading the risk associated with a job among two or more joint venture partners, each partner's risk is reduced.

Enhanced bonding capacity. Joint ventures often have an easier time qualifying for bonding at reasonable rates. Surety underwriters view a well-structured joint venture as presenting less risk of default than does one of the partners alone.

Choose the right structure

There are many ways to structure a joint venture, including partnerships, corporations and limited liability companies (LLCs). Corporations offer the most liability protection, but present some tax disadvantages — including potential double taxation of the joint venture's profits. And there's little or no flexibility in allocating profits, losses and liabilities among the joint venture partners.

Partnerships provide little liability protection, but they offer "pass-through" tax treatment. In other words, there's no entity-level tax. Instead, the joint venture's income, deductions and credits are passed through to the partners and then reported on their personal tax returns. In addition, partnerships offer the greatest flexibility in allocating profits, losses and liabilities among the partners according to their specific contributions to the venture rather than their percentage of ownership interests.

For many joint ventures, an LLC is the ideal structure because it combines corporate liability protection with many of the tax and financial advantages of a partnership.

Do your due diligence

Before entering into a joint venture, conduct thorough due diligence on a prospective partner or partners. If a partner's business fails, you may be responsible for completing the project.

Examine the prospective partner's financial strengths, bonding capacity, banking arrangements and relationships, quality and safety records, and company culture. Ask for owner references, focusing on jobs that are similar to the project for which the joint venture is formed or that involve related and relevant special skills or expertise.

Review a prospective partner's history of litigation and legal claims, too. It can provide insights into how the company does business and where it stands financially.

Put it in writing

To avoid surprises and disputes, create a joint venture agreement that defines the venture's objectives and ensures that rewards and risks are fairly allocated. The agreement should spell out the parties' respective responsibilities for:

- Running day-to-day operations,
- Accounting and billing,
- Handling cash,
- Procuring supplies and materials,
- Obtaining permits and licenses,
- Ensuring safety, and
- Managing change orders and other matters.

The agreement should also address insurance, bonding and tax issues. Even with a well-drafted agreement, there may be disputes or misunderstandings. So provide for streamlined dispute resolution procedures, such as mediation or arbitration.

Get comfortable

Even if a joint venture looks great on paper, it's important to consider the intangibles. So, before you join forces with another firm, make sure your companies' cultures are compatible and that you'll be comfortable with the people you'll be working with. ■

Understanding the ins and outs of subcontractor surety bonds

It's dangerous for any subcontractor to assume that he or she is protected by performance or payment bonds. Such bonds are generally required on public projects, under the federal Miller Act or one of the many state-level "Little Miller" acts. But you still must perform the due diligence needed to confirm that required bonds exist, that they're valid and sufficient, and that the surety in question is financially stable.

Bonds vs. mechanics' liens

Some private construction contracts require bonds but, in most cases, they're unnecessary because state mechanics' lien laws provide the

most effective remedy for subcontractors who haven't been paid. Mechanics' liens can't be filed on public property, however, so payment bonds generally serve as a substitute on public projects.

Nonetheless, if you're contemplating work on a public project, don't take for granted that you'll be protected by a payment bond. For one thing, some apparently public projects are, in fact, privately financed — and the Miller Act doesn't apply. Even if the Miller Act or a Little Miller act applies, that doesn't necessarily mean you're covered.

The Miller Act, for example, requires bond protection only for first-tier subcontractors and suppliers (those that contract directly with the prime contractor) and for second-tier subcontractors and suppliers who contract with a first-tier subcontractor. Most Little Miller acts have similar requirements.

Absence of a bond

Even if a bond is legally required — and you're within the class of subcontractors entitled to make a claim — there's no guarantee that the general contractor has actually furnished one. Rather than assuming that the bond requirement has been fulfilled, ask for a copy of the executed bond to verify that the general contractor has complied and that the bond is valid and sufficient.

If there's no bond, consider requesting an alternative form of security. For example, you might ask the general contractor to place a certain amount of cash in escrow, provide a letter of credit or furnish personal guarantees. If the general contractor refuses to provide such security, and you're uncomfortable with its ability to pay you in a timely fashion, consider walking away from the job.

Surety viability

Like many businesses in today's economy, some sureties are struggling financially. Even if you're covered by a valid, sufficient payment bond, you may be left without protection should the surety become insolvent.

Before you sign a contract, it's a good idea to investigate whether the surety is financially stable. Also, find out whether the state in which the project is located has an insurance guaranty association or similar program that provides you with insurance in the event the surety becomes insolvent.

Terms and claims

To preserve your right to recover payments from the surety, be sure that you understand any contractual terms that govern your right to payment, as well as all applicable notice and statute of limitation requirements related to the bond.

Even if you're covered by a valid, sufficient payment bond, you may be left without protection should the surety become insolvent.

Under the Miller Act, for example, you must provide written notice of your claim to the principal (the general contractor or other party responsible for furnishing the bond) within 90 days after the last day on which you furnished labor or materials for the project. The federal act also imposes a one-year statute of limitations on bond claims. The bond agreement itself may impose additional procedural requirements.

Having the documentation to back up your claim is essential. First, to comply with statutory notice requirements, you'll need to state the amount of your claim with a high degree of accuracy. Second, you'll need solid documentation to prove that you're entitled to payment under the bond.

No hesitation

As a subcontractor, you need to always ensure your company is protected going into a job by having adequate payment or performance bonds in place. If you're ever hesitant about your bonding status on any project, contact your financial and legal advisors for help. ■

Is your bonus plan eligible for accelerated deductions?

Many construction businesses award performance or safety bonuses to employees at year end. But did you know that it's possible to deduct bonuses on your company's 2013 tax return even if you don't make the payments until 2014?

If you're an accrual-basis taxpayer, you can take accelerated deductions even if you don't calculate the amount of the bonus pool or specify who will receive bonuses until after the end of the year. But you must follow IRS rules.

Event planning

To determine whether an accrual-basis taxpayer can deduct an unpaid expense in a particular year, the IRS applies the "all events" test. Under this test, an expense is deductible if:

- All events have occurred that establish the taxpayer's liability for the expense,
- The amount of the liability can be determined with reasonable accuracy, and
- Economic performance has occurred.

Generally, bonuses earned and awarded during a tax year are deductible on that year's return, provided they're paid by the 15th day of the third month after the close of the tax year (March 15, for calendar-year businesses). In recent years, however, the IRS has challenged bonus deductions when the specifics aren't worked out until after year end.

For example, contractors commonly establish bonus pools based on a formula tied to their performance for the year, which can't be calculated until they've prepared their year end financials. And even if the bonus pool amount is fixed before year end, decisions regarding the specific employees who will share in the pool, and the amounts they'll receive, may not be made until the following year.

Most bonus plans require recipients to remain in the company's employ in order to receive their bonuses. Employees who quit or are terminated before the payment date forfeit their bonuses.

Fortunately, a 2011 IRS ruling allows companies to accrue bonus deductions, even if certain decisions or calculations are made after year end, so long as they meet certain requirements. (See "Special rules for owner bonuses" at right.)

A fixed obligation

In Revenue Ruling 2011-29, the IRS permitted a company to deduct bonuses paid after the end of the tax year — even though it didn't identify the bonus recipients, or the amounts payable to each recipient, until after year end. The key to qualifying for accelerated deductions was that the company's obligation to pay an *aggregate* bonus amount was fixed by the end of the year.

In reaching its decision, the IRS emphasized the following features of the company's bonus plan:

- The plan defines the terms and conditions under which bonuses are paid.
- Bonuses are paid for services performed during the tax year.
- The company communicates the plan's general terms to employees when they become eligible and when the plan is changed.

Special rules for owner bonuses

Generally, accrued bonuses (see main article) to "owners" aren't deductible until paid, so accelerated deductions aren't available. The definition of "owner" varies by entity type:

- For a C corporation, an owner is someone who owns more than 50% of the corporation's stock.
- For an S corporation, an owner is someone who owns more than 2% of the corporation's stock.
- For partnerships and limited liability companies taxed as partnerships, all partners and members are treated as owners for purposes of bonus deductions.

- The minimum aggregate amount of bonuses payable is determined either: 1) through a formula fixed before year end, or 2) based on a board resolution or other corporate action taken before year end.
- Recipients must be employed on the payment date; otherwise, their bonuses are reallocated among other eligible employees.

The business could deduct bonuses for the tax year in question because its liability for the minimum bonus amount was established by the end of the year in which the services were performed. "This is true," the IRS explained, "even though the identity of the ultimate recipients and the amount, if any, each employee will receive cannot be determined prior to the end of the taxable year."

The requirement that forfeited bonuses be reallocated among other employees is critical. According to a November 2012 IRS Chief Counsel Advice letter, if forfeited bonuses revert to the company, its obligation doesn't become "fixed" until the payment date and, therefore, bonuses can't be deducted until the year they're paid.

Review your plan

Accelerating deductions for bonuses paid *after* year end can lower your tax bill and strengthen your cash flow. Review your bonus plan to see whether it complies with IRS requirements. Keep in mind that, if you need to change your plan, you may have to file Form 3115 — *Application for Change in Accounting Method* — with the IRS. ■

4 common bidding errors to avoid

Accurate bidding is critical to any construction company that wishes to be profitable over the long haul. Here are four common bidding errors that you need to avoid:

1. Miscalculating direct costs. Items such as labor, materials and subcontractor fees are typically referred to as direct costs. They tend to be relatively straightforward but mistakes can happen if, for example, you:

- Use inaccurate or out-of-date labor rates,
- Use labor rates that omit certain costs (such as payroll taxes), or
- Overlook minimum wage requirements, such as those imposed by the Davis-Bacon Act.

If you have trouble getting the numbers right, consider using estimating software or upgrade the system you have now. The right application can make the bidding process more efficient and help you avoid these common errors and many others.

2. Relying on inexperienced subcontractors or suppliers. If your bid is based on low prices quoted by inexperienced subcontractors or suppliers, the savings can be erased if they fail to deliver. For example, a novice subcontractor may require additional supervision — increasing your labor costs. And an unreliable supplier can cause delays and other costly problems.

3. Underestimating indirect costs. The only way to develop an accurate bid is to understand a job's *true* costs, including indirect costs. These are costs you incur to keep your business running, such as rent and other office expenses, equipment, supplies, clerical staff salaries, insurance, marketing and accounting.

Build a system for allocating indirect costs that makes sense for your company. For example, many contractors allocate indirect costs based on direct labor hours and include equipment costs — such as depreciation and maintenance — in overhead. But if certain jobs are more equipment-intensive than others, allocating equipment costs based on direct labor hours may mean that you're underestimating the projects' true costs. To improve accuracy, allocate equipment costs based on actual usage.

4. Not including profit as a line item. Building a profit cushion into your bids can help protect your company against the risks and uncertainties inherent in the construction process. But simply calculating profit as a percentage of total estimated costs may not accurately reflect your risk.

A better approach is to use a higher percentage to mark up riskier costs, such as labor, and lower markups for more predictable costs, such as materials. Your financial advisor can help you target the right percentages as well as address many other aspects of your bidding process. ■