

contractor

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If you build it, will they come?

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Preserve your lien rights to ensure timely payment

Plus!

**Bundling services can
present a profitability boost**



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Consolidation exasperation

VIE rules continue to evolve, confuse

Like most contractors, you're probably sick and tired of hearing about variable interest entities (VIEs). They have been an unpleasant fact of life for at least a year now, because the new generally accepted accounting principles (GAAP) rules regarding VIEs generally went into effect beginning with the 2005 fiscal year.

Some of the most common situations that create a VIE are participating in joint ventures and owning separate but related real estate entities.

As is often the case with new accounting pronouncements, there are many situations that require special consideration and many unanticipated consequences. One indication of this: Since the new GAAP rules for VIEs took effect, the Financial Accounting Standards Board (FASB) has issued six "staff position" papers to address issues that have arisen during the application of the rules.

DEFINING THE CONCEPT

Generally, a VIE is a separate company that cannot financially stand on its own. It needs the financial support and backing of another entity — the primary beneficiary of the operating results (income or losses). And, under the GAAP rules, the VIE must be consolidated into the financial statements of the primary beneficiary.

For contractors, some of the most common situations that create a VIE are participating in joint ventures and owning separate but related real estate entities. (For more specifics, see "4 defining characteristics of a VIE" on page 3.)

WHEN CONSOLIDATION IS AND ISN'T REQUIRED

Just because you have an interest in a joint venture or own a separate but related real estate entity, however, doesn't automatically mean you need to consolidate it.

For example, if the primary beneficiary in a joint venture cannot be determined (often because it's a 50-50 arrangement), the VIE may not need to be consolidated. But if you provided the resources (money, manpower, equipment, guarantees) to fund



operations, and, as a result, you're the primary beneficiary, consolidation likely will be necessary.

If you own real estate in a separate entity and there is no debt owed on the real estate, it may not be a VIE and, thus, consolidation may not be required. But if you have cross-collateralized or guaranteed its debt, the entity probably is a VIE and will need to be consolidated.

ASSESS YOUR OPTIONS

The main problem with consolidating a VIE is that it often negatively affects your financial statements. For example, consolidating a VIE for which you have guaranteed debt reduces your current ratio while increasing your debt-to-equity ratio. And this could adversely affect your bank covenants or reduce bonding capacity.

Generally, if you are required to follow GAAP and have a VIE, you will likely need to consolidate the VIE, unless, for example, the VIE is not material to your financial statements as a whole. But if you're in a position where your bank and bonding company — the primary users of your financial statements — are involved with both you and the VIE, you may not need to consolidate. The key is to involve them in the decision-making process, as these institutions don't like surprises.

In certain cases, the bank or bonding company may not want you to consolidate the VIE because they want to be able to assess your construction company by itself.

In other cases, they may accept a qualification or disclaimer from your accountant on your financial statements. Your CPA's ability to qualify his or her opinion will be based on several factors, but, most important, on how significantly the VIE's consolidation would affect your business.

Another way to avoid consolidation is to switch to a different basis of accounting. In some instances, contractors have discussed their situations with their banks or bonding companies and have agreed to use the income tax basis of accounting. This method doesn't require VIEs to be consolidated.

You may still, however, need to make disclosures regarding the VIE because your bank or bonding company will likely want to know about the factors that make the separate entity a VIE.

EVALUATE CONTINUALLY

The concept of "once a consolidated VIE, always a consolidated VIE" generally applies, but re-evaluate your VIEs annually nonetheless. For instance, if your joint venture brings on a new partner who has

4 DEFINING CHARACTERISTICS OF A VIE

You may have a variable interest entity (VIE) if the following general characteristics apply:

1. The owners of your company and/or the construction company itself have significantly participated in the design of a separate entity.
2. You designed the entity so most of its activities involve or are conducted on behalf of your company.
3. Your business provides more than half of the total equity, subordinated debt and other forms of subordinated financial support to the entity, based on an analysis of the fair values of the entity's interests.
4. The entity's activities are primarily related to securitizations or other forms of asset-backed financings or single-lessee lease arrangements.



a majority interest that replaces your majority position, you may not need to consolidate the VIE on your financial statements.

In the case of a related real estate company, if another investor provides a significant amount of capital or if the entity adds significant new operations, it may not need to be consolidated either.

SEEK ADVICE

Consolidation of VIEs is here to stay, but the application of the rules continues to evolve. Be sure to discuss the status and treatment of your VIEs with your accountant and the readers of your financial statements. 💡

5 year end tax-saving opportunities for contractors

Tax planning is an ongoing process that contractors should monitor throughout the year. That said, year end is the perfect time to review your financial situation and see what you can do to lower your tax bill. Here are five ideas to consider:

1. Review your year and act accordingly. If your construction business is using the cash basis method of accounting and you're having a good year, look to ramp up your expenses to offset your income. For example, if you prepay several months of rent before Jan. 1, the payments will count as a 2006 expense.

Conversely, if you haven't had the best year and, thus, may be in a lower tax bracket, you may want to accelerate some income into 2006 to benefit from the lower tax rate and delay your expenses for what you hope will be a larger deduction next year. You might see whether you can get customers with large balances to pay up by offering a nominal discount for payment before Dec. 31.

2. Put off billing, step up collections. If you operate under the accrual basis method of accounting, you must record income and expenses when they're earned and incurred, regardless of when you receive or spend the cash.

To delay some of this income for tax purposes, consider waiting to send some bills until after the first of the year. Also, step up collection efforts — you might be able to deduct bad debts.

3. Sweeten purchases with Section 179. If you're looking to make a big purchase before year end, keep in mind the Section 179 deduction. Under it, you can fully deduct up to \$108,000 of business property placed in service in 2006. The phaseout limit is \$430,000.

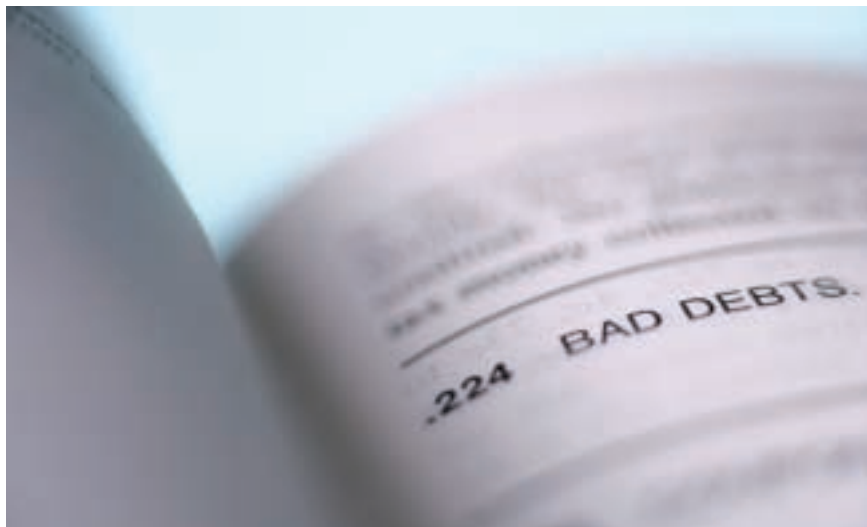
Even if you're a cash basis taxpayer, you need not pay for the equipment before year end to take the Sec. 179 deduction. You can pay for fixed assets in the following year as long as you place them in service by year end. As always, consider whether a large purchase makes financial sense for your construction company rather than buying something just for a tax break.

Step up collection efforts — you might be able to deduct bad debts.

4. "Manufacture" some tax savings. Commonly known as "the manufacturers' deduction," the Qualified Production Activities Deduction (QPAD) allows you to deduct 3% of taxable income from qualified production activities. These include certain construction, engineering and architectural services. (This amount will rise to 6% next year.) The deduction is limited to 50% of wages you report on employees' W-2 forms.

5. Save green with energy-related credits. Homebuilders can really benefit from the tax breaks in the 2005 Energy Tax Act. For each energy-efficient residence built in 2006, these contractors are eligible for a credit of up to \$2,000. Another energy-related tax break is the business or personal credit of up to \$3,400 for the purchase of a qualifying hybrid passenger car or light truck.

As you can see, you have many options when it comes to year end tax planning. Setting aside some space on your crowded calendar to choose the strategies that are right for your construction business will no doubt turn out to be time well spent. 💎



If you build it, will they come?

Financing opportunities abound in economically challenged areas

Over the past 40 years, Americans have witnessed the evolution of our country's landscape. Tax abatements, low-interest financing and grants have been some of the incentives to encourage development in otherwise "overlooked" areas. Anyone willing to turn vacant lots and abandoned buildings into new businesses or affordable housing could enjoy years of benefits.

Yet, while incentives are great, these projects will never get off the ground unless there are people able to buy the homes or offices to be built. If you've considered trying your hand at developing a vacant property in a disadvantaged area, or working with a developer to do so, you should know that there are a variety of financing options available for would-be buyers.

ORGANIZATIONS PROVIDE HELP

Many organizations provide underserved communities access to affordable financing. Some examples include:

The Community Development Financial Institutions Fund. A bipartisan initiative established by the Riegle Community Development and Regulatory Improvement Act of 1994, the Fund has awarded \$771 million to organizations and financial institutions that provide assistance to underserved populations. Its purpose is also to promote economic revitalization and development in distressed areas across the United States.

The Center for Responsible Lending (CRL). Based in Durham, N.C., this group has given \$3.5 billion in financing to help more than 40,000 families own homes or small businesses. The CRL also partners with other organizations to encourage antipredatory lending laws.

Opportunity Finance Network. The successor to the National Community Capital Association, this newly formed group recently announced plans to use \$1 billion a year to fight predatory lenders. Over the decades, its network of 167 community development institutions has provided nearly \$10 billion, resulting in 317,000 homes and helping buyers in every state.



By partnering with a national mortgage banking entity, this organization's "Fair Mortgage™" program offers alternative residential mortgage products to people with blemished credit records.

The National Community Reinvestment Coalition (NCRC). This association of more than 700 community-based members was formed in 1990 to ensure fair access to credit, provide training and technical assistance, and create opportunities for traditionally underserved communities. The NCRC helps victims of predatory lenders and also harnesses the energies of its members to make recommendations to Congress to take antipredatory lending action.

Other state and local programs offer reasonable mortgages. For example, the Woodstock Institute in Chicago created a loan plan to encourage low- and moderate-income families who have been priced out of the metropolitan area to move back.

IT COULD BE A WIN-WIN

When building in a disadvantaged area, you face many risks. You can lessen one risk — namely a dearth of buyers — by getting the word out about financing assistance. Directing interested parties to the organizations mentioned here or similar ones could bring about a win-win for everyone involved — affordable housing or office space for them and a profitable project for you. 💎

Subcontractor focus

Preserve your lien rights to ensure timely payment

Lien rights are an important consideration for all contractors, but they're especially essential for subcontractors. A general contractor usually has an advantage in this area because it typically has direct contact with the owner. A subcontractor, however, doesn't have this contact, so one of the only ways to take action against an owner or general contractor that fails to pay up is to preserve your lien rights.

KNOW THE RULES

Specific rules vary from state to state, but the basics of lien rights are fairly uniform. In fact, the concept of a mechanic's lien goes back centuries, when it was common to give a laborer an interest in the improvements made to a property if he wasn't compensated for his work.

Generally, mechanics' liens provide subcontractors with the right to file claims for the labor, materials and equipment they contributed to a construction project. For the purposes of lien rights, subcontractors are those who are working on a project under contract with another contractor (for example, with the general contractor or a prime contractor).

A subcontractor can be six degrees from Kevin Bacon, so long as Kevin Bacon and each contractor between Kevin Bacon and the subcontractor all have contracts to work on the same project. For example, an HVAC contractor hired by the job's general contractor is a subcontractor, just as the insulation contractor hired by that HVAC contractor is.

FOLLOW THE THREE STEPS

Subcontractors typically must follow three key steps to preserve their lien rights:

1. Obtain a notice of commencement. At the project's beginning, you need to be on the lookout for the owner's notice that the project has, in fact, started. Often called a "notice of commencement," this document includes important information about the job, including the identities of the owner, bonding company and lender(s), and a legal description of the property being improved.

In addition, and perhaps most important, the notice may include instructions for how you should file notice that you've begun work.



2. Provide a notice of furnishing. After receipt of the notice of commencement, you ought to have everything you need to provide notice to the project owner and/or contractor with whom you have contracted that you have started work and intend to preserve your lien rights. Do this as soon as possible with a notice of furnishing. In some instances, there may be time limits to filing, so be sure to look for them.

3. Perfect the lien. If you're in a position where you're not getting paid, you must "perfect" the lien, which sounds more complicated than it is. To do so, simply prepare a mechanic's lien affidavit that covers the work completed to date, record the affidavit in the applicable jurisdictions, and deliver a copy of it to the owner or contractor who hired you.

Once again, be sure to look for time limits and other filing requirements, as they can differ depending on the contract and jurisdiction. After perfecting your lien, you have effectively secured the value of your lien against the property for a set period of time.

APPLY THE RIGHTS

If the time comes when you aren't being paid what you're owed and you have perfected your lien, the good news is that you have a secured interest in the property if it's foreclosed on or sold, thanks to your perfected mechanic's lien. The bad news is that, while a preserved lien protects your rights, it doesn't always guarantee payment.

When a property is foreclosed on or sold, the pecking order of a mechanic's lien can be a complicated matter and can differ depending on the facts and circumstances of the case. For instance, a tax lien or a laborer's lien will generally have a higher priority than other liens.

The lien can sit on the property for a long time. The owner can try to force you to begin a legal action to settle your rights, or you can initiate a lawsuit or foreclosure on your own. If you get to this point, it's usually a good idea to consult legal counsel and carefully consider the costs vs. the potential benefits of acting on your lien rights. In other words, what will it cost to litigate the process? And is there really any money to collect?

PROTECT YOURSELF

Remember, the rules regarding lien rights — particularly the applicable time periods and the process of applying those lien rights — vary by state. Nevertheless, subcontractors who regularly practice perfecting their lien rights will give themselves a head start toward protecting themselves from a lack of payment. ♦

Construction Success Story

Bundling services can present a profitability boost

After 30 years in the business, a stucco contractor knew that many of the factors dragging out his cycle time would always be out of his hands. Yet he was still tired of suffering from the domino effect caused by other subcontractors' poor time management skills. Over and over again, general contractors would hire low-cost painters and drywall installers but never wanted to hear excuses for delays as one crew after another fell behind schedule.

The stucco contractor raised the problem with his financial advisor, and, after projecting the costs and discussing the risks, they devised a bold plan. The contractor decided to add painting and drywalling to his company's repertoire. Rather than hire new workers, he chose to buy a business he had worked with in the past that had a reputation for high-quality work. The owner was ready to retire and had no successors in mind.

Bundling trades in this manner is increasingly popular among contractors — and, in some markets, competitively essential. Some general contractors won't hire any companies other than those that can handle multiple construction stages. The consolidation of materials and service appeals to these builders by reducing the number of vendors to schedule — and the chances for delays.

There are still skeptics who believe subcontractors claiming to be jacks-of-all-trades are masters of none. But with builders pressuring these companies to compress their cycle times, most subcontractors today know they need to offer several services to make themselves more attractive to large builders.

Bundling services allows subcontractors to gain more control over the construction process and the quality of their work. It also saves the buyer (whether it's a homeowner or builder) time looking for subcontractors. Perhaps best of all, it increases the subcontractor's revenues by expanding the scope of services and bringing in more jobs.

In this scenario, the stucco contractor was able to schedule work further in advance than he once could, thereby gaining greater control over the consecutive stages of the construction process. More important, he boosted the quality of his projects, and, going forward, was able to compete for and win larger contracts — ultimately tripling his company's revenues.

Service that builds profits and success

For more than 30 years, Feeley & Driscoll, P.C. has delivered creative and proactive tax, accounting, and consulting services that have helped construction businesses grow and achieve superior profitability. As a result, we have become one of New England's largest and most respected public accounting and business consulting firms.

We have also been ranked in 2003 by *Public Accounting Report* as one of America's Top 100 CPA Firms, and have been named by *Bowman's Accounting Report* to its elite Best of the Best list for the third consecutive year.

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- Management and human resources consulting
- Cost segregation studies
- Claims assessment and preparation
- Income and estate tax planning
- Benchmarking and forecasting

We would welcome the opportunity to put our expertise to work for you. Please contact Edward J. Callahan, Director of Construction Services, at 617-742-7788 or EdC@fdcpa.com and let us know how we can be of assistance.

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