

# CONTRACTOR

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# Out on the border

## Avoiding multistate taxation missteps

**F**or construction companies, crossing state lines for a project can be a savvy way to boost the bottom line. But doing so can also mean dealing with new and complex tax issues.

With many revenue-strapped states stepping up their tax compliance, it's more important than ever to understand your responsibilities should you head out on (and over) the border. Multistate taxation missteps have tripped up many a contractor over the years.

### Nexus or not?

When determining your tax eligibility, governments consider whether your company has “nexus” in their respective states, meaning your presence there is significant enough to subject you to taxes.

Generally, having employees or owning or leasing property in a state creates nexus. Other activities that can qualify you for nexus include maintaining a local bank account, accepting orders for your merchandise or

using a local phone number. Many states have minimum thresholds for establishing nexus, so you might not be subject to certain taxes in a state if you perform only a few service calls a year there.

Generally, having employees or owning or leasing property in a state creates nexus.

The standards for nexus vary from state to state and from tax to tax — you may need to pay “use” tax in a state, for example, but not income tax. In addition, local rather than state governments collect taxes in some places. Make sure you know to whom you're answering.

### What about income taxes?

If your construction company does establish nexus in a state, you'll need to assess the income tax impact. Specifically, you and your tax advisor should sit down and “apportion” your income to determine how much tax you'll owe in each state.

The formula is typically based on your company's sales, payroll expenses and tangible property. If you're working in more than one state, track these costs and revenues carefully so you can apportion your income correctly.

Some states give the same weight to sales, payroll and property in



## A nexus study can answer many questions

Bidding on work in another state comes with many tax-related questions. Is that repair job big enough to subject you to income tax? Will you need to pay use tax on your lumber or crane? Are you responsible for any unusual taxes? How much will state and local taxes eat into your job profits?

If you're considering branching out into unknown territory, a nexus study can be a good way to learn about your obligations. These examinations seek to identify the taxes to which your business activities may expose you and help determine the effect of state and local taxes on the project's bottom line. A nexus study may discover that, for instance, making sales calls in a state or maintaining a local phone number will likely trigger liability.

Many tax advisors offer nexus studies as a service. Having this information upfront can help you bid more accurately on a job or even decide that the sky-high taxes in a particular place make the project not worth the hassle.

their apportionment formulas, while others weight one of the factors more heavily. These formulas also change regularly — a growing number of states have shifted recently to sales- or use tax apportionment formulas, for example.

### Are there other taxes?

Aside from facing income taxes in other states, you may also be responsible for a number of other types of taxes in those states, including payroll taxes and sales and use taxes. Some states even have variations that you might not expect, such as the “transaction privilege” tax for nonresident contractors, or subcontractor-specific sales and use taxes that a general contractor may have to pay if the sub in question doesn't.

Indeed, sales and use tax rules in general will likely be a challenge. If you bring construction equipment or materials across state lines, the new state may charge use tax for the item.

On the bright side, sales and use taxes are mutually exclusive. So, if you have to pay use tax for your equipment or materials, you can generally get a refund on sales tax you paid in your home state. But you'll need to track use taxes yourself and then submit the information to the state or local government that collects it.

Although contractors typically don't collect sales tax on completed construction projects, some

states may require a construction company that performs repairs or maintenance to collect sales tax from customers for the job's materials and labor. If this sounds like a situation that could affect your business, check to see whether this rule applies to you.

### Anything else?

In addition to your tax responsibilities, working in a new state comes with plenty of other to-dos. You'll most likely have to obtain a license and tax identification number in that state — even if you're already licensed in your home state.

Expanding into a new state also means more paperwork. Fortunately, some states allow S corporation shareholders, partners in a partnership or limited liability corporation members to lighten the load by filing a composite income tax return.

### Should you risk it?

Stumbling in your efforts to comply with multistate taxation rules could lead to many bad results. A state may go after you for back taxes from the date you first started doing business there. You may also incur penalties and interest — and, perhaps worst of all, the unexpected tax burden could kill the profitability of the job in question. Look where you leap when it comes to out-of-state jobs and you'll stand a much better chance of succeeding. ■

# Whip your WIP report into shape

Is your profitability lagging? Does your surety seem a bit more hesitant than usual? If so, there may be a number of things you need to do. But one of the simplest is a reassessment of your work-in-progress (WIP) report.

As you know, a WIP report is intended to provide a real-time snapshot of how jobs underway are doing and what's coming up on the horizon. Yet the breadth of detail and accuracy of data in these critical documents can often suffer over time.

## Look at the right things

A WIP report should include all revenues and costs for each of your current and future signed contracts.

You want early and frequent warnings of profit fade on a job as it starts to occur.

More specifically, for each contract, the report should reflect the total contract amount (including change orders) and the estimated gross profit (reflecting signed change orders). Some WIP reports even show the original estimated cost to complete a project, including direct and indirect costs. Additional items may include:

- Current year totals for revenues earned, cost of revenues, gross profit and percentage complete on each job,
- Estimated costs to complete each project,
- Billings to date,
- Actual project costs to date, and
- Actual gross profit to date.

Many WIP reports also have a backlog column to represent billings left on each contract, taking into account the over/under billings currently



on the respective contracts. Almost all reports include the over/under billings per contract — also seen as costs in excess of billings and billings in excess of costs.

## See where you are

Check into the comprehensiveness of your latest WIP report. It should enable you to readily compare the estimated cost of each contract with the actual project cost to date in as much detail as is useful. You want early and frequent warnings of any profit fade on a job as it starts to occur, giving you a chance to get that project back on track.

You can also use WIP reports to discover patterns that need correcting. If you regularly estimate a 15% gross profit, but your actual profit is typically 10%, you may need to re-examine your estimating strategies.

Last, surety underwriters often look at WIP reports when considering how much bonding to offer a construction company. If your cash balance is low, but your WIP report shows a profitable backlog, a surety may still underwrite your project.

#### **Make the commitment**

For the most accurate picture of the financial status of each job, update your WIP report daily, if possible, or at least weekly. Updating more often does mean more work, but it's a commitment worth making. ■

## Could pay-for-performance bonuses give you a boost?

**D**o you want to motivate your employees to work harder *and* use your payroll budget more efficiently? Consider performance-based bonuses. These could give your construction business a motivational boost if you've either stopped offering bonuses to cut costs or no longer wish to hand out bonuses quite so freely.

#### **Everyone gets it**

Traditional one-size-fits-all bonuses are predictable, readily understandable and easy to administer. Everyone gets the same amount, from the staffer who always goes the extra mile to the one who coasts through every day.

Because such bonuses really are nothing more than gifts, they're likely to do little to boost productivity or build loyalty. Plus, many construction companies have done away with them entirely to save money, leaving little to no additional financial incentive for workers to, say, go the extra mile to push business growth up 15%.

#### **Specific activities**

Therefore, if you want to motivate your employees and align their efforts more closely with company goals, consider changing your year end bonus plan (assuming it still exists) to a performance-based bonus plan. After all, most employees will be extremely interested in acquiring bonuses for themselves if the company posts that aforementioned 15% growth.

Developing a performance-based plan that works can be a challenge for construction companies,





however. You should tie bonuses to specific activities that will lead to company success. The areas you target for improvement will depend on your situation, but they could include:

- Improved time to completion,
- Decreased overtime,
- Documented improvements in customer satisfaction, or
- Decreased expenses or labor hours.

Just be sure to communicate with your employees about their eligibility for the bonus pool and perhaps indicate that any bonuses are discretionary. You don't want to commit yourself to bonuses on a couple of jobs if you have multiple problem projects or a lack of backlog.

### Threshold profit levels

While you're selecting your goals, you'll also need to decide how you'll pay for the program. Some rewards pay for themselves. If a crew brings a job in with 10% fewer hours than you bid, for instance, that savings goes straight to your bottom line, and you can give some of it back in the form of bonuses.

Unfortunately, improvements such as a reduction in return-to-work percentage or heightened customer satisfaction don't show up on the balance sheet immediately or directly. Thus, you'll need

to set threshold profit levels for the company to meet before bonuses are paid.

Knowing your break-even margin will make it easier to establish thresholds. You reach the break-even margin when your projects generate enough gross profit to cover fixed expenses. Armed with that information, you can determine how much extra margin is available for incentive pay.

### No sacrifice

Two other important considerations in developing performance-based reward systems are timing and quality.

If you wait until the end of the year to give bonuses earned in June, the connection between the improvement and the reward could be lost. Instead, consider making your bonus plan pay out quarterly — as long as you make it clear that no bonuses will be awarded unless goals are met each quarter. Alternatively, you might consider a job-based system that awards bonuses on criteria specific to each project.

Be sure your bonus plan doesn't encourage savings at the cost of quality or safety.

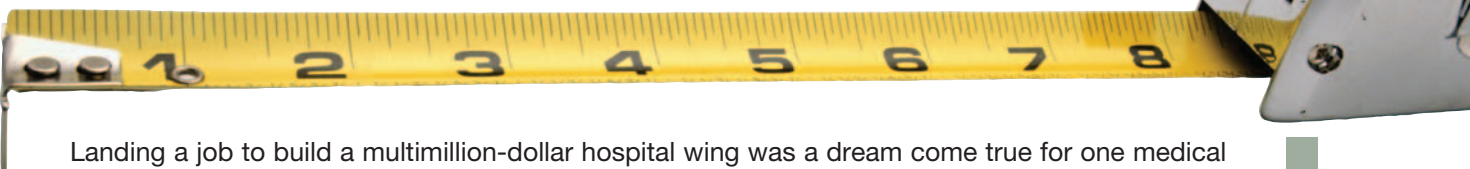
Emphasize, too, that you won't sacrifice quality or safety. It's all well and good to reward people for doing a job quickly, but if they're cutting hours by cutting corners they're actually hurting your bottom line. Be sure your bonus plan doesn't encourage savings at the cost of quality or safety. Perhaps the bonus calculation could include some elements tied to safety goals.

### The edge

Motivation is, of course, important in every kind of business. But, on a construction project, a motivated workforce can mean the difference between a job that barely meets its profit expectations, if at all, and one that markedly outperforms those expectations. A carefully sculpted pay-for-performance bonus plan could give you the edge you've been looking for. ■

## Construction Success Story

### Contractor practices preventive medicine with subs



Landing a job to build a multimillion-dollar hospital wing was a dream come true for one medical facilities contractor. He knew, however, that he'd need to hire multiple subcontractors to supplement his workforce. Although he'd obviously done so before, the contractor wanted to leave nothing to chance on this big job. So he asked his financial advisor for some advice on selecting the right subs.

The advisor told the contractor he was smart to plan ahead. A subpar subcontractor could lead to costly delays. In a worst-case scenario, the contractor might have to terminate one of his subs, which could mean paying attorneys' fees, scrambling to complete or redo the work, and damaging his construction company's good standing with the project owner.

#### Smart selection

Before selecting his subcontractors, the advisor said, the contractor should scrutinize the details of the contract, focusing on the terms and specifications that will likely be affected by subcontractors' work. In addition, knowing the finer points ahead of time could help the contractor avoid disputes with his subs over the project's overall scope or their respective scopes.

When the contractor was ready to hire, the advisor continued, he should consider each applicant's project history to gauge whether the prospective subcontractor could perform the required work. A big project probably wasn't the time to take a chance on an inexperienced sub.



The contractor also needed to compare each subcontractor's bid with industry averages, noting if any bids seemed suspiciously low. And he should call banking, insurance and supplier references to discuss each sub's timeliness in paying bills and whether the company has had previous cash flow problems.

#### On-the-job protection

Documentation would be the key to financial protection once the contractor and his subs broke ground, the advisor emphasized. The contractor should be extra diligent to record meeting minutes, require field supervisors to keep a daily log, file written correspondence, keep trade inspection reports and take pictures to strengthen his case should he need to terminate a sub.

In addition, the advisor noted that each subcontractor's surety would also play a pivotal role. While some sureties will complete a sub's work, other performance bonds simply require the surety to indemnify the contractor from costs stemming from the subcontractor's default. Knowing what kind of coverage he has will help minimize unpleasant surprises if things go south.

#### Up, not south

Fortunately, the hospital wing didn't go south — it went up. Thanks to a thorough selection process, the contractor's subs performed adequately and, in some cases, quite well. Ultimately, the project finished on time and on budget. ■

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