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# The Construction and Real Estate Industry Advisor

*In this issue:*



## Tax Implications of Modifications or Cancellations of Debt

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Owners and developers of real estate already reeling from the recession may be nervously looking for the source of the next damaging blow to their business. It could come in the form of unintended tax consequences resulting from modification or cancellation of debt. When an owner receives relief from a debt that can no longer be serviced due to the poor performance of the related property, careful consideration should be given to avoid exchanging a liability to a lender for an income tax liability to the IRS.

Section 61(a)(12) of the Internal Revenue Code states that gross income includes income from the discharge of indebtedness. This form of income is commonly referred to as “cancellation of debt” or “COD” income. Cancellation of debt income occurs when a debtor is relieved by a creditor of an obligation to repay some or all of a debt. The tax rules which govern cancellation of debt are complex. The analysis of whether COD income is incurred and the options available to a taxpayer are driven by a number of factors, including:

- The type of entity holding the assets and debt (partnership or corporation)
- The type of debt (recourse or nonrecourse)
- Is bankruptcy involved?
- Is the debtor insolvent?
- Was the debt purchase money debt?

Not all situations will result in a debtor recognizing taxable income. IRC § 108 provides a limited exclusion from income for certain types of COD income; the exclusions typically impact real estate owners or developers in situations involving bankruptcy, insolvency, and qualified real property indebtedness.

IRC § 108(a)(1)(A) excludes from gross income debt forgiveness when the discharge occurs in a Title 11 case. Taxpayers subject to this Code section are those under the jurisdiction of a bankruptcy court. To qualify for the exclusion, taxpayers must be granted a discharge of debt by the court or a discharge pursuant to a plan approved by the court.

If a taxpayer is insolvent at the time their debts are forgiven, IRC § 108(a)(1)(B) excludes the discharged debt from gross income. A debtor is considered insolvent to the extent liabilities exceed the fair market value of assets (with fair market value determined immediately before the discharge of debt). In the case of insolvency, a debtor may only exclude recognition of income in an amount equal to the amount of insolvency.

Qualified real property business indebtedness (QRPBI) is the subject of IRC § 108(a)(1)(D). QRPBI is a specific type of indebtedness incurred by a taxpayer in connection with real property used in a trade or business. For purposes of this Code section, rental real estate activities constitute a trade or business. This income exclusion is not available to taxpayers that are c-corporations, and is applicable to all debt incurred before 1/1/93 or debt incurred after this date, if the debt is incurred to acquire, construct or substantially improve real property. The amount of the exclusion is limited to the outstanding principal amount of indebtedness in excess of the fair market value of the qualified real property securing the debt, reduced by the outstanding principal amount of any other qualified real property secured by the debt.

Relief from COD income under this section of the Code is only available if the taxpayer makes the proper election and follows the procedures for reporting on Form 982 Reduction of Tax Attributes Due to Discharge of Indebtedness. In cases involving the discharge of QRPBI, the “tax attributes” referred to on Form 982 are elements used in the calculation of a taxpayer’s taxable income. A taxpayer may choose to reduce the basis of depreciable property in an amount equal to the amount of discharged indebtedness. This is generally the most frequently exercised option in cases involving qualified real property indebtedness. If a taxpayer chooses not to reduce the basis of depreciable property, a taxpayer may reduce the following tax attributes in the order listed (This is not an all-inclusive list.):

- Net operating losses
- General business credits under IRC § 38

Continued on page 7. See “*Tax Implications*.”

## Considerations When Choosing a Subcontractor

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There are several advantages to hiring subcontractors, as they generally operate in specialized fields and own their equipment. This can be more cost-efficient to a contractor than buying or renting. Subcontractors maintain an organization of skilled specialists, and can be used to spread both the risk and the large amount of working capital required by large jobs.

There are disadvantages as well. When a contractor subs out part of a job, an amount of control is sacrificed. If things go wrong, it may take a longer period of time to correct, and the risk of delays is increased. And, while some of the risk is passed on to the subcontractor, the potential loss can be greater and harder to guard against if the subcontractor proves to be insolvent. This makes choosing the proper subcontractor that much more critical.

The most important consideration in choosing a subcontractor is simply determining if the subcontractor can perform the job in the required nature and quality at a competitive price. A mistake in judgment can be expensive and justifies making the selection with extraordinary care.

The next consideration is financial ability. Two major limitations on a contractor's ability to undertake new work are the organization and its available working capital. If a subcontractor is lacking in either, the contractor may have to lend a hand. When looking at financial stability, it is important to note how much working capital the sub has available for a particular job. It is the responsibility of the contractor's accounting department to analyze the subcontractor's credit reports and financial statements in considerable detail to determine the subcontractor's financial responsibility, with net working capital being the key figure.

*"Subcontractors maintain an organization of skilled specialists, and can be used to spread both the risk and the large amount of working capital required by large jobs."*

A third consideration is the subcontractor's reputation for maintaining a work schedule. This is important for two reasons, the first being to prevent delays on the jobs. The second reason is that a subcontractor who is behind on work is generally also behind on the payment of bills, creating a lien risk.

In addition to the above considerations, there are several questions one should consider before signing a contract with a potential subcontractor. These include:

- Is the work to be done described completely and accurately?
- Who owns the plans, drawings and models furnished?
- If samples are to be submitted, to whom do they belong?
- Who is responsible for lines, grades and surveys?
- To what extent does the subcontractor assume the responsibility to protect the work, the public and the owners of adjacent property from loss or damage?
- Has the subcontractor agreed to the same standards of supervision and inspection as those imposed on the prime contractor?
- Has the subcontractor agreed to the same provisions regarding change orders as those in the prime contract?

Continued on page 4. See "*Considerations*."



## New Technology in Construction Equipment Management

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The downward trend in consumer spending is forcing owners to reevaluate their business models and compensate for the decline in demand for services. Staying competitive in this economic environment requires creative thinking and a shift in attitudes. The current environment presents an opportunity for businesses to utilize technology to reduce overhead and gain competitive advantages.

Applying new technology can be perceived as a large undertaking – not only because of the implementation timeline, but also because of the people and process challenges associated with using new technology. As with any investment, it is important to be diligent in understanding what the organization wants to achieve now and in the future by selecting technology that is capable and innovative enough to keep up with the organization's changing needs.

Technological advances in the construction sector, such as the Global Positioning System (GPS), have given companies the means to use various reporting methods to collect data that provides valuable insight into the overall health of an organization.

Though GPS tracking is most commonly used by motorists and preventative maintenance (PM) reporting, it is now being implemented for use as an asset management system within the construction industry. Through the use of cellular and/or satellite transmission, a GPS tracking device mounted on construction equipment can monitor and report data that can be detailed to the specific needs of the organization. By monitoring production issues such as location, fuel consumption, idle time, and run and roll time, businesses can achieve a better understanding of overall asset management, while also raising productivity rates, increasing efficiencies, and realizing overall cost savings. By analyzing data, businesses can become more competitive in the market and bid more accurately on potential projects. Data provided by the GPS system can also give companies information on current environmental issues and emissions regulations.

Before implanting new technology, it is important for a company to understand its business goals and the impact installing new technology will have on the company's culture. An experienced partner can assist organizations in deciding which reporting metrics are important and drive the implementation of the correct solution to meet the business needs. Being diligent in the selection process of a GPS program and following through with the technology's capabilities after implementation will ensure a quick return on investment and allow companies to stay competitive in today's economy. •

## Considerations *(continued from page 3)*

- Have satisfactory provisions been made for correcting unsatisfactory work, delays, and extensions?
- Does the prime contractor have the same power to terminate the subcontractor as the owner has to terminate the prime contract?
- When, and on what basis, does the subcontractor receive progress payments? Is there any relationship between the owner's payments to the prime contractor and the prime contractor's payments to the subcontractor?
- When, and on what basis, does the subcontractor receive his retained percentage? Must the subcontractor wait until the job is complete and accepted?
- To what extent must the subcontractor carry workers' compensation insurance and public liability and property damage insurance?
- Is the subcontractor required to furnish a performance and payment bond?
- Does the subcontractor agree in general terms to be bound by all applicable terms of the prime contract?
- Does the subcontractor have the right to joint-venture or subcontract significant portions of work without approval from the prime contractor or owner? If so, to what extent?
- In the event of default by the subcontractor, does the prime contractor, or the prime contractor's nominee, have the right to take over and use, for the purpose of completing the subcontractors' work, all materials, supplies, equipment and facilities the subcontractor has on the job?

It only takes one subcontractor not performing properly to upset planning, create delays and turn a closely bid job into a loss. Following these considerations and seeking answers to the questions listed above can help reduce one's chance of experiencing such circumstances. •

## Carried Interest and Real Estate

**By Doug Rubenstein, CPA**
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With a change in administration this past presidential election, there are likely to be changes in tax policy over the next few years. One potential change is the treatment of carried interest. The purpose of this article is to explore how this issue affects the real estate industry.

Carried interest is defined as a percentage of income that is allocated to the managing partner of a partnership that exceeds the percentage of the managing partner's capital contribution to the partnership. The income earned is based upon the increase in the value of the real estate partnership when the investment is sold. Current tax law allows this income to be treated as capital gain property. With the country's national debt increasing and Congress attempting to pay for proposed tax cuts by offsetting revenue raisers, the carried interest issue has become a serious topic of debate.

At issue is how carried interest income should be treated. Under the current tax law, carried interest is taxed at the 15 percent capital gains rate. However, over the past several years there have been several proposals to treat carried interest as ordinary income, and subject it to potentially higher income tax rates.

As discussed above, the carried interest income received by the managing partner is based on a percentage of the gain on the sale of the property. The percentage of income earned is determined by the partnership agreement and is often 20 to 25 percent or more. Therefore, the carried interest income allows for the alignment of the managing partner's incentives with the goals of the limited partners. This alignment occurs because the higher return on the investment for the limited partners will also provide a higher share of income for the managing partner. Therefore, the managing partner should base decisions on the best interest of the partnership and not on personal goals.

In addition to the carried interest income, the managing partner will often earn a management fee throughout the project to cover administrative overhead such as operating costs and salaries to employees. The management fee is generally fixed and not based on the performance of the entity. The management fee received by the general partner is considered ordinary income and taxed at ordinary income tax rates.

A major difference between the management fee and the carried interest fee is the guarantee of income. The management fee is guaranteed to the managing partner as it is not based on the performance of the entity. However, the carried interest fee is not guaranteed and therefore is based on the performance of the property. If the property was to be sold at a loss, the managing partner would not receive any carried interest.

Since the carried interest income is earned differently than management fee income, why have there been proposals by Congress to treat carried interest income as ordinary income instead of capital gain income? One reason is that this income is generally earned by individuals with income subject to the highest marginal tax rates. It is easier to sell a tax increase to individuals in the highest tax bracket than to individuals in a lower tax bracket. In addition, the public may not see this as a tax increase, since it is a reclassification of a type of income and not an increase in tax rates.

Another reason for this discussion is whether or not carried interest income is really different from a management fee or compensation. There are two differing views on this matter. One side believes carried interest is an extension of compensation and should be taxed as ordinary income. This belief is held by several prominent leaders, including Peter Orszag, the

Continued on page 7. See "*Carried Interest*."



## Alternatives to the Traditional Financial Statement Audit

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Companies involved in the construction industry can agree that the outlook for the latter part of 2009 and 2010 is concerning. In July, the American Institute of Architects (AIA) Consensus Construction Forecast Panel projected that nonresidential construction activity would decline approximately 16 percent in 2009 and further decline by 12 percent in 2010 after taking inflation adjustments into account.

Contractors are right-sizing their companies based on decreases in backlog, monitoring margins and productivity, and reducing overhead costs. As part of a review of overhead, a savvy finance or accounting executive at a privately-held construction company may notice that the cost of their financial statement audit has increased significantly over the last five years. The costs of a financial statement audit increased between 15 and 30 percent for the implementation of Statement on Auditing Standards (SAS) Nos. 104 to 114, depending on the size and complexity of the company.

An audit is not the only option available to companies, depending on the level of assurance required. For example, a bank, bonding company, stockholder, or federal, state, or local government agency may require the contractor to have an audit of their financial statements.

However, some companies have replaced their annual financial statement audit with a financial statement review, agreed-upon procedures, or some combination of the two to reduce costs. Many companies and users of financial statements are familiar with a financial statement audit and financial statement review and the associated level of assurance that is expressed by an independent public accounting firm for each level of service, but are unfamiliar with agreed-upon procedures as an alternative.

An agreed-upon procedures engagement can provide a cost-efficient alternative to a standard financial statement audit. Agreed-upon procedures are much narrower in scope and typically focus on specific areas such as receivables, work-in-process, and inventory. The main objective of an agreed-upon procedure engagement is for a CPA to report on the credibility of information passed from one party to another, based on a set of predetermined procedures. After the agreed upon procedures are performed, the practitioner reports the findings, in a format that lists procedures, specific findings, and observations, to the interest-holding party for review.

These findings are not in the format of a financial statement, but in a report format that lists the procedures performed and the specific findings and observations. This makes the financial statement review a nice complement to the agreed-upon procedures report. The practitioner does not perform an audit or provide any opinion relating to the subject matter. This is a primary difference when comparing an agreed-upon procedures engagement to a financial statement audit or financial statement review. Agreed-upon procedures reports should only be relied upon by the parties who have agreed that the procedures are suitable for their purposes and therefore are restricted to these parties and should be distributed as a company would distribute their audited or reviewed financial statement.

It is important to understand the requirements of the users of your financial statements while evaluating the level of service being performed by your accountant as it relates to your financial statements. Another important consideration is the current credit and lending environment and the possibility that financial institutions may agree today to a lower level of assurance than a financial statement audit, but may decide otherwise in the near future.

Contractors should talk with their accountant to learn more about alternatives to the financial statement audit and consider talking with the users of the financial statements to determine if a more cost-effective option to the financial statement audit would provide them with the required level of assurance at a decreased cost. •

## Tax Implications *(continued from page 2)*

- Minimum tax credits under IRC § 53(b)
- Capital losses

Taxpayers should be aware of the different treatment given to discharges of recourse debt as compared to nonrecourse debt. If a property subject to recourse debt is transferred in full satisfaction of the debt, then the transfer is treated as a sale of the property to the extent of the property's determined value. This could result in taxable gain equal to the difference between the value of the property and its net book value. In addition, the amount of debt discharge that exceeds the property's determined value is treated as COD income and taxed as ordinary income.

Under the same circumstances as above, but where debt is nonrecourse debt, the transfer is treated as a sale of the property for the full amount of the debt. Taxable gain is recognized to the extent of the excess of the determined value over the net book value of the property. However, no COD income is incurred.

While the tax impact related to complete or partial cancellations of debt is the subject of the above discussion, taxpayers should also be on aware of the potentially adverse impact of modifications to the terms of debt. If terms and conditions of a debt are modified such that the discounted value of the debt is less than the value of the debt prior to modification, COD income will result.

In the case of properties that are not performing, taxpayers must understand the income tax impact of choices made during negotiations with creditors. If you find yourself contemplating a discharge of indebtedness or a modification of terms of a debt, consult with your tax advisor prior to the execution of any such agreements. •

## Carried Interest *(continued from page 5)*

Director of the Office of Management and Budget for the Obama administration. Mr. Orszag testified in July 2007 before the Committee on Finance of the U.S. Senate that the carried interest is performance-based for services provided by the managing partner and not a return on financial capital invested by the partners. The dissenting view is that the managing partner is making an investment in the partnership. The investment by the managing partner is long-term and subject to risk, as the managing partner often provides a credit enhancement such as a debt guarantee. Therefore, the carried interest is not currently earned, but earned based on the future increase in the value of the property upon disposition. Since the carried interest is based on the capital appreciation of the property, it should be considered capital gain property, subject to the lower capital gains rate.

If the law is changed to characterize the carried interest income as ordinary income, there will likely be a change in how real estate deals are developed. Will the managing partner want to structure future deals differently by expecting either more upfront fee income or charge a higher management fee for the development? This type of structure may result in a lower return on investment for limited partners. A limited partner may be more reluctant to invest, due to a lower rate of return. The real estate industry could be severely affected by less development, which could also result in a decrease of employment in the construction industry.

In these tough economic times, the administration's goal is to stimulate the economy, but re-categorizing the carried interest could potentially stagnate job creation in certain industries.

Today's down-turn in the economy is creating challenges for the construction and real estate industries. Legislative mandates surrounding the issue of carried interest and its future treatment could potentially be ill-timed. Any governmental efforts to stimulate growth will need to be carefully tempered to avoid further erosion of these two key economic sectors. •

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## KSM Construction and Real Estate News

Christopher Bradburn joined the Indiana Chapter of the U.S. Green Building Council

Chris Felger obtained the certification of Certified Construction Industry Financial Professional (CCIFP)

Ron Lenz and Chris Felger attended the Construction Industry CPAs/Consultants Association's (CICPAC) annual meeting in Chicago, Illinois

Lisa Leventhal participated on a panel discussion on economic incentives hosted by the Urban Land Institute (ULI) of Indiana

Tom Nowak attended the Construction Financial Management Association's (CFMA) annual conference in Las Vegas, Nevada

Aron Spreen joined the Leadership Development Committee of the Indiana Construction Association (ICA)

Aron Spreen and Matt Bishop attended the ICA Leadership Development Committee Program "Embracing Sustainability: A Necessity for Today's Contractor"

For more information about Katz, Sapper & Miller, LLP, please visit www.ksmcpa.com.

*The Construction and Real Estate Industry Advisor* Editorial Committee:
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