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THE CONSTRUCTION AND REAL ESTATE INDUSTRY ADVISOR

In this issue:

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Hold or Sell? Understanding the Impact of a Capital Gains Rate Increase

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Anybody See a Rate Increase Coming?
This newsletter has arrived in your mailbox shortly after we elected a new President, but I began to formulate the thoughts I'd like to share the week after the Federal Reserve lent $60 billion to Wall Street investment firms committed $85 billion to AIG, and, together with the U.S. Treasury, announced a plan to spend $700 billion to buy troubled assets.

With these developments and a weakening economy, how can we not expect next year's federal deficit to grow significantly beyond the current fiscal year estimate of $400 billion? We are not yet sure what the new administration will propose, but during the campaign both presidential candidates promoted plans that arguably put even more pressure on budget deficits. Senator McCain advocated cuts to corporate taxes and the repeal of AMT, and Senator Obama proposed increased spending on infrastructure and alternative energy. Largely due to our low savings rate, the U. S. government increasingly turns to foreign countries to finance our spending. In the past year alone, China purchased more than $300 billion in U.S. and agency debt; in years to come, it is quite possible we will find this trend unacceptable. That means that in addition to taking action promoting economic growth, the incoming administration will need to evaluate real spending cuts and/or tax increases.

Low Long-Term Capital Gains Rates; A Big Part of Real Estate Investment
One of the hallmarks of real estate investment is the creation of a favorable tax treatment afforded to long-term capital gains. Currently, the federal capital gains rate applied to individuals is at an historic low of 15% (0% for individuals in the 10% or 15% bracket). Senator McCain stated he would maintain the current law and Senator Obama stated that he would seek a rate of 20% for those families making more than $250,000 per year. While it would be unprecedented to increase tax rates retroactively to a prior year, in this case 2008, it is possible that the incoming administration will seek a rate increase effective sometime in 2009.

Possible Impact
Let's say the long-term federal rate goes to 20%. This would be a whopping 33% tax rate increase! However, given the federal budget deficit outlook, this is a real possibility. So how should we look at this possibility and the impact on investment decisions? Compared to other variables the impact is likely to be less than you think.

Let's take an example operating property with net operating income of $1,000 and assume a current cap rate of 8% and a basis of $7,500. (For simplicity we will ignore state tax rates, cost of sale, and any depreciation recapture, which for real property is currently taxed at 25%). At today's tax rate, the after-tax sale proceeds would be $11,750 ($12,500 in value less federal taxes on the $5,000 gain of $750). With these same economic assumptions and a 20% federal tax rate, the after-tax proceeds would be $11,500, a difference of $250.

Now let's assume that the financial markets improve, allowing buyers greater leverage and reducing the cap rate by .5% to 7.5%. At the 15% tax rate, the net proceeds are $12,458 ($13,333 in value less taxes on the $5,833 gain of $875) and at the 20% tax rate, the net proceeds are now $12,166. Based on this example, the impact to after tax proceeds of the .5% reduction in cap rates ($12,458 less $11,750 or $708) is 2.8 times greater than the impact of the higher tax rate. Lower basis property would reduce the $250 impact differential, but even with a zero basis the net proceeds would be greater at the 7.5%/20% cap rate/tax rate scenario compared to the 8%/15% scenario. In other words, after-tax values are much more sensitive to changes in capitalization rates than changes in capital gains rates.

So What Do I Do?
Our recommendation is to follow your business plan. If your plan is to sell property so that you can reinvest the proceeds in better locations or faster growing property types, be a seller now. On the other hand, if your plan is to hold property in competitively stronger locations, don't let the possibility of an increase in long-term capital gain rates make you a seller. In other words, don't let the tax tail wag the dog. The tail might not be as long as you think. •

Partnership Transactions: Tax-Free Distribution or Taxable Disguised Sale?

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As a choice of operating entity, partnerships and LLCs offer great flexibility to partners who wish to combine their economic resources to create a business. At the creation of a partnership, a partner may generally contribute cash or property to the partnership without immediate tax effect. Contributed property might be tangible (e.g. equipment) or intangible (e.g. options to purchase land for development). In general, the Internal Revenue Code allows a partner to withdraw assets from a partnership (in a non-liquidating distribution), to the extent of the partner's tax basis in her partnership interest, without recognizing taxable income. But while partnerships present flexibility in terms of contributions and distributions, care must be taken not to run afoul of the disguised sale rules of IRC section 707.

Prior to the Deficit Reduction Act of 1984, a partner could contribute property to a partnership and then receive a distribution in the form of different property or money to the extent of his contribution without resulting in treatment as a taxable sale. For example, partners A and B would agree to form a partnership and to contribute equal economic value to the partnership. Partner A contributes property with a fair market value of $75,000 and a basis of $50,000 while partner B contributes cash of $50,000. Since A has contributed property worth more than partner B's contribution, partner A might receive a non-liquidating distribution of $25,000 taken from the cash contributed by partner B. As a result of this set of transactions, both partners are left with capital accounts of $50,000 and partner A received $25,000 of cash without income tax effect.

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This ability to contribute and distribute economic value from partnerships was abused, however, by taxpayers who used the partnership structure not as a vehicle for operating a business, but rather as a mechanism to exchange property for cash without recognizing taxable income. As a result of the Deficit Reduction Act of 1984, the IRS now has broad authority to re-characterize a series of contributions and distributions into taxable fee payments or property sales if:

1) There is a direct or indirect transfer of money or other property by a partner to a partnership;
2) There is a related direct or indirect transfer of money or other property by the partnership to such partner or another partner; and
3) These transfers, when viewed together, are properly characterized as a sale or exchange of property.

Transfers of value that satisfy the above tests may be treated either as a taxable payment to a non-partner or as a taxable exchange between the two partners. Such transactions are commonly referred to as "disguised sales." Under current Internal Revenue Code the example given above would result in partner A being deemed to have sold 1/3 of the property for $25,000 with a resulting gain of $8,333 [($25,000 – ($50,000/3)].

The rules governing determination of whether a disguised sale has occurred are complex. In general, a facts and circumstances two-part test is applied for purposes of determining whether a disguised sale exists:

1) One Transfer would not have been made but for the other, and

2) Non-simultaneous transfers are not dependent upon the entrepreneurial risks of partnership operations.

In other words, if neither the transfer nor the distribution would have occurred without the other and the distribution will be made regardless of the operational success of the partnership, a sale would be indicated. The facts and circumstances in existence on the date of the earliest transfer are generally the relevant ones to be considered.

Because the identification of a disguised sale is highly subjective, partners may unwittingly find themselves subject to a taxable transaction where none was intended. Fortunately, the regulations contain a nonexclusive list of 10 factors which can be used to indicate whether a disguised sale exists. Summarized, the factors are as follows:

1) Timing and amount of subsequent transfer is determinable with reasonable certainty;
2) The transferor has an enforceable right to subsequent transfer;
3) Right to subsequent transfer is secured;
4) Any person has agreed to make loans or contributions to partnership to facilitate transfers;
5) Obligations by partnership to incur debt to facilitate transfers;
6) Partnership has or is obligated to incur debt to make transfers;
7) Partnership holds money or liquid assets beyond reasonable needs;
8) Effective exchange of burdens and benefits of ownership of property;
9) Transfer disproportionate to continuing interest in partnership profits;
10) Little or no obligation to return or repay consideration.

To minimize complications of these factors, the IRS issued a "two year presumption" rule regarding the treatment of transfers as a disguised sale. If, within a two-year period, a partner contributes property to the partnership and receives back a distribution of cash or other consideration, the contribution and distribution may be presumed to be a disguised sale. Conversely, transfers made more than two years apart are presumed to not constitute a sale. In either situation, the particular facts surrounding the transactions can overcome the presumption. Distributions of operating cash flow generally will not be re-characterized as part of a disguised sale. Normally, if there is a distribution within the two-year window, the taxpayer bears the burden of proof to show that the transfer was intended to be a transaction other than a sale of an asset.

The disguised sale rules create interesting tax issues that should be identified and incorporated into planning a withdrawal of assets from a partnership. The easiest way to avoid adverse tax treatment would be to delay the partnership distribution until at least two years after the property is contributed to the partnership. Alternatively, the partner may consider structuring the distribution as a bona fide loan.

Another option to reduce the risk of disguised sale treatment would be to draft the partnership agreement to include a reasonable guaranteed payment for the use of capital. In general, guaranteed payments for capital are not treated as part of a sale. A payment to a partner that the parties treat as a guaranteed payment is presumed to be a guaranteed payment unless the facts and circumstances establish otherwise. The payment must be reasonable and determined without regard to the partnership's income. It is basically a return on investment and should not be designed to liquidate a partner's interest in the partnership. These payments must be made pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount. The regulations provide a formula to use in order to determine what constitutes a reasonable amount.

There are many other issues when dealing with the disguised sales rules including the contribution of services, preferred returns and the transfer of property subject to liabilities. While waiting for two years prior to distributions (other than distributions from operating cash flow) should provide a safe harbor in most situations, the heavily subjective nature of disguised sale rules still carries risk of adverse tax treatment. If you and your partners are considering a series of contributions and distributions, consult with your tax advisor about the potential impact of disguised sale rules. •

Construction Company Valuation

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The valuation of closely-held companies is a large and growing practice. However, most people are not aware of this valuation activity since the companies being valued are closely held and are, thus, private in nature. Additionally, since closely-held firms are typically smaller than publicly-traded firms, fewer investors are affected by the results of such valuations. Valuation needs arise for a number of reasons, including tax liability determinations, mergers and acquisitions, shareholder disputes, litigation, buy/sell agreements, employee stock ownership plans (ESOPs), succession planning and divorce.

Regardless of the type of company being valued, each company has specific issues and factors that uniquely affect its value. General construction company valuations present their own certain nuances when trying to ascertain a reliable value conclusion. As a result of the IRS issuing Revenue Ruling 59-60 (which provided guidance for valuing privately- held stock), three primary approaches have been developed to apply to privately-held company valuations. Further, the definition of fair market value was developed as well through subsequent regulations as "the cash or cash equivalent price at which property would change hands between a willing buyer and a

willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of relevant facts." (Rev.Rul. 59-60; T.D. Reg 25.2512-1) For construction companies considering a potential transaction, succession planning, potential ESOP structure, or other, the methodologies outlined below would be applied by a qualified business appraiser when determining a realistic value conclusion.

Valuation Methodology

The three primary approaches are the market approach, income approach, and adjusted balance sheet approach. The market approach compares the private company to other companies in the public securities markets. This includes adjusting financial statements of the private company, analyzing multiples of the public securities, and making adjustments for the differences between the private company and its publicly-traded counterparts. Private transactions of other companies sold in the marketplace can also serve as evidence of the subject company value. However, this information is difficult to find and is sometimes unreliable. The income approach to valuing a private company involves measuring some level of income or cash flow and capitalizing these amounts into value. The value of a company to any investor is always the present value of its future income or cash flow. Sometimes an analysis of the private company's past performance is the best indication of its future performance. Other times, a forecast of future cash flows is determined to be a more reliable expectation of the company's future performance. In this scenario, the future cash flows are projected and then discounted back to today's value. This process is commonly referred to as discounted cash flow (DCF) analysis. Although the DCF method is theoretically correct, it is very complex and sensitive to changes in assumptions.

The adjusted balance sheet approach is used in situations such as real estate and other types of holding companies. This approach involves adjusting the assets of a company to their fair market value and deducting all outstanding liabilities. Other situations for this approach arise when application of the market or income approach yields a value below the company's book value, or when those approaches are eliminated from consideration all together. In those cases, the adjusted balance sheet approach is used to establish a valuation floor, since every company is worth at least the fair market value of its assets less its liabilities.

Construction Company Issues/Factors

Although the three approaches discussed apply to valuing most private stock, construction company valuations have their own specific factors that affect the application of these approaches. Some of these factors include longevity and reputation of the business, level of repeat business, reliance on single or few owners/management team, current backlog of projects, accounts receivable collection history, stability of workforce, specific construction industry niche, surety bonding practices, overall size of the company, and financial condition of the company.

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Most construction companies rely on a steady backlog of new projects to continually generate cash flow. Many construction companies cannot accurately project their future revenue since many of their projects are not repeat business. The "project to project" nature of construction companies has a depressing affect on valuation and results in transactions at lower multiples of cash flow versus companies that have longer term contracts in place or have a repetitive nature regarding the projects they perform for their customer base. Despite the "project to project" nature of construction businesses, there are many companies that have operated successfully for several years and survived economic downturns on more than one occasion. There are certainly varying degrees of this project nature in the construction business. The degree to which this impacts value depends on the specific industry niche, general size, customer diversification, and overall economic conditions. For example, a small local company serving the residential home construction industry will be much more negatively impacted in today's economy than a large national company serving the oil and energy industries.

Some construction companies may be fortunate to have strong relationships with customers that are always in need of construction work. For companies that have strong relationships, although their work is still "project to project," they have a more repetitive nature with these customers. As a result, these companies have more stable businesses compared to other construction companies.

Companies with stronger and deeper management teams also tend to have more stability in their business compared to companies who are more reliant on one single key person or owner. A company with a deeper management team has relationships with a much broader network of customers and referral sources. Companies with one key person simply cannot have a network as broad as a company with multiple owners or various sales and management team members. Companies with larger "order backlogs" tend to be valued at larger multiples as well. A strong backlog of projects is an indication of a more diverse customer base and reduces the level of risk in future cash flow projections.

Financing Ability

All of the factors discussed impact the value of a particular construction company. When valuing construction companies for transaction purposes, the valuator must consider the borrowing capacity of a company when reaching a valuation conclusion. A consideration for the company's ability to collateralize its assets in a transaction can affect the valuation conclusion. In most businesses, accounts receivable is one of the most common assets available for collateralization. Since many construction businesses perform projects for municipalities, they are often required to have surety bonding in place in the event that they default on completing the contracts. However, the underwriter of these bonds often takes a security interest in the assets of the company, typically accounts receivable. Thus, when a buyer of a business is considering the ability to finance a transaction with debt using the company's assets, it is important to understand that some of these assets may already be pledged to the surety bond underwriter. Furthermore, the surety bond underwriter may have covenants regarding the tangible equity of the company. Thus, construction companies need to be careful about covenant violations when considering additional borrowings, shareholder distributions, or using cash for other reasons.

As a general industry, construction companies present their own special set of circumstances when determining value. However, even within its industry group, each construction is further differentiated by the factors discussed here. No construction company is alike and each needs to be considered with its own specific factors affecting its value. For companies facing valuation issues with regard to potential transactions, surety bonding requirements may present more limited financing options compared to non-construction related transactions. •

Captive Insurance and the Construction Industry

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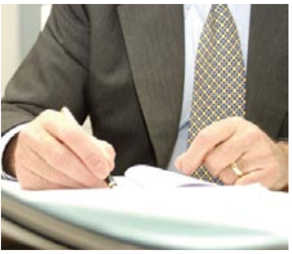
Middle market businesses in a variety of industries, including construction and real estate companies, are more frequently using captive insurance companies as part of their overall risk management and/or wealth management strategies.

What Is a Captive Insurance Company?
A captive insurance company is a company established to insure the risks of related companies. It operates as an insurance company, pays claims, collects premiums, etc., but typically does not offer insurance to the general public. The majority of Fortune 500 companies have used captives for years and assuming favorable claims, they became profit centers and provided opportunities to avoid sudden increases in premiums. In the past, captives were considered too burdensome and expensive for middle market companies, but increased awareness and to some extent IRS revenue rulings, have made them more attractive to middle market companies.



There are several different types of captives, but two that will be used most commonly by our clients are cell captives and group captives. A cell captive is formed by an insurance company that creates segregated cells within an insurance company. An individual cell would then provide insurance to a company while the premiums and claims of the company are tracked within that cell. At the end of a specified term, premiums and investment income are returned to the company, net of claims and fees. Group captives can be formed by members of an industry or trade association to share the risks and returns associated with that industry.

What Risks Can Captives Insure?
Captives can be used to insure risks currently covered by commercial carriers, or to cover risks that are currently uninsured. One of the first steps that should be completed when investigating a captive is to determine if your company has a risk and financial profile that fits with a captive. This is often referred to as a feasibility study. This will involve a review of your current insured and uninsured risks, taxable income and other factors. Some popular lines of coverage for captives that may currently be uninsured are deductibles, construction defect, mold, and litigation defense.

Tax Issues
Smaller captives may try to qualify under IRC section 831(b). This provision allows small non-life insurance companies with annual premiums under $1.2 million to pay no tax on underwriting income. The captive is still taxed on its investment income at the normal corporate tax rates. In its simplest form, the parent could contribute $1.2 million in premiums to a captive and the parent would have an ordinary tax deduction for the premiums. The captive would pay no tax on the premiums and when dissolved the balance in the captive would be returned to the owners and would be taxed at the capital gains rate, currently 15% for federal income tax purposes. Depending on claims, the wealth accumulation in a captive could be significant, which leads to other estate planning techniques using captives. The premium maximum of $1.2 million under a cell captive or a group captive can make qualifying under this exception difficult.

In any type of captive it is critical that the premiums to the captive are deductible for federal tax purposes. Recent rulings have upheld that there needs to be “risk shifting” out of the “economic family” in order to qualify as a tax deduction. In a group captive, the risk shifting would occur, as you are sharing risks with others participating in the captive. The cell captives would need a method to achieve this “risk shifting.” The insurance industry has developed several ways to achieve this “risk shifting” in captives, including the captives participating in risk pools which include risks from unrelated companies. Cells could also share in the risk of other cells. For example, if other cell’s claims exceeded their premiums your cell could be liable for any shortfall. These are just a couple of the examples of the way “risk shifting” can occur in cell captives. A common sense approach should be used in determining whether risk shifting actually occurs and whether the IRS would support the cost of the premiums as appropriate for the policy.

Although the IRS rules are clearer than in the past, this is still a complicated part of the tax law and there are also insurance regulations and filings that must be understood. A captive can be a very valuable part of a company’s risk and wealth management programs, but there should be significant time and energy contributed to understanding the process and working closely with lawyers, accountants and insurance professionals to develop a captive that is right for you.

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Our depth of experience translates into the ability to assure that our clients receive the best possible service and advice in order to provide peace of mind along with financial success.

Keep pace with an evolving economic environment. For more information about topics included in this newsletter, or to learn how Katz, Sapper & Miller can help your company to achieve greater success, please contact the authors, the partner-in-charge of the Construction Group, Ron Lenz, or the partners-in-charge of the Real Estate Group, Kent Manuel and Keith Gambrel at (317) 580-2000 or visit www.ksmcpa.com.

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