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# construction & real estate industry advisor

The Financial Side of the Construction & Real Estate Industries

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Katz, Sapper & Miller, LLP
Certified Public Accountants

# Gift and Estate Tax Rules for 2012: Addressing Succession Planning

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Gift and estate tax rules were enacted by Congress in December 2010, which add a renewed sense of urgency for contractors to address succession planning. Prior to the enactment of these rules, the gift tax exemption was $1 million, and the gift tax rate was 35 percent. The Federal estate tax was repealed for 2010, but starting in 2011, the estate tax was scheduled to return with only a $1 million exemption and rates ranging from 41 percent to 55 percent. Also in 2011, the gift tax exemption was scheduled to be $1 million, with rates ranging from 41 percent to 55 percent.

The December 2010 law delayed the effective date from Jan. 1, 2011, to Jan. 1, 2013, of the gift/estate tax rules, reverting to a $1 million exemption and rates ranging from 41 percent to 55 percent. Meanwhile, for 2011 and 2012, the tax rules are very taxpayer favorable.

As a result of the law change, for 2010 the gift tax rules stayed the same (i.e., $1 million exemption and 35 percent rate). For 2011 and 2012, the gift tax exemption increased to $5 million, with a 35 percent rate, which means that a taxpayer can gift up to $5 million total during life without paying any gift tax. The gift/estate exemption is indexed for inflation, so the 2012 amount is actually $5.12 million. Gifts in excess of $5.12 million are subject to tax (imposed on the donor) at a rate of 35 percent. Note that the $5.12 million exemption is a lifetime exemption. If a taxpayer previously used his $1 million exemption, then he only has $4.12 million remaining.

Before the end of 2012 is a great time to consider making gifts. When a taxpayer makes a gift, not only are the gifted assets out of the estate, but the future appreciation on the gifted assets is out of the estate as well. Further, as noted above, if Congress does not act before 2013, starting in 2013, the gift tax exemption drops back to $1 million. Consequently, the opportunity to make gifts in excess of $1 million with no gift tax might be short-lived.

**These changes in the gift and estate tax rules provide an excellent opportunity for owners of construction companies to evaluate their succession plan.**

These changes in the gift and estate tax rules provide an excellent opportunity for owners of construction companies to evaluate their succession plan. A documented succession plan is an essential planning tool for continuity of the successful business one has built. The succession plan should include written goals addressing weaknesses, opportunities and threats to business continuation with a timeline of action steps. Effective succession planning will build value, grow the company, and identify needs within key management personnel.

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*See "Succession Planning."*

# Five Prime Suspects in an Investigation of Profit Fade

**By Tom Nowak, CPA**
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On crime-solving television dramas, the police search for evidence, parade a lineup of suspects in front of a two-way mirror, and then ask the witness behind the glass to identify the perpetrator.

For construction projects, one of the most common "crimes" is profit fade — when the job's margin dims from view as work progresses (or finishes). Here are five possible causes of profit fade — and how a contractor can arrest each one by performing a crime scene investigation.

**1. Unusual Project Type or Scope**
The rocky economy may force contractors to turn to unusual jobs or those that involve work beyond one's typical scope. Projects like these often trigger profit fade as unexpected costs and delays arise. In these situations, be extra conservative in the estimates. Perhaps even do some networking with other contractors, architects or developers familiar with the work to gain insight about what could go wrong.

**2. Inaccurate Estimating**
One could say that profitability begins with the estimate; therefore, invalid assumptions at this stage can doom the job's bottom line. Compare job estimates that lost money with those previously used on profitable projects, and analyze the different elements, such as labor costs, direct costs and indirect costs. What went wrong (and right)? Are the estimates relying on outdated concepts or data?

**3. Poor Project Management**
All too often, project managers lose sight of the contract once work is under way, which can also lead to profit fade. Try holding pre-project meetings to not only discuss contractual provisions for scope of work and change orders, but also to remind managers of the estimates.

As the job progresses, check in with the project manager (or ask the project manager to submit reports) about how actual costs are comparing with bid cost amounts.

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*See "Profit Fade."*

# Unclaimed Property: From a Nuisance to a Problem

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In the world of state and local taxes, the topic of unclaimed property continues to rear its ugly head. The continuing emergence of this issue is especially frustrating to accounting and tax professionals, since, technically, unclaimed property is not a tax at all. However, because the existence of unpaid debts on a company's books and records can result in an annual reporting requirement to state governments, unclaimed property compliance gets lumped with all the other reporting functions that construction and real estate businesses deal with — such as taxes.

For those unacquainted with the world of unclaimed property, or escheat, unpaid debts that may require state reporting take many forms: payroll and vendor checks, old accounts receivable balances, and insurance proceeds to name a few. All 50 states, the District of Columbia, and other subject jurisdictions require companies holding unclaimed property (known as holders, not taxpayers) to file an annual report that lists the reportable property along with payment of these funds.

For these debts to rise to the level of a reporting requirement, several criteria have to be met. The first is determining whether the type of property at issue is even reportable. For example, many states have exempt categories of unclaimed property not subject to reporting, such as gift cards. In these instances, even though a gift card may go unclaimed, a business is not necessarily required to report it based on the state entitled to the funds.

The next question is whether the property is in fact unclaimed. A company may have an uncashed payroll check on its books and records. But if the employee with the uncashed check has indicated to the company through a letter or other form of communication that it intends to cash the check, then that property may not be reportable.

For property to reach the level of reportability, it must have also reached a specified age, known as its dormancy period. Dormancy periods range by property type. For example, in most states payroll checks have a dormancy period of one year. The dormancy period is measured from the origination date of the debt to the cut-off date as set by statute. In Indiana, the cut-off date for most types of reporting companies is June 30. So, for reporting year 2011, all unclaimed payroll checks issued June 30, 2010, or earlier, were at least one year old as of June 30, 2011, and thus reportable.

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*See "Unclaimed Property."*

# Qualifying for the Credit for Certain Retained Workers

**By Jolaine Hill, CPA**
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In 2010, President Obama signed the Hiring Incentives to Restore Employment Act (HIRE Act), which provided a payroll tax holiday for hiring certain unemployed workers for the 2010 tax year. The act also provided an additional credit for certain retained workers for the 2011 tax year. An employer can claim both the payroll tax exemption (for hiring certain unemployed workers) and the retention credit (with respect to the same employee) as long as the requirements for both the exemption and the credit are met.

The credit for certain retained workers (retention credit) is the lesser of $1,000 or 6.2 percent of the retained worker's wages during a 52-week consecutive period. To reach the $1,000 maximum credit, the annual compensation for the retained employee would be at least $16,130. All amounts that are considered wages for federal income tax withholding purposes are counted for purposes of the retention credit. The act does not expressly limit the number of retained workers for which an employer can claim the retention credit.

The following is an example of how the retention credit is calculated.

- In 2010, XYZ Company, which has a tax year ending Dec. 31, has one retained worker whose wages are $14,000 during the 52-week period. The amount in the increase to XYZ's current year business credit is the lesser of: 1) $1,000 or; 2) 6.2 percent of $14,000, which is $868. Therefore, the increase to XYZ's current year business credit is $868.

A retained worker is an individual who, in 2010, qualified for the payroll tax holiday. In addition, a retained worker is an individual who:

1. Was employed by the qualified employer on any date during a tax year ending after March 18, 2010; and

2. Continued in that employment for a period of at least 52 consecutive weeks; and

3. Earned wages during the last 26 weeks of that period equal to at least 80 percent of the wages for the first 26 weeks of the period.

The credit applies for the first tax year in which the retained worker meets the 52-week test, which, for a calendar year taxpayer, would be 2011. For a fiscal year taxpayer, the credit is claimed in the fiscal year in which the 52-week test is met.

For example, a corporation with a tax year beginning April 1, 2010, hires an employee on March 15, 2010, and the employee meets the requirements for being a retained worker by March 31, 2011. The business is eligible to claim the retention credit for the tax year beginning April 1, 2010, and ending March 31, 2011.

The retention credit is part of the general business credit. The credit cannot be carried back to a tax year beginning before March 18, 2010. If you believe you may qualify for this retention credit, contact your KSM advisor.

# Creative Concessions Get the Deal Done

**By Chris Bradburn, CPA**
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Negotiations are a fundamental part of many business transactions. The subject of negotiation is frequently the price to be paid by the buyer, but the purpose of both buyer and seller is the same: maximize value, in whatever form, according to their own expectations.

Many sellers, though willing to compromise to a certain extent, may hold out for their "bottom-line" price to the point of appearing unwilling to negotiate. But buyers can still find ways to wrap up a deal by identifying creative concessions that deliver value to the buyer without directly impacting the purchase price. Such transactions allow the seller to feel like he or she got the asking price while giving the buyer the desired reduction in the effective cost of the purchase.

**Ask for Repairs or Improvements**
Begin the quest for concessions by asking the seller to correct any health and safety problems with the potential investment, such as asbestos cleanup or electrical infrastructure repairs discovered during inspection. Roof repairs, new paint and carpet replacement are all subject to negotiation. Also, office build-outs or custom leasehold improvements are fair game, such as ventilation systems and signage.

If the seller has agreed to patch the roof, but it is known that the roof must be replaced soon after closing, consider forgoing the repairs and ask the seller to remove that cost from the purchase price.

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## Winning Negotiation Strategies

The key to winning at the negotiation table is to memorize the rules of success, and then stick to them. Start by keeping options open. Buyers who have other alternatives and are willing to walk if the deal is not right stand a much better chance of remaining in the driver's seat during negotiations.

Be sure to keep emotions firmly in check. Keep looking for other properties even while closing in on a deal — and make the seller aware that there are other options. Target properties based on their unique physical attributes, the required rate of return and borrowing capacity — not emotional attachment.

Savvy buyers know the market, stay atop comparable listings and recent sales, and understand valuation basics, including how to evaluate a rent roll. They also get to know the seller personally and explore what the seller wants from the sale — or can offer the buyer, including improvements, financing and other creative alternatives.

A financial professional can help guide the buying decision. Do not waste time on unrealistic sellers or properties that fail to meet investment criteria for size, location, physical specifications and zoning.

## Creative Concessions

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Another option would be to ask the seller to include furniture or equipment (such as a forklift or loading ramps) with the building. Be selective when asking for concessions, however. Buyers who nickel and dime a seller risk damaging their negotiating position.

**Request Seller Financing**

Another tried-and-true tactic for effectively lowering the purchase price involves below-market seller financing. Ask a seller who insists on a specific asking price to lend part or all of the financing at below-market interest rates. By going this route, a buyer may save more than if the seller sold the property at the initial offer. Also consider lease-to-own or installment contract options. These were common in the 1980s when high interest rates limited the amounts buyers could borrow. Now they are regaining popularity in the tight lending climate.

Sellers can also benefit from installment sales, because they can defer much of the capital gains tax liability. Instead, taxes are extended over a period of years as payments are received. However, due to the possibility that capital gains rates could increase in the coming years, installment sales may be less attractive to sellers today.

**Determine What Matters**

Flexibility and creativity are key to closing a deal these days. A buyer's options are bound only by imagination — the secret is figuring out what each side values. For example, a cash-starved seller might concede on price or offer a credit for the buyer's closing costs for a quick closing date.

Be prepared to accommodate the seller's need for an Internal Revenue Code Section 1031 (like-kind) exchange, which allows a business or investor to defer capital gains (or losses) due upon sale. It may take the seller time to locate a like-kind property that fits Section 1031 requirements, but tax incentives can be a powerful bargaining tool. Also, consider asking the real estate agents involved in the transaction to lower their commissions. Some might refuse on principle, but others recognize that lower commissions are better than forgone commissions.

**Be Open-Minded**

For buyers, setting a "bottom line" can also be a dangerous strategy. While the bottom line is supposed to keep you from losing or spending more than can be afforded, it can also impede or prevent a deal. It is important to be open minded. In reality, a buyer cannot know what the bottom line is in advance.

**Deal or No Deal**

Given the right incentive, especially in the tenor of today's real estate market, many sellers will make necessary concessions. If someone will not budge, recognize that the seller is unmotivated — and move on.

Remember, some deals simply cannot be made. If the numbers do not work or the profit potential is not there, walk away from the table. And be sure to seek expert advice — especially if the benefits of the deal are unclear or only marginally beneficial. Professional real estate and financial advisors can pay for themselves many times over during a deal.

# Document Retention: Storage Versus Management

**By Darrell Williams**
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Whether it is organizing financial reports or handling client information, companies are accustomed to dealing with hundreds of different types of electronic and hardcopy files. By understanding the difference between storage and management, it becomes clear that a document retention policy is needed.

*Storing* data and information is the business process of storing paper in file cabinets and storing electronic data in business applications, in e-mails, and on file servers without any policy that dictates how long information is kept before disposing of it. Typically, 90 percent of data and information remains in electronic form.

*Managing* data and information, on the other hand, is the business process of identifying the different types of information (both paper and electronic) that is housed in the organization, including e-mails, text messages, financial reports and invoices.

Once the type and form of data have been identified, document retention policies are created to outline how long information is retained in the organization before being purged. At this point, after the policies have been created and agreed upon by management, processes and technology solutions must be implemented to enforce the document retention policies.

**Why Create a Document Retention Policy?**
When companies are in the habit of storing data and information, physical space and electronic storage must be purchased as the amount of information grows over time. When data management techniques are practiced, such as implementation of a document retention policy, the storage requirements will be dramatically reduced. Therefore, a cost savings is realized.

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Additionally, in the event of litigation or a subpoena request for documents, the ability for an organization to communicate the document types and purge cycles for their information will save considerable time and cost with legal counsel. If a document retention policy is actively enforced, companies will have less information to search on their systems, which will not only save significant time for internal or external IT resources, it will also allow internal staff to conduct privileged and non-privileged reviews. The most important piece to realize is in this regard is that a document retention policy can identify to a court that certain types of information were destroyed based on a predefined schedule.

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## Document Retention

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**Getting Started**

Although best practices regarding document retention policies may have differed in the past, we believe the following seven-step process reflects current best practices and will help with implementation.

1. Enforcing a document retention policy can cause pushback from staff, including senior management, so be sure it is being driven from the top. After executive management determines it is a priority for the company, establish an executive sponsor and a project team. Involving legal counsel is also important.

2. Know the law! Identify and understand who the governing bodies might be. For example, trucking companies likely have state and federal Department of Transportation guidelines to which they need to adhere regarding how long certain documents and information should be retained. Other governing bodies include HIPAA, the IRS, Sarbanes-Oxley and the SEC.

3. Begin categorizing data and information by type and storage location. For example:

    - E-mail System and Archive → Exchange E-mail System
    - Quotes → Client Sites on File Share J:\ Drive
    - Statements of Work → SharePoint Document Management System

4. Identify the retention periods of each category based on the regulatory guidelines that were established in step 2.

5. Determine how the newly created policies will be enforced; otherwise, these policies will be useless. There are several available technology tools that can set retention periods and automate the purging process.

6. Circle back with executive management to review — and receive permission — on the newly created categories and retention periods.

7. Establish a rollout and training program for all employees on the new policy.

Document retention is a vital issue for any organization, regardless of size. An effective system can not only reduce expenses by decreasing the amount of storage requirements, but also reduce time and cost in the event of a legal request for documents. Although implementing a document retention policy requires the full cooperation of staff on all levels, it will pay dividends to those companies dedicated to managing the present and preparing for the future.

## Succession Planning

*(continued from page 1)*

If one's succession plan includes transfer of ownership to family members, these gift and estate tax rules allow for a limited time opportunity.

The current rules also changed the law related to estate tax at death. For deaths occurring in 2010, estates were given a choice to:

1. Do nothing, and the estate tax applies retroactively to Jan. 1, 2010, with a $5 million exemption, a 35 percent rate, and a full step-up in basis for income tax purposes; or

2. "Opt out" of the estate tax for 2010 and pay no estate tax but get a limited step-up in basis for income tax purposes.

For deaths in 2010, estates smaller than $5 million owe no estate tax and get a full step-up in basis. Larger estates generally opted out of the estate tax, even though they only received a limited step-up in basis.

For deaths occurring in 2011 and 2012, the estate tax applies with a $5 million exemption ($5.12 million in 2012) and a 35 percent rate (and a full step-up in basis). Keep in mind the gift tax exemption counts toward the estate tax exemption. For example, if a taxpayer uses $2 million of the $5.12 million gift tax exemption during life, his or her estate only has $3.12 million of the $5.12 million estate tax exemption remaining to shelter the estate from estate taxation at death.

Current rules also provide for "portability" of the gift/estate tax exemption. Prior to 2011, if a taxpayer's estate did not use all of the estate tax exemption available, it was wasted. For 2011 and 2012 only, unless Congress provides otherwise for 2013 and later years, current rules apply to allow a surviving spouse to use the unused exemption of the predeceased spouse. Thus, if a husband's estate does not use any of his $5.12 million estate tax exemption, then the wife's exemption becomes $10.24 million ($5.12 million of her own exemption and $5.12 million from her predeceased spouse).

There are limitations to portability though. A surviving spouse can only use the unused exemption of the *last* deceased spouse. Thus, if a spouse remarries and survives the second spouse, the surviving spouse cannot use the unused exemption of the first deceased spouse. Also, a surviving spouse can only use the unused exemption of the predeceased spouse if the personal representative of the predeceased spouse's estate makes an election on a timely filed estate tax return to allow the surviving spouse to use the unused exemption. Further, the unused exemption of the predeceased spouse is not indexed for inflation.

Because of the above limitations, it is generally best to plan to use the exemption of the first spouse to die. This involves careful planning regarding titling of assets and appropriately drafted estate planning documents (i.e., wills and trusts).

While the increased gift/estate tax exemption provides for gift planning opportunities, it also suggests that estate planning documents be reviewed to ensure the taxpayer's goals are still being met. Formula clauses should be reviewed to determine if they need to be rewritten, and life insurance needs should be reevaluated. However, it is important to remember these rules are only good through 2012, unless the law changes to extend these rules or make them permanent.

## Profit Fade

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**4. Faulty Cost Reporting**
Profits are sometimes lost in the office and not the job site. Bad information can lead to bad project management because decisions are being made with incorrect data. Ask a CPA to perform a fade analysis for all active jobs to see how profit fade is affecting the bottom line and where it might be originating.

**5. Fraudulent Activity**
Obviously, profit will tend to fade when someone is stealing. If profit fade has been an issue, and none of the other usual suspects seem to apply, it may be time to see if foul play is involved. The CPA may be able to help determine if any fraud has taken place.

Profit fade is a crime against contractors and needs to be investigated to collar the correct criminal and avoid future incidents. Teaching project managers and accounting staff to review job profit progress from beginning to end will hinder future profit fade incidents.

## Unclaimed Property

*(continued from page 3)*

The final test is if the underlying debt is fixed and certain. "Fixed" means the holder and the payee agree as to the amount at issue. "Certain" means both parties agree that the property is reportable. For example, if a business offers to make a charitable contribution to an organization and later reneges on that promise, that business might assert the donation was not unclaimed property for two reasons: the amount was never determined, and a promise to donate is not a debt and can be rescinded at any time.

But before unclaimed property is placed on the line of an unclaimed property report, and those funds turned over to the state or states, holders are required to perform due diligence on the unclaimed property over a certain dollar amount. Using Indiana as an example again, for any debt of $50 or more, the holder is required to contact the payee in writing prior to reporting the property to the state.

The reason this topic continues to emerge as one of concern for many construction and real estate businesses is the promise from states, such as Indiana, to use Department of Revenue tax auditors or third-party contract examiners to begin performing unclaimed property audits. Because the length of these audits in other states often spans 10 or more years, the prospect of facing such an audit, coupled with the poor records that may be available (especially for the earliest years of the audit), can forebode an unpleasant, if not punitive, financial impact on a company.

Whether called a tax or not, it surely feels like one to those companies receiving such an assessment.

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**Our People: Your Success**

# KSM Construction and Real Estate News

**KSM's Construction Services Group** and **KSM Consulting** will host a meeting for local users of Viewpoint Construction Software June 6, 2012. Viewpoint Product Manager Miles Haladay will be presenting the upcoming Fall 6.5 release, followed by a roundtable discussion on Business Intelligence and Reporting.

Also on June 6, a separate seminar and demonstration will be hosted that is geared toward construction company owners and other C-level executives interested in Viewpoint, which is an industry leader for ERP construction software solutions exclusively for the heavy highway, general contractor and sub-specialty markets.

To RSVP for either event, contact Chris Djonlich at cdjonlich@ksmcpa.com or 317.452.1392 by June 1.

**Tom Nowak** was named co-chair of the Indiana Subcontractors Association's Education Committee.

**Chris Felger** coordinated the Construction Financial Management Association's Annual Junior Achievement Charity Night, which benefitted Junior Achievement's Ace Mentor Program.

**Josh Malarsky** and **Chad Halstead** presented on federal tax planning and Section 118 at KSM's state and local tax seminar, "Tough Tax Issues Made Easier: Information You Need for Successful Economic Development Deals."

**Andie Friedman** was named to the sponsorship committee of IndyCREW, the Indianapolis Chapter of Commercial Real Estate Women.

***The Construction & Real Estate Industry Advisor* Editorial Committee:**
Christopher Bradburn, Jenina Cody, Christopher Djonlich, Jolaine Hill, Jennifer Moore, Mike North, Tom Nowak

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

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