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THE CONSTRUCTION AND REAL ESTATE INDUSTRY ADVISOR

In this issue:

Indiana Legislative Changes Impact Incentives for New Real Estate Development

By Lisa Leventhal
Director
lleventhal@ksmcpa.com

The 2011 session of the Indiana General Assembly resulted in major changes that will undoubtedly affect economic incentives for real estate development in the coming years. Two changes in particular will directly affect the development community.

Perhaps the most drastic change affects property tax abatement. In Indiana, local officials have the authority to grant both real and personal property tax abatement to property owners locating new investment in their jurisdiction. Local officials also control the number of years of abatement awarded to each project, being able to award up to 10 years of benefits. However, prior to this most recent legislative session, the abatement schedules were set by statute as sliding scales.

Under HEA 1007, which became effective July 1, 2011, local officials now have authority to determine both the number of years and the percentage of abatement savings awarded to a project for each year of the project. For example, local officials in ABC City could offer "Company A" 10 years of 100 percent personal property abatement savings on investment in new machinery. Those same local officials could offer "Company B" seven years of 50 percent real property abatement savings on their new facility.

This new law provides more control and flexibility to local officials looking to take advantage of economic development tools. However, the law changes also are likely to make the property tax abatement approval process and compliance requirements much more complicated.

Another legislative update likely to impact Indiana developers results from changes in thresholds to HEA 1005, the Industrial Recovery Credit, also known as the "Dino Credit." This credit is intended to help communities promote reuse of vacant or underutilized industrial facilities. This legislative change should result in a larger number of facilities becoming eligible for the credit. The General Assembly lowered the square footage requirement for buildings to qualify for this credit from 250,000 square feet to just 50,000 square feet. Additionally, buildings are now only required to be vacant for one year, as opposed to the previous two-year requirement. The age of the building requirement has also been reduced from 20 years to 15 years.

Although some of the reduced thresholds are only temporary and will sunset after three years, these changes to the Dino Credit could have a meaningful impact on the buildings themselves as well as surrounding development. The credit can be applied to eligible building rehabilitation costs. In addition, it may help developers and end users close financing gaps.

These changes, along with the phased-in lowering of the corporate income tax rate for C corporations that passed this session, reflect Indiana's trend of reducing its tax burden and expanding its economic development tools to attract jobs and capital investment. All of these changes should only help to enhance real estate development opportunities in the state. •

Continued Debate on Lease Accounting Changes

By Ron Smith, CPA
Director
rsmith@ksmcpa.com

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (the Boards) jointly issued exposure drafts, Leases, on Aug. 17, 2010, which addressed accounting for leases by both the lessee and lessor. Since that date, the Boards have continued to discuss leases and have reached additional tentative decisions on lessee and lessor lease accounting.

The Boards' objective of the lease project is to not only create common lease accounting requirements to ensure leases are recognized on the balance sheet, but also provide users of financial statements with useful and complete information about an entity's leasing transactions. Lease transactions are widely used as a financing tool in today's marketplace and have a major impact on the construction and real estate industries. The proposed changes will alter how both users of the financial statements and companies view lease transactions.

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The exposure draft lays out a single approach for lessees to account for lease transactions. A lessee would recognize an asset representing its right to use the leased asset and a liability for the obligation to pay rentals, essentially capitalizing all leases. As part of the continued discussions, the Boards had temporarily decided to allow two different accounting methods for lessees: finance leases and other than

finance leases. Under both methods, an asset and liability would have been recorded, but under the other than finance leases method, the expense recognition would have been more like today's operating leases. However, the Boards have now reversed course and have temporarily decided to go back to the single-model approach consistent with the exposure draft.

The single-model approach would require a lessee to:

- Recognize a right-of-use asset and a liability, both measured at the present value of the lease payments. This includes estimating the ultimate term of the lease, taking into consideration any options to extend or terminate the lease when there is a significant economic incentive, and considering variable lease payments and residual value guarantees.
- Subsequently measure the liability using the effective interest method.
- Amortize the right-of-use asset on a systematic basis that reflects the pattern of consumption of the expected future economic benefits.

Under the exposure draft, there were two approaches for a lessor to account for a lease. Subsequently, the Boards have tentatively decided on a single approach, a "receivable and residual" accounting approach. This approach would require

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Impact of Variable Interest Entity Consolidation on Bonding

By Matt Bishop, MBA, CPA
Manager
mbishop@ksmcpa.com

The Financial Accounting Standards Board (FASB) has worked diligently over the years to update the accounting rules related to consolidation. These rules can be found in the FASB's Accounting Standards Codification (ASC) Topic 810, *Consolidation*. A potential Variable Interest Entity (VIE) is an entity designed by, whose activities are conducted on behalf of, or whose subordinated financial support is provided by another entity. Under ASC Topic 810, a qualitative approach is prescribed to determine who has control over a VIE and who participates in the risks and rewards of such VIE. The result of the analysis is a determination of whether the VIE should be consolidated with the financial statements of the reporting entity.

There is a natural desire for integration of real estate development and construction operations. Real estate developers may wish to control their construction schedules and retain construction profits, while construction companies may want to earn higher real estate development returns. Depending on ownership structure and control, Generally Accepted Accounting Principles (GAAP) may require such related company financial statements be presented on a "consolidated" level. Should consolidation be required of a contractor, its bonding capacity could be greatly affected.

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Certain aspects of financial analysis that are important to a bonding company include:

- Working Capital
- Net Worth/Profitability
- Cash Flow/Availability of Bank Financing and Terms
- Consistent Estimating

Real estate operations typically result in a balance sheet with long-term assets and long-term debt, of which the current portion would reduce working capital upon consolidation. After the developer profit is contributed as capital, however, this noncash contribution is not recognized in the real estate company's financial statements, resulting in an apparent under-capitalized entity. Similarly, the consolidated financial presentation may appear more highly leveraged than a standalone construction company, to the detriment of the net worth analysis. Also, the cash flow analysis may be negatively impacted due to the debt service requirements of the significant interest-bearing debt of the real estate company.

Should consolidation of real estate operations be required by a construction entity, communication with the contractor's surety company is extremely important. It is good practice for a contractor to schedule regular meetings with both its surety local and home offices to review financial results and communicate company changes. The contractor should also use as a financial communication tool its consolidating schedules. Though not a required part of GAAP-basis financial statements, these supplementary schedules visually outline the make-up of the overall consolidated financial statement balances.

While the rules for consolidation under ASC Topic 810 are not new for 2011 year-end financial reporting, they do require annual evaluation. Therefore, it is in a contractor's best interest to understand the impact of the structure and operation of related party entities and variable interest entities, specifically real estate developers, in regards to consolidation. •

Do You Qualify for the Domestic Production Deduction?

By Jolaine Hill, CPA
Director
jhill@ksmcpa.com

In 2004, Congress added Code Section 199, otherwise known as the domestic production deduction. The deduction is calculated as nine percent of the lesser of the qualified production activities income of the taxpayer for the year or taxable income for the year. The deduction cannot exceed 50 percent of the W-2 wages related to the qualified production activity.

Construction and certain land developer activities can qualify for the domestic production deduction. How does a contractor or a land developer determine if a certain activity meets the qualifications for the deduction?

Under the regulations, the term "construction" means:

> Activities and services related to the construction or erection of real property by a taxpayer that, at the time the taxpayer constructs the real property, is in a trade or business[1] that is considered construction based on the principal business activity code used on the income tax return and carries on the activity on a regular and ongoing[2] basis.

Construction includes most activities that are typically performed in connection with a project to erect or substantially renovate real property. The regulations have added other activities that may qualify as construction activities, such as grading, demolition, clearing, excavating, and any other activities that physically transform the land – but only if these activities are performed in connection with other activities that constitute the erection or substantial renovation of real property.

Also qualifying for the domestic production deduction are taxpayers. For example, construction managers who are compensated for the performance of construction services, such as management and oversight of the construction process.

Contractors who are land developers have a challenge in determining if they are eligible for the domestic production deduction. The sale of unimproved land does not qualify for the deduction. However, a land developer can make an allocation of gross receipts between construction-related activities and the sale of land in order to qualify. The following example shows how a land developer may qualify for the domestic production deduction.

> Mr. Smith is engaged in a trade or business on a regular, ongoing basis that is considered construction. Mr. Smith buys unimproved land and obtains zoning for residential housing. Mr. Smith does grade the land; constructs the roads, sewers, sidewalks, power lines and water lines on the land; and conveys the roads, sewers, sidewalks, power lines and water lines to the local government and utilities. Mr. Smith sells lots to home builders. In order to quality for the production deduction, the land developer must make an allocation of the gross receipts received from the sale of the lots between construction activities and the sale of the land itself. The gross receipts that are related to the grading and the construction of the infrastructure qualify for the domestic production deduction. The gross receipts that are related to the sale of the land do not qualify for the domestic production deduction.

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Health Savings Accounts: More to Them Than You Might Know

By Kimberly Canada, PHR
Benefits Manager
kcanada@ksmcpa.com

By Jim Nestor, SPHR
Director, Human Resources
jnestor@ksmcpa.com

As healthcare costs continue to rise, more employers are implementing High Deductible Health Plans (HDHP) as a way to minimize overall health care expenditures. Through an HDHP, employers can remain competitive by offering health insurance, while the design of the HDHP allows members to take a greater role in managing their own health care.

As HDHPs shift more financial responsibility up front to members through higher deductibles, Health Savings Accounts (HSAs) are an important feature of the plan design. An HSA is a medical savings account that must be paired with a HDHP, and can be used to offset higher deductibles and maximum out-of-pocket dollar amounts. HSAs can be funded on a pretax basis by the employer, the employee, or both. Employees own the account and can take the funds with them when they exit employment for any reason.

Each year, the IRS provides the inflation-adjusted HSA combined (for the employer and the employee) contribution and HDHP minimum deductible and out-of-pocket limits. For 2011, the IRS combined contribution limits are $3,050 for single-plan coverage and $6,150 for family-plan coverage. In addition, the minimum deductible is $1,200 for single coverage and $2,400 for family coverage. The maximum out-of-pocket employee expense, including deductibles, is $5,950 for single coverage and $11,900 for family coverage.

HSAs offer a variety of significant benefits to both employees and to employers.

HSA benefits to employees:

- Contributions reduce an employee's taxable income.
- Withdrawals for qualified medical expenses are not taxed.
- Unused HSA funds roll over from year to year.
- HSA funds are portable.

HSA benefits to employers:

- Employees enrolled in a HDHP/HSA typically take greater control of their healthcare expenses, which can positively impact the group health plan's bottom line.
- Tax savings are realized by employers who make contributions to employees' HSAs.
- Employers who contribute to their employees' HSAs are more competitive.
- It creates employee goodwill.
- It helps ease transition to HDHP if employer contributes to the plan.

As of January 2010, about 10 million people were enrolled in an HDHP and HSA, which was a 25 pecrecnt increase over 2009, according to research by America's Health Insurance Plans. According to a survey done by HSA Bank, 76 percent of employers contribute to their employees' HSAs on an annual basis. Of those employers who contribute to their employees' HSAs:

- 22.4 percent of employers contribute within the range of $725-$1,499.
- 20.3 percent contribute $1,500-$2,999.

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Health Savings Accounts *(continued from page 6)*

- 16.4 percent ranged from $250-$724.
- 10.7 percent of employers did not contribute to employees' HSAs.

As more employers and employees realize the benefit of a HDHP paired with an HSA, enrollment in an HDHP/HSA combination is only expected to grow.

As companies continue to experience growing healthcare costs, particularly in light of healthcare reform and the large number of Baby Boomers approaching retirement, a trend toward using HSAs as a long-term savings and investment vehicle will be likely. According to a Fidelity Investments estimate released in March 2011, a 65-year-old couple will need $230,000 to pay for medical care throughout retirement. That number will vary from person to person, but the fact remains that individuals need to consider how they will fund long-term medical expenses at retirement.

Employers who offer and contribute toward their employees' HSAs are assisting them in saving for medical expenses not only now, but also at retirement. Just like with any other account offered by a financial institution, employees must do their own due diligence when it comes to opening an HSA account. Employers can assist by communicating options to employees, including where they can open their account, interest paid and/or investment options. Also, the portability and investment provisions of HSAs encourage participants to conserve the funds and treat them as retirement accounts. Overall, it is important for employers who offer HSAs to educate and encourage employees to look at the HSA as a *savings* account as opposed to a *spending* account.

As with any change that affects your group health plan, it is imperative to have the necessary support and guidance from your HR leader, benefits attorney, tax advisor, benefits broker and/or insurance company to navigate through these considerations. For more detailed information on HSAs and taxes, visit the U.S. Department of Treasury website at www.ustreas.gov or discuss with your tax advisor. •

Lease Accounting Changes *(continued from page 3)*

a lessor to recognize a right to receive lease payments and a residual asset at the date of lease commencement. The right to receive lease payments would be measured at the sum of the present value of the lease payments, and the residual asset would be measured as an allocation of the carrying amount of the underlying asset.

As the Boards continue to debate the final lease accounting changes, it is clear that companies' financial statements will be greatly impacted. Lessees' assets and liabilities will increase, resulting in increased leverage ratios. The income statement will also be impacted by the timing of expense recognition.

The Boards will continue discussing this project and have decided to re-expose their revised proposals. The Boards are expected to have a final draft issued by the end of 2012. As the new rules approach implementation, companies will need to start determining what impact the changes will have on their balance sheet and income statement, due to the potential impact on loan covenants and other external measures of financial performance. •

Production Deduction *(continued from page 5)*

The determination of whether a contractor or land developer qualifies for the domestic production deduction is the first step in the process of calculating the domestic production deduction. If you have any questions regarding qualifications for this deduction, contact your tax advisor.

[1]A "trade or business" is considered to be a construction business if the activity code on the tax return begins with 23.

[2]Additional regulations define the term "regular and ongoing" as a construction trade or business that derives gross receipts from an unrelated person by selling or exchanging the constructed real property within 60 months of the date that construction is complete. A new business is considered to be engaged in a trade or business on a regular and ongoing basis if the business reasonably expects that it will engage in a trade or business on a regular and ongoing basis. •

KATZ, SAPPER & MILLER, LLP
800 East 96th Street
Suite 500
Indianapolis, IN 46240

KSM Construction and Real Estate News

Ron Lenz and Chris Felger attended the Construction Industry CPAs/Consultants Association annual conference.

Tony Brita and Tom Nowak attended the Indiana Construction Assocation's education event, "Top Ten Legal Mistakes Contractors Make," which took place in Fort Wayne.

KSM's Construction Services Group, in conjunction with MJ Insurance, Inc., will hold a seminar for construction company owners and financial professionals on Sept. 1, 2011, at the Indianapolis Marriott East. The seminar, "Current Merger and Acquisition Trends in the Construction Industry: Understanding the Recent Flurry of Deal Activity Despite the Relatively Poor State of the Industry," will be led by Landon Funsten of FMI Corporation.

Keith Gambrel and Jason Miller served as panelists at the Indiana Commercial Board of Realtors District 3 Event, "FASB Proposed Lease Accounting Changes: The End of the World or Much Ado About Nothing?"

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

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