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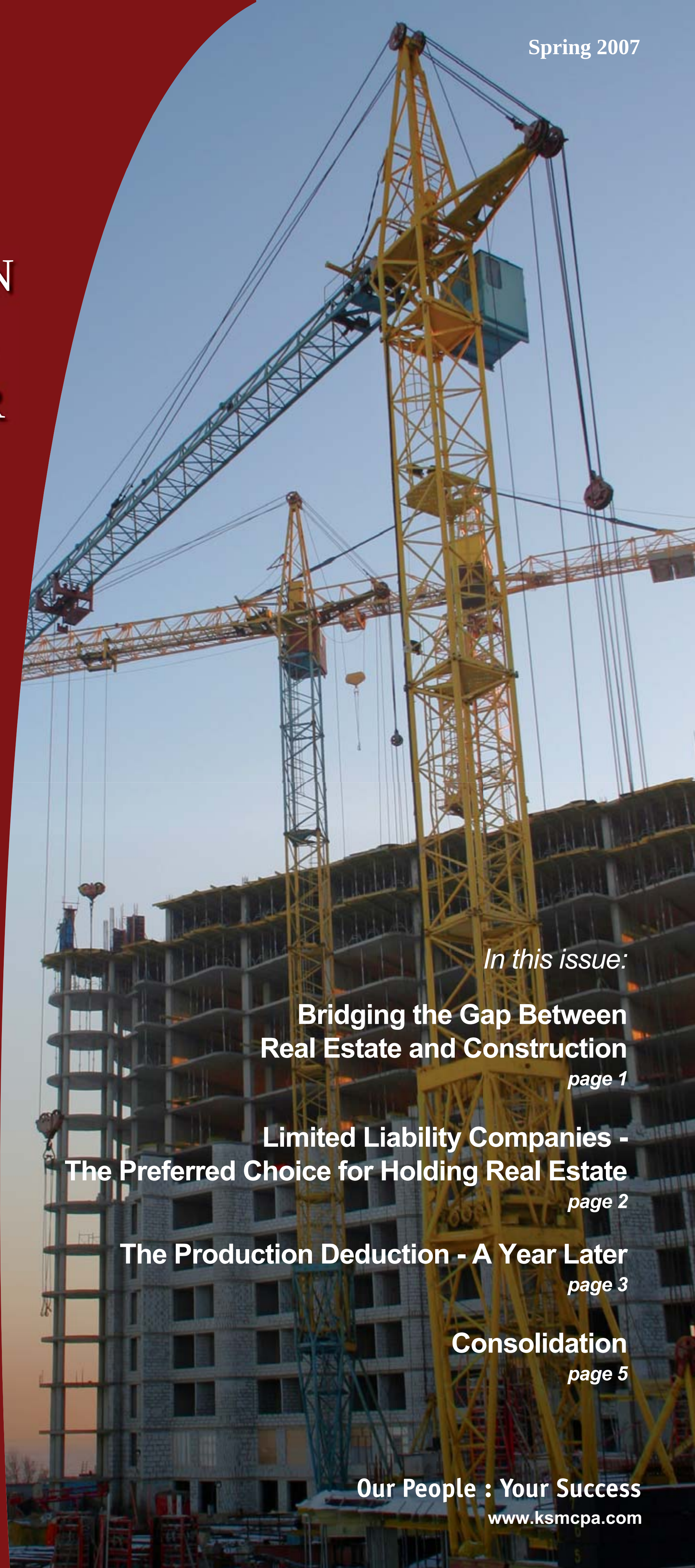
KATZ, SAPPER & MILLER

THE CONSTRUCTION AND REAL ESTATE INDUSTRY ADVISOR



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Construction and Real Estate Industry Advisor

Welcome to Katz, Sapper & Miller's introductory issue of the Construction and Real Estate Industry Newsletter. With this and in future newsletters, we will share information and keep you up-do-date with the happenings of your industry. You can look forward to topical issues authored by our experts in both the construction and real estate industries and we kick-off our first issue with an article by Ron Lenz, Partner-in-Charge of our Construction Services Group. We hope you find its contents informative and useful in keying in on what helps make your business successful.

We welcome your comments and opinions and encourage you to contact any one of us or the article authors.

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Bridging the Gap Between Real Estate and Construction

By Ron Lenz
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It is often said that contractors who enter into real estate development may go broke. The intense capital requirements of self-perform contractors and subcontractors, coupled with the cyclical nature of the industry, are often contrary to long lead times and significant investments that generate real estate returns.

The lure of high returns, with seemingly low risk entices traditional contractors to diversify capital into real estate. Similarly, many real estate developers, envious of apparent profits earned by contractors, frequently enter the construction business. Profits alone are not the only attraction to developers; the ability to control schedules, vertical integration, and diversification are also cited as the reason a developer enters the construction industry. A developer's contractor services include construction management, excavation, carpentry, flat concrete work, traditional general construction, etc. As contractors and developers work together to complete projects, each party develops a belief that the grass is greener on the other side.

Many companies have successfully bridged the gap and created successful complementary real estate and construction concerns. As this relationship evolves within one company, there are frequent discussions as to which division is most profitable. Different management groups of each division and the impact of excessive profits in the construction division (the construction profits are essentially capitalized as part of the real estate project), regularly create a question of what is a reasonable profit for a construction company. This is further blurred in a multi-functional company due to shared resources and overhead, and other related party management arrangements that have the appearances of shifting profit from one division (or company) to another.

Ultimately, every sale for a contractor is tremendously competitive. Few, if any, contractors offer such a unique product, process or service that eliminates virtually all competition, although certainly some contractors exhibit a track record of superior quality, service and performance. In the traditional "low bid" mindset used by many government institutions, numerous contractors and subs are competing for the opportunity to be a low-cost provider. Contractors strive to be in a position to negotiate price, schedule and contract terms with an owner, but even in a negotiated bid situation, there are generally two or more contractors proposing on the work. That said, construction is known as a low profit margin industry,

"Bridging the Gap..." and CFMA's 2006 Construction Industry Annual Financial Survey chart continued on page 6

Limited Liability Companies – The Preferred Choice for Holding Real Estate

By Christopher Bradburn, CPA
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Limited liability companies are the entity of choice for holding real estate used in trade or business and rental activities. By combining the benefits of pass-through taxation associated with partnerships, limited personal liability for members, favorable rules for maximizing recognition of tax losses and improved ability to withdraw cash and property tax free, LLCs and partnerships provide benefits to taxpayers that cannot be equaled by C and S corporations.

Limited Liability and Transferability of Ownership

When choosing to invest in real estate, whether that real estate is to be occupied by its owner, held for rent to an unrelated party, or rented to a related business, a choice must be made about the type of entity in which to hold the property. The corporation, whether in C or S form, has historically been utilized as a business entity due to the protection it offers its individual owners from personal liability for the debts and actions of the corporation. Transferring ownership of a corporation is also relatively easy in that stock owned by the shareholder, notwithstanding restrictions due to marketability or other matters, may be readily bought and sold. However, for many business owners, especially owners of private closely-held companies, the protection the corporation might otherwise offer is compromised by the requirement by lenders or other parties of the owner's personal guarantee of corporate liabilities. In the case of C corporations, for example, the shareholder(s) might find themselves at greater than desired risk due to a lack of limited liability, while simultaneously being subject to the unpleasantries of paying tax on the profits of the C corporations both at the entity and the individual level.

In contrast to a corporation, the LLC provides protection from liability to its members while taxing the LLC's owners under the rules governing partnerships and avoiding double taxation characteristics of C corporations. Member interests in LLCs may be readily transferred (or, transfer may be intentionally restricted), based upon the language of the LLC operating agreement. A properly structured LLC can provide the protections of the corporation while allowing the taxpayer to benefit from more favorable tax rules not available to corporations.

Pass-Through Taxation and Tax Free Distributions

One of the principal attractions of investing in real estate, given the proper business structure, is that tax losses may be recognized while positive cash flows are earned. This is possible where depreciation of the real estate, a non-cash deduction for tax purposes, exceeds the taxable operating income generated by the property.

The C corporation carries with it the burden of double taxation, notwithstanding tax planning techniques designed to minimize the payment of tax at both the entity and individual level. But the C corporation is also a poor choice for holding real estate because the tax losses generated by investment in real estate cannot be passed through to the individual shareholder and used by the shareholder to offset other taxable income.

However, the benefits of being taxed like a partnership (i.e. pass-through taxation) are available to C corporations via the option to elect to be taxed as a partnership. This election is commonly known as the subchapter S election. Thus, through an S corporation a shareholder may enjoy the limited liability of the corporation and many of the features of pass-through taxation. Nonetheless, the S corporation is subject to rules that make it, like the C corporation, a poor choice for holding real estate.

Limiting the S corporation's viability as a holding entity for real estate and cementing the LLC's attractiveness as the entity of choice is the concept and computation of an owner's tax basis. In general, a member's basis in their LLC interest is the sum of cash contributions plus income and gain, minus deductions, loss and distributions, plus the member's share of the liabilities of the LLC. An S corporation shareholder's tax basis is the sum of their adjusted basis in their S corporation stock plus the adjusted basis of their loans to the corporation. Note

"Limited Liability" continued from page 2

that the S corporation shareholder does not receive tax basis for their share of the liabilities of the corporation (for example, a mortgage debt secured by real estate).

Although an S corporation is taxed like a partnership, and therefore losses (for example, a real estate investment loss created by tax depreciation in excess of operating income) may pass through the corporation to the individual shareholder, the taxpayer may only recognize losses in an amount equal to their basis in the S corporation. Any loss in excess of their basis may not be used to offset other sources of currently taxable income, but must instead be carried forward. While an LLC member's ability to deduct losses also is limited to their basis in their LLC interest, the inclusion of the member's share of liabilities in computation of their basis typically creates a higher tax basis (all other assets, liabilities and income being equal between the S corporation and LLC) thereby allowing the LLC member the ability to recognize a higher amount of loss in order to offset currently taxable income.

Conclusion

The choice of entity in which to hold real estate should be made with a clear understanding of the benefits and limitations that accompany that entity. A limited liability company is the legal format of choice in which to hold real estate. If you are planning on purchasing or constructing real estate, give consideration to the type of entity you will use to hold that property. If you currently hold real estate in a C corporation or S corporation, please consult your KSM tax advisor.

The Production Deduction – A Year Later

By Thomas Nowak, CPA
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The American Jobs Creation Tax Act of 2004 added Internal Revenue Code Section 199 providing a deduction from taxable income attributable to domestic production activities beginning with the 2005 tax year. Although there was a lot of confusion on the calculation and taking the deduction on 2005 tax returns, the Treasury Department and IRS have released Revenue Procedure 2006-22 clarifying the deduction. Those taxpayers who took the deduction in 2005 did receive benefit and everyone should prepare to take advantage of the deduction again in 2006.

The production deduction provides a deduction from taxable income attributable to domestic production activities for construction contractors, homebuilders, land developers and architectural and engineering services. The guidance (IRS notice 2005-14), issued in January 2005 to provide details on who qualified and how the computations were completed, was complicated and was issued late in the tax preparation year. Many taxpayers may have ignored the available deduction in 2005 due to the complexity and timing of the guidance. With the issuance of Revenue Procedure 2006-22, all taxpayers should be planning for and taking advantage of the production deduction in 2006.

The following are some example benefits taxpayers received in 2005 taking the deduction:

- A mechanical contractor with gross receipts of $150 million, wages of $2.5 million and taxable income of $6 million. A 40% shareholder received a $62,500 tax deduction on page one of their 1040.

- An industrial contractor with gross receipts of $10 million, wages of $1.2 million and taxable income of $2 million. A 100% shareholder received a $55,000 tax deduction on page one of their 1040.

- A residential land developer with gross receipts of $5 million, wages of $750,000, taxable income of $1.4 million and qualified production activities income of $1.9 million. The developer received a $42,000 tax deduction on page one of their 1040.

As you can see from these examples, the planning for and benefits received from taking advantage of the production deduction are substantial.

"The Production Deduction" continued from page 3

The production deduction is available to taxpayers with gross receipts from construction activities and architectural and engineering services performed in the United States. The deduction is based on a percentage of the taxpayer's qualified production activities net income or taxable income, whichever is less. The deduction is limited to a maximum of 50% of the entity's W-2 wages for the calendar year. The annual deduction percentages are as follows: 2005 and 2006 3%; 2007 through 2009 6%; 2010 and beyond 9%. For pass-through entities, the deduction is determined at the partner, shareholder or beneficiary level.

In determining what qualifies as Domestic Production Gross Receipts, only taxpayers engaged in construction for purposes of the NAICS Codes may claim the deduction. Under NAICS, construction includes land development, infrastructure construction, general contracting and specialty contracting trades. To qualify, the construction receipts must involve real property which is:

1. Residential or commercial buildings
2. Inherently permanent structures
3. Inherently permanent land improvements
4. Infrastructure including roads, power lines, water systems, communication facilities, sewers, sidewalks and cabling and wiring

Although gross receipts received for items classified as tangible personal property do not qualify, there is a rule which states that if more than 95% of the total gross receipts derived from a construction project are derived from real property, then the total gross receipts from the project can be treated as gross receipts derived from real property construction.

After the taxpayer's qualified production activities net income or taxable income is determined, the deduction is limited to 50% of the W-2 wages paid by the entity during the same year. Total W-2 wages include all wages paid during the year for employment by the entity, whether or not those employees are engaged in construction activities. The term "employee" includes all officers and common-law employees. Wages do not include payments to independent contractors or partners.

An Example of the Production Deduction Calculation	
Gross receipts from qualified production activities	$15,000,000
Costs of construction including direct labor	$13,000,000
G&A costs related to construction activities	$1,000,000
Qualified production activities income	$1,000,000
Other income (net)	$100,000
Total taxable income	$1,100,000
W-2 wages	$1,500,000
Calculation of Deduction	
Section 199 deduction ($1,000,000 x 3%)	$30,000
Limited to the lesser of:	
50% of W-2 wages of $1,500,000	$750,000
Taxable income of $1,100,000 x 3%	$33,000
Section 199 deduction	$30,000
Estimated tax savings at 35% effective tax rate	$10,500

Please contact a KSM advisor to discuss year end planning and taking advantage of the production deduction in 2006. Planning for and maintenance of the qualified production activities income is the key to taking the beneficial tax deduction available to you.

Did you know...

*Katz, Sapper & Miller provides tax, accounting and consulting services to **15** of the **Top 20** largest Indianapolis-based real estate developers.*

Consolidation

By Matt Wise, CPA, CIA
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Financial statements prepared in accordance with GAAP are becoming increasingly complex. For many real estate activities, financial statements prepared on an acceptable, non-GAAP basis of accounting may be appropriate.

We have all heard the stories of Enron and the related fallout, which included the passage and implementation of Sarbanes Oxley and the creation of the Public Company Accounting Oversight Board. The Financial Accounting Standards Board (FASB) also got into the mix. Since 2003, the FASB has worked diligently to increase accounting rules related to consolidation. These rules include *FIN 46R: Consolidation of Variable Interest Entities and EITF 04-5: Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights.* This guidance has had significant impact on the way auditors look at related entities; and in many instances has required consolidation of entities that historically have not been consolidated.

For companies in the construction and real estate industry, consolidation of related or special purpose entities may not be the best financial presentation. For example, under current GAAP financial reporting rules, a real estate developer involved with multiple entities financed with non-related investors may be required to consolidate these partnerships. As a practical manner, there may be several lenders, partners or vendors who may require certified financial statements. In addition to divulging confidential information, providing these diverse users with consolidated financial statements may not meet their needs. Fortunately, business owners have an option of presenting consolidated information with financial statements that can be prepared utilizing an alternate basis of accounting.

Financial statements prepared on an OCBOA-basis (other comprehensive basis of accounting) are commonly prepared on the income-tax, cash or modified-cash basis of accounting. In the real estate industry, tax basis financial statements are very common due to the complex nature of the business structure and the separation of real estate holdings into individual partnerships.

In some instances, OCBOA statements may be easier to understand than GAAP-basis financial statements. For example, many partnership and operating agreements require profit or loss allocations based on fair market values, particularly if there are equity transactions after the initial formation of the entity. Using the flexibility provided by an OCBOA, the financial statements could report these transactions more appropriately than GAAP, which is fundamentally based on historical costs. Additionally, in many instances, OCBOA financial statements may cost less than GAAP-basis financial statements. For example, GAAP requires goodwill to be evaluated annually for impairment, which may be extremely difficult; yet for tax purposes, goodwill is simply written off over 15 years.

Many creditors and investors require audited financial statements prepared in accordance with GAAP. If you think a non-GAAP financial statement will provide the best information for the users of your financial statements, be prepared to address the issue as soon as possible, as you might need approval to change the basis of accounting.

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.

"Bridging the Gap..." continued from page 1

due primarily to low barriers of entry, which provides for numerous competitors.

So what is a reasonable profit for a contractor? There are numerous databases that compare operating statistics, the best of which is the annual financial survey published by the Construction Financial Management Association (CFMA). With over 7,000 members in 89 chapters in major cities across the country, CFMA is the premier association for financial professionals serving the construction industry. The annual survey classifies financial information by three main construction segments: Industrial and Non-Residential, Heavy and Highway, and Specialty Trade Contractors. These studies will not mimic your company directly, but if used consistently, can provide a reasonable metric to benchmark your own company's performance. In the recently released 2006 survey (primarily calendar 2005 results), over 590 companies responded.

In general, 2005 was a profitable year for non-residential construction. Early returns indicate 2006 was another profitable year for contractors. The survey results provide a basic guideline of contractor performance, for many reasons, your company may perform far differently than the respondents. However, benchmarking against these (or other sources) over time, you will gain insight to your company.

CFMA's 2006 Construction Industry Annual Financial Survey

	All		Industrial		Heavy		Specialty	
	All	Best in Class	All	Best in Class	All	Best in Class	All	Best in Class
Return on Assets	6.7%	13.4%	5.1%	10.5%	8.9%	17.3%	10.2%	15.1%
Return on Equity	23.7%	39.5%	24.5%	45.8%	21.6%	36.2%	27.5%	35.3%
Debt to Equity	2.5	1.9	3.8	3.3	1.4	1.1	1.7	1.3
Gross Margin %	8.3%	10.7%	6.0%	6.3%	9.2%	12.4%	15.1%	17.3%
SG & A Expense to Revenue	6.2%	6.5%	4.7%	3.6%	5.6%	5.6%	11.2%	11.6%
Pre-Tax Profit	2.4%	4.4%	1.6%	3.1%	3.7%	7.1%	3.7%	5.5%

Late Breaking News From The IRS...

The IRS has announced that because April 15th falls on Sunday this year and as April 16th is Emancipation Day, a legal holiday in the District of Columbia, there will be a two-day reprieve for taxpayers. The tax deadline is now April 17, 2007.

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