Volume 4 • Issue 1 • 2010

KATZ, SAPPER & MILLER

THE CONSTRUCTION AND REAL ESTATE INDUSTRY ADVISOR

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Common Impairment Issues for Contractors

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Recent economic conditions have led to a rise in the number of contractors dealing with impairment issues on their Generally Accepted Accounting Principles (GAAP) financial statements. Impairment exists, for accounting purposes, when the carrying amount of an asset is greater than the fair value of the asset. The manner in which impairment is tested and measured varies based on the type of asset. The following is a sample of the assets a contractor may measure for impairment.

Property and Equipment

Property and equipment is a common asset type that contractors are forced to measure for impairment. Typically, a contractor's property and equipment only needs to be tested for impairment if there are indications that the assets in question are impaired. An example of an indication of impairment is any economic or regulatory impact that significantly affects the cash flows generated by the assets. Other indicators of impairment could be over supply or technological advancements that make certain property and equipment less valuable. Without any factors that cause doubt of the fair value of the property and equipment, there is no requirement to test property and equipment on a recurring or annual basis.

Once it has been determined that property and equipment should be tested for impairment, this is accomplished in a two-step process. The first step is to determine if any impairment exists. This step requires estimating all future cash flows from the asset in question and adding a disposal value. If this sum is greater than the carrying amount of the asset, then no impairment adjustment is necessary. The guidance does not require any discount to be applied to these future cash flows and does not designate an appropriate term to use for future cash flows. If the sum of the future cash flows is less than the carrying amount of the asset, then the asset is impaired.

The second step in the impairment test is to measure the impairment by comparing the asset's fair value to its carrying (or book) value. Fair value is the price that would be received to sell the asset in an orderly transaction between willing market participants. If this cash flow approach is the manner in which a selling price would be determined between market participants, then the fair value of the asset has been determined. If this is not the manner in which the selling price would be determined, then another methodology, such as analysis of sales of other equipment in an orderly asset sale, should be used to determine what impairment adjustment is necessary to adjust the asset to fair value.

The accounting literature does not allow for any impaired property and equipment to be written back up in another reporting period.

Goodwill

Goodwill usually arises in a business combination where the price paid for the business exceeds the fair value of all identified tangible and intangible assets.

Goodwill is relatively uncommon on contractors' financial statements, but Goodwill should be discussed briefly as GAAP requires an annual impairment test of Goodwill. The Goodwill is also tested in a two-step model. First, it must be determined if there is any impairment in the reporting unit associated with the Goodwill. This involves comparing the estimated fair value of the reporting unit to the book value of the reporting unit. If the fair value is greater than book value, then there is no impairment. If impairment does exist, the next step is to measure the impairment.

To determine the current fair value of the Goodwill the entire reporting unit is valued. This new value is again allocated to the existing tangible and intangible assets, and any remaining value is allocated to Goodwill. This new Goodwill amount is compared to the carrying amount (book value) of the existing Goodwill, and if the carrying value exceeds the fair value, then the Goodwill is written down to fair value. Again, once this Goodwill is written down it cannot be recouped, and any impairment charge will generally not provide a corresponding current tax deduction.

Dealing with impairment issues on financial statements is never an enjoyable process, but when issues are addressed early, this will help almost all situations. As U.S. standards

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Will Short-term “Zero-out” Grantor Retained Annuity Trusts (GRATs) Become Obsolete?

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Short-term, zero-out Grantor Retained Annuity Trusts (GRATs) have been an excellent estate planning technique for years. The Small Business and Infrastructure Jobs Tax Act (H.R. 4849), however, threatens to change this. Passed by the House of Representatives in March, the act would eliminate short-term GRATs, which provide substantial tax-free benefits. As of this writing, the Senate has yet to act on the proposed legislation.

A GRAT is an irrevocable trust to which assets are gifted. The GRAT pays an annuity each year for the specified term of years selected. The annuity is typically structured to increase by 20 percent each year. If this term is survived, then at that time the remaining GRAT assets, if any, will pass to one’s heirs, whether outright or in trust, estate and gift tax-free. GRATs work well with children as beneficiaries, but do not serve well as generation-skipping trusts, such as with grandchildren. If the grantor dies before expiration of the stated term, then the GRAT assets will be included in his or her estate for estate tax purposes.

When assets are gifted to a GRAT, a “remainder interest” gift is made. The taxable value of this gift is the excess of the value of the assets over the present value of the annuity retained from the GRAT. The GRAT term and annuity are set such that the present value of the annuity is exactly equal to the value of the assets transferred to the GRAT. In this way, no taxable gift is made and the gift tax exemption is not used. Hence the name “zero-out” GRAT.

If the GRAT assets grow at a rate in excess of the IRS rate*, then assets will be left in the GRAT to pass onto heirs. The zero-out GRAT thus serves as a “freeze” technique whereby the growth in value of the assets in excess of the IRS rate of interest is out of the grantor’s estate, and the original value of the assets plus a rate of return equal to the IRS’ rate of return is retained by the grantor. If the GRAT assets do not grow at a rate in excess of the IRS rate, then the GRAT assets will be returned to the grantor, and nothing will be left in the GRAT to pass to heirs. The only downside of a “failed” GRAT is the cost of establishing and administering the GRAT.

“If the GRAT assets grow at a rate in excess of the IRS rate, then assets will be left in the GRAT to pass onto heirs.”

The GRAT is a “grantor trust” for income tax purposes, at least during the GRAT term, and perhaps even beyond the GRAT term, depending on the planning desired. This means that for income tax purposes the trust is ignored and the grantor is treated as the owner of the GRAT assets. As a result, the grantor continues to pay tax on the trust income, and no trust returns are required to be filed.

For example, if the grantor transfers $1 million of securities to a two-year “zero-out” GRAT, the annuity amount at the end of year one is about $477,000. The annuity amount at the end of year two is about $573,000, a 20 percent increase. The gift then, for gift tax purposes, is zero. If assets have a 20 percent return, about $295,000 will pass to heirs, outright or in trust, at the end of year two at no gift tax cost to the grantor.

As indicated, short-term, zero-out GRATs can be very taxpayer-favorable. However, the new House bill would require that GRATs have a minimum term of 10 years, thus eliminating “short-term” GRATs. The new bill would also require that the remainder interest have a value greater than zero, but the bill does not state that the remainder must have a minimum value, meaning the remainder value could still be close to zero. If the House bill becomes law, it will have a significantly negative impact on estate planning with GRATs. Because one must survive the GRAT term for the GRAT to be successful, the 10-year minimum term can be a substantial hurdle for older taxpayers. In summary, now is an excellent time to do a short-term GRAT before the law changes. •

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* The IRS rate for June 2010 is 3.2%.

Real Estate, Construction and Green Technologies

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The real estate and construction industries are currently experiencing tremendous challenges. For those companies that survive, now may be an ideal time to rethink conventional wisdom about how to maximize the beneficial use of limited resources. The need to do more with less while generating profits makes consideration of green technologies and ideas a critical part of any company's strategy. By effectively coordinating practical engineering and design with thorough, creative financial analysis and use of financial resources, leaders can support the business case for "going green."

Few issues affecting society, and therefore affecting business, are the subject of the quantity of thought and discussion as is the concept of going green. The U.S. Green Building Council estimates that buildings in the United States are responsible for 72 percent of electricity consumption, 40 percent of raw materials use, 30 percent of waste output, and 14 percent of water consumption. But while most people agree that being green is a good idea, for many leaders the thought of sifting through the overwhelming volume of green information, identifying ideas and practices that are applicable to business, quantifying the impact on their business, and then making choices to invest or not invest in those ideas and practices can be intimidating.

For real estate owners and developers the perceived cost of green technology is seen as a barrier to utilizing such technologies. The conventional wisdom is that green technologies undermine returns due to increased cost while doing nothing to improve the marketability of properties. Contractors may be reluctant to recommend green technologies due to concerns about liability for the failure of such technologies on projects. The conventional wisdom is to be wary of issues related to new construction techniques or material capabilities; however, the ability to assess and harness the positive potential of green technologies can be an element that both real estate professionals and contractors can use to differentiate themselves from competitors.

Reductions in the operating costs of properties might be achieved through relatively simple improvements. For example, some "low-tech" options are to change existing lighting to more energy efficient systems; collect roof top rainwater to replace water lost to evaporation in the air conditioning system or for irrigation, planting drought tolerant landscaping, and native plants; use irrigation system controls linked to local weather stations; use permeable concrete on sites; or use air hand dryers in place of paper towels. More complex options that involve formal engineering and analysis might include reducing run times for exhaust fans based on more precise measures of air quality; use of compact vertical wind turbines for generation of supplemental power; improvements to hot water recovery systems; use of more efficient boilers for hot water production; and improved use of insulating materials.

"Few issues affecting society, and therefore affecting business, are the subject of the quantity of thought and discussion as is the concept of going green."

But even ideas with potential, supported by motivated leadership, can fail to be implemented if the appropriate initial analysis is not completed and mechanisms to measure the economic impact of improvements cannot be identified. A study completed by the UC Berkeley Program on Housing and Urban Policy titled *Doing Well by Doing Good? Green Office Buildings* claims there are measurable benefits to using green technologies. The authors of the study found that rental rates for facilities rated as green, such as a LEED certified building, are 3 percent higher per square foot than those not rated. Selling prices for green properties were

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Are You Ready for the New 2009 Form 5500 Requirements?

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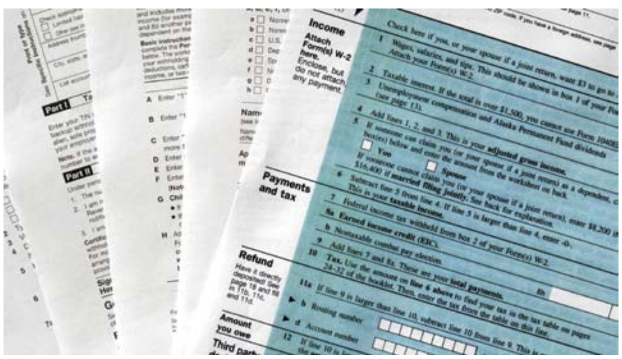
In November 2007 the Department of Labor (DOL) and the Internal Revenue Service (IRS) announced significant changes to the Form 5500 effective for 2009. The Form 5500, Annual Return/Report of Employee Benefit Plan, is required to be filed annually by plan sponsors of retirement and health and welfare benefit plans within seven months of the plan's year-end - July 31, 2010, for a 2009 calendar plan year.



The 2009 Form 5500 will require additional attention and involvement from each plan sponsor and their service providers to address the significant changes which include a mandatory electronic filing requirement, a new Form 5500-SF (Short Form), and modifications to the Form 5500.

The most notable modifications to the Form 5500 are the new fee disclosure reporting requirements on the Schedule C.

Mandatory Electronic Filing Requirement

Beginning in 2009, the DOL will require plan sponsors to submit the Form 5500 for all of their benefit plans electronically. The DOL's system, EFAST2, was designed to streamline the reporting process and to immediately disclose information reported on Form 5500 to the Internet, as the Form 5500 is subject to public disclosure.

To facilitate electronic filing, each individual responsible for signing a Form 5500 must obtain Filing Signer credentials or a user ID and PIN from the DOL's Web site. If credentials have not yet been obtained, they can be requested from the DOL at www.efast.dol.gov. For step-by-step instructions on how to obtain credentials, visit http://image.exct.net/lib/feef13707c6c0c/m/1/Form+5500+-+Obtaining+EFAST2+Filing+Signer+Credentials.pdf.

It should be noted that credentials are personal to the individual obtaining them, and it is prohibited to share them with any others in the company or with any of the plan's service providers.

It is highly recommend that service providers be contacted, including the plan's auditor, if applicable, well in advance of the form's due date to discuss the process for preparing and transmitting the Form 5500 to the firm.

Additionally, it is important to note that the DOL may generally assess a penalty of up to $50,000 for failing to file a return.

New Form 5500-SF

In connection with the transition to the electronic filing requirement, the DOL introduced a new simplified return with the Short Form 5500-SF. The Form 5500-SF may be used by a plan sponsor that meet certain conditions such that the plan is a small plan, which is generally fewer than 100 participants at the beginning of the plan year; the plan does not hold any employer securities; the plan was 100 percent invested in certain secure easy to value assets; the plan is eligible for the waiver of an annual audit; and, finally, that the plan is not a multi-employer plan.

The Form 5500-SF is only two pages long and generally does not require any additional schedules or attachments.

Modifications to the Form 5500

While the 2009 Form 5500 incorporates several modifications including new benefit codes to identify plans that offer automatic enrollment and/or default investment options, new compliance questions on Schedules H and I, and the elimination of the Schedule SSA, the most challenging issue will be the new fee disclosure reporting requirements on the Schedule C.

Over the past several years, fee disclosures have been a hot-button topic in Congress, at the DOL, in the media, and among benefit professionals. Fiduciaries of 401(k) plans

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Major Changes in Lease Accounting on the Horizon

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Lease transactions are widely used as a financing tool in today's marketplace across all industries, but leases are especially important to construction and real estate. With future lease accounting changes on the horizon, lease versus buy decisions will most likely be affected. Every company that is a lessee or lessor of property, plant and equipment will be impacted by the changes.

In March 2009, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a discussion paper regarding leases as part of the continued convergence projects. The discussion paper initially only addressed a lessee's accounting of leases, but in subsequent meetings, the boards have also addressed a lessor's accounting of leases. The project's objective is to create common lease accounting requirements to ensure leases are recognized on the balance sheet, and to provide users of financial statements with useful and complete information about leasing transactions.

Currently a lessee accounts for a lease as either operating or capital. Under the preliminary decisions made by the boards, 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. The boards have tentatively decided the lessor would follow a performance obligation approach in which an asset would be recorded representing the lessor's right to receive rental payments, and a liability representing its performance obligation under the lease.

At the inception of a lease, both the lessee and lessor would be required to estimate the ultimate term of the lease, evaluating the probability of renewal options and contingent rentals, such as an increase in rent based on an index and residual value guarantees. These items would then be factored into the calculation of the asset and liability recorded by the lessee and lessor. Estimates would need to be periodically reassessed and adjusted, which could potentially impact the recorded asset and liability, putting an additional burden on companies to track and monitor leases.

The boards have tentatively determined not to exclude existing leases at the date of implementation, which would require companies to record an asset and liability for all outstanding leases at the date of implementation. This could require a lot of time and effort by companies, depending on the number of leases, to gather the necessary information and calculate impact.

As the discussions stand now, there is no exclusion for short-term leases. There would, however, be a simplified method of calculating the lease asset and liability, which would not take into account the time value of money. Materiality would be a factor that would be considered in all leases.

As a result of these expected lease accounting changes, construction and real estate companies' balance sheets will be greatly impacted. Assets and liabilities will increase, resulting in increased leverage ratios. Cash flow measures, such as EBITDA, will be affected due to replacing rent expense with amortization and interest expense. Additionally, interest expense under the effective yield method is higher in the earlier years of a lease. 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 since these changes may have an effect on loan covenants and other external measures of financial performance.

Companies will also need to put added emphasis on lease versus buy decisions. Lease transactions will have a similar impact on a lessee's balance sheet as other financing arrangements going forward. This may impact the lease versus buy decision, but leases will still be a valuable tool for many companies that do not have other financing options available to them.

The boards will continue discussing this project and are expected to have an exposure draft issued by mid-2010 and a final accounting standard update issued by mid-2011. Implementation is expected for 2012.

To learn more and to follow the lease project visit the FASB's Web site at www.fasb.org. •

Impairment *(continued from page 2)*

move closer to integration with international standards, expect a continued migration toward more fair value concepts in U.S. accounting guidance.

Green Technologies *(continued from page 4)*

found to be 16 percent higher. For each $1 in savings from increased thermal efficiency the valuation of an Energy-Star certified building increased $18.

With regard to recovering investment in green technologies, conventional wisdom, especially as applied to energy consumption measures, focuses on the payback period. The payback period is a simple measure calculated by dividing the cost of the improvement by the annual financial savings generated, thus determining the number of years an improvement takes to pay for itself. A growing number of professionals, however, argue that calculating return on investment (ROI) is a better measure of the financial benefit of energy improvements. The reason is the ROI calculation attempts to consider the benefit of future cash flows in the form of reduced operating costs, the time value of money, and the relatively low risk required to realize energy efficiency savings. ROI calculations should include not only measures of energy cost savings, but also accelerated depreciation of the investment and application of tax incentives such as the energy efficient commercial building deduction (Internal Revenue Code §179(D)) and the energy property investment credit (Internal Revenue Code §48).

Since many green technologies are new to the marketplace and data is limited, some leaders may dismiss their potential value out of a mistaken belief that such improvements are not cost effective. Leaders who are open to the idea of green technologies, who utilize resources to identify technologies applicable to their business, and who focus on ROI rather than the simple payback period, will likely find that green technologies provide a compelling answer to the continuing question of how to do more with less.

Form 5500 *(continued from page 5)*

are under intense scrutiny with respect to the transparency and appropriateness of service provider compensation paid by the plan and their participants. This is a result of a series of lawsuits against both employers and financial institutions relating to revenue sharing, fee arrangements, and the adequacy of fee-related disclosures.

In an attempt to capture and disclose more information about fees and compensation between plan sponsors and service providers, the DOL significantly revamped the Schedule C. Although recent DOL proposed fee disclosure regulations under 408(b)(2) have stalled, they will be addressed in the near future to help plan sponsors comply with the new reporting requirements.

The new reporting requirements include a broadening of the definition of service providers whose compensation must be reported; provide for reporting of direct compensation paid to service providers; and will require reporting of indirect compensation received by service providers. In addition, it will be required to disclose instances where employees of the plan sponsor receive travel, gifts or entertainment, which would include meals from service providers that, in total, are valued in excess of $5,000.

It is intended that the new requirements will help plan sponsors, trustees and other fiduciaries satisfy their obligation to monitor and review arrangements with plan service providers and to disclose pertinent fee information to the plan participants.

Whether it is the new electronic filing requirement, the new Form 5500-SF, or the new Schedule C reporting requirements, now is the time to start asking service providers about how all this may affect benefits plan filings for 2009.

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KSM Construction and Real Estate News

Christopher Bradburn presented a breakout session on advising clients in a green economy at the Indiana Building Green Symposium.

Chris Felger chaired and Tom Nowak emceed the Construction Financial Management Association's Annual Junior Achievement Charity Night.

Tom Nowak became a member of the Indiana Subcontractors Association education committee.

Steve Warner moderated a session on the future of healthcare real estate hosted by the Urban Land Institute (ULI) of Indiana.

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

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