Volume 1 • Issue 2 • 2007

KATZ, SAPPER & MILLER

THE CONSTRUCTION AND REAL ESTATE INDUSTRY ADVISOR

In this issue:

Our People : Your Success

www.ksmcpa.com

New Legislation Creates Potential Conflict Between Tax Preparers and Clients

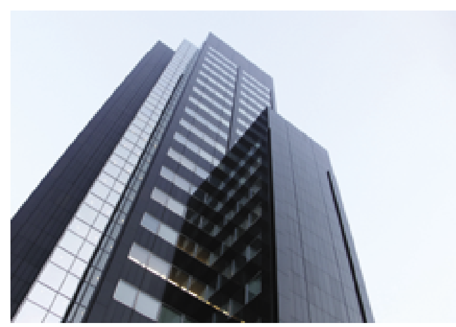
By Kent Manuel
Partner-in-Charge, Real Estate Services
kmanuel@ksmcpa.com

On May 25, 2007, the President signed the "U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007" (the "Act"). The new law, as its name implies, assuredly has many desirable goals. However, a relatively obscure provision relating to tax return preparers is, we think, ill-conceived and wrong.

"The new law, as its name implies, assuredly has many desirable goals. However, a relatively obscure provision relating to tax return preparers is, we think, ill-conceived and wrong."

Section 8246 of the Act significantly increases the reporting standard for tax return preparers. Under previous law, return preparers needed to have a "realistic possibility of success" when reporting items on tax returns. Under the new law, a tax return reporting position must now have a "more likely than not" probability of being sustained on its merits. Failure to meet this standard can result in financial penalties for the preparer and, more importantly, can endanger the preparer's right to practice before the Internal Revenue Service. Of course, the preparer can avoid penalties by disclosing the controversial tax position on the return.

The major problem with this provision is that the preparer's standard for reporting is now higher than the taxpayer's standard. Taxpayers are not penalized for any tax reporting position so long as there is "substantial authority" for such position. "Substantial authority" is a significantly lesser standard than "more likely than not." Therefore, the new law puts tax preparers in potential conflict with their clients. To avoid penalty, preparers would have to disclose a tax position for which there is "substantial authority" but isn't "more likely than not" to prevail. In addition to this problem, this higher standard for preparers could increase the cost of tax preparation. The heightened standard could well involve additional research time in determining whether a tax reporting position meets this new standard.

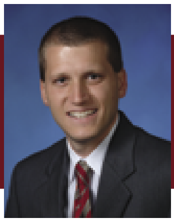


The new standard is overreaching and an overreaction to the highly publicized tax shelter problems from earlier this decade.

Previous legislation, as well as changes to the regulations governing practice before the Internal Revenue Service, has more than dealt with the problems involved with the tax shelters. The Internal Revenue Service, which apparently did not request this change and were somewhat unprepared for the new standard, has announced it will delay enforcing the new standard with respect to tax returns filed before 2008.

The American Institute of Certified Public Accountants (the "AICPA") has sent a letter to the chairmen of the Senate and House tax-writing committees urging the provision be changed such that taxpayers and tax preparers will be governed by the same reporting standard. This is eminently rational and hopefully Congress will listen. ●

Applying New Auditing Standards to Contractors



By Mike North
Manager
mnorth@ksmcpa.com

Over the past several years there have been significant auditing standard changes. The upcoming 2007 audits are no exception. The most recent change effective for calendar year 2007 audits will be "Statement on Auditing Standards 104 - 111." This suite of standards will require auditors to obtain a more in-depth understanding of the entity and its environment, including the key internal controls of the entity. The standards also require a more rigorous assessment of the risk of material misstatement based on the understanding of the entity.

Due to the use of surety credit and often significant bank borrowings, audits are more common in the construction industry than in many others. Thus, the changes in these standards will have a significant impact on contractors.

How will the audit be different?

The auditor will need to gain a more robust understanding of the entity and its key internal controls. This will include conversations with key accounting personnel and key operations personnel to understand what key internal controls exist. The auditors will develop scenarios of "what could go wrong" and ask these key personnel to tell them what control is in place to prevent or detect that scenario. From these conversations, the auditors and the client will have an understanding of what key controls exist at the contractor. A significant change with these standards is that inquiry is not enough audit evidence in gaining an understanding of these key controls. The auditor will likely ask for documentation of these key controls, i.e., an approved invoice, change-order, etc.

These standards will force all auditors to move closer to a "risk-based" auditing approach. At KSM we have already been using a risk-based approach, so the changes may be less apparent than with other firms. Commonly, a "high-risk" area for contractors will be WIP schedules and cost to complete estimates. Most contractors should expect their auditors to have a more thorough understanding of the estimating process, how estimates are updated, how information for changes in estimates is captured in the jobs, and what controls exist to ensure all necessary information is obtained in adjusting estimates on jobs.

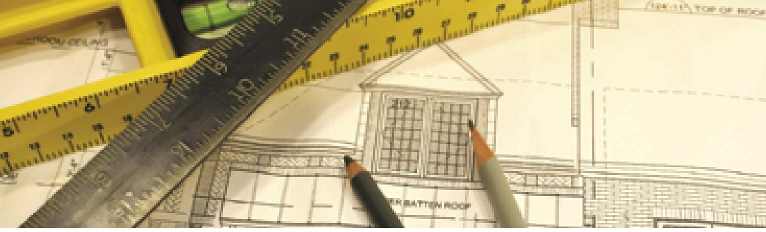
Another result of these new standards will be a more robust understanding of the information technology (IT) at the contractor. Many contractors have IT systems at both the job sites and the home office. The auditors will need to determine what IT controls exist to ensure information is captured properly in the financial reporting system. The auditors may bring an IT specialist into the engagement, depending on the complexity of the contractor's IT system.

"Due to the use of surety credit and often significant bank borrowings, audits are more common in the construction industry than in many others."

It is very likely that the work related to the understanding of the key internal controls, including IT controls, will happen before the end of the calendar year. Thus, auditors will be in the field earlier than normal for their interim work. The interim work is likely to involve similar work to what has been done in the past plus, the additional work discussed above related to the understanding of key internal controls. This will probably involve inquiry with personnel that the auditors may not have had discussion with in the past.

The contractors should note the distinction between these new standards and the Sarbanes Oxley (SOX) rules in place for publicly traded companies. Unlike SOX, the auditor will not issue an opinion on the internal controls of the contractor. The auditors will only gain an understanding of the control environment and what key controls exist.

Continued on page 7. See "New Auditing Standards."



The Growing Appeal of Tenant In Common Interests

By Josh Malarsky
Manager
jmalarsky@ksmcpa.com

Investing in a partnership in order to own assets, as compared to owning assets directly, has many advantages including potentially limited liability and tax-free distributions. However, investment in partnership interests can present tax planning problems with regard to exiting the partnership as compared to directly owning underlying assets. Due to limitations on the ability to defer gain on the value of a partnership interest, a new structure for investing has surfaced over the past few years as an alternative to ownership of interests in partnerships. This investment structure is known as tenancy in common; better known as a TIC arrangement. The primary difference between a TIC and a partnership investment is that in a TIC, each co-owner actually holds an undivided interest in the underlying assets, whether they are land, buildings or personal property. In contrast, all that is owned by a partner is an interest in the entity that owns the assets.

The major appeal of TIC ownership is the ability to treat property owned in this fashion as replacement property in a like-kind exchange under Internal Revenue Code §1031. The like-kind exchange provisions essentially enable a property owner to dispose of property and use the proceeds to acquire replacement property of like-kind without recognizing gain on the disposal of the original property. However, one asset that has consistently been disqualified from like-kind exchange treatment is an interest in a partnership. The TIC arrangement qualifies since a share of the assets themselves, and not a partnership interest, is being acquired with the §1031 exchange proceeds.

In addition to being eligible for inclusion in a tax deferred like-kind exchange, ownership of a TIC interest allows investors access to assets that might otherwise be unavailable. For example, in the absence of a TIC interest as an investment option, someone looking to reinvest like-kind exchange proceeds would either need to buy land and/or buildings worth only the amount available to spend, or they would be required

"The primary difference between a TIC and a partnership investment is that in a TIC, each co-owner actually holds an undivided interest in the underlying assets, whether they be land, buildings or personal property."

to invest additional money on top of the replacement proceeds in order to acquire more valuable property. An investor's ability to reinvest like-kind exchange proceeds into a quality asset might be limited by acquisition price, the supply of quality replacement property or other factors. A TIC provides the opportunity to invest a smaller amount of money to acquire pieces of larger projects. These properties may involve stronger tenants and demographics, which may lead to a better risk-reward ratio. Investors can also stretch their money over pieces of multiple TIC properties, allowing them to spread their risk through diversification. Since nearly all real estate is considered to be of like-kind with other real estate, diversification can be accomplished by investing in properties differing by geographic location or asset class (e.g. retail, office, residential).

Perhaps the biggest difficulty in attaining ownership as a TIC is avoiding a situation that makes the arrangement look too much like a partnership. The TIC co-owners should not operate under a common name, nor should they file an entity-level income tax return as would the partners in a partnership. In Revenue Procedure 2002-22, the IRS has provided a number of safe harbor guidelines by which a certain ownership arrangement will qualify for §1031 non-recognition treatment as a TIC interest. These guidelines merely represent the criteria that need to be in place in order to receive an official ruling from the IRS. If one or more of these items are not met, the arrangement is not automatically considered to be a partnership; it just means that the decision would be left up to a court if challenged by the IRS.

Some of the more significant components of Rev. Proc. 2002-22 are as follows:

- Each co-owner must share in cash flow, income, expenses and debt encumbering the property according to the proportionate share its undivided interest. There are no special allocations as one might find in a partnership agreement.
- The number of co-owners is limited to 35, however a husband and wife are only counted as one.
- Each co-owner must have the right to transfer its interest at any time, with the exception of various lender-imposed restrictions.
- Unanimous approval must be required for the sale of the property, hiring a property manager and negotiation of a mortgage or a lease for any portion of the property.

To keep the everyday operations of the property as simple as possible, most TIC arrangements include a management agreement in which a manager (who may also be a co-owner or a related party) is paid a fair market value fee for various management services. These include maintaining a common bank account for collecting rents and paying expenses, preparing financial statements for the co-owners, and obtaining insurance on the property. Under Rev. Proc. 2002-22, this management agreement must be renewed by the co-owners no less than once per year to avoid having the manager develop into a role too similar to that of a general partner.

As with most investment options that offer significant advantages, a TIC arrangement also presents certain disadvantages. Similar to holding a limited partnership interest, a TIC co-owner has reduced control since there is a manager and other co-owners who have a say in what happens to the property. There is also no established secondary market for the resale of a TIC ownership interest, so there may be marketability and liquidity issues if a co-owner wanted to sell. Finally, there may be additional fees associated with the purchase of a TIC interest due to the need for a sponsor to identify and package the property interests as well as the sponsor's marketing costs and performance of due diligence.

Overall, TIC ownership arrangements may make a lot of sense, especially for investors looking for replacement property in a like-kind exchange and for investors seeking ways to create a more diversified portfolio of real estate properties than they might otherwise be able to access. Given the prevalence of §1031 exchange transactions and the growing availability of TIC properties, investors should at least consider this option in comparison to alternative forms of investment.

Preferred Partnership Interests

By Christopher Bradburn
Manager
cbradburn@ksmcpa.com

Partnerships are often the preferred form for conducting business because of legal characteristics that are adaptable to a variety of business transactions. One technique available for effecting the economic expectations of partners is the use of preferred partnership interests. Discussion between partners at the start of a business venture, coupled with a well-written partnership operating agreement, will capture the economic expectations of the parties (i.e. "the deal") and will anticipate issues that arise from expected or unexpected events or circumstances.

A preferred partnership interest is an interest in a partnership that entitles a partner to an additional benefit beyond that provided by the partner's simple percentage interest in the partnership. Preferred partnership interests generally impact the timing of a benefit or a partner's participation in profits. Timing preferences create temporary differences in the benefits received by partners, whereas participation interests create permanent differences in the cumulative benefits realized by partners. If partners negotiate a deal that requires differences in the timing of allocations, or the achievement of certain performance and/or return thresholds before receiving allocations, preferred partnership interests can provide a mechanism to implement those negotiated terms.

Timing preferences confer an economic benefit to one partner prior to another. The preference may apply to loss allocations, cash distributions, return of capital or other economic items. The cumulative difference in value of the partners' capital accounts is temporary and is equalized upon liquidation.

For example, consider the interaction of cash distributions and timing preferences. The overriding questions to answer are when and from what source should the preference be paid. Payment may be made from operating cash flow. Operating cash flow is generally the most readily available source of funds, and it provides a more predictable source of payment, thereby reducing risk that the partner won't receive the preference. However, the basis for making the preferred cash distribution (for example, based on all or a portion of contributed capital) may prevent a non-preferred partner from receiving cash.

Payment of a cash distribution preference may be made from the proceeds of a capital event such as the sale of a particular asset or the refinancing of debt. However, partners should discuss how to handle unexpected circumstances involving the capital event. If the proceeds of the capital event are insufficient to pay the promised preference, should non-preferred partners repay distributions they've received to the extent necessary to pay the preference? Such a "clawback" provision assumes that partners, preferred and non-preferred, have been receiving distributions from operating cash flow prior to the capital event. Should proceeds from a capital event fund a preference if reinvestment of the proceeds is necessary for a capital expenditure? What if the fair market value of an asset (such as real estate) declines and distributable proceeds of the capital event are lower than expected? How will partners handle a preferred distribution that is reliant on refinancing a debt if the lending market is unfavorable?

> *"Preferred partnership interests offer business partners a wide degree of flexibility in structuring a deal."*

As opposed to timing preferences, participation preferences create permanent differences in the economic value received by partners. Most often a participation interest takes the form of a preferred profits interest, meaning that one partner receives a cumulatively greater allocation of income, deduction, gain, loss and cash distribution than another partner. The cumulative difference in value of the partners' capital accounts is permanent and is not equalized upon liquidation.

The value of a participating preference is frequently determined by reference to contributed or committed capital. A participation interest often is negotiated when the preferred partner desires a particular rate of return in order to invest in a business. Partners should consider the rate of return provided by the preference, the source of funding, timing of payment, and the impact on non-preferred partners.

Following the example of timing preferences given previously, consider the interaction of participation interests and cash distributions. The rate of return of a preference is a function of an interest rate applied to all or a fraction of capital. Questions for partners to answer include: Should the return be calculated on capital actually contributed, or capital committed? Should the rate of interest be fixed or variable? If variable, what is the frequency of adjustment? What is the base rate or index? Should the rate be simple or compounding?

Partners should be concerned with whether distributions based on a rate of return first reduce the amount of preference payment due or the underlying capital on which the preference is calculated. A non-preferred partner would rather apply distributions toward underlying capital, as this would reduce the size of the "engine" generating preference payments. The preferred partner might want preference payments to continue, or might want to reduce the risk of losing the initial capital contribution by having it repaid first. Partners should also decide whether the operating agreement will permit or require non-preferred partners to contribute capital to the extent necessary to pay a preference return. Such a provision might reduce the risk that a preference payment is not made, but it may resemble a guaranteed payment to the preferred partner. Partners should consider whether the participating preference will be funded by operating cash flow, a capital event or even upon liquidation of the business. And in considering the source of funding for a preference, careful planning should be given to the tax character of the funds – the preferred partner would generally fund a preference through capital gain rate transactions rather than ordinary rate transactions.

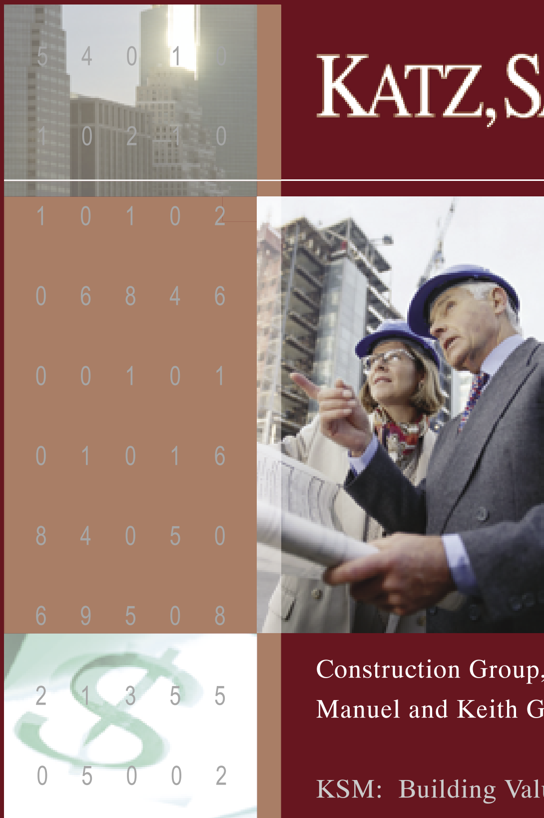
Preferred partnership interests offer business partners a wide degree of flexibility in structuring a deal. However, to maximize the effectiveness of preferences in representing the economic expectations of partners, careful planning should be done at the beginning of the partnership. If you are considering the use of preferred partnership interests a business venture, please consult your KSM tax advisor. •

New Auditing Standards *(continued from page 3)*

What can a contractor do in preparation?

The cost of audits will increase as a result of these new standards, but the severity of the increase will in large part depend on the preparedness of the contractor. CFO's and controllers should begin thinking about what their key controls are concerning for example, their estimating, billing, payroll and IT functions. Documenting what these key controls are and how they operate would be extremely helpful to your auditor and is likely to result in less auditor time (and cost) in gathering and documenting this information. Also involve your IT department and ask them to prepare documentation as to their key IT controls. This documentation will be helpful in preparing for the new auditing standards, but it may also help you identify some weaknesses in your internal controls that can be corrected prior to your audit. As mentioned before, it will be necessary for the auditor to observe, and to some extent, test these controls; but having the documentation prepared will simplify the process.

In summary, contractors are accustomed to complying with government and industry regulations; this is another example of increased effort and cost to comply, in this case, with new auditing regulations. Being prepared to discuss key controls, having those key controls documented, and understanding the new standards are the most important steps a contractor can take in preparing for the changes. You should discuss the implementation of these new standards with your audit team and how specifically you can help prepare for your upcoming audit. •



KATZ, SAPPER & MILLER

Certified Public Accountants

Katz, Sapper & Miller has a tradition in Indiana: Working side-by-side with many premier Indiana construction and real estate companies.

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

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

KSM: Building Value.

The Construction and Real Estate Industry Advisor is a bi-annual publication distributed to our clients and friends. Any tax advice or opinion herein contained is not intended to be used, and cannot be used, by anyone to avoid the imposition of any federal tax penalties.

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

PRESORTED
FIRST CLASS
U.S. POSTAGE
PAID
INDIANAPOLIS, IN
PERMIT NO. 1240