November 2004

BKD

Blueprint

Building Profits for Construction & Real Estate Companies

BKD Financial changes name

BKD, LLP's corporate finance subsidiary, BKD Financial, LLC, has changed its name to BKD Corporate Finance, LLC (BKDCF), effective October 15.

Founded in 1994, BKDCF helps companies and stockholders create corporate value through mergers, acquisitions, sales, recapitalizations, management buyouts, employee stock ownership plans, financing and initial public offering advisory services.

BKD Corporate Finance, LLC

BKDCF has helped companies buy, sell and divest in a wide range of industries, including communications, defense, financial institutions, construction, real estate, health care, manufacturing, technology and wholesale distribution.

"A real benefit BKD Corporate Finance brings is in the sale of companies—the value to the seller can be dramatically enhanced through the methods we employ," says BKDCF President Steve Blumreich, left. "We've demonstrated this with many successful transactions, resulting in sales that exceeded the value expectations of our clients."

* * *

Learn more about BKD Corporate Finance, LLC. Visit **www.bkdcorporatefinance.com**.

Year end ideal for reviewing tax-planning strategies

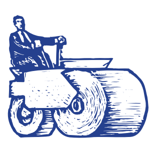
by Mark Wilkerson, Kansas City, mwilkerson@bkd.com

By the time year end draws near, many companies know their tax position and have a good idea what it will look like for the remainder of the year.

This knowledge can help you take actions that may save you taxes now or in the future, making year end an opportune time for tax planning.

Following are tax-planning ideas your construction or real estate development company should consider before implementing its year-end tax strategies.

Bonus depreciation & expensing election



For many companies, the decision to purchase new machinery and equipment in either 2004 or 2005 will have tax implications.

The first-year bonus depreciation election of either 50% or 30% will end December 31, 2004. As a result, your company will have an incentive to accelerate asset purchases and place them into service in 2004 if the goal is to increase this year's deductions.

In addition, your company also should consider making asset purchases that qualify for the $102,000 business property expensing election under Code Section 179.

To be eligible, business property generally needs to be tangible personal property or off-the-shelf computer software.

In addition, the expensing allowance is phased out dollar for dollar by the amount of eligible property that exceeds $410,000.

Bonus depreciation and the expensing election can influence your decision to acquire new assets.

If your company is hit by the alternative minimum tax (AMT), bonus depreciation and the expensing election are available for AMT purposes and could decrease your AMT tax liability.

Finally, it's important to note bonus depreciation and Section 179 are not prorated based on the date the qualified asset is placed into service during the year.

However, plan carefully because accelerated depreciation can increase your cost incurred on open contracts, resulting in an increase in revenue and profits that may partially or fully offset the bonus deduction.

Cost segregation studies

A cost segregation study can result in significant tax savings if your company built or acquired a building in the current or prior year.

Cost segregation studies allow certain asset components of a building to be segregated and depreciated over five, seven or 15 years.

By accelerating tax depreciation deductions, significant cash-flow savings can be achieved.

Cash-basis method for prepaids

Regulations were recently finalized for the capitalization of payments to acquire/create intangible assets, including favorable expensing rules for amounts that have a benefit of 12 months or less, *e.g.*, many types of prepaid expenses. This is known as the 12-month rule.

Instead of recognizing the cost over the life of the contract, the 12-month rule allows a company to deduct qualifying business costs up front. Eligible costs include insurance, warranty and service contracts and licenses and taxes.

Example: Let's say a calendar-year company prepays $60,000 in insurance costs November 1, 2004, for coverage from November 1, 2004, to October 31, 2005, and expenses $10,000 by December 31,

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Inside

Succession planning

by Larry Van Horn, Wichita, lvanhorn@bkd.com

Contractors are a varied and often staunchly independent group, generally blessed with mechanical aptitude, an innate sense of organization—and did we mention independence?

This quality might make it difficult for many contractors to consider succession planning, but it is important that they do.

The majority of contracting businesses are privately owned. In the next few years, an estimated 39% of the many that are family owned will experience leadership and/or ownership changes due to retirement or semiretirement .

A recent national survey shows 25% of senior family business shareholders have not completed any estate planning other than writing a will.

In addition, 81% want the business to stay in the family, and 20% question the next generation's commitment to the business.

Is your succession plan in place?

Your business successor can come from a number of areas:

- ✔ Family member
- ✔ Management
- ✔ Combination family/management
- ✔ Outside owner

What if something happens to you before you put your plan in place? Equally important, what if

Incentive compensation options can help grow your business

by Sarah Farrell, Kansas City, sfarrell@bkd.com, & George Gabor, Indianapolis, ggabor@bkd.com

It's that time of year again, when almost all the beans have been counted and next year's budget planning has started. It's also time to look at compensation and how to leverage increases into greater productivity.

Employee salaries and total compensation are among the largest investments most companies make.

Link your compensation investment to achieving your business goals by developing a compensation philosophy that will provide your company a framework for decision making.

Form a compensation philosophy

Top management usually determines a company's compensation philosophy, not only because it has a broad organizational perspective but also has expertise in business plans and goals, as well as strategies for achievement.

What is your company's pay position in your local labor market? From a business perspective, it should be consistent with short- and long-range goals and policies.

It also should be sufficient to recruit, motivate and retain a workforce that will contribute to the company's financial stability, growth and success.

Salaries are typically the largest component of total cash compensation but not the *only* component.

Variable pay in the form of short- and long-term incentives can help motivate higher levels of performance by increasing company earnings opportunities and resolving issues like pay compression.

Given your company's ability to pay and still recruit quality talent, your base pay range should closely match the local labor market's and can serve as a variable pay "platform."

This is because it's easier for variable pay to mirror the changing, evolving goals and successes of your company than it is for base pay to perform the role alone.

There are many variable pay alternatives to choose from:

- ✔ Discretionary bonus
- ✔ Special recognition award
- ✔ Individual variable pay
- ✔ Group variable pay
- ✔ Lump-sum award
- ✔ Profit sharing
- ✔ Gainsharing
- ✔ Winsharing
- ✔ Long-term variable pay
- ✔ Stock options
- ✔ Deferred compensation

Each method can offer your company something of value. Based on your strategy and what you want to attain, you can mix, match and change your variable-pay method as new opportunities arise.

Actual Year-end Computations

Bonus Pool:	$790,000	Net Income Before Bonuses
	(220,000)	10% of Beginning Stockholder Equity
	570,000	
	x 20%	
	$114,000	"Bonus Pool"

Allocation	Total Points	Bonus*	Less Bonus Advance Paid in December	Remainder Paid in March
Manager 1	32	$34,093	$15,000	$19,093
Manager 2	20	21,308	10,000	11,308
Manager 3	16	17,047	10,000	7,047
Manager 4	12	12,785	8,000	4,785
Manager 5	15	15,982	9,000	6,982
Manager 6	12	12,785	8,000	4,785
	107	$114,000	$60,000	$54,000

*Individual bonus = individual points divided by total points x bonus pool

Design a pay plan

When designing a plan for variable pay, it's important not to create one that's overly complicated and difficult to communicate.

Establish a clear pay methodology and limit individual goals and objectives to two or three. Make sure they send a clear and consistent message, including:

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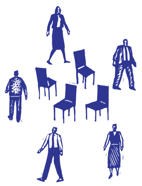
for contractors

something happens to the person(s) you plan to succeed you?

Who will succeed you?



When planning for a successor, consider the following:

Family succession - Will the family member you choose be able to run the business without you? Are means available to critically and fairly evaluate and compensate family members?

How do you balance family issues with those that concern the business? Unexpected issues can develop when additional family members or key employees are involved. Will you be ready to address them?

Management succession - If nonfamily managers are in place, can they succeed you? What keeps them with the company?

To protect your company, do you have employment agreements, noncompete agreements or key man life insurance for yourself and key employees?

Third party - A third-party sale is an option, particularly to a buyer with a related background, such as a contractor from an allied specialty in your market or to a consolidator.

Incentive-based compensation - Have you considered an incentive-based compensation plan for key management that rewards employees based on results and is equal to or exceeds that of their peers? (See "Incentive compensation options can help grow your business," page 2.)

Tax consequences - For planning purposes for individuals, ordinary rates up to 40% and long-term capital gain rates up to 20% can apply to cover both federal and state tax. If you have a taxable estate, a 49% rate may apply.

As you can see, tax planning's impact on what you realize can be extraordinary. A $1 million gain, if ordinary, may result in approximately $380,000 in tax; however, it may result in approximately $200,000 in long-term capital gain, a difference of almost 100%.

Estate tax can then take approximately 50% of what is left (yes, there is still estate tax). A word of caution: Tax benefits that are good for the seller are typically not so good for the buyer and vice versa.

Put taxes into perspective and do not let them drive your planning; there will be give and take on both sides, so you must look for ways to make the most of tax opportunities.

Methods of sale - You can sell the business entity or its assets. How, what and when you sell will affect the amount and timing of tax consequences.

Most contractors own relatively small, privately held businesses that can be sold for cash—all cash. This is unlikely, but it could happen, making tax consequences easier to determine.

A reasonable sale scenario would be 20% (or more) down by the buyer, 60% to 80% financed by a bank and 20% (or more) carried by the seller, with a five- to seven-year length of payout (could be longer, but that is unlikely).

Typically, the seller financing is subordinated to the bank—and the bank may even want you to guarantee the bank loan. Make certain tax consequences follow the cash.

Properly structured, a sale to an employee stock ownership plan may be your best alternative for deferring substantially all taxes due upon sale of your business.

Health, disability & life insurance - Insurance becomes a huge factor for buyer and seller, especially if the seller finances a large part of the purchase price.

The economic consequence of life or health issues can be devastating.

But health insurance is costly and difficult for an employer to carry. How does the seller afford coverage when no longer employed? How will life insurance be affected as the buyer's commitment lessens?

Banking & bonding - Banks and bonding companies ask for succession plans because they want to cover their risk. Who finishes the job if you are not there?

Can your company sustain its value?

Many business owners have a feel for what their business is worth (or at least what they want out of it), but their perception of value may not always be correct.

Contractors often believe their companies are worth "book value," *i.e.*, the net worth (equity) of the company. Adjustments are sometimes made for differences in the fair market value of equipment, land, buildings and other tangible assets.

But seldom added to value are jobs in process, awarded or outstanding bids, workforce in place, bonding capacity or specialized knowledge/abilities, patents, etc.

No, book value does not equal fair market value. Value is based on future expectations, not necessarily past performance.

The question is can your company continue to be profitable without you? If it cannot, put in motion the changes that will allow your company to sustain itself.

What to do now

Your independence and self-reliance are important qualities for a contractor but don't let them cause you to delay succession planning for your company when the time is right.

Depending on where you are in the planning process—even if you're just getting started—use this article as a broad planning checklist.

Start a loose-leaf binder and categorize and articulate your thoughts and choices. Answers come once you know the questions.

Think of succession planning this way: If the company has supported you (as a producer), how will it continue to support you (as a nonproducer), sustain growth and go forward with adequate capital to fund operations?

Succession planning is critical for your future, as well as your company's, and it will help you focus on the business issues of survival and continued growth.

* * *

For more information about developing and implementing a succession plan for your company, contact your BKD advisor.❑

Incentive compensation options. . .

continued from page 2

- ✔ Increased net income
- ✔ Fewer injuries
- ✔ Greater productivity

Example: The bonus plan BKD recently designed for key managers at a contracting company helps illustrate some of the above concepts.

First, take a look at the company's profile:

- ✔ Specialty contractor
- ✔ 100% owned by one family
- ✔ $25 million in contract revenue
- ✔ Six key managers (nonowners)
- ✔ $2,200,000 in stockholder equity
- ✔ Calendar year end
- ✔ Key managers' base pay increases annually by CPI index

BKD developed a bonus plan that included these provisions:

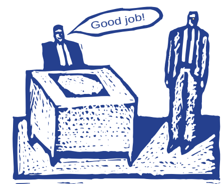
Company & individual goals/ criteria conveyed to key managers - Increase in net income, work safety, customer satisfaction, departmental cost reductions, etc.

Bonus pool computation - 20% of net income before bonuses less 10% of beginning stockholder equity ($220,000)

Bonus allocation method to key managers - Points are awarded to the six key managers based on criteria communicated by the president/owner.

Post year end, the managers receive a portion of the bonus pool based on their individual points compared to the total points of all the key managers.

The majority of the points are added at the beginning of the calendar year end—or employment date for new employees added to the plan during the year—with additional points awarded during the year for exceptional effort or success.



After bonuses are computed, president/owner meets individually with each manager to explain how points were earned and efforts were recognized.

Contact your BKD advisor about ways to develop and implement a variable pay plan for your company.❑

Year end ideal for reviewing. . .

continued from page 1

2004. The company may be eligible to deduct the $50,000 prepaid insurance balance at year end 2004.

The 12-month rule can result in an accelerated deferral of income tax for accrual-basis businesses. To take advantage of this under current rules, a special filing is due by the business's taxable year end.

Bonus payments

The deductibility of bonus payments differs based on an entity's structure.

Example: An accrual-basis corporation can deduct current-year bonus payments made to shareholders that are legitimately employed; however, bonuses to C-corporation shareholders that own more than 50% of the corporation (2% for S-corporation shareholders) are not deductible until paid.

Payments made to other employee shareholders are deductible in the current year as long as the company has accrued the bonus on its financial statement and pays it within two and a half months after year end.

Accounting method

When was the last time your construction or real estate development company reviewed its accounting methods to help manage the cash flow and timing of income taxes?

For potential tax savings, we urge you to periodically review your accounting methods.

Additional tips

- ✔ To fully recoup your casualty loss deduction in the current year, settle existing insurance or damage claims before year end.
- ✔ Review any small-tool purchases made in 2004; if the cost of the tools as a lot was high, but the cost of each individual tool was low, consider expensing the tools instead of capitalizing them.
- ✔ Is your company planning to make any charitable contributions in the next few months? Consider making them in 2004 to get the deduction now.

* * *

Before you implement any tax strategy, contact your BKD tax advisor for more information and assistance.❑

How to Reach BKD

For a complete list of our offices and subsidiaries and their contact information, go to bkd.com or call Director of Communications at 417 831-7283.

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