July 2005

BKD

Blueprint

Building Profits for Construction & Real Estate Companies

Selling your construction company

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Typically, contractors sell to family members or employees, so a decision to sell your construction company to a third party is significant and, in many cases, the most important financial decision of a business owner's life.

Whatever prompts the sale—retirement, industry consolidation, liquidity, succession issues or valuation concerns—selling your construction company and making the most of its value involves three major factors: timing, planning and execution.

Do homework before going to market

In mergers and acquisitions, timing is everything, and it's especially important for construction.

Selling your company at the right time can add significant value, while selling at the wrong time can be disastrous.

Before going to market, it's crucial to study:

- ✔ Industry trends
- ✔ General financial markets and economic trends
- ✔ Overall deal climate
- ✔ Interest rates
- ✔ Current tax and regulatory environment

Construction spending, for example, has grown at a healthy rate over the past few years as housing construction has soared.

For the first five months of 2005, total construction reached $242 billion, up 2% from the same period a year ago.

Construction activity has been powered this year by continued low-interest rates as short-term interest rate hikes by the Federal Reserve have had little impact on long-term rates set by the markets.

Acquisition activity increasing

These positive trends in the construction industry have contributed to one of the industry's most active periods of mergers and acquisitions.

In recent months, numerous mergers and acquisitions have been announced, involving strategic buyers like Universal Forest Products, BMHC, Lanoga, Wolseley PLC, Hovnanian Enterprises, Cemex, Lafarge and many other large suppliers, distributors, manufacturers, builders and contractors.

Private equity companies have record amounts of capital to invest and are also very active buyers in the industry.

National and large regional companies are looking to grow

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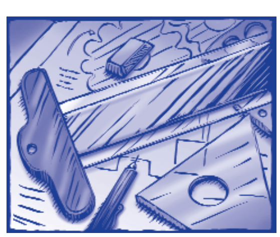
BKD Webcast

BKD is planning a webcast for contractors that will cover in detail the deduction for qualified production activities. The date and time are being scheduled and were unavailable at press time. For more information, contact your BKD advisor or visit bkd.com.

New deduction for qualified production activities: you may qualify

by John Matthiesen, Merrillville, jmatthiesen@bkd.com

Construction, architectural and engineering businesses should be aware of a deduction available for tax years beginning in 2005.



The new deduction for qualified production activities provides a deduction for a percentage of business income earned from certain U.S. production activities.

While various production activities qualify, this article focuses on the construction industry.

For 2005 and 2006, the deduction is equal to 3% of the lesser of "qualified production activities income" or taxable income.

The percentage increases to 6% for 2007-2009 and 9% thereafter, resulting in an effective federal tax rate decrease of 1% in 2005 and 2006, 2% in 2007-2009 and 3% thereafter.

However, the deduction is further limited to half the business's total W-2 wages for the calendar year. Congress imposed this limitation to restrict the new deduction to businesses with employees. Businesses without employees will generally not qualify.

Activities involving the construction and substantial renovation of the following real property generally qualify:

- ✔ Residential buildings
- ✔ Commercial buildings
- ✔ Permanent structures

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through acquisition. With interest rates low and large amounts of investment capital available to fund acquisitions, activity is definitely increasing.

However, that activity is not necessarily spilling over to contractors; therefore, the search for an appropriate match could be more of a challenge.

Planning helps increase value

Increasing the value of your company begins with planning. To help identify areas of value, analyze your company's financial condition, its products and services, markets, competition, customer base and management.

It's important to create a clear financial picture. "Recasting" financial statements is an important step in this process.

Mine your balance sheet

Many construction companies sell on some basis related to adjusted book value, *i.e.*, fair market value of assets, less liability.

Many construction companies lease machinery and equipment with an option to purchase and do not record any equity on their balance sheet.

It's critical to complete a market value balance sheet that recognizes the value of these additional assets and includes a corresponding liability to reflect the payoff balance of the lease.

There also may be assets not on the books. Quarry operations, for example, should consider the market value of their reserves. Many quarry operators are finding alternative post-quarrying uses for the property, such as landfills or lakes used in a new land development.

In some instances, the secondary use has a significant value and should be shown to potential buyers to demonstrate additional value.

Income statements

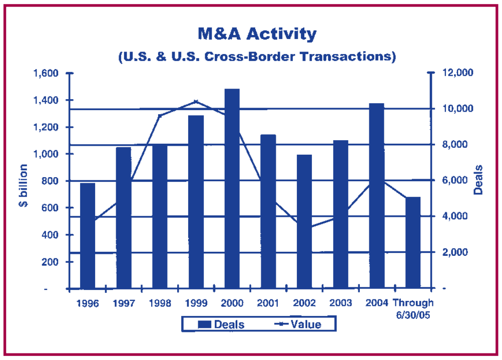
Most privately held companies have "discretionary" or unique expenses that will not continue under new ownership. Be sure to identify these expenses three years before the sale, including the current period.

Items to consider include owners' salaries, bonuses, perks, airplanes, cars, vacation homes, life insurance, etc.

Identifying these expenses and adding them to the bottom line can have a significant impact on your company's ultimate value because, to a large degree, it supports multiples based on operating cash flow.

If you lease equipment under a lease-purchase arrangement and expense the payments, it may be appropriate to adjust the lease payments affecting the bottom line and show the equipment as an asset with a corresponding liability for the remaining lease obligation.

Identify special nonrecurring costs—appraisals, legal and accounting, consulting fees—that will not recur.



Increasing the multiple

Your company's value will be judged on a multiple of operating cash flow or earnings before interest, taxes, depreciation and amortization (EBITDA) related to adjusted book value.

For you to get the most value for your company, any incremental increase in this multiple is critical.

Make certain your key employees have employment agreements and noncompetes. If you expect to sell for a sum above adjusted book value, upgrade and execute your sales and marketing program; otherwise, your value will be primarily based on tangible assets.

To increase the multiple, your company must be thoroughly prepared to properly present its strengths and opportunities, effectively execute the marketing program and conduct confidential and competitive negotiations.

Find right buyer

Sellers should not assume they have already identified the perfect buyer, but how do you find the right one? A detailed market analysis is vital to finding the right buyer and can help increase the sale price.

Buyers come from several areas and can include industry competitors or peers and companies in unrelated industries that want to diversify and require comparable skills and equipment.

BKD Corporate Finance sees strong buyers from the strategic sector—as well as the financial sector (investment companies)—looking to acquire good, operational contracting companies.

Negotiate competitively

To produce negotiating leverage and increase the value of your company, manage the sales process so you can simultaneously negotiate with multiple buyers.

This will provide choices in a controlled time frame and will contribute to achieving the best fit, deal structure and increased value.

Other items to consider:

- ✔ Maintain confidentiality during the sale process
- ✔ Soften stress on management
- ✔ Limit post-sale risks

BKD Corporate Finance has managed the sale of many companies and has helped owners realize higher values for their companies.

We can help you value and market your construction or real estate development company. In addition, we can screen buyers, assist with negotiating and structuring the transaction and help you avoid potential pitfalls.

Contact your BKD advisor for an introduction to a BKD Corporate Finance representative.❑

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What IRS looks at when it audits contractors

by Jerry Isaacs, Tulsa,
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The Internal Revenue Service (IRS) recently indicated its audits will generally increase.

What to expect

The IRS issues audit technique guides (ATGs) to help agents conduct more informed audits and focus on specific areas of concern. These industry-specific manuals are published for a wide range of commercial enterprises and market segments.

Late last year, the IRS issued the **Construction Industry Audit Technique Guide**, which contains examination techniques, common and unique industry issues, normal business practices, industry terminology and other pertinent information.

Following are industry areas an agent may examine.

Accounting methods - Depending on the contract type and contractor's size, accounting for contractors can present some complicated tax issues because at least 10 different overall accounting methods available to contractors relate to revenue recognition.

Because some contractors use more than one method for different lines of their business, agents may focus on whether an allowable accounting method is used and if specific rules are followed.

Cost allocation - What expense items are considered direct costs and are directly allocated to the contract? What items of overhead are allocated to contract costs and to what extent?

Taxable income can vary significantly in a given year depending on your method of accounting and cost allocation; tax cost allocation methods are often different from those used for financial statement purposes.

For example, Section 179 depreciation or bonus depreciation does not simply create an additional deduction on the tax return.

This additional expense must be properly allocated as part of the contract costs for tax purposes but not for generally accepted accounting principles (GAAP).

Reasonable compensation - The IRS continues to focus on reasonable compensation. Recent court cases considered some of the following factors in deciding if compensation is reasonable:

- ✔ Employee qualifications
- ✔ Nature and scope of employee's work
- ✔ Size and complexity of the business
- ✔ General economic conditions
- ✔ Employer's financial condition
- ✔ Ratio of sales and income to salaries paid
- ✔ Dividends paid and retained earnings
- ✔ Whether the salary was arm's length (would an independent investor have approved it?)
- ✔ Prevailing compensation for comparable positions in comparable entities

Capitalization issues - Does the taxpayer capitalize fixed assets exceeding $500 or $1,000 depending on their size? The Internal Revenue Code has no such provision. The general capitalization rule relates to the life of the asset, not the cost of the asset purchased.

While certain accounting practices are required simply for ease of administration, **be aware of the actual rules**. Most agents are reasonable in their audits, but those who strictly follow the rules could require capitalization of small items.

Alternative minimum tax - The alternative minimum tax (AMT) affects more taxpayers every year; expect the IRS to confirm all are calculated properly.

AMT adjustments are required in areas of depreciation calculations, cost allocations and sometimes even the overall method of revenue recognition.

Look-back interest - Taxpayers using the percentage-of-completion method must generally apply the look-back method on completion of each contract.

In the taxable year a contract reaches completion, taxpayers should determine whether taxes paid each year of the contract were more than or less than what would have been paid if the *actual,* not the *estimated*, contract price and cost had been used to compute gross income.

This look-back computation does not result in an adjustment to tax; however, depending on the results of the computation, it may result in interest due to or from the taxpayer.

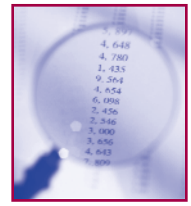
Some claim the IRS does not audit look-back calculations, but this will be a focus area in future audits. **Again, don't forget the AMT, which may apply in this calculation.**

Income issues - For large contractors, the IRS focuses on proper computation of income under the allowable method of accounting. One specific area of attention is the tax treatment of advance payments.

For smaller contractors, the IRS will focus on unreported income. The ATG suggests agents look at owners' lifestyles as a clue to any apparent underreporting of income.

Expense issues - Agents are instructed to look at various expense issues, such as:

- ✔ Deduction of per diems. Specifically, are taxpayers deducting 100% of the meal portion of per diems, though it should be limited to 50%?
- ✔ Depreciation of vehicles. Recent publicity has encouraged the IRS to ensure the proper depreciation is being deducted.
- ✔ Personal use of business assets. The **Construction Industry ATG** suggests agents look for personal use of business assets by sampling invoices for delivery to owners' addresses or by evaluating the supplies charged to a job.



- ✔ Charitable contributions of assets. Agents are instructed to scrutinize the intent of taxpayer donations and values.
- ✔ Losses on contracts in progress. While financial reporting (GAAP) requires contractors to recognize the full amount of any *anticipated* loss on a contract in progress, IRS rules do not permit this. Agents are instructed to evaluate the proper deduction for loss contracts.
- ✔ Related-party transactions. Agents are told to scrutinize transactions to ensure they're conducted at arm's length.

Evaluate internal controls - Agents are required to evaluate the existence and effectiveness of internal controls for all types of business returns.

To determine the appropriate audit techniques to use, IRS agents may evaluate internal control, even in the small business environment where owner/managers control the entire operation.

The type of business, its records and its owner's financial status will be considered when internal controls are evaluated. The weaker the internal controls, the more likely it is that agents will look for unreported income.

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New deduction for qualified production. . .

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- ✔ Permanent land improvements
- ✔ Infrastructure

However, tangible personal property sold as part of a construction project, *e.g.*, appliances, furniture and fixtures, generally does not qualify.

Land improvements like grading, landscaping and painting qualify only if they are performed in connection with one of the qualifying activities listed above.

Similarly, tangential services, *e.g.*, hauling of trash and debris and delivering of materials, do not qualify unless rendered by the taxpayer performing the qualifying construction.

Thus, construction industry contractors that provide a mix of repair services and those related to qualifying construction activities, such as landscaping, painting, electrical, plumbing, etc., will need to devise a method to identify and track qualifying revenue sources.

If you're engaged in construction activities, you may qualify for the deduction even if you don't own the property under construction.

Therefore, more than one taxpayer may be considered as engaging in constructing real property for the identical activity on the same construction project. This means a general contractor and subcontractors can all qualify for the deduction.

Real property lessors generally do not qualify for the new deduction.

Exclusion protested

One item of controversy involves the sale of land. Preliminary IRS guidance excludes the sale of land as a qualifying activity. Thus, for construction companies and land developers, the profit element on the sale of land does not qualify.

Various industry groups have protested this exclusion. The government will issue comprehensive regulations on this deduction, including this particular issue. Until then, we won't know how this controversy will be resolved.

As noted, engineering and architectural services generally qualify if they are rendered in connection with a construction qualifying activity.

For this purpose, engineering generally includes the application of special knowledge of mathematical, physical or engineering sciences to consultation, investigation, evaluation, planning, design or supervision of construction to ensure compliance with plans, specifications and designs. Architectural services include:

- ✔ Consultation
- ✔ Planning
- ✔ Aesthetic and structural design
- ✔ Preparing drawings and specifications
- ✔ Supervision of the construction to ensure compliance with plans, specifications and designs

The new deduction may be beneficial to you. Act now to identify qualifying income and allocable deductions. Consult your BKD advisor for help in determining if you qualify.❑

What IRS looks at. . .

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***Employee vs. independent contractor* -** While this may seem an age-old issue, the IRS will continue to focus on compliance in this area.

What you should know

Though ATGs were designed for IRS auditors, business owners can use them to their advantage and learn the key issues the IRS has identified for various industries and professions.

For the construction industry audit guide, go to **irs.gov/pub/irs-mssp/build.pdf**.

Advance knowledge of what can trigger an audit and what auditors are looking for can help you better comply with tax law.❑

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