



November 2006

# Blueprint

Building Profits for Construction & Real Estate



## 2006 tax law recap: some changes will affect owners & contractors

by Jerry Isaacs, [jisaacs@bkd.com](mailto:jisaacs@bkd.com)

While 2006 did not bring sweeping tax changes, two acts were signed into law, and there were other changes that could affect contractors and business owners. Following are 2006 tax law highlights:

### Enhanced Code Section 179 expensing extended

Under Internal Revenue Code (IRC) Section 179, a taxpayer generally may elect to deduct as an expense (rather than depreciate) up to \$108,000 (for 2006) of the amount of the cost of new or used tangible personal property placed in service during the tax year. Certain phase-outs apply to the expense.



This allowable expense was to drop to \$25,000 for property placed in service in tax years beginning after 2007. (Section 179 is still limited to \$25,000 for certain sport utility vehicles.) The new law extends the enhanced deduction through 2009.

### IRS updates per diem rates

The IRS has updated the simplified "high-low" per diem rates for business travel. The new rates are effective for lodging, meal and incidental expenses (M&IE) paid to reim-

burse employees for business travel costs on or after October 1, 2006.

Your business may pay a per diem amount to an employee for business travel instead of reimbursing actual, substantiated expenses. If the rate paid does not exceed IRS-approved maximums, and if certain substantiation requirements are met—time, place and business purpose—the reimbursement is not subject to income tax or payroll tax withholding.

IRS per diem amounts are based on rates paid by the federal government to its workers, which varies from one locale to another. Your business can use the location-based per diem rates, but it can also use the simplified high-low rates to reduce record-keeping costs. Under this method, there is one per diem rate for "high-cost" areas and another rate for all other areas.

Under the optional high-low method, post-September 30, 2006, business travel has a high-cost area per diem rate of \$246 (\$188 for lodging and \$58 for M&IE); the per diem rate for all other localities is \$148 (\$103 for lodging and \$45 for M&IE).

These rates are up from \$226 (\$168 for lodging and \$58 for M&IE) for high-cost localities and \$141 (\$96 for lodging and \$45 for M&IE) for other areas.

### Lower capital gain tax rates extended

A noncorporate taxpayer's adjusted net  
*continued on page 3*

## Year-end surety requirements

### How many chips to keep in play, how many to take off the table

by George Gabor, [ggabor@bkd.com](mailto:ggabor@bkd.com)

For many contractors, the lifeblood of their businesses is a bonding program. So, when the surety (bonding company) talks, contractors listen.

Even if your construction business does not need bonding, if you understand tried-and-true surety requirements, it will help you set financial goals and determine your company's optimal capital needs.

### Surety requirements

A contractor's total available bonding capacity or work program, *e.g.*, uncompleted

costs or revenue under contract, is determined through a combination of the following:

**Working capital** - Typically, the bonding company uses eight to 12 times the "adjusted" working capital to determine bonding capacity; however, some go as high as 20 times but only if overall cash flow supports it and the company has a good credit history with commensurate available credit facilities.

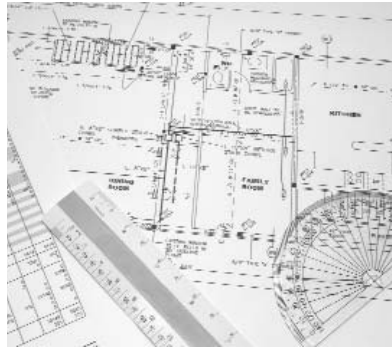
**Net equity** - After certain "adjustments," the bonding company will use eight (specialty contractors) to 20 (general contractors)

*continued on page 2*

## Inside

- 2 Interpreting the energy-efficient home credit
- 4 Avoid disaster with IPS blueprint

# Interpreting the energy-efficient home credit



by Patrick Malayter, pmalayter@bkd.com

**U**nder the *Energy Tax Incentives Act of 2005* (Energy Act), property may qualify for either the \$1,000 or \$2,000 credit if eligible contractors obtain certification that the dwelling units they construct are “energy-efficient.” Two recently issued Internal Revenue Service (IRS) bulletins explain how contractors may claim the new credit for energy-efficient homes.

## Year-end surety requirements. . .

*continued from page 1*

times the financial statement equity to determine bonding capacity.

**Debt-to-equity ratio** - For sureties to do business with you, your debt-to-equity ratio must generally be less than 3 to 1.

**Capability of management** - The stronger your management team, the higher your working capital or equity multiples tend to be.

### Surety “adjustments”

Sureties are very concerned the contractor has sufficient cash flows (liquidity) to handle

the work program, so, when evaluating a balance sheet, the liquidity of an asset or liability is important. Sometimes, adjustments are made to determine “adjusted” working capital or equity. The accompanying table shows common surety adjustments to balance-sheet amounts.

### Determining optimal capitalization

Generally speaking, general contractors require less capital as a percentage of work program (3 to 8%) than specialty contractors (8 to 12%).

In other words, if a general contractor wants a bondable work program of \$40 million, the optimal adjusted capital would need to be around \$2 million (5% of \$40 million).

On the other hand, a specialty contractor with a similar work program would need adjustment capital of approximately \$4 million (10% of \$40 million).

### Beware too much capital

Once you’ve computed the optimal capital for your company, you may be fortunate to have excess capital, prompting you to decide whether to keep the excess capital in the business or distribute it.

Construction is a very risky business with high failure rates: Not only can one major mistake on a large job wipe out your excess capital—but *all* of it. On the other hand, retaining excess capital can cause difficulty in transitioning ownership of the business.

It can also promote additional overhead expenses by way of extravagant administrative buildings, excess administrative staff, luxury vehicles, company planes, etc.

Finally, too much cash on hand (a by-product of excess capital) can attract theft, lax accounts receivable collection and other cash management problems. Why not consider distributing the excess capital and diversify your investments?

\* \* \*

Before making your final decision about whether to make distributions and diversify, make sure you consider and understand your work program, balance sheet and surety requirements. This, plus advice from your surety agent and BKD advisor, can help you decide how many chips to keep in play and how many to take off the table. ■

## Surety Adjustments

### Asset

Marketable securities

Accounts receivable

Inventory

Prepaid expenses

Notes receivable - officer

Intangible assets (Goodwill)

Deferred tax asset

Underbillings

Undeveloped land and other investments

### Liability

Subordinated notes payable - owner

### Surety Adjustment

Government bonds - no adjustment

Equity securities - 25% discount

Retainage - no adjustment

Ninety days or older, up to 100% discount or at least classify to long term

Up to 50% discount

Up to 100% discount

Up to 100% discount

Up to 100% discount

Up to 100% discount if it relates to net operating losses

Lots of questions/concerns - up to 100% discount

Up to 100% discount or at least classify as long term

Add up to 100%

## Qualifying for credit

The credit is available for all new homes, including manufactured homes, to the extent they meet all the following:

- ✓ The property is located in the U.S.
- ✓ The facility's construction is substantially completed after August 8, 2005
- ✓ The home meets specified energy-savings requirements
- ✓ The property is acquired from an eligible contractor after 2005 and before 2008 for use as a residence

To satisfy the energy-savings requirements, contractors must certify the home provides a heating/cooling energy consumption level of at least 30% to 50% for manufactured homes and 50% for all other homes below that of a comparable home constructed in accordance with standards of the **2004 Supplement to the 2003 International Energy Conservation Code**.

*Under the Energy Tax Incentives Act of 2005, property may qualify for either the \$1,000 or \$2,000 credit if eligible contractors obtain certification that the dwelling units they construct are "energy efficient."*

The property must also have building envelope component improvements that provide a heating/cooling energy consumption level of at least 10% below that of a comparable home. Manufactured homes can qualify for the credit by meeting the Energy Star standards.

The IRS notices provide that contractors must obtain the necessary home certification from an eligible certifier before claiming the credit. The certification does not need to be filed with their tax return but must be retained as part of the builder's books and records.

In addition to the certifier's contact data and the property's address, the certification must include:

- ✓ A statement by the certifier that (1) the dwelling unit has the requisite projected level of annual heating/cooling energy consumption below the needed annual consumption level of heating/cooling energy of a referenced dwelling unit in the same climate zone, (2) the building envelope component improvements alone account for a level of annual heating/cooling energy consumption at least 10% below the annual level of a referenced dwelling

and (3) the energy and cost savings have been calculated in a manner prescribed by Internal Revenue Bulletins (IRBs) 2006-27 and 2006-28, available at [www.irs.gov/irb/2006-11\\_IRB/ar12.html](http://www.irs.gov/irb/2006-11_IRB/ar12.html) and [www.irs.gov/irb/2006-11\\_IRB/ar13.html](http://www.irs.gov/irb/2006-11_IRB/ar13.html), respectively.

- ✓ A statement by the eligible certifier that field inspections of the property during construction and after completion confirm all features of the home related to heating/cooling energy consumption comply with the design specifications provided to the certifier (special rules apply for high-volume builders)
- ✓ A list identifying the home's energy-efficient building-envelope components

and their respective energy performance rating, including the energy-efficient heating/cooling equipment installed in the dwelling and the energy-efficient performance of the equipment

- ✓ Identification of the software program used to calculate energy consumption
- ✓ An appropriate declaration signed under the penalty of perjury by a person authorized to bind the eligible certifier in these matters

In the future, the IRS will create and maintain a public list of software programs that may be used to calculate energy consumption for purposes of providing the certification. ■

## 2006 tax law recap...

*continued from page 1*

capital gain is taxed at a maximum rate of 15% or (to the extent it would have been taxed at a 10% or 15% rate had it been ordinary income) at a maximum rate of 5% (0% for tax years beginning after 2007).

Generally speaking, adjusted net capital gain is net capital gain plus qualified dividend income. The preferential capital gain rates were set to expire at the end of 2008, but the new law extends them through 2010.

### Energy Act incentives

You may be able to take advantage of one or more new-for-2006 energy conservation tax incentives, including:

- ✓ Tax credits for the purchase of hybrid, fuel cell, advanced lean burn and other alternative-power vehicles placed in service after 2005
- ✓ 30% tax credit for the purchase of qualifying residential solar water heating, photovoltaic equipment and fuel-cell property placed in service in 2006 and 2007
- ✓ 10% personal tax credit for energy-efficient improvements to existing homes; the maximum lifetime credit per taxpayer is \$500 and applies for property placed in service in 2006 and 2007
- ✓ Business tax credit for contractors who construct energy-efficient new homes; the per-home credit is either \$2,000 or \$1,000 depending on the type of home and the energy reduction standard it meets; the

credit applies to homes with construction substantially completed after December 31, 2005, purchased after December 31, 2005, and before January 1, 2008

- ✓ Tax deduction for energy-efficient commercial buildings placed in service in 2006 and 2007 that meet a 50% energy reduction standard; the deduction, generally \$1.80 per square foot, is 60 cents per square foot in some cases (see "Interpreting the Energy-efficient Home Credit," pages 2 and 3).

### Be careful when donating vehicles

Be careful before you donate an automobile, boat or plane to charity. Special rules apply to limit your charitable deduction depending on how the vehicle is used by the charity. If the charity sells the vehicle without any significant intervening use or material improvement, your deduction generally can't exceed the gross proceeds from the charity's sale.

Though the charity is required to provide you with an acknowledgement indicating whether it intends to sell, use or improve the vehicle, you should still inquire.

\*\*\*

**As with any tax planning strategy, applying specific information to your situation requires careful consideration of all the facts and circumstances. Contact your BKD advisor before you act on any information published in this newsletter. ■**

# Avoid disaster with IPS blueprint



by Randy Saul, BKD Wealth Advisors,  
rsaul@bkd.com

For most business owners, investing in their businesses is the investment of choice. However, many owners have considerable assets invested in their companies, including personal retirement accounts, making it important to their financial well being to avoid the following five investment mistakes:

**Lacking an overall plan** - Business owners are pressed for time and sometimes make decisions on the run. The 1990s allowed most investors to make money in spite of having little or no plan, but now we find ourselves in a new era with new challenges.

Setting basic investment objectives that take into account risk tolerance and investment horizon is essential to meeting financial objectives. Developing a personal investment policy statement (IPS) helps provide a blueprint for your financial future.

**Lacking diversification** - Diversification means different things to different people. Because many business owners own numerous mutual funds and often have multiple investment accounts, the theory is if one account is good, four or five are better.

However, the various accounts often hold many of the same types of investments, causing overall portfolio diversification to be less than optimal. The investment industry hasn't made diversification easy, but, with a little research to make sure you cover the basic asset classes, producing at least average results while reducing your risk should be achievable.

**Timing the market** - Although there have been many individuals who have tried to time the market, no one has consistently succeeded. The problem is obvious: To be a successful market timer, you have to be right twice—when getting out and getting back in.

Most who attempt this strategy end up selling low and buying high. Over time, a more effective investment strategy is to determine the right mix of stocks, bonds and other asset classes that results in a risk profile you can live with—in both good and bad markets—and then stick with it.

**Unrealistic expectations** - One of the most commonly misunderstood facts in investing relates to the return stream of stocks. A good example of this phenomenon comes from the period between 1926 and 2001, when common stocks had an average annual 10.7% compounded rate of return.

The problem with this number is there are very few years during that period when the return was actually 10.7%. Stocks are a risky asset class, and the return stream can be volatile. Investors often form return expectations based on their most recent experiences, which is not often the best indicator of forward returns.

To have financial success, it is very important to set realistic expectations that consider historical return trends, as well as the current market environment and valuation levels. An experienced investment advisor can help you set reasonable expectations.

## Look at your portfolio as a whole -

Business owners wear many hats and, as such, find themselves with many pockets of investments. Failing to coordinate investments can lead to overlap, concentration and unnecessary risk.

If you take time to verify your actual asset allocations, you may be able to increase your potential return and reduce risk. Leading behavioral finance author Daniel Kahneman said it best: "Investing isn't about beating others at their game. It's about controlling *yourself* at your game."

You can avoid these five serious mistakes. Designing an IPS can help you make investments that are far less likely to crack your company's financial foundation. Just like the plans you follow to run your business every day, an IPS or financial blueprint can provide a base for constructing investment strategies for building your business. ■

## About BKD Advisor

This newsletter's content is written by qualified, experienced BKD client service professionals; however, to apply specific information to your situation requires careful consideration of all the facts and circumstances. **Consult your BKD advisor before acting on any matter covered in this newsletter.**

To change your mailing information, e-mail your instructions to [newsletters@bkd.com](mailto:newsletters@bkd.com) and include the code that appears above your name on the mailing label. To add your name to our mailing list, contact a sales & marketing specialist at the BKD office nearest you. To inquire about information in this newsletter, contact your BKD advisor.

**bkd.com** E-subscribe to *Blueprint* by following the simple online sign-up instructions at [bkd.com/enews/](http://bkd.com/enews/). BKD will never sell your e-mail address and other personal information to vendors or share it with anyone outside BKD.


© BKD, LLP. All rights reserved.



CPAs & Advisors

P.O. Box 1900  
Springfield, MO 65801-1900

For a complete list of our offices and subsidiaries and their contacts, visit [bkd.com](http://bkd.com) or contact the sales & marketing specialist at the BKD office nearest you.

An independent member  
of Moores Rowland  
International 

PRESRT STD  
US POSTAGE PAID  
SPRINGFIELD, MO  
PERMIT #801

Address Service Requested