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# Blueprint

Building Profits for Construction & Real Estate



## Credit available but only for those who make a strong case

by Don Wengler, [dwengler@bkd.com](mailto:dwengler@bkd.com)

As the subprime mortgage crisis unfolds, demand for residential housing continues to fall, while more homes become available as borrowers with variable-rate mortgages discover they can no longer afford their increasing monthly payments. At the same time, from the record highs of 2005 until now, government statistics show declines throughout the nation in housing starts and building permits.

### Credit crunch creates perfect economic storm

The impact of the subprime mortgage crisis on residential housing developers is twofold: The decline in demand for new housing development creates uncertainty for current business prospects, and the availability of funds for lending—both generally and for the housing sector specifically—has become more restricted.

For developers, the uncertainty about the length and severity of the subprime mortgage crisis exacerbates the current credit crunch. While its initial impact hit Main Street, the crisis now spills over to Wall Street, because local lenders sell off mortgages, which are then packaged into mortgage-backed securities by investment banks and financial institutions. Proceeds from investors in these securities flow back to the bank that originated the mortgage, making new



funds available for additional lending.

Currently, numerous investment banks and financial institutions are under multiple investigations by the Federal Bureau of Investigation, the Securities and Exchange Commission, state attorneys general and various U.S. attorneys. Every institution involved in the origination, sale, securitization and resale of mortgage loans and instruments is second-guessing whether it has conducted business appropriately, and many questions remain open:

- ✓ Were borrowers misled?
- ✓ Did we recruit unqualified borrowers?
- ✓ Were investors misled?
- ✓ What are the mortgage securities worth today?

The questions posed in today's financial markets threaten the flow of mortgage funds to individuals in local markets and threaten the availability and terms on residential construction and other loans to commercial borrowers.

### Proven track record speaks for itself

Most of a bank's profits come from lending—not investments or fee income. Even now, banks need quality customers to whom they can make sensible loans. Though credit does not flow as freely today, and though loan terms are not as

favorable as they were in the recent past, developers and other businesses that have a proven use for funds can obtain loans.

The companies with a proven track record that are better able to communicate their use for and ability to repay loans will still receive attention and funding from lenders. In the competition for funds, stable companies will squeeze out those with a blemished history or those which are involved in high-risk projects.

Needs vary among companies, but BKD can help in a number of ways:

- ✓ Feasibility studies can help the lender understand your company's project and its potential for both risk and return
- ✓ A due diligence investigation can help the lender understand the nature of your investment in a proposed project or deal and the level of homework you did before deciding to invest
- ✓ Even troubled companies with existing loans can benefit from assistance in accounting, not only to identify a problem but to communicate to the lender a plan for resolving it and the time it may require

If credit is crunching your company, contact your BKD advisor for an introduction to members of the BKD team who can help you with your particular situation. ■

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# ESOPs: no longer considered a business fable

by Alan Taylor, ataylor@bkd.com

While this wasn't always the case, today it seems most private companies have some awareness of employee stock ownership plans (ESOPs) and some of the benefits of using them as part of a succession plan. Further, of the various alternatives owners have when it comes time to transfer ownership, it seems a growing number are ultimately selecting ESOPs from the succession tool chest.



In terms of succession, an ESOP is similar to a leveraged management buy-out, with some enhanced tax benefits and broader employee ownership. Most ESOP transactions involve the ESOP borrowing money (a leveraged ESOP) to acquire some or all of the company stock.

This article will explore some of the benefits of ESOPs and reasons owners ultimately choose ESOPs to address succession.

But first, a couple of caveats. ESOPs are not for everyone and every company. It is important for owners of privately held businesses to thoroughly explore all their options before making one of the most important decisions of their lives. Also, in every ESOP transaction, the owners' motivations are unique. The key is to determine what is important to you and your business and to mold the ESOP transaction or other succession strategy around your goals and objectives.

## Ensuring continuity

Preserving company legacy seems to be the number one reason owners select ESOPs to address succession. If not at the top of the list, company legacy needs to be near the top for an ESOP to be considered.

For a lot of privately held companies, the owners are also the founders and as a result have seen an idea bloom into a successful and well-known company with

hundreds if not thousands of employees who have contributed to its success. As a result, there is often a strong emotional attachment to the business and its employees. The thought of selling to an outsider creates questions and concerns about the future of the company and its employees. Will the new owners change the name on the sign? Will they terminate some of the most loyal employees?

An ESOP can provide owners with liquidity while preserving the company's management and operating structure. Owners can sell 100 percent of their stock to an ESOP while maintaining control of the company, and ultimately select the management team to succeed them. From an operational and management standpoint, an ESOP can be a nearly seamless succession alternative.

## Stockholder benefits

An ESOP can provide a market for owners to sell their company in a tax-advantaged or tax-free manner.

An ESOP transaction involves the purchase of stock, which is generally the tax-preferred method for a seller, versus selling company assets. Also, the tax law contains a provision that could potentially allow an owner to sell his or her stock tax deferred or tax free.

A tax-deferred or tax-free sell has certain requirements. One is that the selling stockholder must reinvest in qualified replacement property (QRP) within 12 months from the sale date.

QRP is commonly defined as stocks or bonds of domestic operating companies. The tax basis in the stock sold carries over to the QRP. The deferred tax is realized when the QRP is sold; however, the QRP will receive a step-up in tax basis if held until death, which results in a complete avoidance of income tax.

Outside the scope of this discussion, QRP strategies exist that help preserve the tax deferral while freeing up most of

the sale proceeds to invest or use at the stockholder's discretion.

## Company tax benefits

Because of certain tax benefits available to the company, the purchase by the ESOP is essentially funded with pre-tax dollars. One advantage with leveraged ESOPs is that principal borrowed by the ESOP to purchase company stock is tax deductible.

Further, an S corporation's earnings attributable to an ESOP are exempt from federal and state income taxes (except in states that do not recognize S corporation status).

Companies that are 100 percent ESOP-owned and taxed as an S corporation are free from federal and state income tax regardless of profitability. Many companies have been tremendously successful as a result of this tax structure by paying off the ESOP debt more quickly than otherwise possible and building the company on a pre-tax basis.

## How employees benefit

ESOPs can provide long-term employees retirement security. Generally, in order to participate, employees must be 21 years old and have worked for the company at least one year.

Stock is allocated annually to eligible employees based on that employee's compensation relative to the company's total payroll. For example, an employee with a \$50,000 salary will receive twice as many shares as one making \$25,000. It is important to note that stock is only being allocated on employees' behalf, and that they are not legally receiving "shares" of stock. The legal stockholder is the ESOP trust. Employees are beneficial owners only with regard to the value of the stock in their participant accounts.

Employees must earn the right to receive the assets in their account when they are no longer company employees. This right, known as "vesting," usually takes from three to six years. Further, once they leave and are vested, there are special rules regarding when they are entitled to receive a distribution of their account balance. First, it is important to note that most ESOPs require the partici-

# but a viable option for succession planning

pany to receive a distribution of cash, not stock. Second, when involving shares of stock acquired with money borrowed by the ESOP, terminated participants are not eligible to receive a cash distribution of their account until the ESOP loan is fully repaid. This preserves operating cash flow in the early years to repay debt versus paying out terminated participants.

Through proper communication, employees can learn how their efforts can have a positive effect on the company's financial performance and, ultimately, on the value of their participant accounts.

According to various studies, employee ownership typically results in higher employee productivity and higher profitability.

## Is an ESOP right for your company?

ESOPs are inherently complex and subject to regulatory oversight. However, careful consideration and planning with the help of qualified ESOP advisors can produce a succession plan with more advantages than traditional alternatives. ■

## Completed contract method benefits home builders: lot developers may not qualify

by Jeff Wilmes, jwilmes@bkd.com

**W**hen it comes to figuring taxable income, home builders may have a better option than the percentage of completion method (PCM).

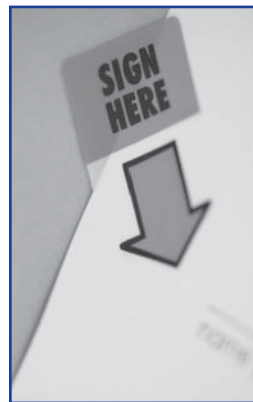
While the Internal Revenue Service (IRS) and related regulations have generally required taxpayers engaged in long-term contracts to use the PCM, contractors building homes have an option to choose the completed contract method (CCM).

Home building contractors might prefer the CCM because it lets them wait until a contract is considered complete before paying income tax on it. With PCM, on the other hand, it's a kind of "pay as you go" method; contractors pay income tax proportionately as they incur costs over the contract's life.

Not every construction contract relating to home building will be eligible to use the CCM, however. And the rules and regulations regarding lot developers are still somewhat unclear and are under review by the IRS.

### Rules for home construction contracts

In order to use the CCM, a home construction contract must first meet an IRS Code definition. In general, the Code defines a home construction contract as having 80 percent or more of the estimated total contract costs coming from building, rehabilitating, installing or improving real estate used for housing. This



is as of the close of the tax year when the contract was entered. The housing should be contained in buildings with four or fewer dwelling units and improvements should

be made to the real property directly related to and located on the site of such dwelling units.

Subcontractors can use the CCM, too, if they are making infrastructure improvements—roads, sewers, etc.—for the contractor building dwelling units. The IRS indicated this in a Non-docketed Significant Advice Review (NSAR 020006) issued in 2002.

### Lot developers and the CCM

If, however, a subcontractor is building infrastructure for a contractor that will sell the improved lots but not build dwelling units, then the IRS does not consider the subcontractor to be part of a home construction contract and will not permit the subcontractor to use the CCM.

In a Technical Advice Memorandum (TAM) issued Dec. 30, 2005, the IRS concluded that only taxpayers (and their subcontractors) who actually build dwelling units can use the CCM under the home construction contract exception. Lot de-

velopers who simply sold improved lots to home builders but did not build housing were not entitled to use the CCM.

In 2005 the Construction Financial Management Association and Associated Builders and Contractors Inc. asked the IRS for a clarification of the definition of a home construction contract. In response to this request, in August 2005 the IRS announced that the Industry Issue Resolution (IIR) program would address the issue of defining a home construction contract. The IIR program is designed to provide clarity and consistency to complex tax issues so that those issues do not become contested issues during tax examinations. As of the date of this writing, the IIR program had yet to address the issue.

In March 2007 the IRS issued an Industry Director Directive (IDD) to give IRS field auditors of large and mid-sized contractors some direction while working with these taxpayers. The IDD instructs field auditors to be on the lookout for the improper use of the CCM by land developers who are not building dwelling units and the improper use of the CCM by subcontractors to those land developers. The IDD acknowledges that an IIR team is working on the definition of a "home construction contract."

Although a reading of the legislative history relating to this issue might seem to suggest otherwise, the IRS's position is that the Code is clear and the lot developer and its subcontractors are not

*continued in page 4*

## Completed contract method of accounting benefits . . .

*continued from page 3*

considered to be performing home construction contracts unless they are also building dwelling units and hence can't use the CCM.

The IRS's position may change when, and if, it issues a clarification under its

IIR Program. In the meantime, lot developers who improve and sell lots but do not build dwelling units should be prepared to face a challenge from the IRS if they choose to use the CCM. Given the views expressed by the IRS in TAM 200552012 and its 2007 IDD, the only

choice may be to litigate the issue if the IRS challenges it.

If you have concerns or questions regarding this issue, please contact your BKD advisor to discuss your specific facts and circumstances. ■

## Out & About

by Gary Bennett, [gbennett@bkd.com](mailto:gbennett@bkd.com)

**Event:** Executive Officers Council Seminar

**Date:** August 5-8, 2008

**Location:** Providence, Rhode Island

**Speaker & Topic:** Angela Morelock, Certified Forensic Accountant, BKD Partner, Forensics & Dispute Consulting, will speak to the executive officers of state and local home building associations on fraud prevention and investigations.

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