

contractor

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Smith & Gesteland_{LLP}

Certified Public Accountants & Business Consultants

Not The Same Old Bottom Line

8383 Greenway Blvd., Suite 400 • PO Box 1764 • Madison, WI 53701-1764

Phone 608.836.7500 • Fax 608.836.7505

mail@sgcpa.com • www.sgcpa.com

Coverage costs leave contractors puzzled

Is captive insurance the answer?

The construction business may not be any riskier now than it's been in the past, but it's sure hard to tell that from the rising cost of insurance.

Like many contractors, you've probably watched the price of your coverage soar in recent years, and you're trying to figure out how to cope. The situation can indeed be puzzling.

Some insurers have pulled out of construction altogether. Others are consolidating, leaving you with fewer and fewer options. When you can find insurance, you're likely paying more for it. There are several reasons for this, including an increase in construction-related claims for problems such as mold and recent catastrophic claims from disasters such as Hurricane Katrina.

THE MANY FACES OF CAPTIVE INSURANCE COMPANIES

There are many types of captive insurance companies. Some are more appropriate than others for specific businesses, so it helps to understand your options. They are:

Single-parent captives. These underwrite only the risks of related group companies, meaning you couldn't choose to partner with, for example, a building supply company to form one. You would be able to partner with only other construction businesses.

Rent-a-captives. Here the rented company provides captive services without requiring you to help capitalize them. You pay a fee to use the captive and provide some sort of collateral to protect the rent-a-captive against any losses you may experience.

Association captives. This type is owned by a trade organization to benefit its members.

Group captives. As discussed in the main article, these are jointly owned by several companies to meet common insurance needs and can include nonrelated group businesses, such as the building supply company cited above.

As valid as these reasons may be, they can't help you control your costs. That's why many contractors are pondering whether the answer to the puzzle lies in captive insurance.

BANDING TOGETHER

Under a captive insurance arrangement, a group of contractors form their own insurance company, which then finances the risk for owners and participants. The advantages of doing so include:

- Lower costs, because premiums more accurately reflect the contractors' cumulative loss experience,
- Better claims management, because the cumbersome bureaucracy inherent to many commercial insurers is eliminated,
- Improved cash flow, due to reduced premiums and from income earned off of the captive's investments, and
- Expanded coverage, because the captive participants can choose to include industry-specific concerns (such as mold) that commercial insurance companies are often reluctant to cover.

Captives also may be viewed as profit centers in the sense that, if they make money, they're doing so on behalf of the contractors who own them. In addition, captives usually retain only a portion of the overall risk and reinsure the remainder.

With a captive, you're building investment income that will eventually come back to you if losses aren't extreme.

When claims are fewer than expected, the captive keeps the excess of net premiums over claims. Conversely, when claims are higher than expected, the reinsurance is designed to minimize the group's exposure.

MINIMIZING RISK

A single construction company can form its own captive, but you may realize greater benefits — and carry less risk — if you partner with other contractors

to gain economies of scale through a group captive. Try to keep your captive small enough to remain manageable, however.

One thing to keep in mind is that your upfront costs won't represent your actual costs. About 60 cents of every dollar you spend on insurance is set aside to cover potential losses. The other 40 cents goes to overhead and operations.

If it isn't used, the 60 cents per dollar earmarked for losses is invested. This means you're building investment income that will eventually come back to you if losses aren't extreme. Thus, the captive's losses determine your actual cost.

PICKING YOUR PARTNERS

Because of the way captives are set up, it's critical to pick the right partners. Whether you intend to join an existing group or partner with other contractors to form a new captive, work with your CPA, attorney and an insurance consultant specializing in captives.

These advisors can help you analyze your potential partners' recent loss history, safety programs, financial stability and other relevant factors. They may also advise you on where to form your captive. For example, you may form one in several states and the District of Columbia, or you may find that an offshore domicile, such as the British Virgin Islands or Bahamas, offers key tax advantages.

WEIGHING THE DRAWBACKS


While you're weighing the advantages of joining a captive, you must also weigh the potential drawbacks. One is the amount of risk you're asked to shoulder.

The size of your initial investment will depend on how your captive is structured and where it's domiciled. (Requirements vary by jurisdiction.) You may be able to control these factors somewhat, but you can't control the volatility of the reinsurance market.

You also should be prepared for some increased administrative responsibilities and a steep learning curve if you and your partners choose to run the captive yourselves. If you prefer to hire a management company to run the captive, as most captives do, you'll probably have to offset the cost with higher premiums.

MAKING THE COMMITMENT

As you can see, there's a good deal of time and money involved in forming a captive, and you should regard it as a long-term commitment. That said, it's important to also devise an exit strategy: Know in advance how the captive will be dissolved if member companies so desire, as well as how you can withdraw if your circumstances change.

If your construction company is financially solid, your safety record is good, and you can afford to take on some additional risk, a captive may be a way to control your insurance costs. Just be sure you know what you're getting into. 



Playing the match game

How to find the right business partner

There are a number of reasons a contractor might consider taking on a long-term business partner (as opposed to undertaking a short-term joint venture). You may want to spread out your risk on the types of projects you specialize in, build the leverage to take on bigger jobs or boost your bonding capacity.

Whatever your reason, playing the match game is never easy, so you need to know what you're looking for when you start.

WHO IS IT?

Decide what kind of partnership is best for you. Do you want an active partner who's involved in day-to-day operations or a passive partner who will supply financial or marketing muscle without getting near a construction site? Do you just want financial backing or could you use some strategic planning assistance, too?

Only after answering questions such as those can you embark on your search. And as you do, remember that your potential partner's financial or business strengths aren't enough. You also want a partner who's known for integrity, a working relationship that can ride out the rough spots and values that are consistent with yours.

WHERE DO YOU GO?

To find the right candidates, ask people you trust: your accountant, attorney, banker and those in your personal construction business network (architects, engineers, city planners, and so forth). When you have a list of possibilities, hold exploratory meetings to gauge the



extent of their interest, their ability to help you form strategic alliances, their experience in collaborative working relationships, and their tolerance for risk.

You also must determine whether potential partners will be candid about their capabilities and limitations, as well as whether you have similar business objectives and approaches. If you need quick turnarounds or decisive responses, for instance, ask how they typically make decisions.

HOW WILL IT WORK?

Once you've decided on a partner, you'll need to establish whether you have competitive overlaps and how you'll handle them. You'll also need to decide how to handle disagreements, whether someone should be clearly identified as "the boss," and how to structure the partnership.

Determine whether potential partners will be candid about their capabilities and limitations, as well as whether you have similar business objectives and approaches.

One problem that arises all too often is that partners disagree on how the business should grow. You may, for instance, envision building houses until the day you die while your partner may see high-rises or big-box retail projects in the future.

Regardless of your eventual growth strategies, be sure to develop and agree on a plan for ending the relationship. Few things are certain in the construction business, but even the best partnerships will end sooner or later.

When they do, you or your successors will be much happier if you've established how to make the ending as painless as possible. Develop a strategy that covers when the partnership may be dissolved and how assets will be divided, so you can avoid expensive, lengthy court battles.

IS THE TIMING RIGHT?

You may benefit from taking on a business partner, but the timing has to be right for both parties. And the only way to determine that is if both parties communicate thoroughly and honestly. 🗨️

Weakened states: The plague of presenteeism

There's little doubt that absenteeism can take its toll on any construction company's productivity. But employees who *come in* to work when they aren't feeling well — a phenomenon known as "presenteeism" — may pose an even greater risk.

In fact, presenteeism may account for up to 60% of employer health costs, according to a 2004 study by the Cornell University Institute for Health and Productivity Studies. For more common conditions, such as allergies and headaches, the percentage may be even higher.

Why? Because illness leaves employees in weakened states, threatening any number of follies.

COSTLY SLOWDOWNS

Consider a carpenter who can typically frame a window in an hour. If he or she has a cold or the flu, the same task could take much longer to complete. Worse yet, other workers on the job may catch the carpenter's illness and then become less productive themselves.

That can be costly for any employer, but, as a contractor, you may pay an even higher price. Construction is a high-risk undertaking under even the best conditions. Workers who are fighting illness or injury may have slower reflexes, diminished decision-making skills and a lack of concentration that make errors and accidents more likely.

The problem is convincing workers who don't feel well to stay home. After all, it's hard when workers don't have paid sick days. For others, all paid time off — including sick days, vacation days and personal days — is lumped together. So the more sick days they take, the fewer vacation days they get.

Exacerbating the problem is the long-standing but unhealthy view that employees who come to work when they don't feel well are somehow more dedicated or more important than those who call in sick. By the same token, some workers may fear they'll be fired or disciplined for missing work.

CARROTS, NOT STICKS

So how do you get sick workers to stay home? Start by reviewing your disciplinary policies. If you penalize employees to control absenteeism, you may unwittingly be encouraging presenteeism. Instead, consider advising



managers and supervisors to send workers home — with a kind word of reassurance — if they report to work sick.

In addition, develop a wellness program that includes a presenteeism policy that educates workers not only about the costs of this problem, but also about when it's appropriate for them to stay home. People who have fevers or vomiting, for example, should stay home until they have been symptom-free for 24 hours.

Emphasize the safety risks associated with presenteeism, too. Someone who is taking an over-the-counter flu medication to stay on the job, for instance, could jeopardize other workers' safety if he or she operates heavy equipment.

(If you're a union contractor, you'll need to consider these issues with your unions, perhaps during collective bargaining negotiations.)

PREVENTION = PROFIT

As the cliché goes, prevention is the best medicine for presenteeism. Of course employees are going to get ill at some point — but if you want to meet your productivity and profit goals, encourage them to stay at home when they are. 💧

Tax tips for contractors

Like-kind exchanges offer big savings (but complex rules)

When you're ready to trade in a piece of heavy equipment for a newer model, don't just sell it outright or arrange a trade-in with your local dealer. Instead, consider using a like-kind exchange to defer gain without decreasing your basis for depreciation.

Under Internal Revenue Code Section 1031, you can swap unwanted property for property of the same nature — and defer gain until you ultimately sell something outright. Although the rules governing like-kind exchanges are complex, they offer the potential for big tax savings.

ABIDE BY THE REQUIREMENTS

All like-kind exchanges must meet these general requirements:

- The properties exchanged must be like-kind (real estate for real estate or equipment for equipment, for example).
- There must be an actual exchange, rather than a sale (though cash can change hands).
- The properties must be used in business or held for investment, but can't be inventory.
- The exchange must be completed within specified timeframes, as explained below.

Like-kind exchanges can involve more than two parties and are allowed for both real and personal property as long as the property is business-related. The property doesn't even have to exist at the time of the exchange — as could be the case in real estate or construction exchanges.

KNOW YOUR LIMITS

You have less wiggle room on the timing, however. You aren't required to exchange property simultaneously, but there are strict timeframes for completion of the trade.

The first is that you must identify the property you'll receive within 45 days after you close on the property you're trading. Thus, if you're trading your office building for newer, more convenient facilities, you have 45 days to designate in writing where your new quarters will be.

This provision was enacted in the aftermath of the *Starker* case of the 1970s, in which property was relinquished in exchange for property that was to be identified within five years. The court concluded that like-kind exchanges don't



have to be simultaneous, but legislators acted to put limits on their durations.

The second timing requirement for delayed exchanges involves your receipt of your chosen replacement property. Replacement property must be in your possession either within 180 days after you transfer your original property or by the time the relinquishing party's tax return is due for the taxable year — whichever is earlier.

If you receive the property 160 days after the transfer date, for example, but five days after the relinquishing party's taxes were due, you can't consider the transaction a like-kind exchange. If it's impossible to complete the exchange before the tax due date, the relinquishing party can request an automatic extension. But you still can't go beyond 180 days in finishing the exchange.

MIND THE "BOOT"

In some cases, you may have to include some non-like-kind property in a like-kind exchange. For

example, say you want to get a new pickup truck. You can pay the dealer some cash for a new one without losing the tax benefits of the like-kind exchange.

To do so, however, rather than trading your truck in on a new model, you'd have to sell your old truck to the dealer for its trade-in value and then buy your new truck from the same dealer. Because the sale and purchase are reciprocal and mutually dependent, you can treat the transaction as a like-kind exchange.

In such cases, the cash is called "boot," and the recipient must recognize it as gain. Similarly, if any property you

receive has assets (such as fixtures and equipment) that the property you trade doesn't have, you may have to recognize gain on those assets.

GET SOME HELP

Undertaken properly, a like-kind exchange can save you substantial tax dollars. But, as you can probably tell, the rules governing these arrangements are detailed and complicated. To avoid ugly surprises, discuss any potential exchange with your CPA before you enter into the transaction. Also consider involving a qualified intermediary in some exchanges. ♦

Construction Success Story

BIM adds vim to one contractor's project management capabilities

A general contractor in a fast-growing region finally got the break she was waiting for. Her company won its first high-profile construction contract: a convention center in her city's most visible area.

After the initial elation wore off, she rushed to her financial advisor's office to discuss the dollars and cents of the deal. Their conversation soon turned toward project management. To keep the job on schedule and on budget, she'd have to coordinate many subcontractors, architects, engineers and other parties.

Her financial advisor mentioned that he had recently been researching the potential cost advantages of building information modeling (BIM). This computerized modeling system covers every facet of a building project, from CAD drawings to work schedules and manufacturer recommendations for building components.

In addition to generating specifications and drawings, BIM allows everyone on a project to access the same updates, changes and other information in the same place. BIM also operates continuously, so it shows not only how physical components look (3-D), but also when each facet of a structure will be built (4-D) and how much each component will cost (5-D). Plus, BIM can detect conflicts in building design and alert team members with detailed computer visualizations of each part in relation to the total project.

Although BIM promises some significant competitive advantages in terms of project management, it is still in its infancy. Thus far, there isn't even universal agreement on its name, with terms such as "virtual building environment" and "integrated practice" being bandied about.

Moreover, like any new technology, BIM software will likely exact a steep learning curve, which the contractor's company would have to navigate quickly. Any subcontractors involved would also have to get on board, an issue that would need to be addressed during the bidding process.

And then there's the initial cost: BIM systems generally run around \$5,000 initially, though the actual price will vary depending on the system's specific features (add-ons, modules), any support offered and training costs.

For this contractor, BIM turned out to be the right move. Aside from a few implementation glitches, the system worked like it should. The convention center went up on time and *under* budget and, suddenly, the general contractor found her company's profile had risen to remarkable new heights.

The expertise you need, the service you want.

At Smith & Gesteland, LLP we know that running a successful construction company these days requires more than just dedication and hard work. It takes the assistance of experts who understand the industry and the challenges contractors face, and who have the specialized knowledge, hands-on experience and service commitment it takes to help them achieve their business goals.

Our Construction Industry Services Group consists of experienced professionals focused on increasing the success of companies like yours. For more than 50 years, our firm has served individuals and businesses throughout south central Wisconsin. We are delighted to currently work with more than 100 contractors and to have recently been voted Madison's Number 1 accounting firm. We are ready to assist you with a broad range of services tailored specifically to your needs, including:

- Profitability improvement
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- Lease vs. purchase analyses
- Tax reduction strategies
- Business valuations
- Succession and estate planning
- Financing assistance / growth management
- Project management and accounting systems
- Litigation and claims support

As specialists in the construction industry, Smith & Gesteland has developed the expertise needed to help contractors address and meet their many challenges. We would welcome the opportunity to help you build your success.

To find out what we can do for you, or for more information about the ideas presented in this newsletter, please contact John Folsom or Steve Pullara at (608) 836-7500 or mail@sgcpa.com. We look forward to talking with you.

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