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Ensuring a successful succession

3 key methods to transfer ownership

A good succession plan is a necessity for every construction company. And among the most important parts of any viable succession plan is precisely how to transfer ownership to both provide the departing owner with funds for retirement (or for another purpose) and ensure that the business continues to thrive. Here are three common methods to consider.

1. SELLING YOUR STAKE

By selling your ownership interest, you remove its potential future appreciation from your estate and receive income either in the form of a lump sum that you can invest or periodic payments on an installment note.

Sometimes, a sale may be structured to take advantage of lower long-term capital gains rates and creative financing can be used to help the next generation to make the purchase.

Often, however, the tax impact or a lack of liquidity on the part of the buyer makes a “straight sale” unappealing and makes it worthwhile to consider another method for transferring ownership.



2. GIVING IT AWAY

If your succession plan involves family members, annual exclusion gifts are another option. You can gift \$12,000 per recipient per year free of gift tax (\$24,000 if you split gifts with your spouse) and without using up any of your \$1 million lifetime gift tax exemption.

Annual exclusion gifting also can help preserve your estate tax exemption (the amount you may pass estate-tax free at death) — \$2 million for those dying in 2006 or 2007. Why? Because the exemption available at death is effectively reduced by the amount of taxable gifts you make during life, but not by annual exclusion gifts.

Trusts often provide the most appropriate means for transferring a business.

Nonetheless, there’s nothing wrong with using some or all of your \$1 million gift tax exemption — especially if you’re getting a potentially rapidly appreciating asset out of your estate.

You may be able to further leverage the gifts with valuation discounts. For instance, you may be able to claim that the gift of a minority interest is worth less than its share of the underlying value of the assets, thereby allowing you to transfer a larger proportionate interest tax-free. But discounts also may trigger IRS scrutiny as to whether they are too big — or warranted at all.

Another potential disadvantage is that, using annual gift exclusions, you’ll likely need many years to transfer an entire business. Thus, many business owners use annual gifting only in conjunction with other methods.

3. MAKING A “PARTIAL” GIFT

Trusts can often provide the most appropriate means for transferring a business. In succession planning, one common vehicle is the grantor retained annuity trust (GRAT).

A GRAT is an irrevocable trust that can be funded with your construction company stock and from which you receive an annuity (calculated using the IRS’s Section 7520 rates) for a term of years.

Funding a GRAT does create a taxable gift (and possible use of your lifetime exemption) to the extent that the value of the assets contributed exceeds the current value of the annuity payments due back to you.

The tax leverage of a GRAT comes in two ways:

1. You gain tax leverage if an appraisal on funding supports a discounted value of the stock, allowing you to transfer more shares at the same gift tax price.
2. Fewer and fewer shares of stock are needed to be paid back to the grantor to fund the annual annuity payments to the extent the company stock appreciates at an annual rate greater than the Sec. 7520 rate.

The fewer the shares needed to fund the annuity, the more shares will be left in the trust to pass free of estate tax to the GRAT's beneficiaries. If you die before the expiration of the term, however, the entire GRAT is pulled back into your estate, thereby nullifying its tax advantages.

DON'T FAIL TO PLAN

Failing to create a succession plan could trigger a tragic financial and strategic failure when it comes time to pass your construction company on to the next generation. And even if you're not considering retirement anytime soon, you still need a succession plan in case an unexpected event takes you away from the business. 💎

Bankruptcy update

How is BAPCPA affecting contractors?

A little over a year ago, the federal government addressed the issue of insolvency when it passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Now that the dust has begun to settle, we can see a little more clearly what has changed for contractors doing business with companies that have filed for Chapter 11. Let's take a look.

RECLAIMING GOODS

If you deliver materials or equipment to a job site for a business that subsequently declares bankruptcy, the timetable regulating the reclamation of goods has expanded.

You may reclaim items that were delivered to the job site as far back as 45 days before the bankruptcy filing — a much larger window than the 10 days previously allowed. To reclaim them, however, you must provide written notice of your intent within a 20-day period following the filing date.

GETTING OR KEEPING PAYMENTS

If you deliver items within the 20-day period before the filing of the bankruptcy case, and if you deliver them in the ordinary course of business, you are entitled to an administrative claim under BAPCPA. This means immediate payment from the debtor.



On the other hand, the trustee in charge of the bankrupt business may look to recoup payments the business made to you for materials you've delivered or for labor you've performed. In that case, BAPCPA makes your argument to keep the funds less complicated — at least when it comes to materials delivered.

As a contractor that has received payment within the 90-day period before the debtor filed for bankruptcy (called a defendant in a preference action), you now need to establish that the exchange occurred *either*:

1. "... in the ordinary course of business," or
2. "... according to ordinary business terms."

In the past, you needed to establish *both* elements of the test to protect against having to return the payment.

Thus, if you ordinarily extend credit to your customers, including the debtor, and if they have historically paid you

ANOTHER LAW TO CONSIDER: THE PENSION PROTECTION ACT OF 2006

Along with recent changes to the bankruptcy code (see main article), rules regarding the administration of employee retirement plans have also undergone some legislative revision. Here are some highlights of the Pension Protection Act of 2006:

Participation promoted. Employees can now be automatically enrolled in a 401(k) or other qualified plans, such as Simplified Employee Pensions (SEPs) and Savings Incentive Match Plans for Employees (SIMPLEs), unless they specifically opt out.

In addition, higher contribution limits enacted in 2001 have been extended permanently along with the Saver's credit for the first \$2,000 of annual contributions, available to taxpayers whose incomes fall within the adjusted gross income limits.

Roth 401(k)s made permanent. These arrangements combine elements of both the Roth IRA and the traditional 401(k). Roth 401(k)s are funded with after-tax dollars and not only does the account grow tax free, but subsequent withdrawals aren't subject to income tax.

Funding brought to the fore. The law tightens and clarifies the regulations on employer funding of defined benefit plans (traditional pension plans). For example, a permanent interest rate enables you to more accurately measure your liabilities and calculate your plan contributions.

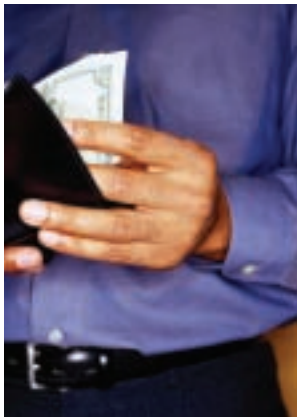
Furthermore, an employer no longer has the choice of skipping pension payments during strong economic times. In fact, higher caps on employer contributions encourage greater boom-time contributions.

Conversely, if times become tight, there is no longer the illogical demand for increased pension funding when it can be least afforded. If a plan has been systematically underfunded, however, additional contributions are mandated.

PBGF contributions have been raised. Employers providing traditional pension plans must now pay higher premiums to the Pension Benefit Guarantee Fund (PBGF). If a plan is poorly funded, the employer's premium is even higher. Moreover, companies in reorganization must now pay a premium of \$1,250 per participant per year for the first three years after emerging from bankruptcy.

within 45 days, then a payment to you from the debtor made before bankruptcy under those terms would likely be considered ordinary. Still, the burden of proof rests on you, so the cost-saving choice for you as the defendant may be to settle the preference action out of court.

Defending your right to keep a payment you received for labor performed, however, is not as simple because BAPCPA fails to address this issue directly. One thing is clear: It's critical to establish the fair market value of your services.



PROTECTING SMALL PAYMENTS

If the payment you received was small, you may benefit from a BAPCPA safe harbor for de minimis preferences. In the context of business bankruptcy, a de minimis preference is a transfer that, aggregated, amounts to less than \$5,000. Section 547(c)(9)

ostensibly eliminates your responsibility to pay back any de minimis preferences.

Before BAPCPA, if you were a creditor in such a situation, you would typically have been forced to settle an otherwise defensible preference action for less because of the legal fees and other expenses that would be involved in defending your claim.

Another small victory for common sense is the adoption of the requirement that a preference action filed against you must be filed in the district in which you reside. This restriction applies when the insolvent business seeks to recover less than \$10,000 in preferential payments made to one vendor.

GETTING A HEAD START

For contractors doing business with companies in bankruptcy, BAPCPA by and large brings good news, as its changes are generally friendlier to creditors than to debtors. Nonetheless, be sure to consult your financial advisors and attorney as soon as a business you deal with appears to have financial problems that could lead it into bankruptcy. 💎

Same mold song and dance: Contractors still at risk

Mold is a word that makes homeowners and builders alike cringe. Just as nobody would want to live in a house or work in an office mottled with mold, no contractor wants to even think about being held responsible for that mold's existence.

Although the toxic mold litigation craze of a few years ago seems to have calmed down, contractors are still at a significant financial risk from mold-related claims — regardless of their location. In fact, states with dry climates, such as Arizona, Nevada and Oklahoma, are among the top 10 states at risk for mold, according to the Greenguard Environmental Institute.

MOLD 101

In the simplest terms, mold is caused by water. When a building or its materials become susceptible to water, either in liquid or vapor form, the result is mold. If the mold exists in a building that is already completed, you need to find the source of the water problem and fix it.

Of course, ideally, you'd like to avoid mold problems altogether by designing and building in ways that prevent water infiltration. To do this, you need to minimize the water that enters the building and also provide ways for the water to escape if it does enter.

In addition, choosing the appropriate materials for each moisture condition is important. If you put materials into the building that have been at risk for water damage in the past, you run just as great of a chance of mold as if an element is poorly designed as a whole.

A PREVENTION PLAN

So how do you minimize your risk of “water-borne” lawsuits? Create a mold prevention plan. It should detail the materials, techniques and timing you'll use to reduce the risk of water problems — and mold. Some of the most critical details to address include:

Proper site grading. You need to control running water on the job site and ensure that water drains away from the foundation. Pay special attention to water coming from the roof, driveways and patios.

Safe storage. Be sure to set up a moisture-free area to store building materials. Often water seeps in before items have even been installed.



Effective roof design. Cladding and flashing details are important, but the initial design of the roof is key. Does the roof deflect water away from the structure or draw it in?

Accurate placement of ducts and plumbing. These are two of the areas where the most leakage can occur. Be sure to verify the correct positioning of all related items.

Strict control of the timing of interior finishes. While the house or building is under construction, and before it's made weather-tight, be sure that any materials added to the interior are protected from moisture.

Also consider adding specifics to your plan about dealing with mold that does arise, such as insurance notification and confidentiality procedures. Consult your attorney to see whether you need to address legal liability issues as well.

THE BIG, BAD MONSTER

Mold doesn't have to be as scary as the media sometimes makes it out to be. As long as you're proactive about preventing problems, you can keep the big, bad mold monster away from your projects — and your bottom line. 💎

Limit the cost of construction disputes with ADR

Whether it's coming to an agreement on a small change order or a multimillion dollar scope revision, resolving disputes is a required skill for contractors. When margins are tight and competition is intense, the added costs of litigation can be crippling.

Alternative dispute resolution — or ADR as it's commonly called — has become a common term in the construction business. Still, not every contractor fully understands how to use it and how it can help limit the hit to his or her bottom line when one of those inevitable job conflicts comes to pass.

3 COMMON METHODS

By and large, ADR offers three methods, differing in their intensity, to tackle a problem:

1. Arbitration. Thanks to its continual presence in the standard AIA construction contract forms, this is probably the best known ADR approach.

Like a trial, arbitration usually involves sworn witnesses who testify on direct and cross examination, but it's

private and less formal. The decision of an arbitrator (or panel of arbitrators) may be kept confidential from the public, and appeals may be less likely than in traditional litigation.

2. Mediation. Here an independent third party acts less as a final decision maker and more as a facilitator. In that capacity, the mediator can creatively help the parties resolve their dispute. As long as both sides come to an agreement, pretty much anything goes.

When you begin a job as partners, the lines of communication are open, which can build trust.

Like arbitration, mediation is private, but it's generally voluntary, which can be beneficial in maintaining business relationships. Mediation often works simply because it gets the parties to sit down and discuss the problem. Sometimes just getting to the table to talk provides results satisfactory to both.



In addition, because the parties at odds control the process, mediation can be less expensive and more rapid than arbitration. Here the best-case scenario is a quick resolution, but if necessary you can still turn to more formal arbitration or, at worst, give in and head to court.

3. Partnering. This approach can also be an effective method for managing disputes, because it seeks to prevent them before they start. Partnering starts at the inception of a construction project with a formal and explicit agreement between you and another party to resolve disputes in a specified manner.

When you begin a job as partners, the lines of communication are open, which can build trust. And that trust can then lead to better planning, easier conflict resolution and, one hopes, faster and more efficient project completion.

MANY ADVANTAGES TO CONSIDER

The costs of litigation are measured not only in terms of legal fees, but also productivity. You could spend countless hours putting together your case, pulling project managers and office staff away from their day to day responsibilities.

Ultimately, ADR offers many advantages to consider. It can also reduce the number of adversarial relationships affecting your construction business, more directly involve you in decisions critical to your company's success, and save you time and money. 💎



Construction Success Story

The importance of backing up computer data

For 10 years, a locally owned and operated roofing contractor had operated successfully without any significant data loss or backup issues. That changed overnight when a fire broke out in his offices late one evening, destroying the computer equipment. And because of an ineffective and inadequate disaster recovery plan, the data stored on all of the local machines, network servers and bimonthly tape backups was lost.

Fortunately, the contractor had taken home tape backups once a month and kept them in a fireproof safe. So, actually, all the data wasn't lost, though he would have to re-create all of the information related to the current month.

When the contractor informed his financial advisor of the disaster, she referred him to a technology consultant and the two immediately went to work eliminating the possibility of future data loss. They discovered three particularly appealing solutions for contractors:

- 1. Online planning packages.** These allow the posting of online documents, such as contracts and blueprints, that can be modified by contractors and viewed online by customers.
- 2. Customer management software.** These applications simplify the process of contacting clients by having online forums, discussions and Web research tools available to customers, secured and stored electronically offsite.
- 3. Offsite electronic data backup.** Typical backup solutions include local hardware that backs up data and then automatically encrypts and sends it to offsite storage via the Internet.

As this contractor learned the hard way, data backup and storage is critical for companies that conduct most operations and daily functions in-house. Factors such as overworked networks, inadequate housing of computers and mainframes, and even power-handling limitations can destabilize computer networks and equipment, making data loss imminent.

What the contractor in this case found especially appealing about integrating online resources and automatic offsite backups into his operations was the reduction in onsite storage. By turning to online solutions, he cut in half the amount of necessary local backup space, which not only saved him money, but also improved his data security.

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
- Cash flow projections
- Quality and productivity enhancement
- Estimating/bidding improvement
- Bonding capacity maximization
- 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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