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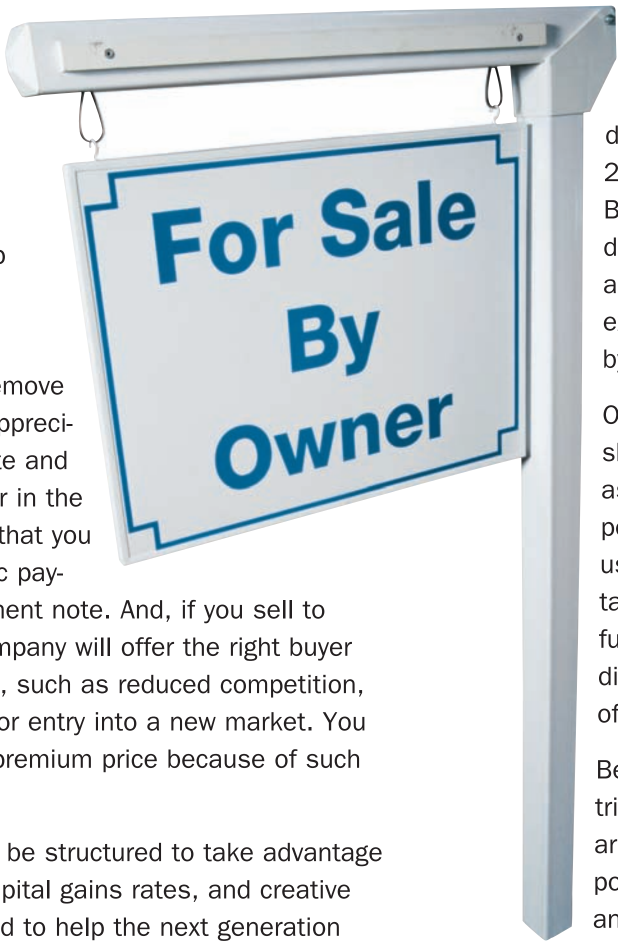
Tried and true ownership transfer methods

Avoid harsh tax consequences with careful planning

If not planned for carefully, an ownership transfer can have harsh tax consequences for either the owner of a construction business or his or her heirs. On the bright side, various tried-and-true ownership transfer methods are available — and each deserves careful consideration.



Hang out the "For Sale" sign

Perhaps the most straightforward way to transfer ownership of your construction company is to sell it.

By doing so, you'll 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. And, if you sell to an outsider, your company will offer the right buyer strategic advantages, such as reduced competition, increased efficiency or entry into a new market. You may even receive a premium price because of such business synergies.

Typically, 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 make the purchase if you want to keep the business in the family. An intentionally defective grantor trust may allow you to transfer business assets to your heirs without having to recognize gain from the sale. (See "IDGTs offer succession and estate planning advantages" on page 3.)

Although a "straight sale" may be appealing in terms of relative simplicity and speed of execution, the potentially substantial tax consequences can quickly make it less attractive.

Make gifts to family

Passing ownership to family members is often a key goal of an owner exiting a construction company. In this regard, annual exclusion gifts may be a good option. You can gift up to $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.

Another reason to consider annual exclusion gifting: It can help preserve your estate tax exemption (the amount that may pass estate-tax free at your death) — $2 million for those dying in 2008 ($3.5 million in 2009). Why? Because the exemption available at death is effectively reduced by the amount of your $1 million gift tax exemption you use during life, but not by annual exclusion gifts.

On the other hand, if your intent is to shed a potentially rapidly appreciating asset from your estate as quickly as possible, there's nothing wrong with using some or all of your $1 million gift tax exemption. And you may be able to further leverage the gifts with valuation discounts for lack of control or lack of marketability.

Be careful, though. Discounts may trigger IRS scrutiny as to whether they are too big — or warranted at all. Another potential disadvantage is that, using only annual gift exclusions, you'll likely need many years to transfer an entire business. Thus, business owners often use annual gifting only in conjunction with other methods.

Put it in trust

Putting your ownership shares in trust is yet another strategy worth considering. For instance, some contractors have turned to grantor retained annuity trusts (GRATs) for this purpose.

Here you fund an irrevocable trust with your construction company stock and, in turn, you receive an annuity (calculated using the IRS's Section 7520 rates) for a term of years. The IRS does view such a trust as a taxable gift (and it may use up your lifetime exemption) to the extent that the value of

IDGTs offer succession and estate planning advantages

One ownership transfer method that's gained popularity among contractors is the sale to an intentionally defective grantor trust (IDGT). This is essentially an irrevocable trust with special provisions that allow it to be treated differently for estate and income tax purposes. That is, it's a separate legal entity for estate tax purposes; therefore, once the sale is completed, the assets are no longer included in your estate.

But a built-in and intentional flaw in the trust language (hence the name) causes the trust assets to be treated, for income tax purposes, as owned by you, the grantor. Because you are treated as the owner, you aren't liable for tax on the gain on the sale to the trust.

After the sale, any income generated by the trust is taxed to you. Yet any increase in value of the assets belongs to the trust. As a result, each time you pay tax on the trust's income, you further increase the benefit because the trust isn't depleted by income taxes and, ultimately, more assets will go to your heirs.

the assets contributed exceeds the current value of the annuity payments due back to you.

Yet you garner a couple of tax advantages. First, you gain tax leverage if an appraisal upon funding supports a discounted value of the stock, allowing you to transfer more shares at the same gift tax cost. Second, to the extent the company stock appreciates at an annual rate greater than the Sec. 7520 rate, eventually fewer and fewer shares of stock are needed to be paid back to you to fund the annual annuity payments; after the annuity period is over, the trust still has value left for its beneficiaries.

Timing is key, however. 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. But if you die before the expiration of the term, the entire GRAT is pulled back into your estate, thereby nullifying its tax advantages.

Create a total plan

Choosing how to best transfer your ownership share is really only one part, though a critical one, of the total succession plan you need to create. Work with your financial and legal advisors to get this job done as soon as possible.

Interest rate swaps

An intriguing financing alternative for contractors

In the due course of business, contractors face many risks — bad weather, job-site accidents, insolvent owners, difficult market conditions. Yet an additional risk that may not cross your mind quite as often is the current interest rate affecting your outstanding business loans.

As that rate rises, your cash flow may suffer, potentially putting you at a significant competitive disadvantage. One way to hedge against this risk is to engage in a banking transaction called an "interest rate swap."

Signing a contract

Under this arrangement, two parties sign a contract to exchange one set of cash flows for another. More specifically, a borrower with a variable interest rate

loan from a bank or other lender will arrange with another third-party lender to exchange the variable interest rate for a fixed rate.

The contract's terms depend on the situation at hand. Most commonly, one party pays a fixed price (fixed interest rate) and one pays a floating price (market interest rate). The floating price is based on a published market rate — typically either the London Interbank Offered Rate (LIBOR) or the prime rate.

Watching the rates

Once the contract is signed, it's time to watch the rates. If the market rate rises above the fixed rate, the party paying the fixed amount (the borrower) will have to pay the market rate to the bank on its original loan, but the party paying the floating price (the third-party lender) is required to give the borrower cash to effectively bring the market rate down to the fixed rate.

Precisely how much cash the borrower receives will vary based on the difference between the market rate and the fixed rate. In this scenario, the borrower benefits from a swap because, under the terms of its original loan, it should be paying the higher variable rate, but the cash from the third-party lender brings its net cash outlay down to the lower fixed rate.

But what if the market rate drops below the fixed rate? In this case, the borrower pays only the market rate to the bank on their original loan. It then pays any difference between the market rate and fixed rate to the third-party lender, adjusting the swap to the fixed rate.

Generally, the borrower in this instance doesn't benefit from a swap because, under the terms of its original loan, it should be paying the lower variable rate. The payment to the third-party lender, however, brings its net cash outlay up to the higher fixed rate.

Aiming for a fixed rate

Construction companies using interest rate swaps typically aim to be the party that pays the fixed price. As you may know, banks generally prefer to offer variable interest rates, because doing so allows them to keep loans at fair value. So, to lock in a fixed rate on a loan, banks may charge a fee, and/or the fixed rate will generally be higher than the current variable rate available. Interest rate swaps can provide you with a fixed rate that you couldn't get with an ordinary bank loan or provide the fixed rate at a lower cost.

Locking in a fixed interest rate may be an effective way to manage your construction business's susceptibility to fluctuating interest rates. And doing so may, in turn, help you manage your cash flow and budget.

With a variable rate, interest expense will vary from month to month. Locking into a fixed rate means the same percentage of your outstanding loans will accrue each month. You might also use an interest rate swap to lock in a lower rate when the market is expected to rise.

Doing the math

As you can see, interest rate swaps are hardly simple affairs. They're not always the easiest transactions to understand and, to target a successful one, you'll need to look carefully at your construction company's financing needs and evaluate the risks and rewards. Your CPA can offer invaluable help in this regard. ☒

Surety bond fraud: It could happen to you

Among contractors, the importance of bonding is widely understood. You just can't take on jobs beyond a certain size without procuring the right surety bond. But what if you discovered that, after jumping through all those hoops, you got nothing at all? And that the premium you paid landed in the pocket of a criminal? That's precisely the situation some contractors have found themselves in after falling victim to surety bond fraud.

Who perpetrates it?

Fraudulent surety bonds most typically originate with individuals. In many instances, an agent of a legitimate surety will use his or her knowledge of the bonding process to execute a false bond. He or she will generate fake supporting documents (such as insurance and power of attorney), attach them to the contract and, as mentioned, pocket the premium.

In other cases, a former employee of the surety, or perhaps someone never employed there but who's nonetheless familiar with the surety process, will use the bonding company's name to carry out the same scheme. In more extreme cases, two or more fraudsters will work together to form a ghost surety company, complete with an actual office or at least phone numbers, an e-mail address and a mailing address.

If a false bond is issued and a default does occur, the resulting fallout could trigger a variety of conflicts.

Once a false bond is issued, often the project is carried out and, assuming the contractor doesn't default, no one is ever the wiser. If a default does occur, however, the resulting fallout could trigger a variety of conflicts at the job at hand among the owner, the surety that's been falsely represented (assuming that's the nature of the scam) and the construction company involved.

How do you stop it?

To stop surety bond fraud, you have to catch it. Fortunately, there are several resources available:

The Department of the Treasury. The department's Financial Management Service Web site (http://fms.treas.gov/c570/) maintains a list of companies authorized to write and issue bonds. If you encounter an unfamiliar surety, you can check here.

The Surety & Fidelity Association of America. This organization also provides a list of its corporate members, including contact information, on its Web site (surety.org). Obviously, as only its members are included, the list isn't all-inclusive.

A company-specific bond validation system. Some sureties are taking the bull by the horns and developing their own bond validation systems that contractors can use to verify the authenticity of a bond. For example, Zurich (zurichna.com) has introduced its "Surety Bond Validator" system that lets you check a bond's status and confirm its accuracy by entering the bond number with one other piece of coverage information, such as principal, bond penalty amount or effective date.

Rising danger?

Surety bond fraud isn't a crime that makes many, if any, headlines. And, as mentioned, it often goes undetected. Nonetheless, as the surety market has tightened (and the number of sureties has shrunk) in recent years, the danger of fraud has risen. You could avoid a whole lot of trouble by double-checking the authenticity of your bonds as you acquire them.

Futurescope: *Construction Business Trends*

Disaster recovery niche draws contractors' interest

Whether watching forest fires on the West Coast, floods along the Mississippi or hurricanes on the Gulf Coast, we've all seen thousands affected by a catastrophic event struggle to recover. In between those stories, however, many smaller disasters occur — mudslides, flash floods, building collapses. Out of this more everyday chaos is rising an increasingly popular construction niche: disaster recovery.

Although many contractors still bring in the bulk of their profits abiding by the traditional design-bid-build system, some are now finding that participating in emergency response measures is profitable and fulfilling. After heavy winds, for instance, roofers are often immediately needed to enclose facilities so that interior dry-out, clean-out and repair can begin. Heavy construction companies can also find high priority work clearing roads and demolishing homes and other buildings to make way for progress. Electricians and plumbers are typically in high demand as well.

Not surprisingly, there are risks to the disaster recovery niche. Jobs spring up immediately, requiring you to be capable of quickly assembling a workforce and the necessary materials. You must also have the flexibility to generate (or, if working for a government agency, receive) a task list and carry it out without hesitation. Another key skill: the ability to meticulously document your activities. Why? As you might expect, insurance is a huge issue. Multiple parties in crisis, along with multiple insurers and insurance adjusters, are usually in play.

So why get involved in disaster recovery at all? For starters, when undertaken with the appropriate care and planning, it can drive additional dollars to your bottom line. It's also a great way to increase awareness of your company among the general public. Seeing your name and logo on the trucks or heavy equipment restoring their community is something many people will remember.

Last, there's an element of personal fulfillment that's made disaster recovery work a "must-do" for many contractors. Sure, there's a certain satisfaction from completing just about any project — but doing a job that helps people in need can feel even better.

The Contractor's Corner

Is it time to implement field management software?

For the first several years of its existence, my construction company was a relatively small niche specialty that took on one project at a time. But, as of late, we've grown and are fortunate enough to be juggling several jobs at a time. As a result, keeping track of all the data is getting harder and harder. I know there's software that can help me out, but I'm not sure if now is the right time to implement it. What do you think?

Whether they involve city skyscrapers or a country road, construction projects are complicated undertakings. Every job requires project management in the field and financial management in the office. And that's where field management software comes into play. Why don't we look at the details and let you decide whether it would be a good fit for your fast-growing company?

3 primary functionalities

The purpose of field management software (also referred to as "job-tracking software") is to gather, track and store your project-specific data, giving you the means to analyze that information for best possible results. Better solutions should give you dynamic functionality in three general areas:

1. Job analysis/reporting. A good system will track jobs in progress, giving you up-to-the-minute data on actual and projected expenses (by job or cost code) as well as equipment use. Moreover, the software is capable of generating reports that will help you use this information to better manage your jobs and the company as a whole.

Working on payroll? You can run an employee hours report to see whether the proper overtime rates are being correctly applied. Curious about how much value you're getting out of a piece of equipment? You can run an equipment utilization report.

2. Billing. Field management software can let you create invoices in the office or in the field and immediately submit them to an owner or general contractor.

In addition, some applications will serve as de facto spreadsheets, allowing you to calculate and revise billing items on the screen. This can be a huge plus for cash flow, because it allows you to submit invoices conveniently and instantly rather than waiting until project's end or for given points during the job.

3. Systems integration. Perhaps the most dynamic aspect of field management software is its ability to integrate with your existing systems. For instance, if you have existing Excel spreadsheets to maintain project budgets, you can easily import those into the system.

More important, better field management solutions will *export* data to your accounting system. That way, you can eliminate double entries and save substantial time processing financial data — particularly that related to payroll.

A huge boost

So, after reading about its features, does field management software sound like a good option? If so, there are a variety of products out there to consider, including HeavyJob/Field by HCSS and Pioneer StarTech by Pioneer Interactive. Like any technology acquisition, however, implementing a field management solution does come with inherent risks. Without proper training or allowing for an adequate learning curve, you or your project managers could wind up misusing it and actually hurting, rather than helping, your projects. Nonetheless, when installed and used properly, these applications can be a huge boost.