CliftonLarsonAllen

# Heartland CFMA

## What is Our Position and Strategy on Revenue Recognition and Lease Standards Changes?

# Brief Firm Background

- Top 10 among CPA firm rankings
- Substantial Construction and Real Estate Practice
- Recent Addition of Gallina
- Heartland Presence

# My Background

- Started in 1989 as Construction Group was just building
- Currently Head of Construction Assurance within the industry group
  - Industries have primary role for quality and risk management
  - We also have a National Assurance Technical Group
  - Wrote firm's comment letter on first Rev Rec exposure draft

# My Background – cont.



- My current role:  try to get consistent quality in construction assurance across the firm
  - ◊ Second review some critical/high risk engagements
  - ◊ Client acceptance/high level staffing assignments
  - ◊ Coordinate technical resources and help entire group work as a team

# Overall Take on Revenue Recognition



- What do we **like** about current standards?
  - 81-1 tracks well with how jobs are bid, performed, billed, and wrapped up
  - Most practical implementation issues are addressed in the standard
  - Meaningful representation of revenue, cost of revenue, gross profit over time
    - ◊ When bad accounting is the result, the problem is usually poor application of the current standards rather than bad standards
      - Story from early in my career: underbilled road job

# Overall Take on Revenue Recognition – cont.

– Impact of estimates is enormous; current methods provide tools to manage the effect
  - ◊ Jobs in process schedules are relatively straightforward to understand
  - ◊ Effect of changes in estimates can be readily measured
    - Example: change order revenue over-recognized under the current standards in year one will become profit fade in year 2

# Overall Take on Revenue Recognition – cont.

- What is NOT changing
  - Fundamental economics, with its importance of the individual contract as the key measure
  - Overall systems need to track billings and costs by job as a key management tool
  - One contract will normally be one performance obligation
  - POC will still be done
    - ◊ Cost to cost still permitted

# Overall Take on Revenue Recognition – cont.



- What Changes Will We Need to Deal With? (Just ideas, not a comprehensive list)
  - Variable consideration at inception
    - ◊ Existing standards say we need to consider, but not much specific guidance
    - ◊ New standard defines how to use likelihoods and probabilities to record
  - Unapproved Change Orders
    - ◊ Become a form of variable consideration
    - ◊ Now will use likelihoods and probabilities, rather than the hard rule
    - ◊ Reality: unapproved change orders have been handled inconsistently in practice

# Overall Take on Revenue Recognition – cont.

- Initial costs that benefit the entire performance of the contract may be handled differently
  - ◊ Proposal costs, commissions: capitalize and amortize
  - ◊ Bonds/Insurance/mobilization: capitalize and amortize
- Uninstalled materials
  - ◊ Standard has confusing language
  - ◊ New guidance in the works that should help

# Overall Take on Lease Standard



- What do we **dislike** about the current standard
  - Inconsistent application of capital lease testing
    - ◊ Example:  SBA real estate loan example
  - Ability to plan around the standards to obtain desired results
    - ◊ "Finance it off balance sheet!"
  - Some truly incomprehensible results
    - ◊ Example capital lease asset cannot be removed even when the terms causing capital lease treatment are no longer there.
  - User confusion
    - ◊ Properly capitalized real estate leases confuse bankers
    - ◊ Lenders and sureties do not treat lease obligations as a real liability

# Overall Take on Lease Standard – cont.

- What is changing
  - Leases longer than one year will all be booked by lessee
    - ◊ Lease asset and lease liability booked at present value
    - ◊ Asset amortized over the life of the lease;  payments reduce the liability
    - ◊ Exact nature of expense depends on the type of lease.  I.e. there will still be some differences between “capital” and “operating” lease

# Overall Take on Lease Standard – cont.

- Critical financial ratios will change
  - ◊ If leasing activity is significant, the changes to ratios will be more problematic
  - ◊ Obvious change is that measured leverage will increase
  - ◊ Working capital will decrease because of current portion of liability
  - ◊ Operating measures such as EBITDA could change because of changing character of expense

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# Top Tax Tips in Trump Territory

Emily Hilsabeck

Tax Principal

Construction and Real Estate Group

Continuous learning in action



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# Highpoints of Tax Reform

- *Trump Plan and "Better Way" plan from the House*
  - Reduce Rates: Income tax rates of 12/25/33%
  - Reduce Rates: Business tax rate of 15-20% (Corporate & Pass-through)
  - Attract Capital: Deemed repatriation at 5-10% rate
  - Reduce Regulation: Repeal NIIT and AMT
  - Reduce Rates:  Repeal the Estate Tax

| | Current Law | President Trump's Proposals | House Republican Tax Reform Blueprint |
|---|---|---|---|
| **Personal tax rates** | Seven tax brackets: 10%, 15%, 25%, 28%, 33%, 35%, 39.6% | Three tax brackets: 10%, 25%, 35% | Three tax brackets: 12%, 25%, 33% |
| **Personal long-term capital gains tax rates** | Up to 23.8% | Up to 20% | Ordinary rates with a 50% exclusion (i.e., 6%, 12.5%, 16.5%) |
| **Maximum passthrough tax rate** | 39.6% | 15% | 25% for "active business income"; 33% for other ordinary income |
| **Maximum corporate tax rate** | 35% | 15% | 20% |
| **Personal standard deduction** | Married filing jointly: $12,700<br>Head of household: $9,350<br>Single: $6,350 | Married filing jointly: $25,400<br>Single: $12,700 | Married filing jointly: $24,000<br>Single with a child: $18,000<br>Single: $12,000 |

| | Current Law | President Trump's Proposals | House Republican Tax Reform Blueprint |
|---|---|---|---|
| **Depreciation** | Fixed assets are generally capitalized and depreciated with section 179 immediate expensing available in some cases | U.S. manufacturers (possibly including construction contractors) can elect to expense cost of fixed assets in year of purchase | Cost of tangible and intangible property, including buildings (but not land), is immediately expensed |
| **Interest expense deductibility** | Generally deductible | U.S. manufacturers lose deductibility of interest expense when full expensing of fixed assets is elected | Deductible only to the extent of interest income |
| **Carried interest (capital gains allocated to the holder of a partnership profits interest)** | Taxed at capital gains rates | Taxed at ordinary income rates | Taxed at capital gains rates |
| **Domestic production activities deduction** | Construction contractors eligible for a deduction equal to 9% of their construction income | Not specifically addressed but plan generally involves limiting tax deductions | Repealed |

| | Current Law | President Trump's Proposals | House Republican Tax Reform Blueprint |
|---|---|---|---|
| **Border adjustment tax (20% tax on imported goods and services)** | No | No | Yes, although recent statements by House leaders suggest the tax is no longer being considered |
| **Alternative minimum tax (AMT)** | Potentially imposed on both corporations and individuals | Repeal | Repeal |
| **Gift and estate tax** | Tax of up to 40% imposed on gifts and estates, subject to a $5.45 million lifetime exemption per spouse | Repeal estate tax (replaced by income tax in Campaign proposal); proposal is unclear regarding gift tax | Repeal estate tax; proposal is unclear regarding gift tax |

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# Top Tax Tips for Construction Clients

Continuous learning in action



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# #1 Time Your Income

- Defer income and accelerate expense
- How?
  - Accounting methods
  - Contract management
  - Capital investment decision-making(when to purchase equipment)
  - Loss dispositions
- The above examples suggest that every $1 million shifted between tax years may be worth $200,000+ after tax

# #2 Plan Your Capital Stack

- Business interest expense may become nondeductible in future years, increasing borrowing costs relative to equity

- How?
  - Refinance over longer terms in the event grandfathered debt is exempt
  - Plan for equity growth

# #3 Capital Investment Planning

- Future capital investments might be immediately deductible. Current capital investments may be deducted over periods ranging from 1 to 40 years.
- How?
  - Ex: What's the after tax cost of a building investment now, versus in a future year when buildings become deductible.
- Also consider tax credits (many of which are investment based) as many credits may disappear in tax reform

# #4 Plan for Tax Losses

- Net Operating Losses in 2017 may be carried back two years and past tax dollars recovered at current rates. If income is recognized in future years, rates will be lower.

- How?
  – Plan now to manage your taxable income/loss for 2017 using these 10 points

# #5 Plan Charitable Giving

- Charitable gifts today are deductible at top tax brackets. Future deductions seem likely to yield lower tax rate benefits.
- How?
  - Private foundations
  - Donor advised funds
  - And especially: gift appreciated stock, *the market is high*!
- Donate in 2017 at current rates then allocate to your charities over time with a donor advised fund.

# #6 Manage Long Term Contracts for Tax

- Have a top quality evaluation made of the differences allowed between GAAP and tax reporting for your 2017 contracts, and utilize the tax law *smarter*.

- How?
  - LTCs can come in several categories under the tax code based on your size and the project character.
  - GAAP requires PCM on many LTCs that tax does not
  - PCM generally accelerates income recognition (and tax)

  - Our studies say roughly 70% of construction contractors are using PCM for tax but only half of those need to.

# #7 Get Control of Your Materials

- Materials purchased and assigned to a job are immediately "costs incurred". Costs incurred increase Percent Complete Income

- How?
  - Plan year-end material needs
  - Make special arrangements with material suppliers
  - Consider use of customer-purchased materials

- A $1 million job expected to yield a $200,000 gross profit is 10% done on the day a $100,000 load of raw materials gets delivered. => $20,000 taxable income.

# #8 Take Your Losses in 2017

- 2017 may offer the best tax benefit on business losses we may see for a while.

- How?
  - Write-off bad debts
  - Settle legal disputes
  - Close loss jobs

# #9 Budget for Reform Costs

- Though we don't know the future law, we can anticipate changes may be substantial and adapting business practices are likely to consume time and money, both internal and out-sourced.

- How?
  - Budget internal staff work-plan time for adaptation
  - Increase professional budgets of attorneys, accountants, benefits providers, banking costs, etc.

# Summary: Top Tax Tips for Construction Clients

- Time your income
- Plan your capital stack
- Plan capital investments for tax results
- Plan for tax losses (NOLs)
- Plan long term charitable giving
- Manage LTCs for tax
- Control your materials
- Take your losses in 2017
- Budget for Reform costs

**Emily Hilsabeck, Tax Principal**
**St. Joseph, MO**

**(816)-671-8921**
**Emily.hilsabeck@CLAconnect.com**

CLAconnect.com

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