What do the new revenue recognition standard and the new tax law mean to you and your business?

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NAVIGATING REVENUE RECOGNITION STANDARDS FOR THE CONSTRUCTION INDUSTRY

January 15, 2018
CONSTRUCTION REVENUE RECOGNITION
INTRODUCTION TO NEW REVENUE RECOGNITION STANDARDS (ASC 606)

Objectives:

- Steps to prepare for and implement the new revenue recognition standard
- How to minimize the disruption of implementing the new revenue recognition standard
- Key impacts of the new revenue recognition standard on construction contractors
CONSTRUCTION REVENUE RECOGNITION
INTRODUCTION TO NEW REVENUE RECOGNITION STANDARDS (ASC 606)

Effective dates:

- **Public entities**: Periods beginning after December 15, 2017 or January 1, 2018
- **Privately held entities**: Periods beginning after December 15, 2018 or January 1, 2019
  - Early adoption permitted up to public entity adoption date

Transition – two methods allowed:

- **Full retrospective** – All periods presented would report under the new standard
- **Modified retrospective** – Only initial period of adoption reported under the new standard – cumulative effect on beginning retained earnings
CONSTRUCTION REVENUE RECOGNITION
INTRODUCTION TO NEW REVENUE RECOGNITION STANDARDS (ASC 606)

Core Principle: A Company should recognize revenue to depict the transfer of promised goods or services, to customers in an amount that reflects the consideration to which the entity expects to be entitled, in exchange for those goods or services.

New Terminology

- Performance Obligation
- Contract Asset
- Constraint
- Transaction Price
- Transfer of “control”
- Variable Consideration
- Distinct
- Onerous Contract
The 5 Step Process

- **Step 1** – Identify the contract(s) with a customer
- **Step 2** – Identify the performance obligations in the contract(s)
- **Step 3** – Determine the transaction price
- **Step 4** – Allocate the transaction price to the performance obligations in the contract
- **Step 5** – Recognize revenue as the entity satisfies a performance obligation
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STEP 1: IDENTIFY THE CONTRACT

Contract: An agreement that creates enforceable rights and obligations

Criteria

- Approval and commitment of the parties
- Identification of rights and payment terms
- Commercial Substance
- Collectability is probable at inception
Evaluating Collectability

- Amount expected to be collected vs. stated contract value
- Mitigating items that reduce risk of non-collection:
  - Right to terminate services for future transfer of goods
  - Enforceability of prompt pay by law
  - Advance payment through overbillings or mobilization
  - Lien rights
  - Mitigating items that reduce risk of non-collection
- Repossession right should not be considered
Under current rules, contracts may be combined if:

- The contracts are negotiated as a package in the same economic environment with an overall profit margin objective
- The contracts constitute an agreement to do a single project
- The contracts require closely interrelated construction activities
- The contracts are performed concurrently or in continuous sequence
- The contracts constitute in substance an agreement with a single customer
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STEP 1: IDENTIFY THE CONTRACT – COMBINING CONTRACTS

Accounting Standards Codification ("ASC") 606 requires contracts to be combined when entered into at/or near the same time with the same customer and if ONE of the following is present:

- Negotiated as a package with a single commercial objective
- Amount of consideration to be paid in one contract depends on the price or performance of the other contract
- Goods or services promised in the contracts are a single performance obligation
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STEP 2: IDENTIFY PERFORMANCE OBLIGATIONS

Performance obligation: Is a promise in a contract to transfer a good or service

- When are performance obligations identified?
  - At contract inception
  - As modifications to the project occur over the life of the contract (Change orders)
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STEP 2: IDENTIFY PERFORMANCE OBLIGATIONS

**Performance obligation criteria:**

- A distinct good or service; or

- A series of substantially similar distinct goods or services that have same pattern of transfer

**A good or service is distinct if:**

- Customer can benefit from the good or service; and

- It is separately identifiable from other promises in the contract
  - Isn’t used as an input to produce a combined output (integration)
  - Doesn’t significantly modify or customize other goods or services in the contract
  - Isn’t highly dependent or interrelated with other goods or services in the contract
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STEP 2: IDENTIFY PERFORMANCE OBLIGATIONS

Warranties?

- Assurance-type warranties:
  - If no option to separately purchase the warranty or there is no additional services, there is no separate distinct performance obligation

- Service-type warranties:
  - If the customer has the option to purchase a warranty separately from the construction service or if the warranty provides an additional service, a separate performance obligation likely exists
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STEP 2: IDENTIFY PERFORMANCE OBLIGATIONS

Consideration related to internal controls and procedures in your Company:

- What procedures and controls are in place to monitor and identify contracts?
- What procedures should be implemented to identify all distinct goods and services within the contracts with customers?
- Does an independent review occur for determination that are made in regards to separate performance obligations identified within a contract?
- How does your Company verify there is consistent judgement and application in identifying performance obligations?
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STEP 3 – DETERMINE TRANSACTION PRICE

Key Concepts:

- How will variable consideration impact the transaction price?
- How will variable consideration be estimated?
- Constraint concept
- Development of new accounting policies
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STEP 3 – DETERMINE TRANSACTION PRICE

Transaction price - amount of consideration which an entity expects to be entitled in exchange for transferring goods or services

- Terms:
  - Variable Consideration
  - Constraint
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STEP 3 – DETERMINE TRANSACTION PRICE

- Examples of variable consideration:
  - Unapproved/Unpriced Change Orders
  - Liquidated Damages
  - Performance Bonuses
  - Safety Bonuses
  - Shared Savings
  - Economic Price Adjustments

- Two methods for estimation:
  - Most likely amount (binary, yes/no outcomes)
  - Expected value (probability weighted)
EXAMPLE – MOST LIKELY AMOUNT

- $100 million fixed price contract to construct a bridge
- $10m performance bonus if completed by July 1, 2018
- Total potential contract $110m
- Single performance obligation
- Company determined at inception it is 40% likely that it will complete by July 1, 2018
What should be the recorded transaction price?

- Answer: $100 million
  - Most likely amount approach is most appropriate since there are only two possible outcomes ($0 or $10m)
  - Management needs to evaluate past performance and other factors
EXAMPLE – MOST LIKELY AMOUNT

- $100 million fixed price contract to construct a bridge
- $10m performance bonus if completed by July 1, 2018
- Total potential contract $110m
- Single performance obligation
- Company determines six months in it is 85% likely that it will complete by July 1, 2018
What should be the recorded transaction price?

- Answer: $110 million
  - Contractor historically completes bridge contracts timely 80% of the time
  - Variable consideration in the contract should not be constrained as the likelihood is greater than 70%
EXAMPLE – EXPECTED VALUE

- $100 million fixed price contract to construct a casino
- $100,000 per day liquidated damages if not complete by September 1, 2019
- Company determined:
  - 50% probable complete by September 1st
  - 20% probable complete by September 15th
  - 25% probable complete by October 1st
  - 5% probable complete by October 15th
What is the transaction price (prior to constraint)?
$100m – $1.2m = $98.8m  (contract less LDs)

<table>
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<th>Delay (days)</th>
<th>LDs per Day</th>
<th>Total LDs</th>
<th>Probability</th>
<th>LD’s</th>
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<td>$0</td>
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<td>$0</td>
</tr>
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<td>$100,000</td>
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<td>$600,000</td>
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<tr>
<td>45</td>
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<td>5%</td>
<td>$225,000</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>100%</td>
<td>$1,200,000</td>
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</tbody>
</table>
Constraint on variable consideration:
- Only include to the extent that it’s *probable* a significant revenue reversal won’t occur.

First make estimate, then evaluate the constraint.
EXAMPLE – CONSTRAINT (cont.)

At inception the contract should be constrained based on when probability of incurring LDs exceeds 70%.

100m-375k = $99,625,000

<table>
<thead>
<tr>
<th>Delay (days)</th>
<th>LDs per Day</th>
<th>Total LDs</th>
<th>Probability</th>
<th>LD’s</th>
</tr>
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<tr>
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<td></td>
<td></td>
<td>75%</td>
<td>$375,000</td>
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</table>
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STEP 3 – ACCOUNTING POLICIES

- Company will need to maintain contemporaneous documentation over:
  1) Estimation methodology and assumptions for variable consideration
  2) Evaluation of constraint
- Important as assumptions will change as project progresses toward completion
- Consideration of materiality
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STEP 3 – FS DISCLOSURE

- Significant Judgments and Estimates:
  - Variable Consideration
    - Methods
    - Inputs
    - Assumptions
    - Likelihood of revenue reversals
  - Out-of-Period Revenue Adjustment:
    - Revenue that is being recognized in the current reporting period but were satisfied in a previous period. (due to change in transaction price or change in variable consideration estimate)
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STEP 4 – ALLOCATE THE TRANSACTION PRICE

- Objective – To allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration the entity expects to be entitled in exchange for transferring the promised goods or services.

- Topic 606 defines the **Standalone Selling Price** as the price at which an entity would sell a promised good or service separately to a customer.
  - Multiple performance obligations
    - Standalone price not directly observable
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STEP 4 – ALLOCATE THE TRANSACTION PRICE

- Three methods are provided under Topic 606 to estimate standalone selling prices:
  - Adjusted market assessment
  - Expected cost plus a margin
  - The residual approach (limited)
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STEP 5 – RECOGNIZE THE REVENUE

Under Topic 606, a company may recognize revenue only when (as) the entity satisfies a performance obligation by transferring a promised good or service to the customer. **A good or service is considered to be transferred when the customer obtains control.**

- Two methods:
  1) At a point in time
  2) Over time

- Reasonably consistent with current GAAP
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STEP 5 – APPLYING THE CORE PRINCIPLE

SATISFACTION OF PERFORMANCE OBLIGATIONS

For each performance obligation identified in Step 2, an entity shall determine at contract inception whether it satisfies the performance obligation over time or satisfies the performance obligation at a point in time. An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

IF AN ENTITY DOES NOT SATISFY A PERFORMANCE OBLIGATION OVER TIME, THE PERFORMANCE OBLIGATION IS SATISFIED AT A POINT IN TIME.
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STEP 5 – RECOGNIZE THE REVENUE

Input Method:

- Exclude costs with no direct relationship on transfer of goods
  - Costs do not contribute to satisfying performance obligation
    - Wasted or defective materials, labor or other resources
  - Costs not proportionate to the progress in satisfying performance obligation
    - Recognize revenue to extent of materials delivered to jobsite

Example:

$100m Bridge Project, deliver $20m in steel. Carve out steel piece $20m from the contract and recognize revenue based upon installation. Profit will be recognized as the steel is installed
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STEP 5 – RECOGNIZE THE REVENUE

Example:

<table>
<thead>
<tr>
<th>Bridge Project:</th>
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<tbody>
<tr>
<td>Transaction Price</td>
<td>$ 100</td>
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<tr>
<td>Costs:</td>
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<tr>
<td>Steel</td>
<td>$ 20</td>
</tr>
<tr>
<td>Labor</td>
<td>40</td>
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<tr>
<td></td>
<td>60</td>
</tr>
<tr>
<td>Costs to date:</td>
<td></td>
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<tr>
<td>Labor</td>
<td>$ 10</td>
</tr>
<tr>
<td>Labor complete</td>
<td>25%</td>
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<tr>
<td>Revenue calculation:</td>
<td></td>
</tr>
<tr>
<td>Revenue recognized</td>
<td>$ 20</td>
</tr>
<tr>
<td>Cost of steel</td>
<td>20</td>
</tr>
<tr>
<td>Total revenue</td>
<td>40</td>
</tr>
<tr>
<td>Costs to date</td>
<td>(30)</td>
</tr>
<tr>
<td>Profit to date</td>
<td>$ 10</td>
</tr>
</tbody>
</table>
CONSTRUCTION REVENUE RECOGNITION

STEP 5 – RECOGNIZE THE REVENUE

Loss Contracts

- No changes expected loss to be accrued

Capitalization of Costs

- Costs incurred in fulfilling a contract
  - An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover the costs.
  - Amortize over life of the job until goods are transferred
  - Examples: bond, set-up, mobilization
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STEP 5 – RECOGNIZE THE REVENUE

Retainage

- Retention no longer a “receivable”
  - A receivable is a right to consideration that is conditional only upon the passage of time
  - Retentions are contingent upon additional performance by the contractor and/or acceptance by the customer
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TRANSITION OPTIONS

The transition decision is an important one for all entities as it will impact the level of effort needed to the new revenue recognition standards.

There are two options to consider for transition for nonpublic companies:

- Full Retrospective Approach
- Modified Retrospective Approach
Full Retrospective Approach:

- Under this method, an entity shall apply the new standard retrospectively to all periods presented in the financial statements.
- If the contractor adopts the new standards in 2019 and presents a two-year comparative financial statement, both 2018 and 2019 would need to be presented as if the new standards were in effect for both years.
- Cumulative catch-up adjustment to beginning retained earnings.
- All contracts, both completed and in progress, would need to be presented and accounted for as if Topic 606 had been in place since contract inception.
- Since application of Topic 606 may result in revisions to the 2018 financial statements, disclosure of these changes would be required.
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TRANSITION OPTIONS

Modified Retrospective Approach:

- An entity shall recognize a cumulative effective change to opening retained earnings in the year of adoption of the new standard.
- If an entity uses this transition approach, the prior year financial statements will be presented in accordance with its historical revenue recognition methods.
- Cumulative catch-up adjustment to beginning retained earnings in the year of adoption (i.e. 1/1/2019).
- In the year of adoption, entities must disclose what revenue would have been under previous U.S. GAAP.
- Concerns with this approach include changes in recognition of certain revenue and expenses in the year of adoption under the new standards vs. prior year treatment under previous U.S. GAAP.
The Objective Of The Disclosure Requirement Changes

“The objective of the disclosure requirements in Topic 606 is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose **qualitative** and **quantitative** information about all of the following:

- Its contracts with customers
- The significant judgments, and changes in the judgments, made in applying the guidance in Topic 606
- Any assets recognized from the costs to obtain or fulfill a contract with a customer

Companies will need to determine how much detail to include in order to achieve the objective.
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DISCLOSURE

Contracts with Customers

Companies shall disclose all of the following amounts for the reporting period:

- Revenue recognized from contracts with customers separate of other sources of revenue.
- Disclose separately any impairment losses on any receivables or contract assets arising from contracts with customers, which the entity shall disclose separately from impairment losses from other contracts.
Disaggregation of Revenue

Requirement for non-public entities

- **Quantitative** disclosures about revenue disaggregated based on:
  - transfer of goods or services *at a point in time*
  - transfer of goods or services *over a period of time*

- **Qualitative** information about how economic factors affect the nature, amount, timing, and uncertainty of revenue and cash flows, such as:
  - type of customer,
  - geographical location of customers,
  - and type of contract
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DISCLOSURE

Contract Balances

- An entity is required to disclose the opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed.

- **Contract asset** - If right to payment is contingent on an entity performing additional acts, that asset does not represent a receivable. Instead, the standard refers to the asset as a contract asset.

- **Contract liability** - A contract liability represents the obligation to transfer goods or services to a customer in the future, for which payment has already been received.
CONSTRUCTION REVENUE RECOGNITION
DISCLOSURE

Performance Obligations

An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following:

- When the entity typically satisfies its performance obligations:
  - upon shipment or delivery,
  - as services are rendered, or upon completion of service
- The significant payment terms:
  - when payment typically is due,
  - significant financing components,
  - When consideration amount is variable, and whether the estimate of variable consideration is typically constrained
- Types of warranties and related obligations.
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DISCLOSURE

Significant Judgements

An entity shall disclose the judgments, and changes in the judgments, made in applying the guidance in this Topic that significantly affect revenue recognition:

- Judgements and assumptions must be constantly evaluated throughout the life of the contract.
  - (Examples of items to consider include liquidating damages, bonuses for early completion, issues caused by weather, etc.)

- The timing of satisfaction of performance obligations, the methods used to recognize revenue (for example, a description of the output methods or input methods used and how those methods are applied).

- The transaction price and the amounts allocated to performance obligations – assessing whether an estimate of variable consideration is constrained.
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KEY CONSIDERATIONS FOR TRANSITION

- Changes in the process of how revenue is recognized
- Changes to internal controls
- Tax implications
- Perspective of impact in the eyes of key users of the financial statements (i.e. surety, banking, and shareholders)
- IT systems
- Disclosures
- Contracts
- Other business processes
CONSTRUCTION REVENUE RECOGNITION
REPORTING AND RECOGNITION IMPLICATIONS

Increased Disclosures:
- Significant increase in the amount of information required to be disclosed in the financial statements.
  - This will require new processes, procedures, and controls to gather the information that is required in these disclosures.

Separate Tracking of Performance Obligations:
- Any separate performance obligations will require costs, billing, and revenue recognition to be tracked separately. How will the contract value of these separate components be determined?

Surety Considerations:
- Since contracts are generally bonded under a single surety bond, sureties will likely want to see the combined results of certain contracts (vs. shown as separate performance obligations).
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REPORTING AND RECOGNITION IMPLICATIONS

Banking Considerations:
- Changes in revenue recognition can have an adverse impact on loan covenants
- Wording in loan documents may need to be amended

Accounting Software:
- Software companies will need to incorporate enhancements which provide the ability to track the reporting of contracts both on a combined basis, as well as by each respective performance obligation, as well as also provide users with a means to easily identify and properly account for all of the input considerations to comply with the new standards
  - (i.e. variable consideration, warranties, uninstalled materials, etc.)

Income Tax Implications:
- Tax reporting may not be consistent with financial reporting in accordance with the new standards.
Compensation Considerations:
- Changes in revenue recognition may have an impact on compensation arrangements for executives, project managers, as well as those who receive compensation in the form of commissions or other sales incentives.

Contracts and Sales Agreements:
- Wording in these documents should be evaluated to determine if amendments are warranted.

Additional Time and Costs:
- Additional costs and time will likely be incurred in order to evaluate the impact of this new standard on the company’s internal and external reporting process, as well as in the evaluation and development of changes to the company’s existing internal controls and processes.
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DEVELOPING AN IMPLEMENTATION PLAN

Start planning now!
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DEVELOPING AN IMPLEMENTATION PLAN

Assign an individual to take the lead of the implementation:
- Assembles a cross-functional team
- Takes lead on understanding the new standard
- This leader does not necessarily need to be someone from accounting

Assemble a cross functional team:
- Team should consist of key representatives from various departments:
  - Accounting and financial reporting
  - Project management (job costing, contract accounting)
  - Estimating
  - Legal
  - HR
Develop an implementation plan:

- Assign roles and expectations
- Document your plan as it develops
- Team should be educated on the new standards
- Establish timelines and key milestones
- Leader should monitor and track progress against established timelines
- Identify and develop an understanding of where the new standards could have the greatest impact on the company
- Avoid the details at this preliminary stage
  - Focus on identifying and understanding the potential issues
Key areas where the standard may have a significant impact:

- Compensation
- Debt agreements
- Bonding capacity
- Internal controls
- Software
- Tax planning
- Identification of contract and performance obligations
- How variable consideration will be measured?
- How will prices and costs be allocated?
- Will the new standards accelerate or slow down revenue recognition?
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DEVELOPING AN IMPLEMENTATION PLAN

Preliminary evaluation - Evaluate the current schedule of contracts:

- Group similar types of contracts with similar contract terms together
- Identify contracts for potential multiple performance obligations
- Is there the potential for or existence of uninstalled materials?
- Is there variable consideration?
- Are there warranties?

Apply the new standards to one or two existing contracts of each type:

- Identify the key issues encountered when these standards are applied:
  - Software and reporting
  - Project accounting and reporting
  - Controls and procedures
  - Tax reporting
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DEVELOPING AN IMPLEMENTATION PLAN

Develop accounting policies to address the new standards:

- Identification of contracts that meet the new standards
- Identification of performance obligations
- Allocating contract price and costs to various performance obligations
- Identification of and accounting for variable consideration
- Identification and accounting for uninstalled materials
- Identification of warranties
- Revise accounting and reporting procedures (including project and job cost accounting) where necessary
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DEVELOPING AN IMPLEMENTATION PLAN

Deeper Dive - Recalculate interim WIP schedules to comply with new standard:

- Determine the potential impact on financial reporting
- Determine the impact of adoption (full or modified retrospective adoption)
- Identify and evaluate potential qualitative and quantitative disclosures
- Develop the process of accumulating the information required to be disclosures
- Develop wording for disclosures
- Test the effectiveness of new policies and procedures in parallel with existing controls and procedures. Identify areas which need further adjustment

Conduct in-house training:

- Educate staff on background of new standard
- How the company will need to adapt for compliance
- Roll out of new policies, procedures
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DEVELOPING AN IMPLEMENTATION PLAN

Communicate the anticipated impact with internal/external users:
- Banks
- Sureties
- Board of directors, executives, stockholders
- Investors, or other external users of the statements

Work with outside accountants/auditors to work through questions and issues as they arise
- They will need to understand and get comfortable with your implementation process
THANK YOU!

QUESTIONS?
New Tax Law Overview
TAX REFORM

- TAX REFORM AS ORIGINALLY PROMISED BY THE GOP WAS DESIGNED TO:
  - Simplify the tax code to make tax planning and compliance easier and less costly
  - Changes to the tax code would be permanent
  - Provide a clear reflection of income and reduce the impact of taxes on economic activity
  - Significantly grow the economy and pay for itself by creating substantial economic growth
  - Primarily benefits the middle-class; the richest 1% will enjoy no net benefit under the GOP plan.
ACTUAL OUTCOMES OF TAX REFORM

- Tax reform was more focused on business than individuals.
- For low to middle class individual taxpayers, the provisions of the act are in many cases simpler.
- For middle to high income taxpayers, the new business provisions could affect everything about your business:
  - Business entity selection and organizational structure
  - Buying or leasing fixed assets
  - Capital investment planning
ACTUAL OUTCOMES OF TAX REFORM

• The most significant point:

  - In order to capture the tax benefits of the Qualified Business Income Deduct, planning and restructuring (i.e. of W-2 wages) might need to take place effective January 2018.

  - Many of provisions of tax reform have interrelated consequences, which makes modeling an important step in understanding how tax reform will impact your business.

  - Review and revision of accounting periods and methods is an integral part of the process for both tax and accounting (GAAP) purposes.
HIGHLIGHTS OF INDIVIDUAL TAX PROVISIONS

• Old Law: 7 Tax Brackets – 10%, 15%, 25%, 28%, 33%, 35%, 39.6%
• New Law: 7 Tax Brackets – 10%, 12%, 22%, 24%, 32%, 35%, 37%
• Old Law: Standard Deduction - $6,500, $9,550, $13,000
• New Law: Standard Deduction - $12,000, $18,000, $24,000
• Repeal of personal exemptions
• Individual AMT
HIGHLIGHTS OF INDIVIDUAL TAX PROVISIONS

• SALT Deduction at Individual Level - $10,000 limitation
• Mortgage Interest Deduction on Personal Residence Acquisition – limited to interest on up to $750,000 of mortgage.
• Alimony – after 12/31/18: Not deductible by payer and not includible in income by payee
• Excess Business Loss Rules – Limited to $500,000, any additional losses are added to NOL (rule applied after PAL rules)
• NOL carrybacks eliminated; only carryforwards
HIGHLIGHTS OF INDIVIDUAL TAX PROVISIONS

• Charitable contribution limitation for cash to public charities increased from 50% to 60%
• Medical expense threshold dropped from 10% to 7.5% of AGI
• All miscellaneous itemized deductions formerly subject to 2% limitation repealed
• Moving expense deduction repealed
• Child Credit and Dependent Credit – increased to $2,000 per child and $500 per non child dependent
OVERVIEW OF CORPORATE TAX PROVISIONS

- Old Law: C Corporation Tax Brackets – 15%, 25%, 34%, and 35%
- New Law: Flat tax rate of 21%
- AMT for C Corporation entities – REPEALED
OVERVIEW OF DEPRECIATION PROVISIONS

- Old Law: Section 179 Expensing - $500,000 deduction $2MM threshold
- New Law: Section 179 Expensing - $1MM deduction $2.5MM threshold
- Bonus depreciation on qualified assets – 100% for assets in service after September 27, 2017 and before Jan 1, 2023
OVERVIEW OF ACCOUNTING PROVISIONS

- Long term contracts - $25MM test instead of $10MM test
- Cash method of accounting - $25MM test regardless of business type
OVERVIEW OF OTHER PROVISIONS

• Section 1031 (LKE) – only available for real property
• Interest Provision – limited to 30% of adjusted taxable income
• Section 199 (DPAD) – repealed
• Meals and Entertainment Changes
• IRA Recharacterizations – ROTH to traditional conversations no longer allowed
• Estate taxes – Lifetime exclusion doubled to approximately $11M
OVERVIEW OF PASSTHROUGH PROVISIONS

• Section 199A (QBI) – enacted
  ❑ 20% automatic deduction for taxpayers through:
    – $157,500 (single)
    – $315,000 (MFJ)
  ❑ Limitation to 50% of wages or 25% of wages and 2.5% of fixed asset cost
    – $207,500 (single)
    – $415,000 (MFJ)
Eligible businesses and taxpayers

- Sec. 199A Available
  - Partnerships
  - S corporations
  - Sole proprietorships
  - Cooperatives

- Eligible For deduction
  - Individuals
  - Trusts
  - Estates
# Four Business Classifications and the limitations

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The Heart of Planning is Managing Taxable Income and the Wage/Capital Limitation.
Example:

• John is a lawyer who earns $150,000 from his law practice (sole proprietor). He is married and his taxable income is $300,000.

• John may deduct $30,000 as his Section 199A deduction.

• If John's taxable income was $425,000 he would receive -0- Section 199A deduction.
What is a Qualified Trade or Business

In General

• A taxpayer must be engaged in a “qualified trade or business” in order to claim the Section 199A deduction.

• Section 199A defines a qualified trade or business by exclusion; every trade or business is a qualified business other than:

  • The trade or business of performing services as an employee, and

  • A specified service trade or business

• The first prohibition prevents an employee from claiming a 20% deduction against his or her wage income.
A “specified service trade or business” means:

- Any trade or business described in Section 1202(e)(3)(A), which is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or “any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners”.

- A trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

- Engineering and architecture trades or businesses are specifically excluded as “specified service trade or businesses” under Section 199A and thus presumably are qualified trades or businesses.
Calculation of QBI Deduction (non-Service business with owner’s above the threshold)

- Lesser of: \(QBI \times 20\%\)

  or

- Greater of: \(50\%\) of wages

  or

  \(25\%\) of wages + \(2.5\%\) of net adjusted assets

The result is limited to \(20\%\) of Taxable Income
WHAT’S YOUR GAME PLAN

• Q&A Session
FOCUS ON WHAT COUNTS