Summer 2019

CONSTRUCTION INDUSTRY ADVISOR

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Lease accounting for contractors

New rules on the way

It's been 13 years since the Financial Accounting Standards Board (FASB) started overhauling its lease standard. For some time now, the new rules have been scheduled to take effect for private companies with fiscal years beginning after December 15, 2019 — in other words, 2020 for companies with a calendar year end. (Public business entities are already using the new standard.) However, as of this writing, there's strong support from various organizations, including the AICPA and AGC, for delaying the implementation date at least one year.

If your construction company is "FASB-friendly" — that is, it follows Generally Accepted Accounting Principles (GAAP) — it's time to start preparing for the new standard if you lease real estate, equipment or other property. Because it will increase both the assets and liabilities recorded on your balance sheet, the new rules may affect the financial ratios that lenders and sureties use to evaluate your business's financial health. (Note: The most significant impact will be on lessees; lessors won't see major changes to their lease accounting practices.)

What's changing?

Historically, leases have been classified in one of two ways:

1. A "capital" lease, which generally involves a transfer of ownership of the underlying asset to the lessee, and

2. An "operating" lease, which merely transfers the right to use the asset during the lease term.

Capital leases are recorded on a company's balance sheet, while operating leases aren't (though they must be disclosed in the financial statement's footnotes).

To improve transparency and financial statement comparability, the new standard requires most leases to be recorded on the balance sheet (with an exception for short-term leases with terms of 12 months or less). Typically, the lessee records a "right-of-use" asset that reflects the value of its right to use the leased property during the lease term, as well as a liability that reflects its obligation to make lease payments. Generally, the amount recorded, for both the asset and the liability, is the present value of minimum payments expected to be made under the lease, with certain adjustments.

The new standard retains the distinction between operating leases and

Related party leases: Month-to-month doesn't necessarily mean short-term

It's not unusual for construction businesses to lease property or equipment from a related party for various tax, financial or liability reasons. Often these arrangements involve month-to-month leases or leases with terms of less than one year. But that doesn't necessarily mean that they qualify as short-term leases that need not be recorded on the balance sheet. Under the new lease standard (see main article), one must examine factors that may indicate that such a related party lease is, in substance, a long-term lease that must be recorded.

For example, if your company has made substantial depreciable improvements to leased property, or if it would be disruptive to your business or prohibitively expensive to relocate, the lease may not qualify as short-term. The lease may also be treated as long-term if the lessee guarantees the lessor's debt or provides the lessor with cash to pay that debt, or if the leased property is unique and not readily used by anyone other than the lessee. For further clarification and specific guidance, talk with your CPA.

capital leases (referred to as "finance leases"), but the classification mainly affects the recognition of lease-related expenses on the income statement rather than a lease's balance sheet treatment.

Will you be viewed differently?

If your company has significant off-balance-sheet leases, it's important to talk with your lenders and sureties about the potential impact of the new lease standard. Keep in mind that moving existing leases onto the balance sheet merely changes the way these leases are reported. It doesn't change your company's underlying economics, and most lenders and sureties understand this. But a sudden increase in liabilities may make your balance sheet appear weaker, so it's a good idea to review the situation with your financial partners to be sure there are no surprises and everyone is on the same page.

In particular, you should evaluate the impact of the new standard on certain key financial ratios. In some cases, increased liabilities can cause you to violate loan covenants that are tied to debt-to-equity levels or other ratios. Although the standard contemplates the treatment of lease liabilities as "operating liabilities" rather than debt, it's possible to fall out of compliance depending on the language of your loan agreement.

As you discuss loan covenants with your lenders, ask them to consider building some flexibility into the covenants to avoid violations triggered by future changes to accounting standards. For example, some covenants provide that, if implementation of a new accounting standard changes a financial ratio, either 1) the change won't be deemed a violation, or 2) the parties will be required to renegotiate the covenant. In such cases, it's important to know which avenue you'll have to take.

The new standard requires most leases to be recorded on the balance sheet.

Are you ready?

If your construction business is engaged in significant leasing activity, work with your CPA to review your leasing arrangements and evaluate the impact of the new lease standard on your company's financial statements. In addition, contact your lenders and sureties before you implement the new standard to discuss potential changes to your company's balance sheet and ensure a smooth transition. ■

Deductibility of meals and entertainment after tax reform

The Tax Cuts and Jobs Act (TCJA) made significant changes to the deductibility of meal and entertainment expenses. Unfortunately, there's still a great deal of confusion about which deductions have been eliminated and which remain. Here's a summary with you, the contractor, in mind.

Entertainment and meals

The TCJA eliminated most deductions for activities considered "entertainment, amusement or recreation," as well as club memberships — even if substantial business discussions are involved. (We discuss a few exceptions below.) The act also eliminated deductions for the cost of facilities related to entertainment, amusement or recreation activities.

There's a common misconception that the TCJA also eliminated deductions for business meals. Not true. As before, taxpayers may continue to deduct 50% of eligible meal expenses. In general, a business qualifies for the deduction if:

- The expense is an ordinary and necessary business expense (in other words, business is conducted),
- The expense isn't lavish or extravagant,
- An owner, executive or employee is present, and
- The meal is provided to a current or potential customer, client, consultant or similar business contact.

What if food and beverages that otherwise meet the above requirements are provided during an entertainment activity? Suppose, for example, that you take a client or prospective client to a baseball game and treat your guest to hot dogs and beer.

According to the IRS, you can deduct 50% of the cost of food and beverages provided during an event so long as they're bought separately or stated separately on bills or receipts. In the case of a baseball game, the tickets are a nondeductible entertainment expense, but the hot dogs and beer are 50% deductible.

But note that, if you attend the game in a corporate suite that includes food and drinks, the entire cost is nondeductible unless meal costs are reasonable and stated separately in the invoice. (Also note that the TCJA didn't affect the 50% deduction for meals during business travel.)

Eats on the jobsite

Before the TCJA, construction companies could deduct 100% of the cost of certain meals provided at jobsites or other business premises, provided they were excludable from employees' income as "de minimis fringe benefits." These included:

- Meals furnished on or near the employer's premises for the employer's convenience,
- Meals provided to employees occasionally or so they could work overtime,

- Certain expenses related to on-premises eating facilities, and
- Water, coffee or snacks made available on the business premises.

The deduction for these expenses has been reduced to 50% and will generally be eliminated after 2025 (though it appears that occasional and overtime meals will continue to be 50% deductible). Even after the deductions are eliminated, de minimis fringe benefits will still be excludable from employees' income.

A few exceptions

As outlined above, most entertainment is now nondeductible and most meals are 50% deductible. But there are some exceptions. Namely, you can deduct:

- 100% of both meal and entertainment expenses if they're treated as employee compensation or included in a nonemployee's income,
- Meal and entertainment expenses that aren't treated as employee compensation but are reimbursed by customers,
- 100% of the cost of recreational or social activities (holiday parties, picnics or other company outings, for example), so long as they're primarily for the benefit of employees other than officers, certain owners and highly compensated employees,
- Both meals and entertainment provided at certain employee or stockholder business meetings or conferences, with meals being 50% deductible and entertainment expenses apparently 100% deductible (subject to further IRS guidance), and
- 100% of expenses for attendance at business league events (other than membership dues).

Also, meals and entertainment are fully deductible if they're provided to the public — for example, at an open house at your office or a jobsite — as are promotional and other expenses related to the event.

Handle with care

We hope this article provides some general guidance, but the rules are complex and subject to change. Consult your CPA about specific expenses to ensure the proper tax treatment. ■

Help build tomorrow's workforce with an apprenticeship program

The construction industry has been struggling with a skilled labor shortage for quite a while now. It's not always easy to find good news on the topic, but here's some: There are few industries better poised to create its own workforce than construction.

One reason is apprenticeships. Because of the hands-on nature of construction work, a mentor teaching an apprentice how to complete job tasks is a clear and feasible path to building tomorrow's workforce.

Consider the benefits

There are various ways that construction companies can benefit from a well-planned apprenticeship program. For starters, apprentices receive customized training that results in highly skilled employees trained to your needs and project types. On-the-job learning from an assigned mentor, combined with

related technical instruction, increases productivity and knowledge transfer.

What's more, employees who have undergone apprenticeships are highly likely to remain loyal to the company, lessening hiring costs. A participating company can gain a reputation as an employer that's willing to invest in its employees. Meanwhile, a focus on safety training can reduce workers' compensation costs.

Certified apprenticeship programs offer a systematic approach to training that ensures employees can produce at the highest skill levels required for the jobs they fill. In doing so, the program provides a stable and predictable pipeline for the development of qualified workers.

As for the employees, chances are they won't want to participate in an apprenticeship program unless they can see it as benefiting them directly. A well-developed program offers participants the opportunity to qualify for paying jobs, and provides the training needed to command higher wages.

Explore registration

One way to differentiate your apprenticeship program from others is to register with the U.S. Department of Labor (DOL). Doing so will place it within a network of registered apprenticeships that offers access to additional expertise and support. Your graduates will receive a national, industry-recognized credential, while your construction business may qualify for tax breaks at the state and/or federal level.

To get off to a good start, the DOL recommends addressing key questions such as: Do we already have employees who could participate in an apprenticeship program? How will our business change in the future and which skill sets will we most likely lack? Ideally, your program will focus on the specific types of skilled workers who will be in shortest supply in years to come.

The agency also recommends looking for various partners with whom you might collaborate. Partner organizations can help you design a program, provide some of the educational resources and assist in finding the apprentices themselves.

The program creates a stable pipeline for the development of qualified workers.

These may include other construction businesses or related companies (such as an engineering or design firm), industry or professional associations, and labor organizations. It's also critical to make your presence known with educational institutions (for example, community colleges) and public agencies (such as police and fire departments).

Test the waters

You can learn more about registering your apprenticeship program with the DOL at apprenticeship.gov. (Click on "Employers / Registered Apprenticeship Program.") But even if you don't go all-out and create a registered program, just testing the waters with a well-chosen apprenticeship can get the ball rolling — for both your construction company and the industry. ■

Should your company conduct a cybersecurity assessment?

Cybersecurity is an important issue for every business, but it's particularly critical in the construction industry. Contractors are particularly vulnerable to hackers and other threats because of the mobile nature of their businesses.

A cybersecurity assessment or audit can help ensure that your construction company is taking the proper steps to protect sensitive information. It can also give you a competitive edge by demonstrating to clients or prospective clients that you take information security seriously.

A closer look at threats

Many contractors today are taking advantage of technologies that allow them to share and view financial and job-related information from jobsites and other remote locations. They may use cloud-based systems for remote access to payroll, billing, estimating, procurement, scheduling and project management systems.

GPS tracking systems, robotics, 3D printing and other technologies are finding their way into the construction process. Many project teams use building information modeling or similar technologies to view and edit plans, specifications and other construction data online. All these things are raising the stakes of cyber-exposure.

With all this data flying around, the risk of a breach is high and goes far beyond disclosure of confidential financial information or competitive intelligence. It also raises serious concerns about potential personal injuries, property damage and work stoppage. Imagine the harm a hacker could cause by altering plans or specifications, destroying data, interfering with a building's security or safety systems, or remotely tampering with vehicles or equipment.

Benefits of an assessment

Conducting a cybersecurity assessment helps you:

- Take inventory of your hardware and software,
- Identify potential vulnerabilities (including access by vendors, partners and current and former employees), and
- Implement controls and other protections to reduce the risk of a breach.

It can also help you develop an incident response plan to mitigate the damages in the event of a breach.

There are several recognized cybersecurity standards and frameworks available to guide these efforts, including those developed by the National Institute of Standards and Technology and the International Organization for Standardization. Some construction companies may even consider obtaining a certification of compliance with one of these standards or frameworks. Doing so can create a competitive advantage, as an increasing number of government agencies and other clients are requiring their service providers to obtain such a certification.

Importance of protection

It may be comforting to think that the bad guys only go after the big guys. But hackers don't always go after companies or other entities with deep pockets. Sometimes they attack the easiest target. Make sure your construction business is well protected. ■

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Industrial Tax Exemption and Its Effect on the Construction Industry

Louisiana has been soliciting for state-wide industrial investment since the 1930s. The State's Industrial Ad Valorem Tax Exemption Program, commonly referred to as the ITEP, was created in 1936 to stimulate expansion into Louisiana markets. By providing tax incentives for in-state growth, the ITEP hopes to beat out neighboring states and make Louisiana the most attractive jurisdiction for new construction.

Tax Exemption Basics

The ITEP provides manufacturers with property tax abatements for up to ten years if they build or expand into the state. The program is not a subsidy; contractors receive no money from the government. It is a tax-saving measure that allows for even more growth, spurs job creation, and improves the standard of living for Louisiana residents.

Industry Concerns

The ITEP has been under fire in recent years. Small grassroots organizations like *Together Louisiana* are actively working to dismantle the long-running program. Unfortunately, their arguments against the program very rarely mention how beneficial the construction industry has been for Louisiana's gross regional product. According to a recent report by the Bureau of Economic Analysis (a division of the U.S. Department of Commerce), Louisiana's manufacturers deliver almost a fifth of the state's total economic output and employ nearly seven percent of the workforce, both of which exceed national industry averages.

Interestingly, the grassroots organizations have made headway. Just last year, legislation was passed by the Louisiana Board of Commerce and Industry that requires local parishes to approve or disapprove of expansion projects into their jurisdictions. They must "yea" or "nay" the project within 60 days. Local taxing authorities are uncertain of their role in the ITEP process, and they are struggling to develop approval processes that can function within this strict timeline. As the clock ticks down, applications are sitting in wait, and would-be investors are considering alternative markets.

The Future

Prior to these recent changes, Louisiana was admired around the globe for its ability to win large energy and construction projects, in large part due to the success of the ITEP. Without the ITEP, Louisiana is at risk for losing many large-scale construction projects that might otherwise have come to the state.

If you have questions about ITEP, please contact a member of LaPorte's Construction Industry Group.