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Bulletin #88, How is Your Accounting? – Tax Strategies for the Construction Industry (June 28, 2005)

In an industry where cost overruns are not uncommon and cash crunches are a nagging problem, some relief may come from the least expected sources – tax authorities. The Internal Revenue Code (the "Code"), accompanying Treasury regulations (the "Regulations"), and IRS pronouncements provide ample opportunities for structuring accounting methods used by contractors to allow flexibility in the timing of recognition of revenue and deduction of expenses.

In addition to the value that can be realized from keeping money longer, taking advantage of timing differences could result in better cash flow. This article provides a general overview of the accounting methods approved under the Code and Regulations, highlights areas with greater potential for audit in recent years, and explores federal income tax planning opportunities in the area of accounting methods.

The following discussion involves a general analysis of methods for decreasing tax liability. It is important that you discuss these matters in detail with your attorney and/or accountant to make sure that your particular situation permits the implementation of the strategies discussed below.

I. Types of Accounting Methods

An "accounting method" is used to determine when and how transactions should be reported for tax purposes. Taxpayers generally compute their taxable income using the same method of accounting they regularly use in keeping their books. Although the Code provides some flexibility in choosing an accounting method, the method used must clearly reflect taxable income. The types of accounting methods specifically approved under the Code include: the cash method, accrual method, a combination of the two, or any other method approved by the Code or Regulations.

The two commonly used accounting methods include the "cash method" and the "accrual method." Under the cash method, taxpayers report revenue when income is actually or constructively received. Expenses are generally deductible in the year paid, unless the deduction must be delayed in order to clearly reflect income.

On the other hand, under the accrual method, taxpayers are required to recognize income when all events have occurred that fix the right to receive income and the amount of the income can be determined with reasonable accuracy. Expenses are likewise deductible when all events have occurred that fix the liability and the amount of the liability can be determined with reasonable accuracy.

Taxpayers ordinarily prefer the cash method over the accounting method because taxes are paid based on income actually received. Under the accrual method, the taxpayer must pay income tax based on income that it has the right to receive, regardless of whether the income is actually received. This could cause serious problems for cash−poor taxpayers. Realizing the difficulty the accrual method may pose for small businesses and contractors, Congress carved out certain exceptions that are specific to such taxpayers. In general, most taxpayers with average annual gross receipts of $5 million or less are permitted to use the cash method. Contractors with gross receipts of $10 million or less, whose contracts require not more than two years to complete, also qualify for the cash method of accounting ("Small Contractors Exception").

In recent years, there has been a rise in audits involving accounting methods. Use of the cash method is particularly vulnerable to IRS scrutiny since it is susceptible to manipulation. In its audit manual, the IRS points out taxpayer practices that improperly defer tax liability, such as unreasonably prepaying expenses, purchasing materials and supplies in advance, or deferring income by delaying billings. In addition, taxpayers may improperly compute the $5 and $10 million thresholds in order to qualify for the cash method of accounting.

Another issue the IRS has raised with cash method taxpayers is that they have to use the accrual method because they carry inventory. The Code requires taxpayers, who use inventory, to produce a significant (or material) portion of their income to use the accrual method due to the beneficial timing differences that a cash method taxpayer could realize by taking current deductions for inventory purchases while deferring income until later years when payments for the goods are received.

On the other hand, in one case, the IRS unsuccessfully argued that an asphalt contractor should have treated the asphalt as merchandise, carried it as inventory, and used the accrual method of accounting. The court found that the IRS abused its discretion since the peculiar physical properties of emulsified asphalt make it impossible for the taxpayer to hold it in inventory. In another case, a court again ruled against the IRS for requiring a contractor to treat concrete as inventory. Generally, items used in providing construction services that are not separately sold by a contractor do ***not*** constitute inventory.

II. Accounting Methods for Construction Contracts

In addition to the general accounting methods discussed above, the Code provides specific accounting methods for long−term construction contracts – the percentage−of−completion method (PCM), the percentage−of−completion—capitalized cost method (PCM−CCM), and the completed contract method (CCM). A long−term contract is a contract for the construction of property, where construction will not be completed within the taxable year in which the contract is signed. Unless a specific exception applies, taxpayers are generally required to use the PCM or the PCM−CCM. Certain eligible taxpayers may use the CCM.

Under the PCM, a contractor recognizes income as work on the contract progresses. The PCM−CCM is a slight variation of PCM, which uses the taxpayer's normal accounting method for recognizing a certain percentage of income and expenses. The income reportable under the PCM each year equals the total contract price multiplied by its completion factor. A contract's completion factor is a fraction whose numerator is contract costs actually incurred through the end of the current tax year and whose denominator is estimated total contract costs.

Since the PCM requires recognition of income based on the percentage of work completed rather than actual receipts, it has the tendency to accelerate the payment of taxes. Small contractors and home construction contracts are exempt from the requirement to use the PCM. The audit exposure areas for taxpayers using the PCM include improper computation of contract amounts by excluding change orders, overstating estimates, and including nondeductible costs and allowances for contingencies.

Under CCM, income or loss is reported on a contract−by−contract basis in the year in which the contract is completed and accepted. For those using CCM, the IRS alerts its auditors to potential issues in the areas of

the improper allocation of expenses between contracts to accelerate deductions, failure to close a contract in a timely manner, and improper aggregation or severance of contracts to achieve the deferral of income or acceleration of losses.

III. Ideas and Strategies for Managing Tax Reporting

Many of the tax planning ideas in the accounting methods' area involve timing differences. This means that the method chosen allows the deferral of recognition of income or the acceleration of deductions. The deferral may involve a specific item or may result from a change in the overall accounting method of a taxpayer. For instance, taxpayers whose gross receipts have declined in recent years may have the opportunity to convert from accrual method or PCM to the cash method. Such a change may generate a refund of taxes paid on recognized but uncollected receipts.

1. **Deferral of Income:** The following ideas may be helpful for lowering the amount of income to be recognized while construction is in progress.

    1. **Retainages Payable:** One of the IRS approved approaches to calculating recognized income under the PCM involves retainages payable. Under the PCM, expenses incurred determine the percentage of income upon which a contractor should be paying taxes. It follows then that the lower the expenses incurred, the lower the income recognized. By excluding retainages payable from current year contract costs, a contractor can reduce the completion factor, thereby lowering the percentage of a project deemed completed and the amount of income to be recognized. The contractor, however, is not allowed to take a deduction for the retainages payable that were excluded from the completion factor calculation.

        The manner in which the construction contract is drafted affects whether retainages payable can be excluded from the completion factor in the current year. Primarily, the construction contract must address when retainages are to be paid and the caliber of work required to be performed before the retainages are paid. In addition, the contract should state that retainages are not payable until the contract is completed, inspected and approved, or the owner pays in full. Changing the method of accounting for retainages payable requires IRS approval.

    2. **Ten Percent Election:** Large contractors may be able to elect to defer the recognition of revenue until at least 10 percent of the total costs of a project are incurred and allocated.

2. **Accelerating Deductions:** The following ideas may help you time your deductions to achieve better results.

    1. **Immediately Deductible Expenses:** Generally, expenses associated with research and development, marketing, selling, and advertising expenses, and costs of unsuccessful bids and proposals are immediately deductible. In addition, for those taxpayers qualifying for the Small Contractor Exception discussed above (Section I), costs do not have to be capitalized altogether.

        In contrast, unless a specific exception applies, the Code and Regulations generally require taxpayers to capitalize, rather than immediately expense, costs incurred for the acquisition and development of land. Such costs include the cost of the land, direct and indirect costs of work–in–process, direct and indirect costs of completed improvements, and costs associated with initial steps in development, such as permit fees, and costs of drafting architectural plans, and performing engineering and feasibility studies. Even where there have been no steps taken for development, costs incurred must be capitalized if future development of the land is likely.

2. **Recurring Item Exception:** Generally, the cost of future improvements is not includible in the cost of lots sold until construction is actually performed. If you have certain recurring expenses, however, the recurring item exception may allow you to take a deduction for future construction expenses, provided that the construction will occur within 8½ months of the taxpayer's year end. The recurring item exception creates a permanent layer of deferral if the status quo is maintained.

3. **Allocation of Costs:** Where land is developed in phases, there is some flexibility for allocating costs attributable to each piece of property being developed. The manner in which costs are allocated may be of a great benefit in deferring the payment of taxes. For instance, an allocation methodology may take into account market changes for the types of homes to be constructed or if homes constructed in a single subdivision vary in size, design, and materials due to market conditions.

   Courts and the IRS approved at least four methods of allocating costs in a subdivision:

   - ◊ **Relative Sales Value Method:** Total costs are multiplied by a fraction, the numerator of which is the aggregate selling prices of the houses sold and the denominator is the aggregate estimated selling prices of all houses sold and to be sold;

   - ◊ **Average Cost Method:** Total costs are multiplied by a fraction, the numerator of which is the aggregate number of completed houses sold, and the denominator is the aggregate number of houses sold and to be sold;

   - ◊ **Square Footage Method:** Total costs are multiplied by a fraction, the numerator of which is the aggregate square footage of the completed houses sold, and the denominator is the aggregate square footage of all houses sold and to be sold; and

   - ◊ **Job Cost Method:** Each home is treated as a separate costing unit with all directly identifiable costs charged to a particular home and with variable overhead costs (payroll, taxes, insurance, supplies, vehicle operating costs, etc.) assigned ratably based on labor costs or some other method.

   All four methods described above conform to generally accepted accounting principles (GAAP). Entities filing federal consolidated returns may use different methods for allocating costs.

4. **Alternative Cost Method:** Generally, the costs of common improvements are not deductible until they are actually incurred. However, the IRS has approved the alternative cost method that allows developers to include, in the basis of properties sold, their allocable share of the estimated total cost of common improvements without regard to whether the costs are incurred, subject to a ceiling of actual costs incurred to date.

Conclusion

As the discussion above indicates, this is not "simple." Nevertheless, with the assistance of your attorney and/or accountant, you can use the complexities of federal income tax accounting rules to your advantage to defer taxes and increase cash flow. Although timing differences simply delay the payment of tax, the contractor nonetheless benefits from continued use of its money. Consequently, it is worthwhile for those in the construction industry to periodically assess their tax position to determine if their accounting method is working for their business.

(For a hands–on treatment of financial management, see "Financial Tools for SMACNA Contractors – A Practical Guide to Financial Management" at the Members Only section of the

SMACNA Web site, www.smacna.org.)

SMACNA wants the Contracts Bulletins to serve its members. Your feedback or topic suggestions are welcomed by contacting Steve Yoch (e−mail: syoch@felhaber.com; telephone 651 312 6040) or Tom Soles, SMACNA's Executive Director – Market Sectors, (e−mail: tsoles@smacna.org; telephone: 703 803 2988).

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