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## Internal Revenue Service

# Construction Industry

## Audit Technique Guide (ATG)

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Department of the Treasury  
**Internal Revenue Service**

[www.irs.gov](http://www.irs.gov)

Training **3147-123 (10-2004)**  
Catalog Number **84851H**

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**CONSTRUCTION INDUSTRY GUIDE**  
*(Formerly Audit Technique Guide)*

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## Chapter 1: Introduction to the Construction Industry

### Intended Audience

This Industry Guide is intended to be used by examiners conducting audits in the construction industry and as information for taxpayers and practitioners associated with the construction industry. Review of this guide is recommended prior to initiating an audit. Users of this guide may need to augment these guidelines by researching specific tax issues and new tax law.

### The Construction Industry as a Market Segment

The construction industry represents a large segment of the total economy. Over 2.5 million companies ranging in size and specialty make the construction industry one of the largest of all industries. Businesses in the construction industry interact with businesses in related industries that supply materials, equipment, financing, and bonding to the construction contractor. Each business is dependent on one another for their survival.

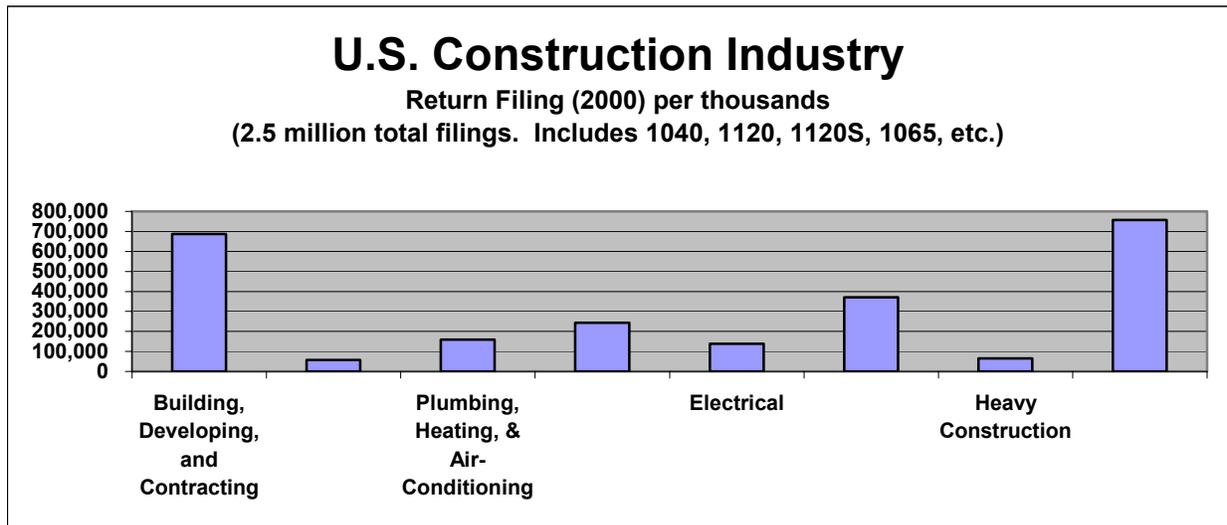
In 2000, approximately 2.5 million returns with construction income were filed in the United States reporting gross receipts of \$1,160,379,989,413 (see the chart below).

- Individual Forms 1040 Schedule C, represented 1,820,522 or 73.5% of total construction industry filings and \$134,146,800,842 (11.5%) of the total reported gross construction receipts.
- Corporate filings were 540,697 or 21.8% of the total construction filings and were responsible for over \$901,204,198,936 (77.8%) of the reported gross receipts.
- The remaining 115,803 filings, by Partnerships, represented 4.7% of the total construction filings and \$125,028,989,635 (10.8%) of the total gross receipts.

**2.5 Million Returns filed reporting gross receipts of \$1,160,379,989,413  
For the Construction Industry in 2000**

Type of Return	Filings	%	Gross Receipts	%
Individual Form 1040 Schedule C	1,820,522	73.5 %	\$134,146,800,842	11.5 %
Corporate Forms 1120,1120S & Misc. 1120	540,697	21.8 %	\$901,204,198,936	77.7 %
Partnership Form 1065	115,803	4.7 %	125,028,989,635	10.8 %

This information was extracted from codes placed on each return by the taxpayer. The six digit codes are based on the North American Industry Classification System (NAICS) and are used to facilitate the administration of the Internal Revenue Code. NAICS was developed jointly by the U.S., Canada, and Mexico to provide new comparability in statistics about business activity across North America. The North American Industry Classification System (NAICS pronounced Nakes) is a unique, all-new system for classifying business establishments. It was adopted in 1997 to replace the old Standard Industrial Classification (SIC) system, and is the industry classification system used by the statistical agencies of the United States.



## Participants in the Construction Industry

Numerous participants that part in the construction industry. Each participant plays a distinct role in the process. The key participants will be discussed briefly in this introduction.

### Contractors

Contractors perform the construction work in accordance with the plans and specifications provided by the owner. In general, contractors are required to be licensed by state law under separate classifications (plumbing, electrical, general building, etc.).

### General/Prime Contractors

A general building contractor's principal business is the performance of the construction work in accordance with the plans and specifications of the owner. A general contractor takes full responsibility for the completion of the project. The general contractor will normally subcontract out a substantial part of the work, while maintaining overall control

through project managers and onsite supervision. The general contractor can be any size and any form of entity, i.e., sole proprietorship, partnership, or corporation. The general contractor may utilize specialty subcontractors, but can perform any portion of the work. Generally contractors must be licensed. If the contractor is a corporation or partnership, an officer or partner must be licensed.

### **Construction Managers**

Generally, the construction manager does not perform construction work on projects, but is an agent for the owner. The construction manager may be engaged in lieu of or in addition to a general contractor. As an agent, the construction manager coordinates the construction project, but has no contractual relationship with the subcontractors. Generally, construction managers provide only services, neither doing the actual construction work, nor being liable for defects in the construction. However, the construction manager may be liable for design defects.

### **Commercial Contractors**

Commercial contractors specialize in commercial construction projects. These projects may include the construction of a single building or any number of buildings.

Commercial Projects include:

- Retail Projects: Shopping centers, restaurants, grocery stores, etc.
- Rental Facilities: Office buildings, industrial parks, apartments, etc.
- Business Locations: Company headquarters, manufacturing plants, insurance companies, etc.
- Municipal Buildings: City halls, prisons, schools, hospitals, etc.
- Special Projects: Amusement parks, race tracks, coliseums, churches, etc.

A distinction is made between the residential and commercial contractor. A residential contractor specializes in single family homes, duplexes, etc., usually building for resale to one or more individual homeowners. A commercial contractor constructs nonresidential buildings, such as office buildings, warehouses, and shopping centers.

### **Commercial Project Owners**

The owner of a construction project may be an individual, corporation, partnership, or government body. The owner evaluates whether a project is feasible and will provide the future benefits desired. The owner then engages an architect or engineer to design the plans and specifications of the project. Normally, the owner secures the necessary financing for the project for both the construction period and permanent financing upon completion. The owner will retain title to the project throughout the construction phase, subject to liens from construction loans and mechanics liens. The general contractor may or may not have an ownership interest in the project. The contractor may own a percentage interest in one of the following ways:

1. Owning stock in the corporation that owns the project
2. Being a partner in a development partnership

### 3. Owning the property or an interest in a joint venture as an individual

#### **Residential Construction Developer**

The examination of residential developers is different than the examination of a contractor who builds in accordance with a contract between himself or herself and an owner. The developer is generally the owner of the residential development as well as the builder. The developer acquires land, obtains approval, secures construction financing, and begins construction of the residential development in stages or phases of construction. The initial phase is sold, and the construction process begins on the next phase. This process requires that the builder allocate a per-unit cost to each unit sold. The cost of each unit (on-site costs, such as direct materials and labor, and an allocated portion of off-site costs such as streets and amenities) must be matched with the sales price of each unit sold. The sales price is often based on what the market will bear under the current economic environment. During periods of low interest rates residential construction usually booms, while high interest rates cause the market to recede.

#### **Subcontractors**

The largest number of taxpayers in the Construction Industry are specialty subcontractors. They can range from one-man operations to nationwide, publicly traded corporations, or divisions of larger corporations. Over 70 percent of the construction returns filed are Schedule C returns by individuals. Subcontractors are distinguished from the general contractor by the limited scope of their work, which usually involves a special skill, knowledge, or ability. Subcontractors include specialists, such as plumbers, electricians, framers, and concrete workers. They generally enter into contracts with the general contractors, and may provide the raw materials used in their specialty areas. The general contractor, not the owner of the property, will usually pay the subcontractors. Materials purchased by the subcontractors are generally delivered directly to the job site. The subcontractors' work may be completed in stages, or it may be continuous.

#### **Highway Contractors**

Highway and street contractors require specialized equipment and techniques. The equipment includes bulldozers, graders, dump trucks, and rollers. Examples of highway construction include city streets, freeways, country roads, highway bridges, and tunnels.

#### **Heavy Construction Contractors**

Heavy construction contractors require large and complex mechanized equipment, such as cranes, bulldozers, pile drivers, dredges, and pipe-laying devices. Some examples of projects in this category include dams, large bridges, refineries, petrochemical plants, nuclear and fossil fuel power plants, pipelines, and offshore platforms. Most industrial

plants are classified in this category because of the complexity of the work. The largest engineering and construction firms are included in the heavy construction classification.

### **Architect/Engineers**

The architect or engineer designs the plans to be used by the construction contractors. The plans provide the necessary detail (dimensions, materials to be used, location of fixtures, etc.) to the contractors. When the project is started, the architect/engineer may monitor the contractor's progress and often approves progress payments to the contractors. The architect/engineer will make modifications (change orders) in the plans as needed. Change orders are written revisions to the contract, which increase or decrease the total contract price paid to the construction contractors. The change order document contains the change order number, change order date, a description of the change, and the amount of the change order. Change orders can also be issued by the contractors under the terms of the contract.

### **Material Suppliers**

Material suppliers provide the raw materials used in the construction project. Material supplies are purchased by the subcontractors and installed by them in accordance with their contract. General contractors often write joint checks to subcontractors and material suppliers to ensure that all parties have been properly paid. Materials are generally delivered directly to the job site and are direct job costs, which are not normally inventoried by the contractor. In some situations the contractor will maintain inventories of miscellaneous yard stock frequently used.

### **Construction Lenders**

The construction lender provides the necessary funds to pay contractors on a progress basis. In return for making the loan, the lender receives interest on the outstanding loan balance. Construction period interest (referred to as "soft costs") paid to lenders must be capitalized by the owner during the construction period. Interest and other loan costs are often taken directly from the loan principal as a result of the institutions interest provisions. As construction work progresses, the construction lender (bank, savings and loan, insurance company, etc.) will advance the funds based on the work performed or based on a payment schedule. The construction loan is generally secured by the land and construction in progress. When construction is completed, the owner will secure permanent long-term financing.

### **Surety Companies**

Sureties are generally insurance companies who provide bonding to contractors. Bonds provide a form of insurance to the owner. Performance bonds protect the owner if the contractor fails to complete the construction work. Performance bonds are typically a percentage of the contract amount. Bid bonds guarantee that the contractor will sign the contract after it is awarded and furnish the necessary performance and payment

bonds within a specified time. Contractors must submit detailed financial data to the surety company to secure a bond. Financial statements prepared in accordance with generally accepted accounting principles (GAAP) are often furnished to the surety on a quarterly basis or more often. Supporting schedules included in these financial statements provide extensive job information, required by the surety in order that they may analyze and limit their risk. Personal financial statements are often required to be supplied from officer shareholders.

## **Multiple Roles**

Each of the above participants can and often do have multiple roles in the construction process. For example, the owner could also be the general contractor (builder/developer). The general contractor in addition to providing supervision may also do specialty work that would typically be subcontracted (for example, concrete work). Design-build companies are growing. Construction lenders frequently hold an equity position in a development partnership in order to participate in the management decisions and to share in the profits. Anchor tenants, such as major department store chains participate in the development partnership in exchange for signing long-term leases. Contractors and material suppliers can obtain rights in the project by filing mechanics liens against the property. The auditor should thoroughly understand each participant's role in order to determine whether the transactions have received the proper tax treatment.

## **THE CONTRACTING PROCESS**

When the owner determines that the project is feasible and that construction financing is available, he will solicit bids from general contractors and/or specialty contractors. Owners will use trade publications and newspapers to invite contractors to bid for the construction contract. The notice will provide the contractors with the procedures to be followed in submitting a bid. The bidding contractor obtains a copy of the plans and specifications from the owner to prepare the formal bid. The bidding contractor solicits bids from subcontractors, estimates direct material and labor costs, and evaluates the ultimate profit potential of the contract. The amount of the bid covers the estimated costs and profit for the construction project. The owner evaluates the submitted bids and will award the contract to the successful bidder. The contract document contains the contract amount, project start/completion dates, progress billing procedures, insurance requirements, and other pertinent information. There are standard cost manuals that a general contractor can use as a guideline in computing the bid. These guides contain a compilation of cost data for each phase of construction.

It is important to realize that the cost of bidding a job can be considerable. The costs include reviewing and reproducing the job specifications and blueprints, calling in subcontractors to get bids on the work involved, developing the total cost figure for the project, and preparing a formal bid. The preparation of the bid is the first step in the cost control system. The bid becomes the budget by which the actual expenditures are

measured. The object of the cost control system is to provide the general contractor with information regarding actual project costs versus anticipated or budgeted costs. These cost comparisons are essential for internal control as well as for auditing purposes. You may see situations where a contractor might pursue a "break-even" bid to generate enough cash flow to meet payroll, etc., particularly in recession periods.

The general contractor solicits bids from subcontractors in the various trades, the subcontractors bid for the jobs in much the same way general contractors do.

### **Scheduling Subcontractors**

The general contractor is expected to schedule the subcontractors so that the construction runs smoothly and is completed on time. The various specialty areas include, but are not limited to, the following:

1. Clearing the land, which may include demolition of existing structures
2. Excavating the land, which may include digging holes and leveling
3. Pouring the foundation
4. Steel and/or wood framing
5. Rough framing
6. Rough electrical
7. Wood or concrete flooring
8. Roofing
9. Heating and air conditioning
10. Ductwork for the heating and air conditioning
11. Installing elevators and/or escalators
12. Installing sprinklers and other safety equipment
13. Installing electrical fixtures
14. Insulating and weather-stripping
15. Framing window and door sashes
16. Installing tile and marble
17. Installation of suspended acoustic ceilings
18. Installing toilets, sinks and other plumbing fixtures
19. Painting walls, inside and out
20. Laying carpet and other floor coverings
21. Clean up

This list conveys some of the complexity inherent in the construction process. It reflects the necessity of scheduling the work of subcontractors and using a budget, bid costs, and actual cost variances for cost control purposes. Budgeting and scheduling are critical factors in determining the success of the contractor.

### **CONTRACT INCOME**

Most companies use a standard construction contract. The most important information contained in the contract is the amount the general contractor will be paid and how often he or she will be paid. The contract will state whether the contractor will bill monthly, at

the completion of the contract, or at certain stages of the project. The billing invoices may include copies of the subcontractor bills and lien releases. The owner may have a supervisor at the site that confirms the contractor has completed the work for which he has billed. The contract may also include provisions for retainages, which are usually withheld from the general contractor until the project is complete. Retainages are usually withheld at a rate of 10 percent of the billed amounts, but the percentage may decrease over the life of the project. The general contractor, in turn, will retain a portion from the amounts owed to the subcontractors.

## **TYPES OF CONTRACTS**

### **Long-Term Contracts**

Long-term contracts are defined in IRC section 460(f)(1) as any contract for the manufacture, building, installation, or construction of property, if such contract is not completed within the taxable year in which such contract is entered.

### **Short-Term Contracts**

Short-term contracts are contracts started and completed within the taxpayer's taxable year. For short-term contracts, construction costs are treated as current period costs under all methods of accounting except the cash method. Under the cash method, construction costs are treated as current period costs for a short-term contract only if the expense is also paid during the year.

### **Fixed Price or Lump Sum Contracts**

A fixed price or lump sum contract states that the contractor will complete the project for an agreed price, despite unforeseen costs that might exist during the construction phase. Some fixed price contracts, in reality, provide for some variations for economic price adjustments, incentives, etc. If any modifications to the original contract occur, change orders are executed. These often increase or decrease the contract amount.

### **Cost-Plus Contracts**

Cost-plus contracts stipulate that the contract amount will be the cost of the construction project plus a fee. The fee may be earned in various ways. A fixed fee is generally earned evenly throughout the term of the contract. A percentage fee is frequently based on the amount of cost incurred. Most cost-plus contracts have a guaranteed maximum to protect the owner from cost overruns. Many cost-plus contracts allow the contractor to share in cost savings if the project is completed under budgeted cost. The contract will specify which costs are included in the contract amount. Generally, the contract will include a clause that allows the owner to review or audit those costs.

### **Time and Material Contracts**

Time and material contracts are contracts that provide payments to the contractor based on direct labor hours at a fixed rate plus the cost of materials and other specified costs.

### **Unit Price Contracts**

The unit price contract method is a variation of the lump-sum (or fixed price) contract method where the contractor bids a set price per unit item. The unit-price method is generally used in cases in which the number of units required has not been determined when the contract is bid.

### **Change Orders**

Change orders can be initiated by the contractor or the owner. A change order modifies the original contract, and either increases or decreases the contract costs and/or contract price.

## **BONDING**

Owners often require the general contractor to be bonded. In these cases, the general contractor is required to purchase a guarantee or surety bond. The purpose of the bond is to guarantee to the owner and lender that, should the general contractor fail to finish the project, the funds will be available to hire a replacement. A general contractor's bonding capacity is based upon their financial statements and past performance. A bond request will be denied if it exceeds the bonding capacity. A contractor may leave what appears to be an unusually large amount of cash in the company for the purpose of increasing his or her bonding capacity. This should be considered when determining whether or not accumulated earnings tax is applicable. The following types of bonds are available:

- **BID BONDS** provide for payment to the owner of the difference between the bid that is accepted and the next lowest bid if the general contractor with the accepted bid fails to enter into a contract.
- **CONTRACT BONDS** indemnify the owner against the failure of a general contractor to comply with the requirements of a contract.
- **PERFORMANCE or COMPLETION BONDS** guarantee completion of the project by the general contractor.
- **LABOR and MATERIAL PAYMENT BONDS** guarantee the owner that all costs of labor, material, and supplies incurred by the general contractor in connection with the project will be paid, thus voiding mechanics' liens.
- **MAINTENANCE BONDS** guarantee the owner against defects in workmanship and are usually one year in duration.

- **SUBCONTRACTOR BONDS** are performance and payment bonds issued by the subcontractor to the general contractor to guarantee the subcontractor's performance and payment of obligations required under the contract.

State and federal contracts usually require surety bonds. In other cases, collateral bonds in which the contractor pledges real or personal property as collateral with value equivalent to the contract price may be used. When a performance bond is defaulted, it is not unusual for the insurer or bonding company to hire the defaulted contractor to complete the job, because they are familiar with the project. Most bond defaults result from financial difficulties with the project at hand, rather than from the lack of technical ability on the part of the contractor. Thus, the bonding company can act as another third-party control on the business and accounting practices of the contractor.

## **BUILDING PERMITS**

Before construction can begin on a project the necessary building permits must be received from the appropriate municipality. The specifications and blueprints of the project are turned into the Building Department, along with an application for a permit. The issuance of a permit may take time, because the approval process is likely quite involved, especially in the case of new construction. The general contractor or owner may have to submit results of soil testing, environmental impact studies, or other information. Sometimes a public hearing is mandated, if opposition to the project is known. However, in most cases, the permit is issued within a few months. The cost of the permit may be the responsibility of the general contractor. The owner may pay for it, however, along with the costs of any related studies. Construction projects follow the standards of the Uniform Building Code. A Building inspector examines the project at various stages to verify that the project is being constructed according to this Code.

## **NOTICE OF COMPLETION**

Once the building is completed, a Notice of Completion is requested. The project must pass a final inspection. Once the project passes that inspection, a Notice of Completion is issued by the municipality, along with a Certification of Occupancy. These documents are recorded at the office of the local recorder. At this point the property is appraised for property tax purposes. Note: Several appraisals are made throughout the construction process that address timing or allocation issues.

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## Chapter 2: Long Term Contracts

### Background

Before the enactment of the Tax Reform Act of 1986, construction contractors could choose an accounting method from various alternatives with few restrictions. Contractors would recognize income and expense from construction contracts under the cash method, accrual method, completed contract method, or percentage of completion method. Many contractors adopted the completed contract method for tax purposes because they could defer taxes until the completion of the contract.

Internal Revenue Code (IRC) § 460 (effective for contracts entered into after February 28, 1986) generally requires the use of the percentage of completion method. Additionally, IRC section 460 introduced the "Look-back Method." Look-back is discussed in detail in Chapter 5.

A long-term contract method of accounting (completed contract or percentage of completion) is only available to taxpayers that have long-term contracts. Therefore, whether or not a long-term contract exists and the classification of the contract must be determined prior to electing a proper method of accounting. This chapter is designed to bring out the various factors involved in making this determination.

### Definition of Long-Term Contract

The term "long-term" tends to indicate a contract that lasts a long period of time, but the duration of the contract is irrelevant in order for it to be classified as a long-term construction contract. IRC § 460(f)(1) generally defines a long-term contract as one that is not complete at the end of the tax year.

The long-term contract must also be for the manufacture, building, installation, or construction of property.

*IRC § 460(f)(1) In general. The term "long-term contract" means any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.*

#### Example:

A calendar-year taxpayer begins a construction job on December 31 and completes the job on January 1 of the subsequent year. The contract is considered a long-term contract even though the job was only two days in duration.

## Contracts Subject to IRC § 460

Under IRC § 460(b)(1), taxpayers must use the percentage of completion method to report taxable income from long-term contracts. The degree of completion is generally determined by comparing the total allocated contract costs incurred to date with the total estimated contract costs, otherwise known as the “cost-to-cost method.” Engineering estimates or other approaches to determine the degree of completion may not be used if the contractor is subject to the PCM under IRC § 460. If a contractor is able to meet the exemptions of IRC § 460(e), the use of the engineering estimates (or any other recognized output methods) or any appropriate method, meeting the definition of section 460, is allowed. See Chapter 4 (Large Contractors) for additional information regarding contracts subject to IRC § 460.

## Contracts Exempt from IRC Section 460

IRC § 460(e) provides two exceptions for long-term **construction** contracts to the required use of the percentage of completion rules and the application of look-back:

1. Any home construction contract (defined in IRC § 460(e)(6)(A)) entered into after June 20, 1988. Home construction contractors not meeting the small contractor exception (discussed below) are required, under IRC § 460(e)1)(B), to capitalize costs using IRC § 263A. See Chapter 7 (Home Builders and Land Developers) for additional information regarding these home construction contracts.
2. Small construction contracts, as defined in IRC § 460(e)1)(B), require that at the time the contract was entered into, it was estimated that such contract would be completed within a 2-year period beginning on the commencement date of such contract; and the contractor's average annual taxable gross receipts for the 3 taxable years preceding the year in which such contract was entered into did not exceed \$10 million. See Chapter 3 (Small Contractors) for additional information regarding these types of contracts.

### Example:

A contractor enters into two long-term contracts during the taxable year, neither which are home construction contracts. The average annual taxable gross receipts for the prior 3 taxable years are \$9,000,000. Job 1 is expected to be completed within 18 months and Job 2 is expected to be completed within 30 months. Job 1 is exempt from the percentage of completion and look-back requirements of IRC § 460 and may be accounted for under the taxpayer's elected method of accounting for long-term contracts (e.g. completed contract, accrual). However, Job 2 must be accounted for using the percentage of completion method and look-back may be required upon the completion of the

job. Even though the average annual taxable gross receipts for the prior 3 years is less than \$10,000,000, the contract is not estimated to be completed with the 2-year period. In this example, two methods of accounting for long-term contracts are proper.

The two exceptions provided under IRC § 460(e) do not apply to long-term manufacturing contracts.

## Construction Contracts versus Manufacturing Contracts

IRC § 460 makes a distinction between the two categories of long-term contracts: construction contracts and certain manufacturing contracts. A construction contract pertains to real property versus a manufacturing contract, which pertains to personal property.

- **Construction Contract Defined:** *IRC § 460(e)(4) Construction contract. For purposes of this subsection, the term "construction contract" means any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property.*
- **Manufacturing Contract Defined:** *IRC § 460(f)(2) Special rule form manufacturing contracts. A contract for the manufacture of property shall not be treated as a long-term contract unless such contract involves the manufacture of*  
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*(A) any unique item of a type which is not normally included in the finished goods inventory of the taxpayer, or*

*(B) any item which normally requires more than 12 calendar months to complete (without regard to the period of the contract).*

Treas. Reg. § 1.460-1(b)(1) further distinguishes a long-term construction contract from a long-term manufacturing contract:

*Treas. Reg. § 1.460-1(b)(1) Long-term contract. A long-term contract generally is any contract for the manufacture, building, installation, or construction of property if the contract is not completed within the contracting year, as defined in [Regulation § 1.460-1(b)(5)]. However, a contract for the manufacture of property is a long-term contract only if it also satisfies either the unique-item or 12-month requirements described in § 1.460-2. A contract for the manufacture of personal property is a manufacturing contract. In contrast, a contract for the building, installation, or construction of real property is a construction contract.*

This guide is written primarily for the discussion of construction contracts.

## **Real Property and its Integral Components under Treas. Reg. § 1.460-3(a)**

A contract not completed in the contracting year is a long-term construction contract if it involves the building, construction, reconstruction, or rehabilitation of real property; the installation of an integral component to real property; or the improvement of real property (collectively referred to as construction).

Real property means land, buildings, and inherently permanent structures, as defined in section 1.263A-8(c)(3), such as roadways, dams, and bridges. Real property does not include vessels, offshore drilling platforms, or unsevered natural products of land.

An integral component to real property includes property not produced at the site of the real property but is intended to be permanently affixed to the real property, such as elevators and central heating and cooling systems.

### Example:

A contract to install an elevator in a building is a construction contract because a building is real property, but a contract to install an elevator in a ship is not a construction contract because a ship is not real property.

### Example:

A taxpayer enters into a contract to manufacture an elevator; however, an unrelated party will install it. The contract for the manufacture of the elevator is not a construction contract. Even though the elevator is considered an integral component to real property, the regulations define a construction contract as one that involves **the installation** of the integral component.

## **Classification of Contracts**

A taxpayer must determine the classification of a contract on a contract-by-contract basis as one of the following:

- Long-term construction contract,
- Long-term manufacturing contract, or
- Non-long-term contract

Treas. Reg. § 1.460-1(b)(2)(i) clarifies that a contract's classification should be based on the performance required of the taxpayer under the contract, regardless of whether the

contract would be classified as a sales contract or a construction contract. It is irrelevant whether title in the property constructed under the contract is delivered to the customer.

*Treas. Reg. § 1.460-1(b)(2) Contract for the manufacture, building, installation, or construction of property. (i) In general. A contract is a contract for the manufacture, building, installation, or construction of property if the manufacture, building, installation, or construction of property is necessary for the taxpayer's contractual obligations to be fulfilled and if the manufacture, building, installation, or construction of that property has not been completed when the parties enter into the contract. If a taxpayer has to manufacture or construct an item to fulfill his obligations under the contract, the fact that the taxpayer is not required to deliver that item to the customer is not relevant. Whether the customer has title to, control over, or bears the risk of loss from, the property manufactured or constructed by the taxpayer also is not relevant. Furthermore, how the parties characterize their agreement (e.g., as a contract for the sale of property) is not relevant.*

#### Example:

A developer, whose taxable year ends December 31, owns 5,000 acres of undeveloped land. To obtain permission from the local county government to improve this land, a service road must be constructed on this land to benefit all 5,000 acres. In 2000, the developer enters into a contract to sell a 1,000-acre parcel of undeveloped land to a residential developer, for its fair market value. In this “sales” contract, the developer agrees to construct a service road running through the land that it is selling to the residential developer. The construction of the service road is estimated to be completed in 2002. The “sales” contract is a construction contract because the construction of an item (the service road) is necessary for the developer to fulfill its contractual obligations.

**Note:** for contracts entered into after January 10, 2001, de minimus construction activities, which are discussed later in this chapter, must also be considered in classification of the contract.

## **Hybrid Contracts**

A hybrid contract is a single long-term contract that requires a taxpayer to perform both manufacturing and construction activities. Generally, the regulations classify a hybrid contract as two contracts--a manufacturing contract and a construction contract. Treas. Reg. § 1.460-1(f)(2) permits a taxpayer to elect, on a contract-by-contract basis to do either of the following:

- Treat the entire contract as a long-term construction contract if at least 95% of the estimated total allocable contract costs are reasonably allocable to construction activities.

- Treat the entire contract as a long-term manufacturing contract subject to the percentage of completion method of accounting. (Note: there is not a 95% rule as with the election to treat a hybrid contract as a construction contract.)

*Treas. Reg. § 1.460-1(f)(2) Hybrid contracts - -(i) In general. A long-term contract that requires a taxpayer to perform both manufacturing and construction activities (hybrid contract) generally must be classified as two contracts--a manufacturing contract and a construction contract. A taxpayer may elect, on a contract-by-contract basis, to classify a hybrid contract as a long-term construction contract if at least 95% of the estimated total allocable contract costs are reasonably allocable to construction activities. In addition, a taxpayer may elect, on a contract-by-contract basis, to classify a hybrid contract as a long-term manufacturing contract subject to the [percentage of completion method (PCM)].*

## **De minimis Construction Activities**

A contract with de minimis construction activities is not a construction contract under IRC § 460 if the contract includes the provision of land by the taxpayer and the estimated total contract costs attributable to the construction activities are less than 10% of the contract's total contract price. For purposes of the 10% test, the cost of the land provided to the customer is *not* included in the allocable contract costs. Treas. Reg. § 1.460-1(b)(2)(ii).

This 10% threshold provides a "bright-line" test. Prior to enactment of the regulation, Notice 89-15 provided that a contract was a construction contract if the construction activity required by the contract was necessary for the taxpayer to fulfill its contractual obligations.

### Example:

A developer owns 5,000 acres of undeveloped land with a cost basis of \$5,000,000. To obtain permission from a local county government to improve this land, a service road must be constructed on this land to benefit all 5,000 acres. In 2001, the developer enters into a contract to sell a 1,000-acre parcel of undeveloped land to a residential developer for \$10,000,000. In the sales contract, there is a provision that commits the taxpayer to construct the portion of the service road that benefits the acreage sold, as required by the local county government. The portion of the cost of the service road attributable to the 1,000-acre parcel is estimated to be \$10,000. The service road is not completed until 2002. Because the estimated total allocable contract costs attributable to the construction activities (\$10,000) are less than 10% of the total contract price (\$10,000,000), the contract is not a construction contract, and is not to be accounted for under a long-term contract method.

## **Non-Long-Term Contract Activities (e.g., Architect, Engineer Services)**

Long-term contract methods of accounting apply only to the gross receipts and costs attributable to long-term contract activities. Non-long-term contract activities are defined in Treas. Reg. § 1.460-1(d)(2).

*Treas. Reg. § 1.460-1(d)(2) Non-long-term contract activity. Non-long-term contract activity means the performance of an activity other than manufacturing, building, installation, or construction, such as the provision of architectural, design, engineering, and construction management services, and the development or implementation of computer software. In addition, performance under a guaranty, warranty, or maintenance agreement is a non-long-term contract activity that is never incident to or necessary for the manufacture or construction of property under a long-term contract.*

Several revenue rulings have held that contracts for services cannot use a long-term method of accounting:

- An architect is not entitled to report income from contracts extending over more than one year on the completed contract method because the work is in the nature of personal service. (Rev. Rul. 70-67, 1970-1 C.B. 117)
- Engineering services and construction management, unrelated to the construction contractor, are not entitled to use either the completed contract method or percentage of completion method because the contract does not require the taxpayer to construct or build anything, even though the services are functionally related. (Rev. Rul. 82-134, 1982-2 C.B. 88; Rev. Rul. 80-18, 1980-1 C.B. 103)
- A painting contractor cannot use the completed contract method because he provides only painting services. (Rev. Rul. 84-32, 1984-1 C.B. 129)

However, if the performance of a non-long-term contract activity is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the gross receipts and costs attributable to that activity must be allocated to the long-term contract. Treas. Reg. § 1.460-1(d) requires allocation of the contract's gross receipts and costs among the activities.

*Treas. Reg. § 1.460-1(d) Allocation among activities - - (1) In general. Long-term contract methods of accounting apply only to the gross receipts and costs attributable to long-term contract activities. Gross receipts and costs attributable to long-term contract activities means amounts included in the total contract price or gross contract price, whichever is applicable, as determined under § 1.460-4, and costs allocable to the contract, as determined under § 1.460-5. Gross*

receipts and costs attributable to non-long-term contract activities (as defined in paragraph (d)(2) of [§ 1.460-1]) generally must be taken into account using a permissible method of accounting other than a long-term contract method. See IRC § 446(c) and. § 1.446-1(c). However, if the performance of a non-long-term contract activity is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, however, the gross receipts and costs attributable to that activity must be allocated to the long-term contract(s) benefited as provided in §§ 1.460-4(b)(4)(i) and 1.460-5(f)(2), respectively. Similarly, if a single long-term contract requires a taxpayer to perform a non-long-term contract activity that is not incident to or necessary for the manufacture, building, installation, or construction of the subject matter of the long-term contract, the gross receipts and costs attributable to that non-long-term contract activity must be separated from the contract and accounted for using a permissible method of accounting other than a long-term contract method. But see [§ 1.460-1(g)] for related party rules.

Example:

A general contractor is hired to design and construct a building for a customer. The design portion of the contract is considered a non-long-term contract activity. However, it is incidental to the construction of the building (the building could not be built without the design), so the entire contract is accounted for under a long-term contract method of accounting.

## **Contracts of Related Parties**

Treas. Reg. § 1.460-1(g) extends the reporting of the percentage of completion method to related parties that may not generally be required to report their income on the percentage of completion method. A taxpayer who performs an activity that would normally be considered a non-long term contract activity (e.g., architectural services) must report income on the percentage of completion method if it is **incident to or necessary** to a **related** party's long-term contract that must be reported using the percentage of completion method (PCM).

*Treas. Reg. § 1.460-1(g) Special rules for activities benefiting long-term contracts of a related party- - (1) Related party use of PCM- - (i) In general. Except as provided in [Reg. § 1.460(g)(1)(ii)], if a related party and its customer enter into a long-term contract subject to the PCM, and a taxpayer performs any activity that is incident to or necessary for the related party's long-term contract, the taxpayer must account for the gross receipts and costs attributable to this activity using the PCM, even if this activity is not otherwise subject to section 460(a). This type of activity may include, for example, the performance of engineering and design services, and the production of components and subassemblies that are*

*reasonably expected to be used in the production of the subject matter of the related party's contract.*

Treas. Reg. § 1.460-1(b)(4) defines a related party as a person whose relationship to a taxpayer is described in IRC § 707(b) or § 267(b) which includes:

- A partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership.
- Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.
- Members of a family, including only brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.
- An individual and a corporation, more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.
- Two corporations which are members of the same controlled group.
- A grantor and a fiduciary of any trust.
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts.
- A fiduciary of a trust and a beneficiary of such trust.
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts.
- A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust.
- A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual.
- A corporation and a partnership if the same persons own--more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership.
- An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

- An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation
- Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

Example:

An architectural firm enters into a contract with a customer to design an office building. The contract is for the performance of services, and therefore would not be classified as a long-term construction contract. If, however, the architect's related construction company enters into a contract with the same customer to build this "designed" building, and the construction company is required to account for the long-term construction contract under the PCM, the architect must account for the design services under PCM since the services are incidental to the related construction company's contract.

## Severing and Aggregating Contracts

Under IRC § 460(f)(3), contractors are permitted and may be required to sever or aggregate contracts. Severance **treats** one agreement as two or more contracts. Aggregation treats two or more agreements as one contract. Whether an agreement should be severed, or two or more agreements should be aggregated, depends, with certain exceptions, on the following factors as provided in Treas. Reg. § 1.460-1(e):

- Pricing. Independent pricing of items in an agreement is necessary for the agreement to be severed into two or more contracts.
- Separate delivery or acceptance. An agreement may not be severed into two or more contracts unless it provides for separate delivery or separate acceptance of items that are the subject matter of the agreement. The separate delivery or separate acceptance of items by itself does not, however, necessarily require an agreement to be severed.
- Reasonable business person. Two or more agreements to perform manufacturing or construction activities may not be aggregated into one contract unless a reasonable business person would not have entered into one of the agreements for the terms agreed upon without also entering into the other agreement(s).

A taxpayer may **not** sever a long-term contract that would be subject to the percentage of completion method without obtaining the Commissioner's prior written consent.

*Treas. Reg. § 1.460-1(e)(3). Exceptions- - (i) Severance for PCM. A taxpayer may not sever under this paragraph (e) a long-term contract that would be subject to the PCM without obtaining the Commissioner's prior written consent.*

In the case of **options and change orders**, subject to the above Treasury Regulation, a taxpayer must sever an agreement that increases the number of units to be supplied to the customer, such as through the exercise of an option or the acceptance of a change order, if the agreement provides for separate delivery or separate acceptance of the additional units.

Example of Severance:

On January 1, 2001, a construction contractor enters into an agreement to build two office buildings in different areas of a large city. The agreement provides that the two office buildings will be completed and accepted by the customer in 2002 and 2003, respectively, and that the contractor will be paid \$1 million and \$1.5 million for the two office buildings, respectively. The agreement will provide a reasonable profit from the construction of each building. Unless the contractor is required to use the PCM to account for the contract, the contractor is required to sever this contract because the buildings are independently priced, the agreement provides for separate delivery and acceptance of the buildings, and, as each building will generate a reasonable profit, a reasonable business person would have entered into separate agreements for the terms agreed upon for each building.

Example of Aggregation:

In 2001, a contractor enters into two separate contracts, as the result of a single negotiation, to construct two identical special use buildings (i.e. nuclear plant). Because the contractor has never constructed this type of building before, the contractor anticipates that it will incur substantially higher costs to construct the first building. If the agreements are treated as separate contracts, the first contract probably will produce a substantial loss, while the second contract probably will produce substantial profit. Based upon these facts, aggregation is required because the buildings are interdependently priced and a reasonable business person would not have entered the first agreement without also entering into the second.

Example of Contract Options:

A contractor enters into a contract with a developer to construct 10 homes on land owned by the developer to be built in year 1. The contract provides an option in which the contractor is to build an additional 10 homes. In year 2, the option is exercised and the additional homes are built. The option would be severed from the original contract.

## **Conclusion**

The construction industry is both unique and complex with respect to the number of available tax methods of accounting. The proper method of accounting for a long-term construction contract is determined contract-by-contract based on the type and terms of the contract, along with related party considerations.

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## Chapter 3: Small Construction Contractors

### Introduction

IRC § 460 was enacted as part of the Tax Reform Act of 1986, which requires the use of percentage of completion method for long-term construction contracts. However, as with many Code sections, there are exceptions to the required use of the percentage of completion accounting method and to the application of “look-back” interest rules. The exceptions are the home construction contract and the small construction contract. This chapter will provide an overview of the methods of accounting that are available to small construction contractors — cash, accrual, completed contract, and exempt percentage of completion. Specific accounting methods for home construction contracts and large construction contracts (*i.e.*, contracts that do not meet one of the two exceptions of IRC § 460) will be discussed in later chapters.

### Exceptions to the Required Use of the Percentage of Completion Accounting Method and Look-back Interest

IRC § 460(e) provides two exceptions to the required use of the percentage of completion accounting method and application of the look-back interest rules applicable to certain **construction** contracts. (These exceptions do not apply to long-term manufacturing contracts.)

1. The home construction contract.
2. The small contractor exception. In order to meet the small construction contract exception contained in IRC §460(e)(1)(B), two requirements must be met:
  - At the time the contract was entered, it was estimated that the contract would be completed within a 2-year period beginning on the commencement date of the contract; **and**
  - The contractor’s average annual gross receipts for the 3 taxable years preceding the year in which the contract was entered did not exceed \$10 million.

**IRC § 460(e) EXCEPTION FOR CERTAIN CONSTRUCTION CONTRACTS.--**  
**460(e)(1) IN GENERAL.--***Subsections (a), (b), and (c)(1) and (2)*  
*shall not apply to--*  
**460(e)(1)(A)** *any home construction contract, or*

**460(e)(1)(B)** any other construction contract entered into by a taxpayer--

**460(e)(1)(B)(i)** who estimates (at the time such contract is entered into) that such contract will be completed within the 2-year period beginning on the contract commencement date of such contract, and

**460(e)(1)(B)(ii)** whose average annual gross receipts for the 3 taxable years preceding the taxable year in which such contract is entered into do not exceed \$10,000,000.

*In the case of a home construction contract with respect to which the requirements of clauses (i) and (ii) of subparagraph (B) are not met, section 263A shall apply notwithstanding subsection (c)(4) thereof.*

#### Example of 2-year requirement not being met:

The taxpayer's average annual gross receipts are less than \$10,000,000 for the prior 3 taxable years. The taxpayer enters into two different jobs, which are not home construction contracts. Job 1 is expected to last 18 months. Job 2 is expected to last 3 years. The taxpayer would account for Job 1 under its normal method of accounting for long-term contracts (accrual, completed contract, or percentage of completion). However the taxpayer must account for Job 2 using the percentage of completion method as required by IRC § 460.

### **Production Period Interest**

Even though small contractors are otherwise exempt from the requirements of IRC § 460 (i.e. reporting using PCM and applying the look-back interest rules) the interest capitalization rules of IRC § 460(c)(3) are applicable to all contractors. IRC § 460(e)(1) only exempts the small contractor from subsections (a), (b), and (c)(1).

### **\$10 Million Gross Receipts Test**

Income from all trades or businesses (whether or not incorporated) that are under the common control with the taxpayer are considered in determining the gross receipts test. **This is an area that is often overlooked with small construction contractors.** Each return of a related group of tax returns may appear to qualify for the small contractors exception, but, once the gross receipts of all related entities are aggregated, the exception is not met. Therefore, the IRC § 460 requirements of the use of the percentage of completion method and application of "look-back" may apply to each "small contractor".

**IRC §460(e)(2) DETERMINATION OF TAXPAYER'S GROSS RECEIPTS.--For purposes of paragraph (1), the gross receipts of--**

**460(e)(2)(A)** all trades or businesses (whether or not incorporated) which are under common control with the taxpayer (within the meaning of section 52(b)),

**460(e)(2)(B)** all members of any controlled group of corporations of which the taxpayer is a member, and

**460(e)(2)(C)** any predecessor of the taxpayer or a person described in subparagraph (A) or (B), for the 3 taxable years of such persons preceding the taxable year in which the contract described in paragraph (1) is entered into shall be included in the gross receipts of the taxpayer for the period described in paragraph (1)(B). The Secretary shall prescribe regulations which provide attribution rules that take into account, in addition to the persons and entities described in the preceding sentence, taxpayers who engage in construction contracts through partnerships, joint ventures, and corporations.

The gross receipts test looks to the prior 3 taxable years rather than including the tax year during which the contract was entered. This enables the contractor at the commencement of the contract to know whether or not it must be reported using the percentage of completion method, and can adjust the accounting system accordingly. If a taxpayer has been in existence for less than the three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence.

**Treas. Reg. § 1.460-3(b)(3) directs the taxpayer to §1.263A-3(b) to determine what items are included for this gross receipts test. Gross receipts are the total amount, as determined under the taxpayer's method of accounting, derived from all trades or businesses. Gross receipts does not include (not all inclusive):**

- returns or allowances;
- interest, dividends, rents, royalties, or annuities, not derived in the ordinary course of a trade or business;
- Receipts from the sale or exchange of capital assets.

### **Explanation of a Controlled Group**

Two or more corporations whose stock is substantially held by five or fewer persons compose a "controlled group". These groups include "brother-sister" controlled groups, parent-subsidiary groups, combined groups, and insurance companies. Members of a controlled group are subject to related party transaction rules (i.e., income/deduction matching and loss deferrals on sales between members).

### **Example of aggregation of gross receipts for a controlled group:**

Mr. A is the sole shareholder of two corporations. Corporation A operates a roof installation business. Corporation B operates a grocery store. The gross receipts from

both businesses are considered when determining the \$10,000,000 average gross receipts test per IRC § 460(e)(1)(B)(ii).

Example of a controlled group:

Building Corporation has four unrelated shareholders, each owning 25% of the stock. The same four shareholders also own 25% each of Bridge Corporation. Building and Bridge corporations are related parties.

**Attribution of gross receipts of less than controlling interest**

A contractor that has less than 50% ownership but more than 5% ownership must aggregate a proportionate share of the construction-related receipts in determination of the \$10,000,000 test.

***Treas. Reg. 1.460-3(b)(3)*** \$10,000,000 gross receipts test--(i) *In general. Except as otherwise provided in paragraphs (b)(3)(ii) and (iii) of this section, the \$10,000,000 gross receipts test is satisfied if a taxpayer's (or predecessor's) average annual gross receipts for the 3 taxable years preceding the contracting year do not exceed \$10,000,000, as determined using the principles of the gross receipts test for small resellers under §1.263A-3(b).*

*(ii) Single employer. To apply the gross receipts test, a taxpayer is not required to aggregate the gross receipts of persons treated as a single employer solely under section 414(m) and any regulations prescribed under section 414.*

*(iii) Attribution of gross receipts. A taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person that has a five percent or greater interest in the taxpayer. In addition, a taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person in which the taxpayer has a five percent or greater interest. For this purpose, a taxpayer must determine ownership interests as of the first day of the taxpayer's contracting year and must include indirect interests in any corporation, partnership, estate, trust, or sole proprietorship according to principles similar to the constructive ownership rules under sections 1563(e), (f)(2), and (f)(3)(A). However, a taxpayer is not required to aggregate under this paragraph (b)(3)(iii) any construction-related gross receipts required to be aggregated under paragraph (b)(3)(i) of this section.*

Example of \$10,000,000 test for attribution of gross receipts:

Bob owns 100% of Building Corporation, which has average annual gross receipts of \$8,000,000. Bob also owns 10% of Construction Corporation, which has average annual gross receipts of \$25,000,000. The aggregate gross receipts, for IRC § 460 purposes, of Building Corporation are \$10,500,000 (\$8,000,000 + (25,000,000 x 10%)). Therefore, Building Corporation would be required to account for its long-term construction contracts under the percentage of completion method.

## **Determining The Proper Method Of Accounting For Small Contractors**

It is important to note that within the construction industry, a contractor will normally have, as a minimum, at least two methods of accounting: an overall method of accounting (cash, accrual, or hybrid) and one or more methods for its long-term contracts (completed contract, percentage of completion, percentage of completion capitalized cost method). The small contractor's exception must be determined on a contract-by-contract basis.

### Example of Several Methods of Accounting Used by One Contractor:

A small contractor uses the accrual method of accounting as its overall method to account for short-term contracts and the income and expenses not related to long-term contracts. The contractor uses the completed contract method for its exempt contracts and must use the percentage of completion method for the contracts that are estimated to exceed 2 years.

**Rev. Rul. 92-28 I.R.B. 1992-15,41, (Apr. 13, 1992)** - IRC § 460(e)(1) permits a taxpayer to use different methods of accounting for exempt and nonexempt contracts within the same trade or business.

## **General Rule for Accounting Methods**

IRC § 446 provides for the general rule for the methods of accounting that are available to the taxpayer.

### ***IRC section 446 General Rule for Methods of Accounting***

#### ***446(a) GENERAL RULE.--***

*Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.*

#### ***446(b) EXCEPTIONS.--***

*If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.*

#### ***446(c) PERMISSIBLE METHODS.--***

*Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting--*

**446(c)(1)** *the cash receipts and disbursements method;*

**446(c)(2)** *an accrual method;*

**446(c)(3)** *any other method permitted by this chapter; or*

**446(c)(4)** *any combination of the foregoing methods permitted under regulations prescribed by the Secretary.*

IRC § 446 allows the cash method of accounting and the accrual method of accounting. The other methods that IRC § 446(c)(3) references for construction contracts would be, namely, the completed contract method and the percentage of completion method.

## **Methods of Accounting**

Because long-term methods of accounting are determined on a **contract-by-contract basis**, a taxpayer potentially could be reporting long-term contracts under several methods of accounting. The choice of a proper method of accounting for long-term contracts is complex. The methods available to a contractor to account for the income and expenses of a long-term contract are as follows:

**Cash**

**Accrual**

**Hybrid**

**Accrual with deferred retainages**

**Completed contract method (CCM)**

**Exempt-contract percentage of completion method (EPCM)**

**Percentage of completion method (PCM) (cost-to-cost) as required by  
IRC § 460\***

**Percentage of completion simplified cost method \***

**Percentage of completion 10% method \***

**Percentage of completion capitalized cost method (PCCM) \***

\*These methods are discussed in Chapter 4 Large Construction Contractors

## **Selecting an Accounting Method**

If a contractor is exempt from the percentage-of-completion method under IRC

§ 460, the contractor may adopt a method of accounting for its long-term contracts on the **initial** income tax return, or in the first year it has long-term contracts. Once a method of accounting is adopted, this method must be used for all long-term contracts in the same trade or business. Generally, a change is not permitted without obtaining prior permission from the Commissioner.

### **Cash Method of Accounting**

Generally, the cash method of accounting is an acceptable method for small contractors. However, there are limitations on the use of the cash method.

IRC § 448 prohibits the use of the cash method by "C" corporations and partnerships with a "C" corporation partner, unless such entities have annual gross receipts that do not exceed \$5 million. This section also prohibits use of the cash method by all tax shelters.

IRC § 448 does not allow the use of the cash method. It merely **limits** the use of the cash method for certain entities.

#### Example:

An S Corporation that files a Form 1102-S is not subject to the \$5 million gross receipts limitation of I.R.C. § 448. An S corporation that has gross receipts of \$50 million may use the cash method of accounting as long as there are no other sections prohibiting it (e.g., taxpayer required to use accrual method to account for inventory; IRC § 460 requires the use of PCM for long-term contracts).

### **Cash vs. Accrual Issue**

In prior years, the IRS won many cases supporting the change from cash to accrual when merchandise was considered an income-producing factor. Treasury Regulation Section 1.446-1(c)(2)(i) requires the use an accrual method of accounting, if the taxpayer is required to account for inventories per IRC § 471. Treasury Regulation §1.471-1 requires an accounting of inventory in **every case** in which the production, purchase, or sale of merchandise is an income-producing factor.

After much litigation in this area, a safe harbor allowing the use of the cash method (via Revenue Procedure 2001-10 and Revenue Procedure 2002-28) was provided to taxpayers that would otherwise have been required to use an accrual method of accounting.

### **Revenue Procedure 2001-10**

Revenue Procedure 2001-10 permits eligible small businesses (with average gross receipts equal to or less than \$1 million) to use the cash method when an accrual

method would normally be required by IRC § 471 due to inventory. Revenue Procedure 2001-10 was issued on January 8, 2001. The Commissioner provided administrative relief from the requirements of IRC § 471 and Treas. Reg. § 1.446-1(c)(2)(i) to certain small taxpayers. This revenue procedure allows qualifying taxpayers (including those that provide goods and services to their customers) with average annual gross receipts of \$1 million or less to use the cash method.

However, contractors that qualify under this revenue procedure must treat certain property as non-incidental materials and supplies, as defined under Treas. Reg. § 1.162-3. The taxpayer cannot deduct these expenses until the later of the year in which payment for them was made or the year in which the materials and supplies are actually used or consumed in the taxpayer's business. In other words, even though the cash method is an acceptable method, the contractor still has some type of accounting for inventories. See the discussion later in this chapter pertaining to non-incidental materials and supplies.

### **Revenue Procedure 2002-28**

On May 6, 2002, Revenue Procedure 2002-28 was issued. This guidance allows a “qualifying” small business taxpayer, with average annual gross receipts of \$10 million or less, to use the cash receipts and disbursements method of accounting with respect to an eligible trade or business.

### **Gross Receipts Test for Revenue Procedure 2001-10 & Revenue Procedure 2002-28**

Similar to IRC § 460, the gross receipts test uses the average annual taxable gross receipts for the prior three taxable years. However, the definition of gross receipts for these two revenue procedures differs from IRC § 460. IRC § 460 gross receipts does **not** include returns and allowances, interest, dividends and rents. Both Revenue Procedures 2001-10 and 2002-28 define gross receipts to include total sales (net of returns and allowances), all amounts received from services, interest, dividends, and rents.

### **What is a Qualifying Taxpayer Under Revenue Procedure 2002-28?**

The average annual gross receipts for the 3 prior years must be \$10,000,000 or less and the taxpayer’s principal business activity must be a North American Industry Classification System (NAICS) code other than one of the ineligible NAICS codes listed in the Revenue Procedure:

- Mining (NAICS 211 and 212)
- Manufacturing (NAICS 31 – 33)
- Wholesale Trade (NAICS 42)
- Retail Trade (NAICS 44 and 45)
- Information Industries (NAICS 5111 and 5122)

Revenue Procedure 2002-28 does not override IRC § 448. C corporations or partnerships with a C corporate partner with average annual gross receipts greater than \$5 million cannot use the cash method of accounting. Neither does the Revenue Procedure override IRC § 460. Long-term construction contracts (contracts expected to require more than 2 years) that are not home construction contracts must be accounted for under the percentage of completion method.

Another important qualification is that the taxpayer cannot have previously changed from the cash to the accrual method as a result of becoming ineligible to use the cash method under this revenue procedure.

***Rev. Proc. 2002-28 Section 4.01 (1)*** *A qualifying small business taxpayer may use the cash method as described in this revenue procedure for all of its trades or businesses if the taxpayer satisfies any one of the following three tests and did not previously change (and was not previously required to have changed) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method under this revenue procedure.*

### **Revenue Procedure 2002-28 and Inventory**

A taxpayer that is required to account for inventories under IRC § 471 have three options:

1. Can use overall cash method and account for inventories under IRC § 471.
2. Can use overall accrual method and account for inventories as materials and supplies that are not incidental under Treasury Regulation Section 1.162-3 (not deductible until used or consumed in business).
3. Can use overall cash method and account for inventoriable items the same as materials and supplies that are not incidental under Treasury Regulation Section 1.162-3.

If the taxpayer chooses to treat materials under Treasury Regulation Section 1.162-3, they are not subject to IRC Section 263A.

### **Non-Incidental Material and Supplies**

An inventoriable item is any item that is either purchased for resale to customers or used as a raw material in producing finished goods. Inventoriable items that are treated as non-incidental material and supplies, per Rev. Proc. 2002-28, are deductible in the later of the tax year in which payment is made for them or in the tax year in which they are actually used and consumed.

**Rev. Proc. 2002-28 Section 6 Example 15--Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under §1.162-3 --Construction.** Taxpayer is a roofing contractor that is eligible to use the cash method under this revenue procedure. Taxpayer chooses to use the cash method and to account for inventoriable items as non-incidental materials and supplies under §1.162-3. Taxpayer enters into a contract with a homeowner in December 2001 to replace the homeowner's roof. Taxpayer purchases roofing shingles from a local supplier and has them delivered to the homeowner's residence. Taxpayer pays the supplier \$5,000 for the shingles upon their delivery later that month. Taxpayer replaces the homeowner's roof in December 2001, and gives the homeowner a bill for \$15,000 at that time. Taxpayer receives a check from the homeowner in January 2002. The shingles are non-incidental materials and supplies. The cost of the shingles is deductible in the year Taxpayer uses and consumes the shingles or actually pays for the shingles, whichever is later. In this case, Taxpayer both pays for the shingles and uses the shingles (by providing the shingles to the customer in connection with the performance of roofing services) in 2001. Thus, Taxpayer deducts the \$5,000 cost of the shingles on its 2001 federal income tax return. Taxpayer includes the \$15,000 in income in 2002 when it receives the check from the homeowner.

**Rev. Proc. 2002-28 Section 6 Example 16--Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under §1.162-3 --Construction.** Same as in Example 15, except that Taxpayer does not replace the roof until January 2002 and is not paid until March 2002. Because the shingles are not used until 2002, their cost can only be deducted on Taxpayer's 2002 federal income tax return notwithstanding that Taxpayer paid for the shingles in 2001. Thus, on its 2002 return, Taxpayer must report \$15,000 of income and \$5,000 of deductions.

### **Revenue Procedure 2002-28 and Contractors Building Property to Sell on Land They Own**

A contractor that meets the requirements of Revenue Procedure 2001-10 or 2002-28 is permitted to use the cash method of accounting. However, these revenue procedures do not apply to a contractor to the extent it enhances the value of land it owns by building structures it intends to sell. Such contractors are not permitted to immediately deduct the costs of this construction. These costs must be capitalized, and will eventually be offset against the sales price of the land and its improvements (the latter becoming real property as they are completed).

IRC § 263(a)(1) and Treas. Reg. § 1.263(a)-1 generally prohibit deductions for any amount that a taxpayer pays for new buildings or for permanent improvements or

betterments that increase the property's value. Treas. Reg. § 1.263(a)-2 sets forth examples of capital expenditures, including the cost of acquisition, construction, or erection of buildings. Consequently, the taxpayer-contractor must capitalize expenses in connection with real property construction on its own land, including construction of property that it intends to sell.

The purpose of Revenue Procedures 2001-10 and 2002-28 is to provide qualifying small taxpayers an exception to the required accrual method (under IRC § 446) when the taxpayer is required to account for inventories per IRC § 471. However, a taxpayer-contractor building on its own land for the purpose of selling the property constructed is producing or constructing a real property asset that it cannot inventory. See *W.C. & A.N. Miller Development Company v. Commissioner* 81 T.C. 619 (1983); *Pierce v. Commissioner*, T.C. Memo. 1997-411 (1997); Rev. Rul. 86-149, 1986-2 C.B. 67.

Revenue Procedure 2002-28, section 4.02, and Revenue Procedure 2001-10, section 4, provide inventory options that do not apply to expenses related to construction of taxpayer-owned real property. If the taxpayer has expenses related to inventoriable items that are not required to be capitalized (and are not related to construction of taxpayer-owned real property), it can choose from the applicable revenue procedure's inventory options. The taxpayer can still use the overall cash method so long as it meets the definitions of a qualifying small taxpayer. Under the cash method, the taxpayer can deduct business expenses that are not required to be capitalized, the later of when it pays them, sells the expense items, or uses the items for the customer, rather than when accrued. Similarly, the taxpayer would recognize income upon receipt (subject to applicable special rules, such as IRC § 1001), rather than when accrued.

Example 17 of Revenue Procedure 2002-28 illustrates that a taxpayer-contractor must capitalize building costs that occur on its own land and are attributable to property that it holds for sale, rather than deduct or inventory them.

***Rev. Proc. 2002-28 Section 6 Example 17--Timing of Deduction for Non-Inventoriable Items--Speculative Home Sales.*** Taxpayer is eligible to use the cash method as described in this revenue procedure. Taxpayer is a speculative builder of houses that are built on land it owns. In 2001, Taxpayer builds a house using various items such as lumber, piping, and metal fixtures that it had paid for in 2000. In 2002, Taxpayer sells the house to a buyer. Because the house is real property held for sale by Taxpayer, the house and the material used to build the house are not inventoriable items under this revenue procedure. Thus, Taxpayer may not account for the items used to build the house as non-incidentals and supplies under § 1.162-3. Rather, Taxpayer must capitalize the costs of the lumber, piping, metal fixtures and other goods used by Taxpayer to build the house under § 263. Upon the sale of the house in 2002, the costs capitalized by Taxpayer will be offset against the house sales price to determine Taxpayer's gain or loss from the sale.

Example 18 of Revenue Procedure 2002-28 emphasizes the importance of determining the ownership of the property that the taxpayer builds.

*Rev. Proc. 2002-28 Section 6 Example 18--Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162-3 --Construction. Same as in Example 17, except that (1) Taxpayer builds houses on land its customers own, and (2) the houses are built in three months with payment due at completion. Because Taxpayer does not own the house, the lumber, piping, metal fixtures and other goods used by Taxpayer in the provision of construction services are inventoriable items, not real property held for sale. Taxpayer elects to treat the goods used to build the house as non-incidental materials and supplies under § 1.162-3. Taxpayer must deduct the cost of the lumber, piping, metal fixtures and other non-incidental materials and supplies that are used by it to build the house in 2001 (the year those items were used by Taxpayer to build the house) notwithstanding that Taxpayer had paid for the items in 2000. Taxpayer will report income it receives from its customer as the income is actually or constructively received.*

### Summary of Accounting Methods

<b>Construction Taxpayers</b>	
<b>Average Annual Gross Receipts</b>	<b>Use of Cash Method?</b>
Gross Receipts $\leq$ \$1 Million	***Rev. Proc. 2001-10 and Rev. Proc. 2002-28 allows Cash Method but must account for inventories per IRC § 471 or as non-incidental materials and supplies per Treas. Reg. 1.162-3.
All entities except C corporations & Partnerships w/ C corporation partners - Gross Receipts $>$ \$1 Million and $\leq$ \$10 Million	Rev. Proc. 2002-28 allows Cash Method but must account for inventories per IRC § 471 or as non-incidental materials and supplies per Treas. Reg. 1.162-3.
C Corporations & Partnerships w/ C Corporation Partners – Gross Receipts $>$ \$5 Million	IRC § 448 prohibits use of Cash Method
Entities with gross receipts $\leq$ \$10,000,000 but with a non-home construction contract expected to last $>$ 2 years.	IRC § 460 requires the use of PCM for long-term contracts that are not exempt per IRC § 460(e).

All Entities with long-term contracts - Gross Receipts $\geq$ \$10 Million	IRC § 460 requires use of PCM for long-term contracts (with exception of home construction contracts)
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\*\*\* Rev. Proc. 2002-28 can apply to taxpayers with average annual gross receipts of 10 million dollars or less, but excludes certain types of businesses; whereas, Rev. Proc. 2001-10 can only apply to taxpayers with average annual gross receipts of one million dollars or less, but INCLUDES many types of businesses that Rev. Proc. 2002-28 excludes.

### Computation of the Cash Method of Accounting

The general rule (as shown in Treas. Reg. §1.446-1(c)(1)(i)) requires the taxpayer to report income when received and to deduct expenses when paid. Income may be actually or constructively received. Constructive receipt occurs when the taxpayer has unrestricted access to income that has been earned. Treas. Reg. 1.461-1(a)(1) provides, as a general rule, that a cash basis taxpayer shall deduct expenses in the year of payment. It further provides, however, that where an expenditure results in the creation of an asset having a useful life extending “substantially” beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. In *Zaninovich*, 616 F.2d 429, the appellate court adopted the “one-year rule”, on a cash basis taxpayer, distinguishing between currently deductible expenses and capital expenditures having a useful life extending “substantially beyond” the taxable year. The court allowed a full deduction for prepaid rent in the year of payment and did not require it to be deducted on a prorated basis.

#### Example of constructive receipt:

A general contractor contacted a subcontractor and offered payment for a job recently completed in December of Year 1. The subcontractor did not pick up the check until January of Year 2. The subcontractor would be required to report the income in Year 1, because it had been constructively received.

### Accrual Method of Accounting

For book purposes, the contractor generally includes revenue in gross income when it is billable under the contract. For tax purposes, however, the general principle is that income is included upon the first event fixing the taxpayer's right to receive income under IRC § 451, and must be determined under the terms of each particular contract. The relevant test is commonly called the "all-events test." All events that fix the right to receive income occur at the earliest of the following:

- **When the required performance occurs**

- **When payment is due**
- **When payment is made**

See Rev. Rul. 2003-10, Rev. Rul. 84-31; Rev. Rul. 83-106; Rev. Rul. 81-176; Rev. Rul. 80-308; Rev. Rul. 79-292; Rev. Rul. 79-195.

In *Boise-Cascade Corp*, 530 F.2d 1367, cert denied, 429 US 867, the Court of Claims permitted the accrual of income based on the work performed and not upon billing entitlement.

### **Front-loading Billings**

Front-loading billings is common in the construction industry. The taxpayer may require payment of 30 percent “up front” before the contract begins to cover the cost of the materials needed at the job site. Under the accrual method, the 30 percent is income when it is received under the contract, even though no performance of the job has been incurred.

### **Exception to Reporting Advance Payments in Year of Receipt**

As previously mention, accrual method taxpayers generally include advance payments for services in the year of receipt. An accrual-method taxpayer may, however, elect the provisions of **Revenue Procedure 71-21**, which defers the advance payments for services until the next tax year. This election is available only for **advance payments for services to be performed within the next 12 months**.

***Rev. Proc. 71-21--Section 3.02** An accrual-method taxpayer who, pursuant to an agreement (written or otherwise), receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services, subject to the limitations provided in Revenue Procedure 71-21 §§3.07, 3.08, and 3.11. If the inclusion in gross income of payments received is properly deferred under the preceding sentence, and for any reason a portion of such services is not performed by the end of the next succeeding taxable year, however, the amount allocable to the services not so performed must be included in gross income in such next succeeding year, regardless of when (if ever) such services are performed.*

#### Example of Advance Payments pursuant to Rev. Proc. 71-21:

On June 1, 2000, B, a calendar-year accrual-method taxpayer, who is a landscape architect, receives *full* payment for services, which, under the terms of the agreement, must be completed by December 31, 2001. On December 31, 2000, B estimates that three-fourths of the work under the agreement has been

completed. Under the method prescribed in Section 3.02 of Rev. Proc. 71-21, B must include three-fourths of the payment in 2000, but may choose to include the other one-fourth in income in either 2000 or 2001.

### **Deducting Expenses under the Accrual Method of Accounting**

Under the accrual method of accounting, expenses are deductible when all events have occurred that establish the fact of the liability, the amount can be determined with reasonable accuracy, and economic performance has occurred.

*Reg. §1.446-1(c)(1)(ii) Accrual method. (A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.*

The regulations define when economic performance has been met.

*Treas. Reg. §1.461-4(d)(2) Services or property provided to the taxpayer.*

*(i) In general. Except as otherwise provided in Regulation §1.461-4(d)(5), if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.*

### **Accrual Method and Retainages**

Retainages that are withheld from a contractor are generally included in income as the work, related to the retained amounts, is provided. The amounts have been earned. However Revenue Ruling 69-314 allows an accrual-basis taxpayer to elect to defer the retainages withheld until they are billable under the terms of the contract, which is normally when the contractor has the right to receive the retention. The contractor must also defer retainages payable.

If the taxpayer is not currently deferring the retainages and wants to elect this provision under Revenue Ruling 69-314, it is a change in method of accounting that requires the Commissioner's permission.

Retainages that the contractor withholds on subcontractors is not deductible until the "all-events" test is met. Therefore, even though economic performance has occurred (i.e. the subcontractor has completed a portion of the work) the all events test with respect to the retainage may not be established if the contract requires full acceptance and completion.

### Example of Retainage Payable:

A contractor hires a subcontractor and the contract requires a \$1,500,000.00 total payment and a 10% retainage. The retainage is not payable until full acceptance and completion of the job. The subcontractor completes 1/3 of the job and bills the contractor for \$500,000. The contractor withholds

10% and pays the subcontractor \$ 450,000. The contractor can only deduct \$450,000, because all events that establish the fact of the liability in regards to the \$50,000 have not occurred. If the subcontractor fails to complete the job or completes the job unsatisfactorily, the \$50,000 does not have to be paid per the terms of the contract.

### **Completed Contract Method (CCM)**

Taxpayers may elect the CCM to account for their exempt contracts. The general rule is that all contract income and contract related expenses (both direct and indirect) are deferred until the taxable year that the contract is completed. Because of this tax deferral, this is the method preferred by most taxpayers.

*Treas. Regulation § 1.460-4(d) Completed-contract method. (1) In general. Except as otherwise provided in paragraph (d)(4) of this section, a taxpayer using the CCM to account for a long-term contract must take into account in the contract's completion year, as defined in § 1.460-1(b)(6), the gross contract price, and all allocable contract costs incurred by the completion year. A taxpayer may not treat the cost of any materials and supplies that are allocated to a contract, but actually remain on hand when the contract is completed, as an allocable contract cost.*

### **Completion of a Long-Term Contract**

Prior to the issuance of the final regulations, facts and circumstances determined whether there was final completion and acceptance. See *Ball, Ball & Brosamer, Inc. v. Commissioner*, 964 F.2d 890 (9th Cir. 1992) (aff'g T.C. Memo. 1990-454). For contracts entered into after January 10, 2001, the new regulations further define completion by providing a "bright-line" test that explicitly differs from *Ball, Ball, & Brosamer, Inc.* A contract is deemed complete when the customer uses the primary subject matter of that contract and the taxpayer has incurred at least 95% of the total allocable costs.

*Treas. Reg. §1.460-1(c)(3) Date contract completed. (i) In general. A taxpayer's contract is completed upon the earlier of:*

*(A) use of the subject matter of the contract by the customer for its intended purpose (other than for testing) and at least 95% of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer, or*

*(B) final completion and acceptance of the subject matter of the contract.*

#### Example of completion Customer-use rule:

In 2002, a calendar year-end construction contractor enters into a contract to construct a building for a customer. In November 2003, the building is completed in every respect necessary for its intended use, and the customer occupies the building. In early December of 2003, the customer notifies the contractor of some minor deficiencies that need to be corrected and the contractor agrees to correct them in January 2004. Reasonable estimates of the costs to correct these deficiencies will be less than 5% of the total allocable contract costs. The contract is complete in 2003 because in that year the customer used the building *and* at least 95% of the total allocable contract costs attributable to the building had been incurred. The contractor would then use a permissible method of accounting for any deficiency-related costs incurred after 2003.

#### Example of completion: Customer-use rule:

In 2001, a calendar year-end construction contractor agrees to construct a shopping center, which includes an adjoining parking lot. By October 2002, the contractor has finished constructing the retail portion of the shopping center. By December 2002, the contractor has graded the entire parking lot, but has paved only one-fourth of it because inclement weather conditions prevented the contractor from laying asphalt on the remaining three-fourths. In December 2002, the customer opens the retail portion of the shopping center and the paved portion of the parking lot to the general public. The contractor reasonably estimates that the cost of paving the remaining three-fourths of the parking lot when weather permits will exceed 5% of the total allocable contract costs. Even though the customer is using the subject matter of the contract, the contract is not completed in December 2002 because the contractor has not incurred at least 95% of the total allocable contract costs attributable to the subject matter.

### **Post Completion Expenses**

When the contract is considered complete under the 95% completion rule per Treas. Reg. § 1.460-1(c)(3), the remaining contract costs incurred after the completion year are deductible under the taxpayer's permissible method of accounting (i.e. accrual method). The completed contract method (CCM) requires that the taxpayer include all income (gross contract price) in the completion year AND account for all costs incurred after the completion year in the normal manner for such expenses.

*Treas. Reg. § 1.460-4(d)(2): . . .If a taxpayer incurs an allocable contract cost after the completion year, the taxpayer must account for that cost using a permissible method of accounting.*

#### Example of Post Completion Expense on CCM:

As of Dec 31, 2001 a contract, entered into after January 10, 2001, was determined to be 97% complete. The total contract price is reported as income in 2001 as well as the related contract costs that have been incurred to date. The remaining contract costs

(approx. the remaining 3% of total contract costs) incurred during 2002 are deductible in 2002.

### **Allocation of Indirect Costs**

Because all contract costs are deferred until the contract is deemed complete, the non-allocation of all indirect costs, that are required to be allocated, can lead to a substantial mismatching of income and expenses. The non-allocated costs are deducted as period expenses rather than being capitalized to the long-term contract that they benefit.

Taxpayers electing the CCM have the option of allocating all direct and indirect costs as defined in §1.263A-1(e) or as provided in Treas. Reg. §1.460-5(d). Treas. Reg. §1.460-5(d) lists the various indirect costs that are allocable to the contract:

*Treas. Reg. **§1.460-5(d)(2)** Indirect costs--(i) Indirect costs allocable to exempt construction contracts. A taxpayer allocating costs under this paragraph (d)(2) must allocate the following costs to an exempt construction contract, other than a contract described in paragraph (d)(3) of this section, to the extent incurred in the performance of that contract--*

- (A) Repair of equipment or facilities;*
- (B) Maintenance of equipment or facilities;*
- (C) Utilities, such as heat, light, and power, allocable to equipment or facilities;*
- (D) Rent of equipment or facilities;*
- (E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and contributions to a supplemental unemployment benefits plan;*
- (F) Indirect materials and supplies;*
- (G) Non-capitalized tools and equipment;*
- (H) Quality control and inspection;*
- (I) Taxes otherwise allowable as a deduction under section 164, other than state, local, and foreign income taxes, to the extent attributable to labor, materials, supplies, equipment, or facilities;*
- (J) Depreciation, amortization, and cost-recovery allowances reported for the taxable year for financial purposes on equipment and facilities to the extent allowable as deductions under chapter 1 of the Internal Revenue Code;*
- (K) Cost depletion;*

*(L) Administrative costs other than the cost of selling or any return on capital;*

*(M) Compensation paid to officers other than for incidental or occasional services;*

*(N) Insurance, such as liability insurance on machinery and equipment; and*

*(O) Interest, as required under paragraph (b)(2)(v) of this section.*

*(ii) Indirect costs not allocable to exempt construction contracts. A taxpayer allocating costs under this paragraph (d)(2) is not required to allocate the following costs to an exempt construction contract reported using the CCM--*

*(A) Marketing and selling expenses, including bidding expenses;*

*(B) Advertising expenses;*

*(C) Other distribution expenses;*

*(D) General and administrative expenses attributable to the performance of services that benefit the taxpayer's activities as a whole (e.g., payroll expenses, legal and accounting expenses);*

*(E) Research and experimental expenses (described in section 174 and the regulations thereunder);*

*(F) Losses under section 165 and the regulations thereunder;*

*(G) Percentage of depletion in excess of cost depletion;*

*(H) Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is neither en route to nor located at a job-site), and depreciation, amortization and cost recovery allowances under chapter 1 of the Internal Revenue Code in excess of depreciation, amortization, and cost recovery allowances reported by the taxpayer in the taxpayer's financial reports;*

*(I) Income taxes attributable to income received from long-term contracts;*

*(J) Contributions paid to or under a stock bonus, pension, profit-sharing, or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a), and other employee benefit expenses paid or accrued on behalf of labor, to the extent the contributions or expenses are otherwise allowable as deductions under chapter 1 of the Internal*

*Revenue Code. Other employee benefit expenses include (but are not limited to): worker's compensation; amounts deductible or for whose payment reduction in earnings and profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc.;*

*(K) Cost attributable to strikes, rework labor, scrap and spoilage; and*

*(L) Compensation paid to officers attributable to the performance of services that benefit the taxpayer's activities as a whole.*

### **Primary Issues To Consider For Completed Contract Method Taxpayers**

- Determining an in-process contract to be complete (over 95% complete)
- Allocation of Indirect Costs (not all costs allocated to the contract)
- Alternative Minimum Tax (if a non-home construction contract may be subject to Alternative Minimum Tax which is discussed later in this chapter).

### **Subcontracts and completion**

**Treas. Regulation §1.460-1(c)(3)(iii)** clarifies that a subcontractor's customer is the general contractor. Thus, the subject matter of the subcontract is the relevant subject matter in determining a contract's completion.

*Treas. Reg. §1.460-1(c)(3)(iii) Subcontracts. In the case of a subcontract, a subcontractor's customer is the general contractor. Thus, the subject matter of the subcontract is the relevant subject matter under paragraph (c)(3)(i) of this section.*

#### **Example:**

In 2001, a customer hires a general contractor to construct an office building. The building will not be completed until 2003. The general contractor, in turn, hires a subcontractor to pour the concrete foundation. The subcontractor pours the concrete foundation and it is accepted by the general contractor in 2002. The subcontractor's contract is considered complete in 2002, not 2003 upon the customer's use of and/or acceptance of the building.

### **Exempt-contract percentage-of-completion method (EPCM)**

A taxpayer who is exempt from the requirement to use the percentage of completion under IRC § 460 (using the cost-to-cost method) still may elect a PCM. The percentage

of completion may be determined by using any method of cost comparisons, such as the following:

- Direct labor costs to estimated total labor costs
- Work performed (e.g., units of production)--the criteria used to compare the work performed on a contract must clearly reflect the earning of income with respect to the contract
- *Treas. Reg. §1.460-4(c)(2) Exempt-contract percentage-of-completion method.*

*(i) In general. Similar to the PCM described in paragraph (b) of this section, a taxpayer using the EPCM generally must include in income the portion of the total contract price, as described in paragraph (b)(4) of this section, that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year. Under the EPCM, the percentage of completion may be determined at the end of the taxable year by using any method of cost comparison (such as comparing direct labor costs incurred to date to estimated total direct labor costs) or by comparing the work performed on the contract with the estimated total work to be performed, rather than by using the cost-to-cost comparison required by paragraphs (b)(2)(i) and (5) of this section, provided such method is used consistently and clearly reflects income. In addition, paragraph (b)(3) of this section (regarding post-completion-year income), paragraph (b)(6) of this section (regarding the 10% method) and §1.460-6 (regarding the look-back method) do not apply to the EPCM.*

*(ii) Determination of work performed. For purposes of the EPCM, the criteria used to compare the work performed on a contract as of the end of the taxable year with the estimated total work to be performed must clearly reflect the earning of income with respect to the contract. For example, in the case of a road builder, a standard of completion solely based on miles of roadway completed, in a case where the terrain is substantially different, may not clearly reflect the earning of income with respect to the contract.*

#### Example of Exempt PCM:

An exempt contract requires the taxpayer to install 50 miles of utility lines. The entire 50 miles is on comparable terrain, meaning no particular area will require additional costs to install the utility lines. The contract elects the percentage of completion based on units (e.g., miles). At the end of the tax year, 10 miles have been installed; thus, 20% of the contract is determined to be complete.

## **Alternative Minimum Tax (AMT)**

Generally contractors meeting the “small contractor exemption” under IRC section 460(e)(1) are not required to use PCM for regular tax purposes. However, I.R.C. § 56 requires that long-term contracts shall be determined under the percentage of completion method of accounting for alternative minimum tax. Alternative minimum tax is a separate tax system designed to ensure that taxpayers pay a minimum amount of tax on the true economic income when the income may not yet be taxable for regular income tax purposes. Therefore, small contractors that elect a method other than PCM may be required to compute alternative minimum taxable income.

**IRC §56 ADJUSTMENTS APPLICABLE TO ALL TAXPAYERS.--**

**56(a)(3) TREATMENT OF CERTAIN LONG-TERM CONTRACTS.--***In the case of any long-term contract entered into by the taxpayer on or after March 1, 1986, the taxable income from such contract shall be determined under the percentage of completion method of accounting (as modified by section 460(b) ). For purposes of the preceding sentence, in the case of a contract described in section 460(e)(1), the percentage of the contract completed shall be determined under section 460(b)(1) by using the simplified procedures for allocation of costs prescribed under section 460(b)(3). The first sentence of this paragraph shall not apply to any home construction contract (as defined in section 460(e)(6)).*

There are two exceptions to the percentage of completion method for alternative minimum tax:

1. The last sentence in IRC § 56(a)(3), above, states that the alternative minimum tax adjustment for PCM does not apply to home construction contracts.

*A home construction contract is defined by I.R.C. §460(e)(6)(A) HOME CONSTRUCTION CONTRACT.--The term “home construction contract” means any construction contract if 80 percent of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to—*

*460(e)(6)(A)(i) dwelling units (as defined in section 168(e)(2)(A)(ii) ) contained in buildings containing 4 or fewer dwelling units (as so defined), and*

*460(e)(6)(A)(ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.*

*For purposes of clause (i), each townhouse or row house shall be treated as a separate building.*

2. “Small corporations” are exempt from alternative minimum tax for years beginning after 1997 per IRC § 55(e). The definition of a “small corporation” for purposes of the exemption, the corporation must:

- a. Be a C corporation (S Corporations, partnerships, and individual entities (Schedule C) are not exempt per IRC 55(e)).
- b. For the first tax year beginning after 1996, the average gross receipts for the prior 3 years must be \$5,000,000 or less.
- c. A C corporation that meets the initial \$5,000,000 will continue to be exempt from AMT as long as the average gross receipts do not exceed \$7,500,000.

**IRC §55 ALTERNATIVE MINIMUM TAX IMPOSED.**

(e) EXEMPTION FOR SMALL CORPORATIONS.--

(1) IN GENERAL.--

(A) \$7,500,000 GROSS RECEIPTS TEST.--*The tentative minimum tax of a corporation shall be zero for any taxable year if the corporation's average annual gross receipts for all 3-taxable-year periods ending before such taxable year does not exceed \$7,500,000. For purposes of the preceding sentence, only taxable years beginning after December 31, 1993 shall be taken into account.*

(B) \$5,000,000 GROSS RECEIPTS TEST FOR FIRST 3-YEAR PERIOD.--*Subparagraph (A) shall be applied by substituting "\$5,000,000" for "\$7,500,000" for the first 3-taxable-year period (or portion thereof) of the corporation which is taken into account under subparagraph (A).*

(C) FIRST TAXABLE YEAR CORPORATION IN EXISTENCE.--*If such taxable year is the first taxable year that such corporation is in existence, the tentative minimum tax of such corporation for such year shall be zero.*

D) SPECIAL RULES.--*For purposes of this paragraph, the rules of paragraphs (2) and (3) of section 448(c) shall apply.*

If a small corporation later exceeds the \$7.5 million average, the corporation becomes subject to AMT, but only for those contracts entered into after the average was exceeded. C Corporation contractors (other than home construction contracts) with average gross receipts falling between \$7.5 million and \$10 million would be subject to the long-term AMT adjustment. Contractors exceeding the \$10 million average would be required to use PCM for regular tax purposes, and no AMT adjustment would be necessary.

Example:

Assume a calendar-year corporation was in existence on January 1, 1994. In order to qualify as a small corporation for 1998 (the first year the exemption is available), (1) the corporation's average gross receipts for the three-taxable year period 1994 through 1996 must be \$5 million or less and (2) the corporation's average gross receipts for the 1995 through 1997 period must be \$7.5 million or less. If the corporation qualifies for 1998, the corporation will qualify for 1999 if its average gross receipts for the three-taxable year period 1996 through 1998 is \$7.5 million or less. If the corporation does not qualify for 1998, the corporation cannot qualify for 1999 or any subsequent year.

Example:

Assume a calendar-year corporation is first incorporated in 1999 and is neither aggregated with a related, existing corporation under IRC § 448(c)(2) nor treated as having a predecessor corporation under IRC § 448(c)(3)(D). The corporation will qualify as a small corporation for 1999 regardless of its gross receipts for such year. In order to qualify as a small corporation for 2000, the corporation's gross receipts for 1999 must be \$5 million or less. If the corporation qualifies for 2000, the corporation also will qualify for 2001 if its average gross receipts for the two-taxable year period 1999 through 2000 is \$7.5 million or less. If the corporation does not qualify for 2000, the corporation cannot qualify for 2001 or any subsequent year. If the corporation qualifies for 2001, the corporation will qualify for 2002, if its average gross receipts for the three-taxable year period 1999 through 2001 is \$7.5 million or less.

Sole proprietorships (Schedule C), S corporations (1120-S), and partnerships (1065) do not have a gross receipts exception. Therefore, percentage of completion for alternative minimum tax purposes is required for non-home construction contracts.

**Long-Term Contract Adjustment for Alternative Minimum Tax**

The AMT adjustment is computed by taking the difference in the two gross profits, i.e., the gross profit using the taxpayer's accounting method for regular tax purposes vs. the gross profit computed under PCM (using the simplified method or the alternative method to determine percent complete). PCM is required to be used for financial statements per SOP 81-1(Statement of Position) and many companies are required to have financial statements for bonding or lending purposes. Thus, this information is usually available.

Example of AMT Adjustment:

A Schedule C contractor reports income and expenses from long-term contracts on the completed contract method. The contracts are not home construction contracts. The AMT adjustment for the job below would be as follows (only one job-in-process used for simplification purposes):

Tax Year - Job 1	PCM Gross Profit	CCM Gross Profit	AMT Adjustment
2000	50,000	0	50,000
2001	75,000	0	75,000
2002	25,000	150,000	(125,000)

For the tax years 2000 and 2001, the contractor would pay alternative minimum tax since no regular income tax is paid. However, in 2002, the negative AMT adjustment would most likely result in no alternative minimum tax and the contractor would receive an AMT credit on the prior AMT paid.

This AMT adjustment is shown on the line labeled **Long-Term Contracts** which is line 21 of the 2002 Form 6251 Alternative Minimum Tax – Individuals and line 2f of the 2002 Form 4626 Alternative Minimum Tax – Corporations.

### **S Corporations, partnerships, and Alternative Minimum Tax**

The alternative minimum tax adjustment for long-term contracts is determined at the entity level. Each shareholder then reports the AMT adjustment on his or her pro-rata ownership. This amount should be reported on the Schedule K-1 provided to the partner or shareholder which would then be reported on the appropriate line on the Form 6251 if the shareholder/partner is an individual or Form 4626 if the shareholder/partner is a corporation.

### **Look-Back and Alternative Minimum Tax**

Even though small contractors are exempt from the requirement to report long-term contracts on PCM and apply look-back to completed contracts, the look-back applies to those small contractors that must compute PCM for alternative minimum tax purposes.

See the look-back module for more detailed information on the computation of look-back.

### **Small Contractors Becoming Large Contractors**

Small contractors that were exempt from the IRC §460 PCM reporting requirements (due to the average annual gross receipts being less than \$10,000,000) become large contractors when the average annual gross receipts exceeds \$10,000,000. During this converting year, any contracts previously in progress are still accounted for under the method they have been using (e.g., completed contract method). Any new contracts started are computed on the percentage of completion method. This is known as the “cut-off” method. Because this is a statutory change, the change in accounting method procedures (i.e., filing Form 3115) do not apply. Conversely, if, in a subsequent year, the average annual taxable gross receipts go back below \$10,000,000, the taxpayer will compute any new contracts under its “exempt” contract method (e.g., completed contract), and continue to report previous contracts using to PCM.

#### Example:

The contractor has been in business since 1990 and properly elected the completed contract method for reporting its long-term construction contracts. 2000 is the first taxable year that the average annual gross receipts for the prior three taxable years exceeded \$10,000,000. In 2002, the average annual gross receipts dropped below \$10,000,000:

	2000	2001	2002
Job 1 – in process in 1999	CCM	CCM – job completed	
Job 2 – started 2000	PCM	PCM	PCM – job completed
Job3 – started in 2001		PCM	PCM
Job 4 – started in 2002			CCM

## Pros and Cons of Long-Term Accounting Methods

### Completed Contract

- Defer gross profits and income tax on contracts until the job is completed.
- Several contracts completed within one year may require substantial income recognition in a single year.
- Contractors may spend cash received from early billings and not have sufficient funds to pay income tax in year of completion.
- Alternative minimum tax must be calculated using the percentage of completion method, unless taxpayer meets one of the exceptions.

### Percentage of Completion

- Allows recognition of income as work is performed, rather than recognizing substantial amounts when several contracts are completed in one year. This enables taxpayers to take advantage of the graduated tax rates.
- Allows for the deferral of income from front-loading, which, under the accrual method, is recognized when received or billed.
- There may not be any difference in reporting for financial statement purposes and the tax return. This reduces burden of record keeping.
- An alternative minimum tax calculation will not be necessary.

## Conclusion

Small construction contractors have more flexibility in electing methods of accounting for their long-term contracts. However, the small contractor may be subject to alternative minimum tax for those contracts that are not computed on the percentage of completion method. The choice of a proper accounting method, the proper computation of each accounting method, and the alternative minimum tax consequences are complex concepts that must be considered by each contractor.

## Chapter 4: Large Construction Contractors

### Introduction

This chapter introduces the taxation of large construction contractors. For purposes of this chapter, large construction contractors are defined as contractors not meeting the exceptions under IRC section 460(e). Contractors meeting the exceptions of IRC section 460(e) are discussed in separate chapters, Small Construction Contractors (Chapter 3) and Home Construction Contracts (Chapter 7).

### Methods of Accounting for Contracts Subject to IRC § 460 Percentage of Completion Method (PCM)

Large construction contractors are required to account for long-term contracts on the percentage of completion method. The amount of revenue reported each year under the contract, using the percentage of completion method, is determined by multiplying the total estimated contract price times the percentage of completion at the end of the taxable year (completion factor) less any gross receipts reported in the prior tax years of the contract. See Treas. Reg. § 1.460-4(b)(2). IRC § 460 provides two methods of determining the degree of contract completion. They are the “cost-to-cost method” and the “simplified cost-to-cost method.”

### Cost-to-Cost Method

IRC § 460(b)(1)(A) generally requires that the percentage of completion method (PCM) be computed utilizing the cost-to-cost method. Treas. Reg. § 1.460-4(b) describes the “cost-to-cost” computation as follows:

$$\begin{array}{l} \text{Total allocable contract} \\ \text{costs incurred to date} \end{array} \quad \times \quad \begin{array}{l} \text{Total estimated} \\ \text{contract price} \end{array} \quad - \quad \begin{array}{l} \text{Prior years' reported gross receipts} \\ \text{contract price} \end{array} \\ \text{Total estimated allocable} \\ \text{contract costs} \quad = \quad \text{Gross receipts to be reported for the taxable year}$$

*Treas. Reg. § 1.460-4(b) Percentage-of-completion method - -*

*(1) In general. Under the PCM, a taxpayer generally must include in income the portion of the total contract price, as defined in [Regulation § 1.460-4(b)(4)(i)] that corresponds to the percentage of the entire contract that the taxpayer has*

completed during the taxable year. The percentage of completion must be determined by comparing allocable contract costs incurred with estimated total allocable contract costs. Thus, the taxpayer includes a portion of the total contract price in gross income as the taxpayer incurs allocable contract costs.

(2) Computations. To determine the income from a long-term contract, a taxpayer - -

(i) Computes the completion factor for the contract, which is the ratio of the cumulative allocable contract costs that the taxpayer has incurred through the end of the taxable year, to the estimated total allocable contract costs that the taxpayer reasonably expects to incur under the contract;

(ii) Computes the amount of cumulative gross receipts from the contract by multiplying the completion factor by the total contract price;

(iii) Computes the amount of current-year gross receipts, which is the difference between the amount of cumulative gross receipts for the current taxable year and the amount of cumulative gross receipts for the immediately preceding taxable year (the difference can be a positive or negative number); and

(iv) Takes both the current-year gross receipts and the allocable contract costs incurred during the current year into account in computing taxable income.

#### Example of Cost-to-Cost PCM:

B enters into a construction contract in 2001 for which B is to receive \$10 million. B estimates that its total costs under the contract will be \$8 million. At the end of 2002, B has incurred \$4 million of its estimated costs on this project. If using this formula, B included \$3 million of the contract price as gross receipts in 2001, B must include \$2 million as gross receipts for 2002:

$$(\$4,000,000 \div \$8,000,000) \times (\$10,000,000) - (\$3,000,000) = \$2,000,000$$

## **Allocable Contract Costs**

The allocable contract costs that are used in determining the cost-to-cost method are provided in Treas. Reg. § 1.460-5(b) which has a direct link to IRC § 263A costs.

*Treas. Reg. § 1.460-5(b) Cost allocation method for contracts subject to PCM--(1) In general. Except as otherwise provided in paragraph (b)(2) of this section, a taxpayer must allocate costs to each long-term contract subject to the PCM in the same manner that direct and indirect costs are capitalized to property produced by a taxpayer under § 1.263A-1(e) through (h). Thus, a taxpayer must allocate to each long-term contract subject to the PCM all direct costs and certain indirect costs properly allocable to the long-term contract (i.e., all costs that directly benefit or are incurred by reason of the*

*performance of the long-term contract). However, see paragraph (c) of this section concerning an election to allocate contract costs using the simplified cost-to-cost method. As in section 263A, the use of the practical capacity concept is not permitted. See § 1.263A-2(a)(4).*

Direct costs listed in Treas. Reg. § 1.263A-1(e)(2) include:

- Direct material costs
- Direct labor costs

Indirect costs under Treas. Reg. § 1.263A-1(e)(3) include:

- Indirect labor costs
- Officers' compensation
- Pension and other related costs
- Employee benefit expenses
- Indirect material costs
- Purchasing costs
- Handling costs
- Storage costs
- Cost recovery
- Depletion
- Rent
- Taxes
- Insurance
- Utilities
- Repairs and maintenance
- Engineering and design costs
- Spoilage
- Tools and equipment
- Quality control
- Bidding costs
- Licensing and franchise costs
- Interest
- Capitalizable service costs

Subject to PCM, direct material and labor costs, are properly allocable to the long-term contract are all costs that directly benefit or are incurred through the contract's performance. Treas. Reg. § 1.460-5(b)(1). Similarly, indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Treas. Reg. § 1.263A-1(e)(3)(i). Some indirect costs, on the other hand, may benefit both the long-term contract and other business activities of the taxpayer and are not always specifically identified to a particular long-term contract. This allocation may be a

specific “facts-and-circumstances” method, including the specific identification (or tracing) method, burden rate method (i.e., ratios based on direct costs, direct labor, etc.), standard cost method, a “simplified method” provided in Treas. Reg. §§ 1.263A-2(b) and 1.263A-3(d), or any other reasonable method (as defined under Treas. Reg. § 1.263A-1(f)(4)). See Treas. Reg. § 1.263A-1(f) and (g)(3).

### **Direct Material Costs**

Direct material costs include the costs of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production that can be identified or associated with particular units or groups of units of property produced. Treas. Reg. § 1.263A-1(e)(2)(i)(A). Direct material costs must be allocated to a long-term contract when “dedicated” to the contract. Thus, a taxpayer dedicates direct materials by associating them with a specific contract, including by purchase order, entry on books and records, or shipping instructions. Treas. Reg. § 1.460-5(b)(2)(i). Therefore, uninstalled materials that are dedicated to a contract become an allocable job cost.

### **Direct Labor Costs**

Direct labor costs include the costs of labor that can be identified or associated with the long-term contract. For this purpose, labor encompasses full-time and part-time employees, as well as contract employees and independent contractors. Direct labor costs include all elements of compensation other than employee benefit costs described in Treas. Reg. § 1.263A-1(e)(3)(ii)(D). Elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan. See Treas. Reg. § 1.263A-1(e)(2)(i)(B).

### **Bidding Costs**

Bidding expenses are those costs incurred by a contractor in the solicitation of a long-term contract. The taxpayer must defer all bidding costs paid or incurred in the solicitation of a particular contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs allocated to the subject matter of the contract. If the contract is not awarded to the taxpayer, bidding costs are deductible in the taxable year that the contract is awarded to another party, or in the taxable year that the taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be rebid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. See Treas. Reg. § 1.263A-1(e)(3)(ii)(T).

### **Indirect Costs Not Generally Allocable**

Subject to the exception in IRC § 460(c)(2)(costs identified under cost-plus and certain federal contracts) , costs not allocable to the contract are independent research and development expenses, expenses for unsuccessful bids and proposals, and marketing, selling, and advertising expenses. See IRC § 460(c)(4). Treas. Reg. § 1.263A-1(e)(3)(iii) provides a list of additional indirect costs not allocable to the long-term contract under Treas. Reg. § 1.460-5(b). These indirect costs include “deductible service costs,” which generally include costs incurred by reason of the taxpayer’s overall management or policy guidance functions, such costs from the board of directors, chief executive, financial, accounting, and legal officers. See Treas. Reg. § 1.263A-1(e)(3)(iii)(K) and (e)(4)(ii)(B) and (e)(4)(iv)(A). Even though a service cost is classified as “general and administrative,” however, it is allocable to the long-term contract if it directly benefits or is incurred by reason of the taxpayer’s performance of the production or resale activities. Examples are costs from data processing, personnel operations, security services, and legal services. See Treas. Reg. § 1.263A-1(e)(4)(i)(A) and (B) and (e)(4)(ii)-(iii).

### **Nondeductible Costs**

Costs that would normally be allocable to a contract but are nondeductible by the Internal Revenue Code are not an allocable contract cost. A common example would be the nondeductible portion of meals per IRC § 274. The amount incurred as well as the total estimated amount of the nondeductible cost must be removed from the percentage of completion computation.

*Treas. Reg. § 1.460-5(f) Special rules applicable to costs allocated under this section--(1) Nondeductible costs. A taxpayer may not allocate any otherwise allocable contract cost to a long-term contract if any section of the Internal Revenue Code disallows a deduction for that type of payment or expenditure (e.g., an illegal bribe described in section 162(c)).*

### **Impact of Cost Allocation on the Percentage of Completion Computation**

Unlike the percentage of completion method, a taxpayer using the completed contract method must defer the deduction of all allocable contract costs until the contract is completed. See Treas. Reg. § 1.460-4(d)(1). Under the percentage of completion method, however, the taxpayer deducts the allocable contract costs in the year incurred, but the allocable contract cost’s exclusion from the percentage of completion computation (also known as “completion factor”) may affect the gross receipts amount reported in each taxable year of the contract. The key is to know what costs the percentage of completion taxpayer included in the completion computation.

The following scenarios point out the effect that allocation of indirect costs could have upon the gross receipts reported by a percentage of completion taxpayer:

Year 1: At year end, the taxpayer's estimated completion is 20%, determined as follows:

\$100,000 Total allocable contract costs incurred to date  
\$500,000 Total estimated costs allocable contract costs

Scenario 1: An indirect allocable contract cost was included in the total estimated allocable contract costs in the denominator, but the cost, which was incurred during the taxable year, was erroneously not included in the numerator. This incurred cost was deducted on the tax return. The amount is still deductible as an expense; however, it should also be added to the numerator and, as such, impacts the amount of gross receipts to be reported on this contract.

$$\frac{100,000 + 10,000}{500,000} = 22\% \text{ complete}$$

Scenario 2: An indirect allocable contract cost, which is not incurred pro-rata over the life of the contract (e.g., architect fee and building permits which are incurred early in the contract), was improperly excluded from both the numerator and denominator of the PCM computation. The amount incurred during the tax year is the same as the total estimated cost of this expense – no additional amount of this indirect cost is to be incurred on this contract. Again, as mentioned in scenario 1, the deductibility of this expense is proper,<sup>1</sup> only the gross receipts amount to be reported under this contract is impacted.

$$\frac{100,000 + 10,000}{500,000 + 10,000} = 21.57\% \text{ complete}$$

Scenario 3: An indirect allocable contract cost, which is incurred pro-rata over the life of the contract (e.g., indirect labor and officer's salary, which are incurred throughout the duration of the contract), was improperly excluded from both the numerator and denominator of the PCM computation. The cost incurred during the taxable year is included in the numerator and the total estimated cost, which must be determined, is included in the denominator.

$$\frac{100,000 + 10,000}{500,000 + 50,000} = 20\% \text{ complete}$$

As Scenario 3 indicates, theoretically, if a pro-rata cost is not included in the numerator or denominator of the percentage of completion computation it may not have a material impact on the gross receipts to be reported.

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<sup>1</sup> Under PCM, the reference to the regulations under section 263A applies only to what costs to allocate, and how. Allocable contract costs under PCM, however, are still deductible in the year incurred when computing taxable income. See Treas. Reg. §§ 1.460-4(b)(2)(iv) and (h) Ex. 2; 1.460-5(b)(1).

## Cost-Plus Contracts and Federal Long-Term Contracts

Cost-plus fee contracts are common in the construction industry. With this type of contract, the owner agrees to pay the contractor a fee in addition to the costs the contractor incurs to complete the project. This fee may be fixed or based on a percentage of the costs. This type of contract shifts much of the risk to the owner; however, the owner can reduce the risk by establishing a Guaranteed Maximum Price (GMP). The GMP establishes a maximum cost that the owner will pay and may contain a clause for the owner and contractor to share in any savings if the project is completed at less than the maximum price. In cost-plus contracts, the contract will detail which costs are to be reimbursed by the owner. For percentage of completion purposes, if any of these “contract costs” would not normally be allocated to the long-term contract, IRC § 460(c)(2) requires those costs be allocated. See also Treas. Reg. § 1.460-5(b)(2)(iv):

*Treas. Reg. § 1.460-5(b)(2)(iv) Costs identified under cost-plus long-term contracts and federal long-term contracts. To the extent not otherwise allocated to the contract under this paragraph (b), a taxpayer must allocate any identified costs to a cost-plus long-term contract or federal long-term contract (as defined in section 460(d)). Identified cost means any cost, including a charge representing the time-value of money, identified by the taxpayer or related person as being attributable to the taxpayer’s cost-plus long-term contract or federal long-term contract under the terms of the contract itself or under federal, state, or local law or regulation.*

### Example of Cost-Plus Cost Allocation:

A cost-plus contract lists some marketing expenses, which are **not** normally considered an allocable contract cost per IRC § 460(c)(4). However, per IRC § 460(c)(2) these costs are allocated to the long-term contract.

## Simplified Cost-to-Cost Method

IRC § 460(b)(1)(A) generally requires the cost-to-cost method to determine completion. However, IRC § 460(b)(3)(A) provides an elective simplified cost-to-cost method for determining the degree of contract completion for taxpayers using the PCM. Under the simplified cost-to-cost method, only the following costs are used in determining the percentage-of-completion:

- Direct material costs
- Direct labor costs
- Depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the long-term contract

Subcontracted costs represent either direct material or direct labor costs, which must be allocated to a contract. Treas. Reg. §1.460-5(c)(1).

*Treas. Reg. § 1.460-5(c) Simplified cost-to-cost method for contracts subject to the PCM.--. (1) In general. Instead of using the cost-allocation method prescribed in [Treas. Reg. § 1.460-5(b)], a taxpayer may elect to use the simplified cost-to-cost method, which is authorized under section 460(b)(3)(A), to allocate costs to a long-term contract subject to the PCM. Under the simplified cost-to-cost method, a taxpayer determines a contract's completion factor based upon only direct material costs; direct labor costs; and depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to manufacture or construct the subject matter of the contract. For this purpose, the costs associated with any manufacturing or construction activities performed by a subcontractor are considered either direct material or direct labor costs, as appropriate, and therefore must be allocated to the contract under the simplified cost-to-cost method. An electing taxpayer must use the simplified cost-to-cost method to apply the look-back method under § 1.460-6 and to determine alternative minimum taxable income under § 1.460-4(f).*

A taxpayer using the simplified cost-to-cost method must utilize the costs described above in determining both the costs allocated to the contract and incurred before the close of the taxable year, and the estimated total contract cost.

## **Percentage-of-Completion – 10 Percent Method**

Under IRC § 460(b)(5) and Treas. Reg. § 1.460-4(b)(6), the taxpayer may elect to defer recognition of revenue under PCM until 10% of the total estimated allocable contract costs are incurred. Accordingly, the costs incurred before the 10% year are considered pre-contracting year costs and thus are not deductible until the 10% year.

This method of accounting is an election and applies to all long-term contracts entered into during, and all taxable years after, the electing year. Once elected, the taxpayer would be required to obtain the Commissioner's permission to change to another method.

This election is unavailable if the taxpayer elected to use the simplified method for allocation of costs under IRC § 460(b)(3)(A) or is exempt under IRC § 460(e).

### Example –PCM -10 Percent Method:

A contractor, C, whose taxable year ends December 31, determines the income from long-term contracts using the 10 Percent Method. For each of the taxable years, C's income from the contract is computed as follows:

	<u>2001</u>	<u>2002</u>	<u>2003</u>
<b>Cumulative Incurred Costs</b>	40,000	300,000	600,000
<b>Total Estimated Costs</b>	600,000	600,000	600,000
<b>Percent Complete</b>	6.67%	50.00%	100.00%
<b>Total Contract Price</b>	11,000,000	11,000,000	11,000,000
<b>Gross Revenue Reported</b>	-0-	500,000	500,000
<b>Expenses Deducted</b>	-0-	300,000	300,000

### **Percentage-of-Completion/Capitalized-Cost Method (PCCM)**

A taxpayer may determine the income from a long-term construction contract that is a *residential construction contract* using either the PCM or the PCCM. The PCCM allows the residential construction contractor to report 70 percent of the contract under PCM (as required by IRC § 460) and the remaining 30 percent to be reported under an exempt method (e.g., completed contract method).

A residential construction contract differs from a home construction contract in that a home construction contract involves buildings with four or fewer dwelling units; whereas, a residential construction contract involves buildings with more than four dwelling units (e.g., apartment buildings or condominiums with five or more units in each building). See IRC § 460(e)(6).

The final regulations explain the PCCM.

*Treas. Reg. § 1.460-4(e) Percentage-of-completion/capitalized-cost method.*

*Under the PCCM, a taxpayer must determine the income from a long-term contract using the PCM for the applicable percentage of the contract and its exempt contract method, as defined in paragraph (c) of this section, for the remaining percentage of the contract. For residential construction contracts described in § 1.460-3(c), the applicable percentage is 70 percent, and the remaining percentage is 30 percent. For qualified ship contracts described in §*

1.460-2(d), the applicable percentage is 40 percent, and the remaining percentage is 60 percent.

Even though the residential construction contracts are allowed the 70/30 hybrid method for reporting income for regular tax, the entire contract must be reported under PCM for alternative minimum tax purposes. See Treas. Reg. § 1.460-4(f).

## **Total Estimated Contract Price and Claim Income**

The total estimated contract price is the amount the contractor reasonably expects to receive from the owner under the long-term contract. Total estimated contract price includes: the original contract price, “retainages,” “holdbacks,” and approved contract change orders. In addition, contractors must include, in the estimated contract price, contingent compensation such as awards, incentive payments, unapproved contract change orders, and amounts relating to claims<sup>2</sup> when there is a reasonable expectation the contractor will receive these amounts.

*Treas. Reg. § 1.460-4(b)(4) Total contract price-- (i) In general--. (A) Definition. Total contract price means the amount that a taxpayer reasonably expects to receive under a long-term contract, including holdbacks, retainages, and cost reimbursements. See § 1.460-6(c)(1)(ii) and (2)(vi) for application of the look-back method as a result of changes in total contract price.*

Contingent compensation (i.e., bonus, award, incentive payment, and amount in dispute) is included in total contract price as soon as the taxpayer can reasonably predict that the amount will be earned, even if the all-events test has not yet been met. The portion of the contract price that is in dispute is includible in the total contract price at the time and to the extent that the taxpayer can reasonably predict that the dispute will be resolved in the taxpayer's favor, regardless of when the taxpayer actually receives payment or when the dispute is resolved. See Treas. Reg. § 1.460-4(b)(4)(i)(B); Tutor-Saliba Corp. v. Commissioner, 115 T.C. 1 (2000). This regulation also provides that contingent income is includible in the total contract price not later than when it is included in income for financial reporting purposes under generally accepted accounting principles (GAAP).

*Treas. Reg. § 1.460-4(b)(4)(i)(B) Contingent compensation. Any amount related to a contingent right under a contract, such as a bonus, award, incentive payment, and amount in dispute, is included in total contract price as soon as the taxpayer can reasonably predict that the amount will be earned, even if the all events test has not yet been met. For example, if a bonus is payable to a taxpayer for meeting an early completion date, the bonus is includible in total contract price at the time and to the extent that the taxpayer can reasonably predict the achievement of the corresponding objective. Similarly, a portion of the contract price that is in dispute is includible in total contract price at the time and to the extent that the taxpayer can reasonably predict that the dispute will be resolved in the taxpayer's favor (regardless of when the taxpayer actually*

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<sup>2</sup> See Appendix 5 for definitions of “award,” “bonus,” “change order,” “claims,” “holdback,” and “retainage.”

*receives payment or when the dispute is finally resolved). Total contract price does not include compensation that might be earned under any other agreement that the taxpayer expects to obtain from the same customer (e.g., exercised option or follow-on contract) if that other agreement is not aggregated under § 1.460-1(e). For the purposes of paragraph (b)(4)(i)(B), a taxpayer can reasonably predict that an amount of contingent income will be earned not later than when the taxpayer includes that amount in income for financial reporting purposes under generally accepted accounting principles. If a taxpayer has not included an amount of contingent compensation in total contract price under paragraph (b)(4)(i) by the taxable year following the completion year, the taxpayer must account for that amount of contingent compensation using a permissible method of accounting. If it is determined after the taxable year following the completion year that an amount included in total contract price will not be earned, the taxpayer should deduct that amount in the year of the determination.*

Example of Contingent Compensation:

In 2002, a contractor reports \$10 million of disputed income as income on the financial statements, which are prepared in accordance with GAAP. Per Treas. Reg. §1.460-4(b)(4)(i)(B), this amount must also be included the total contract price in 2002.

Example of Bonus:

A contract specifies that the contractor will receive a bonus for meeting an early completion date. At the end of the 2001 taxable year, the contractor is ahead of schedule and anticipates meeting the early completion date; therefore, the bonus would be included in the total contract price.

**Additional Considerations for PCM**

Each component of the PCM computation needs to be analyzed to ensure the proper gross income amount is reported each year under the contract.

Total allocable contract costs incurred to date

Total estimated allocable contract costs                      x Total estimated contract price

Total Allocable Contract Costs Incurred to Date (Numerator) &  
Total Estimated Allocable Contract Costs (Denominator) Considerations:

- Verify that the direct and indirect allocable contract costs, per Treas. Reg. § 1.460-5(b), are included in both the numerator and the denominator as the cost is incurred. See Treas. Reg. § 1.460-4(b). For example, the denominator includes the total estimated allocable cost of equipment rental; however, as this cost is incurred it must also be included in the numerator of the PCM computation. If this cost were not included in the numerator, the completion of the contract is understated which results in understated gross income for the taxable year.

- Verify that warranty expenses are not included in the PCM computation. See Treas. Reg. §§ 1.460-1(d)(2) and 1.263A-1(e)(3)(iii)(H).
- A taxpayer may not allocate any otherwise allocable contract cost to a long-term contract if any section of the Internal Revenue Code disallows a deduction for that cost or expenditure (e.g., an illegal bribe described in section 162(c), nondeductible portion or meals and entertainment per section 274). See Treas. Reg. § 1.460-5(f)(1).
- Total Estimated Contract Price Considerations:
  - Retainages, holdbacks, and cost reimbursements are included in the total estimated contract price because the taxpayer reasonably expects to receive these amounts under the long-term contract. See Treas. Reg. § 1.460-4(b)(4)(i)(A).
  - Contingent compensation such as a bonus, award, incentive payment, and amount in dispute, is included in total contract price as soon as the taxpayer can reasonably predict that the amount will be earned, even if the all events test has not yet been met. Additionally, if the contingent amount is included in income for financial reporting per generally accepted accounting principles, the amount is also included in the total contract price. See Treas. Reg. § 1.460-4(b)(4)(i)(B).

### **Terminated Contract: Reversal of Income**

If a long-term contract (under PCM) is terminated before completion and, as a result, the taxpayer retains ownership of the property, the taxpayer must reverse the transaction in the taxable year of termination. The taxpayer reports a loss (or gain) equal to the cumulative allocable contract costs reported under the contract in all prior taxable years less the cumulative gross receipts reported under the contract in all prior taxable years.

As a result of reversing the transaction, a taxpayer will have an adjusted basis in the retained property equal to the cumulative allocable contract costs reported under the contract. If the taxpayer received and retains any consideration or compensation from the customer, however, the taxpayer must reduce the adjusted basis in the retained property (but not below zero) by the fair market value of that consideration or compensation. To the extent that the amount of the consideration or compensation described in the preceding sentence exceeds the adjusted basis in the retained property, the taxpayer must include the excess in gross income for the taxable year of termination.

The look-back method does not apply to a terminated contract.

*Treas. Reg. § 1.460-4(b)(7) Terminated contract*—

(i) Reversal of income. If a long-term contract is terminated before completion and, as a result, the taxpayer retains ownership of the property that is the subject matter of that contract, the taxpayer must reverse the transaction in the taxable year of termination. To reverse the transaction, the taxpayer reports a loss (or gain) equal to the cumulative allocable contract costs reported under the contract in all prior taxable years less the cumulative gross receipts reported under the contract in all prior taxable years.

(ii) Adjusted basis. As a result of reversing the transaction under [Treas. Reg. § 1.460-4(b)(7)(i)], a taxpayer will have an adjusted basis in the retained property equal to the cumulative allocable contract costs reported under the contract in all prior taxable years. However, if the taxpayer received and retains any consideration or compensation from the customer, the taxpayer must reduce the adjusted basis in the retained property (but not below zero) by the fair market value of that consideration or compensation. To the extent that the amount of the consideration or compensation described in the preceding sentence exceeds the adjusted basis in the retained property, the taxpayer must include the excess in gross income for the taxable year of termination.

(iii) Look-back method. The look-back method does not apply to a terminated contract that is subject to this paragraph (b)(7).

Example of Terminated Contract:

A contractor-taxpayer buys a parcel of land. In 2002, the contractor enters into a contract to construct an office building on that parcel of land. In 2002, the contractor reports gross receipts and allocable contract costs on this contract under the percentage of completion method as follows:

	<u>2002</u>
<b>Gross Receipts</b>	\$2,000,000
<b>Allocable Contract Costs</b>	<u>1,500,000</u>
<b>Gross Profit on Contract</b>	<u>500,000</u>

In 2003, the customer defaults on the contract due to bankruptcy. The unfinished office building remains with the contractor. In 2003, the contractor will report a loss of \$500,000 in relation to this terminated contract, computed by deducting the prior taxable years' reported cumulative gross receipts of \$2 million from the prior taxable years' reported cumulative allocable contract costs of \$1.5 million. As of termination, provided there were no additional expenses incurred on this office building in 2003 and the contractor does not receive or retain consideration or compensation from the customer, the contractor will have an adjusted basis of \$1.5 million, equivalent to the cumulative allocable contract costs reported under the contract in all prior taxable years.

If the contractor had billed and received \$1.8 million from the customer in 2002 (of which none of the proceeds are due back to the customer), the contractor will report \$300,000 in gross income in 2002 because the \$1.8 million compensation exceeds the adjusted basis of \$1.5 million. The adjusted basis of the property would be zero.

## **Conclusion**

Large construction contractors must use the percentage of completion method to report income from long-term contracts. They do not have the flexibility of selecting among several methods as the small construction contractors.

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## Chapter 5: Look-Back Interest

### Introduction

Taxpayers using the percentage of completion method must generally apply the look-back method upon completion of each contract. IRC § 460(b)(2) provides that in the taxable year in which a contract is complete, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if the actual cost and contract price, rather than estimated contract price and cost, had been used to compute gross income. This look-back computation does not result in an adjustment to tax, but instead results in interest due to or from the taxpayer, depending on the results of the computation.

**IRC § 460(b)(1)(B)** *upon completion of the contract (or, with respect to any amount properly taken into account after completion of the contract, when such amount is so properly taken into account), the taxpayer shall pay (or be entitled to receive) interest computed under the look-back method of paragraph (2).*

A taxpayer must file Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, in the tax year in which a contract subject to the look-back method is completed. Such a taxpayer must pay interest (but no tax) if the look-back method reveals an underpayment with respect to a taxable year, and the taxpayer will receive interest if the look-back computation reveals an overpayment.

### Look-Back Is Hypothetical

The computation of the amount of deferred or accelerated tax liability under the look-back method is hypothetical. The application of look-back does not result in an adjustment to the tax liability (i.e., the prior years' look-back computation does not amend the tax liability of those years). The computation is only to determine the interest due to or owed by the taxpayer on the tax differential in each year due to the differences in the estimated and actual figures.

**Treas. Reg. § 1.460-6(a)(1)** *...The computation on the amount of deferred or accelerated tax liability under the look-back method is hypothetical; application of the look-back method does not result in an adjustment to the taxpayer's tax liability as originally reported, as reported on an amended return, or as adjusted on examination. Thus, the look-back method does not correct for differences in tax liability that result from over- or underestimation of contract price and costs and that are permanent because, for example, tax rates change during the term of the contract.*

Example of hypothetical computation:

Job 1 commenced during Year 1 and was completed in Year 3. The taxpayer was required to report the gross receipts and expenses on Job 1 using the percentage of completion method pursuant to the formulas set forth below (IRC § 460(b)):

$$\begin{array}{l} \text{Total allocable contract} \\ \text{costs incurred to date} \quad \times \quad \text{Total estimated contract price - Prior years' reported gross} \\ \text{receipts} \\ \text{Total estimated allocable} \\ \text{contract costs} \\ \qquad \qquad \qquad = \text{Gross receipts to be reported for taxable year} \end{array}$$

In Year 3, the year of completion, the percentage of completion computation would be recomputed in Year 1 and Year 2 using the actual figures rather than the estimated amounts as follows:

Per Return	Year 1	Year 2	Year 3
Job 1	$\frac{450,000}{4,500,000 \times 5,000,000=}$  500,000 Gross Income	$\frac{4,000,000}{4,800,000 \times 5,200,000=}$  4,333,333 – 500,000= 3,833,333 Gross Income	$\frac{5,000,000}{5,000,000 \times 5,500,000=}$  5,500,000 – 4,333,333= 1,166,667 Gross Income
Look back	Year 1	Year 2	Year 3
Job 1	$\frac{450,000}{5,000,000 \times 5,500,000=}$  495,000 Gross Income	$\frac{4,000,000}{5,000,000 \times 5,500,000=}$  4,400,000 – 495,000= 3,905,000 Gross Income	Completion Year = Look-back interest computed on the prior years of the contract
	Gross Income Overstated by 5,000 (500,000 – 495,000)	Gross Income Understated by 71,667 (4,333,333 – 4,400,000)	

In the above example, Year 1 and Year 2 tax returns are **not** amended; the tax computation of look-back is hypothetical. The interest is computed on the tax differential of the changes to income in Year 1 and Year 2, which would be shown on Form 8697 filed in Year 3, the year of completion.

### Scope of Look-back Method

The look-back method applies only to long-term contracts subject to the percentage of completion method described in IRC § 460(b). Thus, look-back interest does not apply to construction contracts meeting the exceptions under IRC § 460(e), such as home construction contracts and taxpayers meeting the small contractor exception. The look-back method applies to the following:

- **Percentage of Completion Method (PCM):** any income from a long-term contract that is required to be reported under the percentage of completion method for regular income tax purposes. Treas. Reg. § 1.460-6(b)(1).
- **Alternative Minimum Tax (AMT):** any income from a long-term contract that is required to be reported under the percentage of completion method for alternative minimum tax purposes. These include non-home construction contracts, with average annual gross receipts for the prior 3 years that are less than \$10,000,000. Although these non-home construction contracts are exempt from reporting income on the percentage of completion method for regular income tax purposes, for alternative minimum tax purposes the taxpayer must report the income on the percentage of completion method. The look-back method is applied in recomputing AMT. Treas. Reg. § 1.460-6(b)(2)(ii).
- **Percentage of Completion-Capitalized Cost Method (PCCM):** Residential construction contracts may be reported under PCCM in which 70% of the contract is reported under PCM and the other 30% is reported under an exempt contract method. (See Treas. Reg. § 1.460-4(e)). Look-back would be computed on the 70% PCM portion of the contract. Treas. Reg. § 1.460-6(b)(1).
- **Related Parties:** To the extent that the percentage of completion method is required to be used under Treas. Reg. § 1.460-1(g) with respect to income and expenses that are attributable to activities that benefit a related party's long-term contract, the look-back method also applies to these amounts, even if those activities are not performed under a contract entered into directly by the taxpayer. Treas. Reg. § 1.460-6(b)(1).

## Exceptions from the Application of Look-Back

Look-back does not apply to the regular taxable income from any long-term construction contract in the following situations:

- **Home construction contract:** exempt per IRC § 460(e)(1)(A) and defined by IRC § 460(e)(6)(A).
- **Small Contractor exception:** any contract which is not a home construction contract but is estimated to be completed within a 2-year period is exempt per IRC § 460(e)(1)(B) if the taxpayer's average annual gross receipts for the 3 tax years preceding the tax year the contract is entered into do not exceed \$10,000,000. However, the look-back may apply to the alternative minimum taxable income from a contract of this type.
- **De Minimis Small Contract Exception:** The look-back method does not apply to any long-term contract that is (1) completed within 2 years of the contract

commencement date, and (2) has a gross contract price that does not exceed the lesser of:

- \$1,000,000 or
- 1% of the average annual gross receipts of the taxpayer for the 3 tax years preceding the tax year that the contract is completed.

Exception from the look-back method is mandatory for de minimis small contracts and applies for purposes of computing both regular taxable income and alternative minimum taxable income. See IRC § 460(b)(3)(B).

**IRC § 460 (b)(3)(B) LOOK-BACK METHOD NOT TO APPLY TO CERTAIN CONTRACTS.—**  
*Paragraph (1)(B) shall not apply to any contract—*

*(i) the gross price of which (as of the completion of the contract) does not exceed the lesser of—*

- (I) \$1,000,000, or*
- (II) 1 percent of the average annual gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the contract was completed, and*

*(ii) which is completed within 2 years of the contract commencement date.*

Example of De minimis Small Contract Exception:

The average annual gross receipts for the 3 preceding tax years are \$55,000,000. The following non-home construction contracts were completed during the taxable year and all jobs were completed within 2 years of the contract commencement date:

Job 1	Gross Contract Price	\$5,000,000
Job 2	Gross Contract Price	900,000
Job 3	Gross Contract Price	15,000,000
Job 4	Gross Contract Price	2,500,000
Job 5	Gross Contract Price	400,000

Only Job 5 would be exempt from the application of look-back. The de minimis exception applies to jobs which have a gross contract price less than \$550,000 (1% of \$55,000,000 – average annual gross receipts), which is the lesser of \$1,000,000 or 1%. However, if Job 5 was not completed within 2 years of the contract commencement date, the de minimis exception would not apply, and look-back would be required.

Note: The \$1,000,000 benchmark would only apply when the average annual gross receipts of the three preceding years exceeds \$100,000,000.

**Election Not to Apply Look-Back to Certain Contracts in De Minimis Discrepancy Cases**

For contracts completed in tax years ending after August 5, 1997, contractors may elect not to apply the look-back method if the amount reported is within 10 percent of the cumulative taxable income or loss as determined using actual contract price and costs for **each** prior contract year. The 10% test must be met in each year of the contract; it is not 10% of the entire contract (i.e. a contract will not meet the de minimis exception if the entire contract is within 10% of the look-back computation but in Year 1 the contract was 11% different). IRC § 460(b)(6)(B).

**IRC § 460(b)(6)(B) DE MINIMIS DISCREPANCIES.**—*Paragraph (1)(B) shall not apply in any case to which it would otherwise apply if—*

*(i) the cumulative taxable income (or loss) under the contract as of the close of each prior contract year, is within*

*(ii) 10 percent of the cumulative look-back income (or loss) under the contract as of the close of such prior contract year.*

This is an election and is not mandatory, compared to the mandatory de minimis small contract exception per IRC § 460(b)(3)(B) (lesser of \$1,000,000 or 1% of average annual gross receipts and within 2 year-completion). Once elected, the de minimis discrepancy exception applies to all long-term contracts completed during the taxable year for which the election is made and any subsequent taxable year. Revoking this election is considered a change in method of accounting, which requires the Commissioner's consent. See IRC § 460(b)(6)(D) and Treas. Reg. § 1.460-6(j).

## **Computation of Look-Back**

The computation of look-back interest involves a three-step process, which is described in IRC § 460(b)(2):

1. Hypothetically reapply the PCM for each year of all long-term contracts that are completed or adjusted in the current year, using the actual, rather than estimated, total contract price and contract costs to determine income for each year of the contract.
2. Compute the hypothetical overpayment or underpayment of tax for each year, which will be the difference between the amount of income reported each year, and the amount that would have been reported if actual, rather than estimated, contract price and costs had been used.
3. Apply the rate of interest on **overpayments** to the hypothetical overpayment or underpayment of tax.

**IRC § 460(b)(2) LOOK-BACK METHOD.**—*The interest computed under the look-back method of this paragraph shall be determined by—*

*(A) first allocating income under the contract among taxable years before the year in which the contract is completed on the basis of the actual contract price and costs instead of the estimated contract price and costs,*

*(B) second, determining (solely for purposes of computing such interest) the overpayment or underpayment of tax for each taxable year referred to in subparagraph (A) which would result solely from the application of subparagraph (A), and*

*(C) then using the adjusted overpayment rate (as defined in paragraph (7)), compounded daily, on the overpayment or underpayment determined under subparagraph (B).*

*For purposes of the preceding sentence, any amount properly taken into account after completion of the contract shall be taken into account by discounting (using the Federal mid-term rate determined under section 1274(d) as of the time such amount was properly taken into account) such amount to its value as of the completion of the contract. The taxpayer may elect with respect to any contract to have the preceding sentence not apply to such contract.*

Each step of the three-step process will be discussed in-depth.

### **Step 1: Hypothetically Reapply the PCM to all Long-Term Contracts Using the Actual Contract Price and Contract Costs (Treas. Reg. § 1.460-6(c)(2))**

For each filing year, a taxpayer must reallocate total contract income among prior years, using actual contract price and costs, to all contracts that are completed or adjusted (e.g., post-completion revenue and expenses, discussed later in this chapter) in the filing year. Treas. Reg. § 1.460-6(c)(2)(i). Look-back cannot be applied to a contract before it is completed. Treas. Reg. § 1.460-6(c)(2)(iii).

The following items may be included in the “actual” contract income and costs for the look-back computation:

- **Treatment of Estimated Future Costs** - If a taxpayer reasonably expects to incur additional allocable contract costs in a tax year subsequent to the year in which the contract is completed, the taxpayer includes these additional costs with the actual costs in the denominator of the PCM ratio. The completion year is the only filing year for which the taxpayer may include additional estimated costs in the denominator of the PCM ratio in applying the look-back method. If look-back is reapplied in any year after the completion year, only the cumulative costs incurred are includible in the denominator of the PCM ratio for look-back purposes. Treas. Reg. § 1.460-6(c)(2)(ii).
- **Amount Treated as Contract Price** – All amounts that the taxpayer expects to receive from the customer are treated as part of the contract price as soon as it is

reasonably estimated that they will be received even if the all-events test has not yet been met. Treas. Reg. § 1.460-6(c)(2)(vi)(A).

### **Percentage of Completion – 10% Method and Application of Look-back**

Contractors that are required by IRC § 460 to use the percentage of completion method to report income on long-term construction contracts may elect to defer the recognition of gross income and the deduction of costs incurred on contracts until the year in which 10% of the estimated allocable contract costs have been incurred (This method of accounting is discussed in depth in Chapter 4, Large Contractors). Contractors that elect this method must also use the 10% method to compute look-back interest. Treas. Reg. § 1.460-6(c)(2)(v). Use of actual contract price and costs under the look-back method will occasionally reveal that the year that 10% of the allocable contract costs have been incurred for look-back (the 10% year) was earlier or later than the year originally reported.

When the look-back year is earlier than the year originally reported, the contract costs must be reallocated to the new 10% year and to subsequent years as incurred. When the look-back year is later than the year originally reported, the contract costs incurred before the new 10% year must be reallocated to the new 10% year. Treas. Reg. §1.460-6(c)(2)(v).

#### Example of PCM – 10% Method and Application of Look-back:

<b>Per Return</b>	Year 1	Year 2	Year 3- Completion Year
Cumulative Incurred Costs	58,000	300,000	500,000
Estimated Total Costs	600,000	600,000	500,000
Percent Complete	9.6%	50%	100%
Total Contract Price	1,000,000	1,000,000	1,000,000
Income to be Reported	-0-	500,000	500,000
Expenses to be Deducted	-0-	300,000	200,000
<b>Per Look-Back</b>	Year 1	Year 2	Year 3
Cumulative Incurred Costs	58,000	300,000	500,000
Actual Total Costs	500,000	500,000	500,000

Percent Complete	11.6 %	60.00%	100.00%
Total Contract Price	1,000,000	1,000,000	1,000,000
<b>Gross</b> income that should have been Reported for look-back purposes	116,000	484,000 (600,000 – 116,000)	
Expenses that should have been deducted for look-back purposes	58,000	242,000 (300,000 – 58,000)	

Year 1 is the new 10% year for look-back, and the income and expenses are reallocated to year 1 to determine the underpayment of tax in Year 1 under the look-back method.

## **Step 2: Computation of Hypothetical Overpayment or Underpayment of Tax (Treas. Reg. § 1.460-6(c)(3))**

This step involves the computation of a hypothetical overpayment or underpayment of tax for each year (a “redetermination year”) in which the tax liability is affected by income from contracts that are completed or adjusted in the filing year. Rather than recomputing the tax liability of each “redetermination year,” a taxpayer may be required, or elect, to use the simplified marginal impact method (SMIM), which uses an assumed marginal tax rate. This simplified method is discussed later in this chapter. The remaining discussion of Step 2 is applicable to those taxpayers not using SMIM.

The redetermination year is any affected tax year for which a look-back computation must hypothetically be computed. The filing year is the year that contracts are completed or adjusted (e.g., post-completion revenue and expenses, discussed later in this chapter).

The taxpayer must determine what its regular and alternative minimum tax liability would have been for each redetermination year if the actual amounts of contract income allocated in Step 1 were substituted for the amounts reported on the taxpayer’s original return (or as subsequently adjusted on an amended return or an examination). Treas. Reg. § 1.460-6(c)(3)(ii). The hypothetical underpayment or overpayment for each affected year is the difference between the tax liability as redetermined under the look-back method and the amount of tax liability as originally reported, subsequently amended or adjusted, or the last previous application of look-back, whichever is latest. Treas. Reg. § 1.460-6(c)(3)(iii). The redetermination of tax liability resulting from previous applications of the look-back method is cumulative. Treas. Reg. § 1.460-6(c)(3)(iv).

Example of Cumulative Application of Look-back:

In Year 2, the year of completion, income for look-back is reallocated to Year 1, which results in an increase in the “hypothetical “ tax liability as follows:

	<u>Year 1</u>
Tax Liability Per Original Tax Return	500,000
Tax Liability Per Look-Back Application	<u>600,000</u>
Underpayment of “hypothetical tax”	100,000

In Year 3, the look-back method is once again applied, and income is reallocated to Year 1 and Year 2, the affected years. In determining the hypothetical overpayment or underpayment of tax liability in Year 1, the \$600,000 tax liability is used in determining the underpayment of the “hypothetical” tax, rather than the tax liability reported on the original return:

Year 1

Tax Liability Per Year 2 reallocation	600,000
Tax Liability Per Look-Back Application (Year 3 reallocation)	<u>650,000</u>
Underpayment of “hypothetical tax”	50,000

**Years Affected by Look-back**

A redetermination of income tax liability under Step 2 is required for every tax year for which the tax liability would have been affected by a change in the amount of income or loss for any other year for which a redetermination is required. For example, if the allocation of contract income under Step 1 changed the amount of a net operating loss that was carried back to a year preceding the year the taxpayer entered into the contract, the tax liability for the earlier year must be redetermined. Treas. Reg. § 1.460-6(c)(3)(v).

Example of Net Operating Loss (NOL) and Look-back:

In Year 5, a contract is completed which was in process in Years 3 and 4. On the original tax return for Year 3, the taxpayer incurred a NOL, which was carried back and fully absorbed in Year 1. When computing look-back for Year 5, the completion year, the reallocation of contract income to Year 3 “hypothetically” decreases the NOL that was carried back to Year 1. The tax liability for Year 1 would be recomputed to determine the underpayment or overpayment of tax for look-back purposes.

**Definition of Tax Liability**

The income tax liability, computed in Step 2, must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. For example, if the taxpayer did not pay alternative minimum tax but would have paid it with the application of look-back, the hypothetical overpayment or underpayment of tax is determined by comparing the hypothetical tax liability (which includes alternative minimum tax) with the actual tax liability for that year. Treas. Reg. § 1.460-6(c)(3)(vi).

## **Summary of Step 2**

For each affected tax year (redetermination year) the hypothetical overpayment or underpayment of tax is the difference between:

- Hypothetical Tax Liability (includes all taxes, credits, NOLs), and
- Actual Tax Liability per return adjusted by amendments, examination, and previous applications of look-back.

## **Step 3: Calculation of Interest on Underpayment or Overpayment of Tax (Treas. Reg. § 1.460-6(c)(4))**

Once the overpayment or underpayment of tax is calculated for each redetermination year, the interest is determined by applying the **overpayment** rate designated under IRC § 6621, compounded daily.

Generally, the time period over which the interest is charged begins on the due date (not including extensions) of the return for the redetermination year and ends on the earlier of:

- The due date (not including extensions) of the return for the filing year (i.e. year of completion or adjustment) and
- The date both the income tax return for the filing year is filed and the tax for that year has been paid in full. Treas. Reg. § 1.460-6(c)(4)(i).

### Example of Interest Computation Period

In Year 3, contracts were completed by a corporate calendar year-end taxpayer. Look-back is required to be computed for Years 1 and Year 2. The interest computation for Year 1 look-back would be computed from the due date of the Year 1 tax return (3/15/X2) to the due date of the Year 3 tax return (3/15/X4), if not filed before the due date of the Year 3 tax return. The interest computation for Year 2 look-back would be computed from the due date of the Year 2 tax return (3/15/X3) until the due date of the Year 3 tax return (3/15/X4).

## **Different Interest Period For Changes in Net Operating Losses (NOLs)**

**(Treas. Reg. § 1.460-6(c)(4)(ii))**

As previously mentioned, if the allocation of contract income under Step 1 changed the amount of a net operating loss that was carried back to a year preceding the year the taxpayer entered into the contract, the tax liability for the earlier year must be redetermined. The interest is computed from the due date of the tax return that gives rise to the net operating loss carryback and not from the due date of the return in which the net operating loss is absorbed. However, for net operating loss carryovers, the interest is computed from the due date of tax return in which the net operating loss carryover is absorbed.

Example of Interest Computation Period on Changes in NOLs

In Year 5, a contract is completed which was in process in Year 3 and 4. On the original tax return for Year 3, the taxpayer incurred a NOL, which was carried back and fully absorbed in Year 1. When computing look-back for Year 5, the completion year, the reallocation of contract income to Year 3 “hypothetically” decreases the NOL that was carried back to Year 1. The tax liability for Year 1 would be recomputed to determine the underpayment or overpayment of tax for look-back purposes. However, the interest computation period would be from the due date of the Year 3 tax return until the due date of the Year 5 tax return.

In the above example, if the NOL in Year 3 was not carried back but carried over and fully absorbed in Year 4, the interest computation period for look-back would be computed from the due date of the Year 4 tax return until the due date of the Year 5 tax return.

**Different Interest Period for Changes in Tax Liability That Generated a Subsequent Refund (Treas. Reg. § 1.460-6(c)(4)(iii))**

If the tax liability in a redetermination year is **decreased** by the application of look-back and any portion was absorbed by a loss or credit carryback in a year subsequent to the redetermination year, the interest computation period would be as follows:

- To the extent the amount of tax absorbed because of the carryback exceeds the total hypothetical tax liability for the year, the interest period for look-back ends on the due date (not including extensions) of the return for the year in which the carryback arose and not the due date of the filing year (i.e. completion year).

Example:

In Year 5, upon the completion of a long-term contract, the taxpayer redetermines its tax liability for Year 3 under the look-back method. This redetermination results in a hypothetical reduction of tax liability of \$300 determined as follows:

	<u>Year 3</u>
Tax Per Return	1,500
Hypothetical Tax Per Look-back	<u>1,200</u>

Hypothetical Overpayment of Tax	300
---------------------------------	-----

In Year 4, a NOL was incurred and carried back to Year 3. The interest computation period for look-back would depend on the amount of reported tax liability of Year 3 that was refunded:

- (A) If the amount refunded because of the NOL is \$1,500: interest is credited to the taxpayer on the entire hypothetical overpayment of \$300 from the due date of the Year 3 return, when the hypothetical overpayment occurred, until the due date of the Year 4 return, when the taxpayer received a refund for the entire amount of the Year 3 tax, including the hypothetical overpayment. Treas. Reg. § 1.460-6(c)(4)(iii)(A).
- (B) If the amount refunded because of the NOL is \$1,000: interest is credited to the taxpayer on the entire amount of the hypothetical overpayment of \$300 from the due date of the Year 3 return, when the hypothetical overpayment occurred, until the due date of the Year 5 return. In this situation interest is credited until the due date of the return for the completion year of the contract, rather than the due date of the return for the year in which the carryback arose, because the amount refunded was less than the hypothetical tax liability. Therefore, no portion of the hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year. Treas. Reg. § 1.460-6(c)(4)(iii)(B).
- (C) If the amount refunded because of the NOL is \$1,300: interest is credited to the taxpayer on \$100 (\$1,300 - \$1,200) from the due date of the Year 3 return until the due date of the Year 4 return because only this portion of the total hypothetical overpayment is treated as having been refunded to the taxpayer before the filing year. However, the taxpayer did not receive a refund for the remaining \$200 of the overpayment at that time and, is therefore is credited with interest on \$200 from the due date of the Year 3 return to the due date of the tax return for Year 5.

### **Interest Rate Computation Period is Annual, not Quarterly**

Generally, IRS computes interest on a quarterly basis. Prior to the Taxpayer Relief Act of 1997, the look-back interest computation was also computed quarterly. However, the Taxpayer Relief Act of 1997 added IRC § 460(b)(7), which provided the annual rate for tax returns ending after August 5, 1997. Rather than using the rates in effect for each quarter, the look-back rate will change only once for each twelve month period. The interest rate to be used for this period is the rate in effect for the calendar quarter in which the interest rate accrual begins.

#### **IRC § 460(b)(7) ADJUSTED OVERPAYMENT RATE.—**

- (A) *IN GENERAL.—The adjusted overpayment rate for any interest accrual period is the overpayment rate in effect under section 6621 for the calendar quarter in which such interest accrual period begins.*

**(B)** *INTEREST ACCRUAL PERIOD.*—For purposes of subparagraph (A), the term “interest accrual period” means the period—

*(i) beginning on the day after the return due date for any taxable year of the taxpayer, and*

*(ii) ending on the return due date for the following taxable year.*

*For purposes of the preceding sentence, the term “return due date” means the date prescribed for filing the return of the tax imposed by this chapter (determined without regard to extensions).*

### **Corporate Interest Rates**

For tax periods ending after 1994, corporate interest rates are different for increases or decreases of tax exceeding \$10,000. Therefore, the first \$10,000 of the look-back interest is computed at one interest rate with any amount over \$10,000 being computed at a lower rate (i.e. 1.5% lower). IRC § 6621(a)(1).

## **Simplified Marginal Impact Method (SMIM)** **(Treas. Reg. § 1.460-6(d))**

The SMIM eliminates the need to refigure the tax liability based on actual contract price and actual contract costs each time the look-back method is applied. Under the simplified method, prior year hypothetical underpayments or overpayments in tax are figured using an assumed marginal tax rate, which is generally the highest statutory rate in effect for the prior year under IRC § 1 (for an individual) or IRC § 11 (for a corporation).

### **Required Use of SMIM by Certain Pass-Through Entities (Treas. Reg. § 1.460-6(d)(4))**

The simplified marginal impact method is **required** to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S-Corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. Treas. Reg. § 1.460-6(d)(4)(i).

The assumed marginal rate to be used at the entity level is determined by the ownership of the entity. For determining the amount of any hypothetical underpayment or overpayment, the applicable regular and alternative minimum tax rates, respectively, are generally the highest rates of tax in effect for corporations under section 11 and section 55(b)(1). However, the applicable regular and alternative minimum tax rates are the highest rates of tax imposed on individuals under section 1 and section 55(b)(1) if, at all times during the redetermination year involved (*i.e.*, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass through entities. Treas. Reg. § 1.460-6(d)(4)(i)(A).

A pass-through entity is closely held if, at any time during any redetermination year, 50 percent or more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons. For this purpose, the term “person” has the same meaning as in IRC § 7701(a)(1), except that a pass-through entity is not treated as a person. In addition, the constructive ownership rules of IRC § 1563(e) apply by substituting the term “beneficial interest” for the term “stock” and by substituting the term “pass-through entity” for the term “corporation” used in that section, as appropriate, for purposes of determining whether a beneficial interest in a pass-through entity is indirectly owned by any person. Treas. Reg. § 1.460-6(d)(4)(i)(B).

A domestic contract is any contract in which substantially all of the income is from sources in the United States. For this purpose, “substantially all” of the income from a long-term contract is considered to be from United States sources if 95 percent or more of the gross income from the contract is from sources within the United States as determined under the rules in IRC §§ 861 through 865. Treas. Reg. § 1.460-6(d)(4)(i)(D).

If a widely held pass-through entity has some foreign contracts and some domestic contracts, the owners of the pass-through entity each apply the look-back method (using, if they elect, the simplified marginal impact method) to their respective share of the income and expense from foreign contracts. Moreover, in applying the look-back method to foreign contracts at the owner level, the owners do not take into account their share of increases or decreases in contract income resulting from the application of the simplified marginal impact method with respect to domestic contracts at the entity level. Treas. Reg. § 1.460-6(d)(4)(i)(E).

### **Elective Use of SMIM**

C corporations, individuals, and owners of closely held pass-through entities that are not required to use the SMIM may elect to use this simplified marginal impact method. In the case of an electing owner in a pass-through entity, the simplified marginal impact method is applied at the **owner level**, instead of at the entity level, with respect to the owner's share of the long-term contract income and expenses reported by the pass-through entity. Treas. Reg. § 1.460-6(d)(4)(ii)(A).

A taxpayer elects the simplified marginal impact method by stating that the election is being made on a timely filed income tax return (determined with regard to extensions) for the first tax year the election is to apply. An election to use the simplified marginal impact method applies to all applications of the look-back method to all eligible long-term contracts for the tax year for which the election is made and for any subsequent tax year. The election may not be revoked without the consent of the Commissioner. Treas. Reg. § 1.460-6(d)(4)(ii)(B).

In the case of a consolidated group of corporations, as defined in Treas. Reg. §1.1502-1(h), an election to use the simplified marginal impact method is made by the common parent of the group. The election is binding on all other affected members of the group (including members that join the group after the election is made with respect to all applications of the look-back method after joining). If a member subsequently leaves the group, the election remains binding as to that member unless the Commissioner consents to a revocation of the election. If a corporation using the simplified marginal impact method joins a group that does not use the method, the election is automatically revoked with respect to all applications of the look-back method after it joins the group. Treas. Reg. § 1.460-6(d)(4)(ii)(C).

### **Operation of SMIM**

First, under the simplified marginal impact method, income from those contracts that are completed or adjusted in the filing year is first reallocated in accordance with the procedures of Step 1, discussed earlier in this chapter.

Second, the increase or decrease in taxable income in the redetermination year due to the reallocation of contract income (Step 1) is multiplied by the applicable tax rate (highest rate of tax in effect for the redetermination year). This rate is determined without regard to the taxpayer's actual rate bracket. The amount of any overpayment

determined in this step may be limited to the taxpayer's actual tax liability (see below).  
Treas. Reg. § 1.460-6(d)(2)(i).

### **Overpayment Ceiling on Refunds**

The net hypothetical overpayment of tax for any redetermination year is limited to the taxpayer's total federal income tax liability for the redetermination year reduced by the cumulative amount of net hypothetical overpayments of tax for that redetermination year resulting from earlier applications of the look-back method. If the reallocation of contract income results in a net overpayment of tax and this amount exceeds the actual tax liability (as of the filing year) for the redetermination year, as adjusted for past applications of the look-back method and taking into account net operating loss, capital loss, or credit carry over and carry back to that year, the actual tax so adjusted is treated as the overpayment for the redetermination year. This overpayment ceiling does not apply when the simplified marginal impact method is applied at the entity level by a widely held pass-through entity. Treas. Reg. § 1.460-6(d)(2)(iii).

### **Anti-Abuse rule.**

If the simplified marginal impact method is used with respect to any long-term contract (including a contract of a widely held pass-through entity), the IRS may recompute interest for the contract (including domestic contracts of widely held pass-through entities) under the look-back method using the actual method. See Treas. Reg. § 1.460-6(d)(3) for additional information on the anti-abuse rule.

### **Post-Completion Revenue and Expenses (Treas. Reg. § 1.460-6(c)(1)(ii))**

When a contractor incurs post-completion year costs or receives post-completion year revenues, additional look-back computations are necessary. Any year in which the look-back method must be applied is treated as a filing year. Treas. Reg. § 1.460-6(c)(1)(ii)(A). The amount of any post-completion adjustment to the total contract price or contract costs is discounted, solely for purposes of applying the look-back method, from its value at the time the amount is taken into account in computing taxable income to its value at the completion of the contract. Treas. Reg. § 1.460-6(c)(1)(ii)(C)(1).

Items to consider with post-completion revenue and expenses are:

- Taxpayers have the option not to discount post-completion year revenues and costs. Treas. Reg. § 1.460-6(c)(1)(ii)(C)(2).
- For purposes of reapplying the look-back method after the year of contract completion, a taxpayer may elect the "delayed reapplication method" to minimize the number of required reapplications of the look-back method. Treas. Reg. § 1.460-6(e).

- A taxpayer may elect not to apply the look-back method in de minimis cases. IRC § 460(b)(6); Treas. Reg. § 1.460-6(j).

### **Revenue Acceleration Rule (Treas. Reg. § 1.460-6(c)(1)(ii)(D))**

IRC § 460(b)(1) requires a taxpayer to include in gross income, for the tax year immediately following the year of completion, any unreported portion of the total contract price not previously required to be included in income (including amounts that the taxpayer expects to receive in the future) determined as of that year. This treatment is required even if the percentage of completion ratio is less than 100 percent because the taxpayer expects to incur additional allocable contract costs in a later year. At the time any remaining portion of the contract price is includible in income under this rule, no offset against this income is permitted for estimated future contract costs. To achieve the requirement to report all remaining contract revenue without regard to additional estimated costs, a taxpayer must include only costs actually incurred through the end of the tax year in the denominator of the percentage of completion ratio in applying the percentage of completion method for any tax years after the year of completion. Treas. Reg. § 1.460-6(c)(1)(ii)(D).

### **Reporting Look-Back – Form 8697 (Treas. Reg. § 1.460-6(f))**

Form 8697 is used for the Look-Back Computation. Each contract year is computed in a separate column on Form 8697, with the totals being netted to determine whether an overall refund or additional tax is due for the filing year (the completion year or a post-completion year). If a taxpayer owes interest under the look-back method, the Form 8697 is attached to the tax return and is considered an additional tax. See Treas. Reg. § 1.460-6(f)(2)(i), and the Instructions to Form 8697. If the taxpayer is due a refund, the Form 8697 is not attached to the taxpayer's tax return, but instead is filed separately. See the Instructions to Form 8697.

If the taxpayer was an owner of an interest in a partnership or an S-Corporation during any year in which long-term contracts were being accounted, Form 8697 must be filed for the tax year that ends with or includes the end of the entity's tax year in which the contract was completed. See Instructions to Form 8697.

Interest required to be paid on Form 8697 will be added to the tax on the income tax return and the Form 8697 will be attached to the income tax return. For a corporation the interest due would still be an interest deduction even though it is added to the total tax on the return. Treas. Reg. § 1.460-6(f)(2)(i). For an individual, the interest is nondeductible personal interest. A taxpayer that fails to pay the amount of interest due is subject to any applicable penalties and interest. Treas. Reg. § 1.460-6(f)(2)(i). If a taxpayer owes interest on Form 8697, the Form 8697 is a form within the tax return, and the statute of limitations on the return under IRC §§ 6501 and 6502 is controlling. Treas. Reg. § 1.460-6(f)(3).

In cases where the taxpayer is entitled to receive a refund of interest, the Form 8697 must be filed **separately; it is not attached to the tax return**. The amount of interest received is treated as taxable interest income and is not treated as a reduction in tax

liability or a tax refund. Treas. Reg. § 1.460-6(f)(2)(i). The amount is includible in gross income as interest income in the tax year it is properly taken into account under the taxpayer's method of accounting for interest income. When the taxpayer is entitled to a look-back refund, the taxpayer has a 6-year period in which to file a claim. See Rev. Rul. 56-506, 1956-2 C.B. 959, and Rev. Rul. 57-242, 1957-1 C.B. 452.

*Treas. Reg. § 1.460-6(f)(2) Treatment of interest on return--(i) General rule. The amount of interest required to be paid by a taxpayer is treated as an income tax under subtitle A, but only for purposes of subtitle F of the Code (other than sections 6654 and 6655), which addresses tax procedures and administration. Thus, a taxpayer that fails to pay the amount of interest due is subject to any applicable penalties under subtitle F, including, for example, an underpayment penalty under section 6651, and the taxpayer also is liable for underpayment interest under section 6601. However, interest required to be paid under the look-back method is treated as interest expense for purposes of computing taxable income under subtitle A, even though it is treated as income tax liability for subtitle F purposes. Interest received under the look-back method is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability or a tax refund. The determination of whether or not interest computed under the look-back method is treated as tax is determined on a "net" basis for each filing year. Thus, if a taxpayer computes for the current filing year both hypothetical overpayments and hypothetical underpayments for prior years, the taxpayer has an increase in tax only if the interest computed on the underpayments for all those prior years exceeds the interest computed on the overpayments for all those prior years, for all contracts completed or adjusted for the year.*

In general, the look-back method is applied by the taxpayer that reports the income from a long-term contract. See Treas. Reg. § 1.460-6(g) for rules regarding who is responsible for applying the look-back method when, prior to the completion of a long-term contract, there is a transaction that changes the taxpayer that reports income from the contract (also known as mid-contract change in taxpayer).

## **Conclusion**

Look-back is hypothetical and does not result in an adjustment to the taxpayer's tax liability as originally reported or amended. It does result, however, in payment of interest from or to the taxpayer upon completion of the contract, depending on the accuracy of the estimated numbers used by the taxpayer in its PCM computations. Due to the hypothetical nature of look-back, a separate tax system is necessary to account for look-back, similar to that of alternative minimum tax. Look-back is a very complex area of the tax law which causes many errors in compliance.

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## **Chapter 6: Financial Accounting Versus Tax Accounting**

### **Introduction**

The accounting methods available within in the construction industry are unique to this industry. Understanding both the financial accounting and tax accounting requirements is important, so the proper book-to-tax adjustments are made.

### **Financial Accounting**

The primary sources for generally accepted accounting principles (GAAP) for accounting for construction contracts are Accounting Research Bulletin (ARB) No. 45, Long-Term, Construction-Type Contracts and Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Under (GAAP) there are two methods of recognizing revenues on construction contracts:

- percentage-of-completion method and
- completed contract method.

These two methods are not alternatives from which a contractor is free to choose. SOP 81-1 establishes a strong preference for the percentage-of-completion method. The only time the completed contract method should be used is when either of the following conditions exists:

- (1) The results do not vary materially from those under the percentage-of-completion method, or
- (2) The contractor can overcome the basic presumption that it has the ability to make reasonably dependable estimates.

Therefore, the financial statements (whether certified, reviewed, or compiled) that are prepared for bonding, banking, or other reporting purposes are almost exclusively prepared using the percentage of completion accounting method. However, as discussed in the Small Contractors and Large Contractors chapter, many more accounting method choices are available to the contractor for tax purposes, depending on the length of the contract, the type of construction involved, and the gross receipts of the taxpayer.

## Balance Sheet Accounts

When accounting for contracts using the percentage-of-completion method (PCM), costs, rather than the contract's earned or billed income, determines the revenue recognition. Determining completion by costs (Total Costs Incurred divided by Total Estimated Costs) is a computation not made through the day-to-day book recording procedures. For instance, there is not a general ledger account for total estimated contract costs.

To account for the difference between percentage of completion method and billings, two balance sheet accounts are created:

- Costs and Estimated Earnings in Excess of Billings (Asset)
- Billings in Excess of Costs and Estimated Earnings (Liability)

### Example Of Journal Entries for a Construction Contract Using Percentage Of Completion Method:

The contractor entered into a long-term construction contract during the 2001 taxable year. The total estimated contract price is \$3,000,000, the total estimated contract costs are \$2,000,000 and the contract is estimated to be completed in 2002. The total costs incurred on this contract during 2001 are \$1,000,000. The contractor billed the customer \$1,200,000 during 2001.

**During the tax year journal entries to record the transactions of this contract would be recorded as follows:**

Costs Incurred	1,000,000 (debit)	
Accounts Payable		1,000,000 (credit)

Accounts Receivable	1,200,000 (debit)	
Costs and Estimated Earnings in Excess of Billings		1,200,000 (credit)

**At year end, the contractor would determine the income to be included under the percentage of completion method as follows:**

$$\frac{1,000,000 \text{ (Total Costs Incurred)}}{2,000,000 \text{ (Total Estimated Costs)}} \times \$3,000,000 = 1,500,000$$

**The adjusting journal entry necessary to bring the books/financial statements in accordance with the percentage of completion method would be as follows:**

Costs and Estimated Earnings in Excess of Billings	1,500,000 (debit)	
Income		1,500,000 (credit)

At year end the Costs and Estimated Earnings in Excess of Billings account has a debit balance of \$300,000, thus is represented as an asset on the balance sheet.

Basically, these two balance sheet accounts represent the difference between the accrual method and the percentage-of-completion method for reporting income on a long-term contract. Under either method, the costs related to the long-term contract are deducted as incurred. Therefore, generally no difference exists between the two methods for costs.

Income per billings (accrual)	\$1,200,000
Income per percentage of completion	<u>\$1,500,000</u>
Costs and Earnings in Excess of Billings	300,000.

### **Balance Sheet Reporting**

A basic reporting principle prevents assets and liabilities from being netted or offset against each other. Thus both accounts (Costs and Earnings in Excess of Billings and Earnings and Costs in Excess of billings) should be present on the balance sheet. The following procedures are performed at year-end:

- For each contract in progress at year-end, the total cost incurred to date plus the estimated earnings (on percentage of completion method) is reduced by the total amount of bills rendered to arrive at a net balance. The net balance, for each contract, will be a debit if the total costs and estimated earnings exceed the billings and a credit if the billings exceed the costs and estimated earnings.
- All contracts that have a debit balance are added together with the total shown as an asset on the balance sheet.
- All contracts that have a credit balance are added together with the total shown as a liability on the balance sheet.

See the Contracts In Process Schedule at the end of the chapter for an illustration of the above procedures.

### **Book/Tax Differences**

Schedule M-1 adjustments result from both timing differences and permanent differences between financial and tax accounting. The following items are intended to point out some of the differences in financial and tax accounting that are unique to the construction industry. These differences should be reconciled through Schedule M-1 adjustments.

## **Revenue Recognition**

As discussed above, Statement of Position 81-1 (SOP 81-1) virtually requires construction companies to report income on the percentage of completion method. Generally, the bonding company or a lending bank will require the taxpayer to submit certified (possibly reviewed) financial statements, which will be reported on the percentage of completion method. For tax accounting, the contractor may use a different method, such as completed contract method, percentage of completion method, or capitalized cost method.

## **Contract Related Services**

SOP 81-1 paragraph 12 provides a listing of contracts which are covered by this statement. Included in that listing are engineers, architects, and construction management taxpayers. Therefore, for financial purposes these contracts would be accounted for under the percentage of completion method. However, for tax purposes, they generally cannot use a long-term contract method (e.g., completed contract or percentage of completion). Revenue Ruling 70-67, Revenue Ruling 80-18, Revenue Ruling 82-134, Revenue Ruling 84-32.

## **Determining Completion for Percentage of Completion Method.**

SOP 81-1 paragraph 44 provides a number of methods to measure the extent of progress towards completion. They include the cost-to-cost method, variations of the cost-to-cost method, efforts expended method, the units-of-delivery method, and the units-of-work-performed method. For tax purposes, IRC § 460 generally requires the cost-to-cost method. However, the taxpayer may also elect the percentage of completion, 10% method in which none of the contract revenue or costs are included in taxable income until the contract is 10% complete. The contractor may also elect the simplified cost-to-cost method to determine contract completion.

## **Loss Recognition**

SOP 81-1 paragraph 85 requires the contractor to report the total loss on a contract as soon as it is evident that a loss will occur. "When the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract should be made. Provisions for losses should be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method." However, for tax purposes, the loss is not recognized until the job is completed, if on the completed contract method, and as incurred, if on the percentage of completion method.

See the following pages for an illustration of sample financial statements reporting construction contracts on the percentage of completion method and items to consider when reviewing these statements.

**XYZ Corporation  
Balance Sheet  
December 31, 2002**

**Assets**

Current Assets

Cash	9,000
Contract Receivables	335,000
Costs & Estimated Earnings in Excess of Billings ***	28,711
	372,711

Property & Equipment

Furniture, Fixtures, & Equipment	6,000
Accumulated Depreciation	-1,500
	4,500

Other Assets

Deposits	750
	750

Total Assets

377,961

**Liabilities and Stockholder's Equity**

Accounts Payable	121,000
Accrued Liabilities	17,000
Deferred Income Taxes	36,000
Billings in Excess of Costs and Estimated Earnings ***	5,666
	179,666

Common Stock	1,000
Retained Earnings	197,295
	377,961

\*\*\*These accounts should reconcile to the Schedule 3 Contracts in Progress

**XYZ Corporation**  
**Statement of Income and Retained Earnings**  
**December 31, 2002**

Contract Revenue Earned **	1,439,159
Costs of Revenue Earned **	1,174,000
Gross Profit	265,159
General & Administrative Expenses	199,000
Income Before Income Taxes	66,159
Income Taxes	
Current	12,000
Deferred	4,000
Net Income ***	50,159
Beginning Retained Earnings	147,136
Ending Retained Earnings	197,295

\*\*From Schedule 1 Earnings From Contracts

\*\*\*Should reconcile to Schedule M-1 Line 1 Book Income

**XYZ Corporation**  
**Schedule 1 - Earnings From Contracts**  
**Year Ended December 31, 2002**

	Revenues <u>Earned</u>	Cost of <u>Revenues</u>	Gross Profit <u>(Loss)</u>
Contracts Completed During the year**	502,000	361,000	141,000
Contracts in progress at year end***	937,159	813,000	124,159
	<u>1,439,159</u>	<u>1,174,000</u>	<u>265,159</u>

\*\* From Schedule 2 Contracts Completed– represents the amounts of revenue earned and costs incurred during the 2002 tax year.

\*\*\*From Schedule 3 Contracts in Progress – represents the amounts of revenue earned and costs incurred during the 2002 tax year.

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**XYZ Corporation**  
**Schedule 2 - Contracts Completed**  
**Year Ended December 31, 2002**

Project Number	Construction Project	Contract Totals			Before Jan. 1, 2002			Year Ended December 31, 2002		
		Revenues Earned	Cost of Revenues	Gross Profit (Loss)	Revenues Earned	Cost of Revenues	Gross Profit (Loss)	Revenues Earned	Cost of Revenues	Gross Profit (Loss)
121	John's Store	312,000	248,000	64,000	193,000	172,000	21,000	119,000	76,000	43,000
122	Ron's Club	267,000	197,000	70,000	178,000	144,000	34,000	89,000	53,000	36,000
127	Parking Lot	403,000	312,000	91,000	250,000	199,000	51,000	153,000	113,000	40,000
128	Hospital	35,000	38,000	-3,000	--	--	--	35,000	38,000	-3,000
130	Office Bldg	106,000	81,000	25,000	--	--	--	106,000	81,000	25,000
		<u>1,123,000</u>	<u>876,000</u>	<u>247,000</u>	<u>621,000</u>	<u>515,000</u>	<u>106,000</u>	<u>502,000</u>	<u>361,000</u>	<u>141,000</u>

These amounts would be used  
for the tax return if on completed  
contract method

**XYZ Corporation**  
**Schedule 3 - Contracts In Progress**  
**Year Ended December 31, 2002**

Project Number	<u>Total Contract</u>		<u>From Inception to December 31, 2002</u>					<u>Before January 1, 2002</u>			<u>At Dec. 31, 2002</u>		<u>For the Year ended December 31, 2002</u>			
	<u>Revenues</u>	<u>Estimated Gross Profit (Loss)</u>	<u>Revenues Earned</u>	<u>Cost of Revenues</u>	<u>Gross Profit (Loss)</u>	<u>Billed to Date</u>	<u>Estimated Cost to Complete</u>	<u>Revenues Earned</u>	<u>Cost of Revenues</u>	<u>Gross Profit (Loss)</u>	<u>Costs &amp; Est. Earnings in Excess of Billings</u>	<u>Billings in Excess of Costs &amp; Est. Earnings</u>	<u>Revenues Earned</u>	<u>Cost of Revenues</u>	<u>Gross Profit (Loss)</u>	<u>Percent Complete</u>
119	1,275,000	210,000	1,228,310	1,026,000	202,310	1,225,000	39,000	1,049,000	880,000	169,000	3,310	---	179,310	146,000	33,310	96.34%
120	211,000	-10,000	107,887	113,000	-5,113	106,000	108,000	---	---	---	1,887	---	211,000	221,000	-10,000	51.13%
123	53,000	15,000	43,237	31,000	12,237	46,000	7,000	---	---	---	---	2,763	43,237	31,000	12,237	81.58%
124	258,000	50,000	129,000	104,000	25,000	117,000	104,000	---	---	---	12,000	---	129,000	104,000	25,000	50.00%
125	218,000	40,000	79,607	65,000	14,607	74,000	113,000	---	---	---	5,607	---	79,607	65,000	14,607	36.52%
126	85,000	13,000	47,222	40,000	7,222	43,000	32,000	---	---	---	4,222	---	47,222	40,000	7,222	55.56%
129	220,000	42,000	181,685	147,000	34,685	180,000	31,000	---	---	---	1,685	---	181,685	147,000	34,685	82.58%
131	160,000	38,000	28,852	22,000	6,852	30,000	100,000	---	---	---	---	1,148	28,852	22,000	6,852	18.03%
133	152,000	1,000	37,245	37,000	245	39,000	114,000	---	---	---	---	1,755	37,245	37,000	245	24.50%
	2,632,000	399,000	1,883,045	1,585,000	298,045	1,860,000	648,000	1,049,000	880,000	169,000	28,711	5,666	937,159	813,000	124,159	

**Audit Considerations:**

- (1) Job #120 has a total estimated loss of (10,000) – the full loss is being reported for financial purposes. However, the job is only 51.13% complete. Thus, there should be an Schedule M-1 adjustment from book to tax.
- (2) Where is Job #132? – Not located on this schedule or the completed contract schedule.
- (3) Job #133 has an unusually low gross profit compared to other jobs. Why?

( Balance Sheet )  
Accounts

## Chapter 7: Homebuilders and Developers

### Introduction

Home construction contracts are one of the two exceptions from some of the requirements of IRC § 460. The small contractors exception is the other one that is discussed in detail in Chapter 3. Contracts that meet the home construction contracts definition are exempt from:

- The requirement to use percentage of completion method
- The application of the look-back provisions
- The requirement to use percentage of completion method for alternative minimum tax purposes.

Even though exempt from the above requirements, construction period interest is still required to be capitalized per IRC § 460(c)(3).

IRC § 460(e)(1)(A) excepts **any** home construction contract and thus is not based on the length of the contract nor the gross receipts of the contractor as with the small contractors exception. However, the last sentence of IRC § 460(e)(1) provides that home construction contracts that do not meet the 2-year or gross receipts test (\$10,000,000) are subject to the application of IRC 263A. These contractors are commonly termed Large Home Builders and will be discussed separately in this chapter.

#### **IRC § 460(e) EXCEPTION FOR CERTAIN CONSTRUCTION CONTRACTS.—**

**(1) IN GENERAL.—***Subsections (a), (b), and (c)(1) and (2) shall not apply to—*

**(A)** *any home construction contract, or*

**(B)** *any other construction contract entered into by a taxpayer—*

**(i)** *who estimates (at the time such contract is entered into) that such contract will be completed within the 2-year period beginning on the contract commencement date of such contract, and*

**(ii)** *whose average annual gross receipts for the 3 taxable years preceding the taxable year in which such contract is entered into do not exceed \$10,000,000.*

*In the case of a home construction contract with respect to which the requirements of clauses (i) and (ii) of subparagraph (B) are not met, section 263A shall apply notwithstanding subsection (c)(4) thereof.*

## **HOME CONSTRUCTION CONTRACT DEFINED**

A home construction contract is any contract where 80% or more of the estimated total contract costs, as of the close of the tax year that the contract was entered into, is reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of dwelling units contained in buildings containing four or fewer dwelling units and improvement to real property that are directly related to such dwelling unit. The distinction between a home construction contract and a residential construction contract is important because residential construction contracts do not meet the exception to the use of percentage of completion and look-back provided by IRC § 460(e). Residential construction contracts contain more than 4 dwelling units (e.g. apartments, condominiums). Residential construction contracts are discussed in more detail in Chapter 4.

**IRC § 460(e)(6)(A) HOME CONSTRUCTION CONTRACT.**—*The term “home construction contract” means any construction contract if 80 percent of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to—*

*(i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and*

*(ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.*

*For purposes of clause (i), each townhouse or rowhouse shall be treated as a separate building.*

Treas. Reg. § 1.460-3(b)(2) clarifies that a contract of a subcontractor working for a general contractor is included in the definition of home construction contracts if it otherwise qualifies, and that common improvements that benefit the dwelling units being constructed or located at the site of the dwelling units are included as part of the 80% test.

*Treas. Reg. § 1.460-3(b)(2) Home construction contract--(i) In general. A long-term construction contract is a home construction contract if a taxpayer (including a subcontractor working for a general contractor) reasonably expects to attribute 80 percent or more of the estimated total allocable contract costs (including the cost of land, materials, and services), determined as of the close of the contracting year, to the construction of—*

*(A) Dwelling units, as defined in section 168(e)(2)(A)(ii)(I), contained in buildings containing 4 or fewer dwelling units (including buildings with 4 or fewer dwelling units that also have commercial units); and*

*(B) Improvements to real property directly related to, and located at the site of, the dwelling units.*

*(ii) Townhouses and rowhouses. Each townhouse or rowhouse is a separate building.*

*(iii) Common improvements. A taxpayer includes in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units.*

*(iv) Mixed use costs. If a contract involves the construction of both commercial units and dwelling units within the same building, a taxpayer must allocate the costs among the commercial units and dwelling units using a reasonable method or combination of reasonable methods, such as specific identification, square footage, or fair market value.*

## **What is a Dwelling Unit?**

Dwelling units are defined in IRC § 168(e)(2)(A)(ii)(I). The term “dwelling unit” means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis.

## **Mixed Use Buildings**

If a contract requires construction of a mixed-use building (e.g. a building that will include both dwelling units and offices) the costs are allocated among the commercial units and the dwelling units using a reasonable method, pursuant to Treas. Reg. § 1.460-3(b)(2)(iv).

## **Taxation of Homebuilders**

To avoid confusion in the tax accounting rules, for both income and expenses, the following types of construction or development will be discussed separately:

- Homes Built for Speculation (No Contract)
- Contractors Building Homes Under Contract

- Land Developers

## Homes Built for Speculation (No Contract)

Homebuilders will purchase a number of lots from a developer of a subdivision to build houses. The homebuilder may build some of the homes as speculative (spec) homes. Speculative homes are not built under a contract. In the industry, homes built for speculation that are on hand at year end are referred to as inventory of unsold houses or work in process. These speculation houses do not meet the definition of inventory in the Code. The Internal Revenue Code defines inventory as tangible personal property. Speculation houses are capital assets as defined in IRC § 263. The builder owns the real property (land) and the house inherently attached to the land. Courts have consistently held that developed real property must be accounted for under a capitalization method. **See *W.C. & A.N. Miller Development Co. v. Commissioner***, 81 T.C. 619 (1983); ***Homes by Ayres v. Commissioner***, T.C. Memo. 1984-475, *aff'd*, 795 F.2d 832 (9th Cir. 1986). See also Rev. Rul. 86-149, 1986-2 C.B. 67; Rev. Rul. 66-247, 1966-2 C.B. 198.

### Income Recognition

Since speculation homes are not built under a contract, long-term contract accounting methods (completed contract and percentage of completion) do not apply. Speculative homebuilders report their income from the sale of a speculative house at the time of settlement/closing per IRC § 1001.

Sometimes speculative homes are started but “sold” during the construction phase, which could become a long-term construction contract (if not completed within the same tax year) subject to the taxpayer’s long-term contract method of accounting. However, in most cases, the completed contract method is the one elected, and the “sale” would not constitute a taxable event until completion.

### Cost Recognition

The direct and indirect costs incurred by a taxpayer in the construction of a house for speculative sale (including the cost of the land, direct materials and direct labor) should be **capitalized** according to the principles in **IRC § 263(a)** and **IRC § 263A**, regardless of the taxpayer’s overall method of accounting.

Under **IRC § 263(a)(1)** and **Treas. Reg. § 1.263(a)-1**, costs incurred in the construction of homes and other permanent improvements to real property are not currently deductible. Instead the cost of unsold homes and construction in progress is a capital expenditure that becomes part of the basis of the real estate, which in turn, is recovered either through a depreciation allowance if the property is used in a trade or business (rented), or as an offset against the price received in the sale or disposition of such property.

**Treas. Reg. § 1.263(a)-2** sets forth examples of capital expenditures, including the cost of acquisition, construction, or erection of buildings having a useful life substantially beyond the tax year.

The uniform capitalization rule of IRC § 263A(a)(1) applies to speculation homes, which mandates certain costs to be allocated to property produced by the taxpayer, and that such costs be capitalized if the property is not inventory in the hands of the taxpayer.

**IRC § 263A(a)(1)** In general. --In the case of any property to which this section applies, any costs described in paragraph (2) shall be capitalized.

The homebuilder must determine the **accumulated production expenditures**, described in Treas. Reg. § 1.263A-11, with respect to each home. This requires the homebuilder to allocate the cumulative amount of direct and indirect costs described in § 263A(a) that are required to be capitalized with respect to the unit of property. A unit of property is defined by Treas. Reg. § 1.263A-10(b) as any components of real property that are functionally interdependent, along with an allocable share of any common feature owned by the taxpayer. For example, the components of a single family home (land, foundation and walls) are functionally interdependent; in contrast, condo units separately placed in service in a multi-unit building are each treated as a functionally interdependent unit, even though they are all located in the same building. In the case of property produced for sale, components of real property are functionally interdependent if they are customarily sold as a single unit. All costs that have been accumulated for a particular home are charged to cost of sales at the time of settlement with the purchaser of the home.

**Rev. Rul. 66-247-** the costs incurred in the construction of a house for speculative sale are capitalized regardless of the taxpayer's overall method of accounting. Such costs shall be applied against the amount realized upon the sale of the house for purposes of determining gain or loss in computing taxable income.

**Carpenter v. Commissioner, T.C. Memo 1994-289** - A building contractor could not use the cash method of accounting for expenses related to construction of houses that were unsold at the end of the tax year because he was a producer of the property. The contractor was required to capitalize (per IRC section 263A) the costs of construction related to the unsold houses.

## **Inventory vs. Real Estate**

In the construction industry, it is common for a contractor to use “inventory” terminology for unsold homes or work-in-progress. However, unsold homes or work-in-progress is real estate which is never considered inventory. Both real estate and inventory are assets but this distinction is important because under several accepted inventory methods, a departure from the actual cost could take place (that is, lower of cost or market).

**Atlantic Coast Realty Co. v. Commissioner, 11 B.T.A. 416 (1928), and Rev. Rul. 69-536, 1969-2 C.B. 109** - Home builders are not allowed to treat real estate held for sale as “inventory” and write their work in process down to market value using a lower of cost or market valuation.

**Homes by Ayres v. Commissioner, T.C. Memo 1984-475, aff’d., 795 F.2d 832 (9th Cir. 1986)** - Taxpayers engaged in the construction and sale of large-scale tract housing developments could not use the LIFO method to account for the property. The court held that real estate is not inventory, and thus an inventory method to account for the property is not allowed.

**W.C. & A.N. Miller Development Co. v. Commissioner, 81 T.C. 619 (1983)** - The taxpayer was engaged in the business of developing real estate, which it acquired, and constructed single-family, detached homes. The taxpayer applied a LIFO method to account for its completed homes. All costs related to each home were charged to the cost of sales only at the time of settlement with the purchaser of the home. The court held that the individual homes or lots which the taxpayer sells are real estate and do not constitute “merchandise” within the meaning of Treas. Reg. § 1.471-1. Thus, LIFO is not permitted.

*“...there is a fundamental difference between capitalization and an inventory method. Under capitalization, gain will be determined pursuant to section 1001 on each individual home when it is sold, and such gain is to be determined based generally on the taxpayer’s actual cost for that particular home.”*

**Rev. Rul. 86-149, 1986-2 C.B. 67** - A real estate developer filed a Form 970 to apply for the LIFO method of accounting for its “inventory” of completed homes and homes in progress. The construction costs of completed homes and costs of construction in progress are capital expenditures under IRC § 263. A taxpayer engaged in the business of developing real estate capitalizes its costs in accordance with IRC § 263.

*“Under section 263(a)(1), costs incurred in the construction of homes and other permanent improvements to real property are not currently deductible. Instead the costs of unsold homes and construction in progress is capital expenditure that becomes part of the cost of the real estate, which, in turn, is recovered either through a depreciation allowance if the property is used in a trade of business, or as an offset against the price received in the subsequent sale or disposition of such property.”*

### **Speculation Homes Becoming Long-Term Contracts**

A contractor may begin building a speculative home and enter into a “sales” agreement with a customer prior to completion. If the remaining construction on the home, after the contract is entered into, extends beyond the taxable year, the contractor has entered

into a long-term contract and would then be able to account for the contract under a long-term method of accounting available for exempt contracts. See Treas. Reg. § 1.460-4(c)(1).

## **Contractors Building Homes Under Contract**

As previously mentioned, any home construction contract is exempt from the requirement to use the percentage of completion method per IRC § 460(e)(1)(A). Therefore, the contractor may elect a permissible exempt contract method which includes percentage of completion, exempt percentage of completion, completed contract, or any other permissible method per section 446. (See Treas. Reg. § 1.460-4(c)(1)). The contractor must use the elected method to account for all its long-term contracts that are exempt from the requirements of section 460(a). Even though exempt construction contracts are not subject to the percentage of completion method, production period interest is subject to the cost allocation rules per IRC § 460(c)(3). See Treas. Reg. § 1.460-1(a)(2)(i).

## **Long-Term Methods of Accounting**

If a contractor elects a long-term method of accounting for an exempt construction contract (e.g., completed contract method, percentage of completion method, or exempt contract percentage of completion method) it is **not relevant** who has title to the land on which the home is being built. Within the definition of a contract for the construction of property, Treas. Reg. § 1.460-1(b)(2) states, “Whether the customer has title to, control over, or bears the risk of loss from, the property manufactured or constructed by the taxpayer also is not relevant.”

Treas. Reg. § 1.460-4 describes the tax recognition of the contract income and expenses attributable to long-term methods of accounting. (See Chapter 3 for a detailed discussion of each accounting method):

- **Completed Contract Method** - Gross contract price and all allocable contract costs incurred are included in taxable income in the year of completion under the completed contract method per Treas. Reg. § 1.460-4(d).
- **Percentage of Completion Method (PCM)**– A taxpayer generally must include in income the portion of the total contract price that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year. The percentage of completion must be determined by comparing allocable contract costs incurred with estimated total allocable contract costs. Thus, the taxpayer includes in gross income a portion of the contract price as the taxpayer incurs allocable contract costs. See Treas. Reg. § 1.460-4(b).
- **Exempt Contract Percentage of Completion Method** – Similar to PCM, above, except the percentage of completion may be determined using any method of

cost comparison (such as direct labor costs incurred to estimated total direct labor costs) or by comparing the work performed on the contract with the estimated total work to be performed. See Treas. Reg. § 1.460-4(c)(2).

### **Other Permissible Accounting Methods**

Title to the property **is relevant** if the taxpayer elects any permissible method, per IRC § 446, other than a long-term method of accounting, because the appropriate rules for income and expenses are contained in other sections of the Internal Revenue Code and regulations.

***Treas. Reg. § 1.460-1(a)(2) Exceptions to required use of PCM--(i) Exempt construction contract. The requirement to use the PCM does not apply to any exempt construction contract described in §1.460-3(b). Thus, a taxpayer may determine the income from an exempt construction contract using any accounting method permitted by §1.460-4(c) and, for contracts accounted for using the completed-contract method (CCM), any cost allocation method permitted by §1.460-5(d). Exempt construction contracts that are not subject to the PCM or CCM are not subject to the cost allocation rules of §1.460-5 except for the production-period interest rules of §1.460-5(b)(2)(v). Exempt construction contractors that are large homebuilders described in §1.460-5(d)(3) must capitalize costs under section 263A. All other exempt construction contractors must account for the cost of construction using the appropriate rules contained in other sections of the Internal Revenue Code or regulations. [emphasis added]***

If the contractor does not elect a long-term accounting method and **owns** the property, the land and the home being built upon it, the contractor must capitalize all costs incurred in the construction of the home per IRC § 263. See Rev. Rul. 86-149, 1986-2 C.B. 67. These costs are capital expenditures that become a part of the real estate cost which, in turn, is recovered as an offset against the price received upon the disposition of the property. See IRC §1001. Therefore, the cash or accrual methods are not allowable methods for contractors building on property it owns.

Conversely, a contractor that builds a home on the customer's property may be eligible for the cash or accrual method of accounting. See Chapter 3 for additional information on these methods of accounting.

### **Large Homebuilders**

A large homebuilder is one failing to meet the requirements of **IRC § 460(e)(1)(B)**, which are:

- A. Any homebuilder whose average annual gross receipts, for three preceding years, exceed \$10,000,000 **or**

- B. Contracts which are expected to exceed a 2-year period beginning on the contract commencement date.

The only distinction between a large homebuilder and a small homebuilder, is that a large homebuilder is required to capitalize the allocable contract costs according to **IRC § 263A**.

*Treas. Reg. § 1.460-1(a)(2) "...Exempt construction contractors that are large homebuilders described in § 1.460-5(d)(3) must capitalize costs under section 263A."*

*Treas. Reg. § 1.460-5(d)(3) Large homebuilders. A taxpayer must capitalize the costs of home construction contracts under section 263A and the regulations thereunder, unless the contract will be completed within two years of the contract commencement date and the taxpayer satisfies the \$10,000,000 gross receipts test described in § 1.460-3(b)(3).*

## **Model Homes**

Homebuilders may buy several lots in a subdivision and build one or more styles of homes to use as a model home. These model homes may contain a portion of the home as a sales office. The model home will eventually be sold at the end of the development. Rev. Rul. 89-25, 1989-1 C.B. 79, states that model homes and sales offices are not subject to an allowance for depreciation.

## **Land Developer**

In the industry, the developer is generally the owner of the development. The developer acquires the raw land, obtains approval for development, secures the financing, and begins to clear the land, install roads, utilities, etc. The land developer may also build the homes in the development, sell the lots to a builder that will build the homes, or a combination of both.

## **Income Recognition – Applicable Method**

Since land developers are involved in the production of property without contracts, they generally report their income from the sale of a parcel of property at the time of settlement/closing.

## **Cost Recognition**

The direct costs incurred by a land developer in the development of real estate (including the original cost of the land, direct materials and direct labor) should be capitalized according to IRC §§ 263(a) and 263A.

The uniform capitalization rules of IRC § 263A(a)(1) apply to land developers, and mandates certain costs to be allocated to property produced by the taxpayer as real property. These costs include pre-production costs (real estate taxes, zoning costs, design fees, etc.), production costs, and post-production costs.

**IRC § 263A(a)(1)** *In general.--In the case of any property to which this section applies, any costs described in paragraph (2) shall be capitalized.*

**Von-Lusk v Commissioner, 104 T.C. 207 (1995)** - Predevelopment costs were capitalized per IRC section 263A because taxpayer was involved in the "production" of property.

The land developer must determine the **accumulated production expenditures** with respect to each unit of property per Treas. Reg. § 1.263A-11. Each unit of property, as defined in Treas. Reg. § 1.263A-10, is treated as a separate costing unit to which all direct and indirect costs described in § 263A(a) are required to be capitalized.

## How Are Costs Allocated to Each Parcel of Property?

Generally Accepted Accounting Principles (GAAP) establishes a hierarchy of cost allocation methods via SFAS 67 Paragraph 11. These methods (in order) are:

1. Specific identification method.
2. Relative value methods (appraised value, relative assessed value for real estate taxes)
3. Other allocation methods (square footage)

If the lots have the same general characteristics and size, cost can be allocated evenly to each lot. If the lots have similar characteristics but different sizes, cost can be allocated on square footage. If lots have different characteristics, costs can normally be allocated based on relative sales value.

In **Homes by Ayres, 795 F.2d 832 (9<sup>th</sup> Cir. 1986)**, the court addressed job-costing methods:

*"Taxpayers accounted for their construction costs by accumulating costs for each phase of a subdivision...taxpayers would accumulate all direct and indirect costs for the year and then allocate them according to one of three methods to determine the cost of the houses sold in each phase (relative sales value method, average cost method, and "square footage method")...All three of these methods comport with generally accepted accounting principles and the IRS admits that they accurately reflect income."*

Normally each house is a separate cost center. But when job costs are accumulated for a subdivision in phases, a cost pool may be used. Costs may be allocated according to standard cost accounting principals. Examples of methods used to determine the cost basis of the houses sold in each phase follow:

1. One technique for allocating the pool of capitalized costs is the "relative sales value method." This method determines cost of houses sold by multiplying total capitalized costs (already incurred plus estimated costs of completion) by the ratio of the selling prices of the houses sold to the estimated selling prices of all the houses in the phase.
2. Another technique for cost allocation, called "average cost method," calls for multiplying total capitalized costs by the ratio of the total number of houses sold to the aggregate number of houses to be sold in a phase.
3. Finally, the "square footage method" allocates costs by multiplying total capitalized costs by the ratio of the aggregate square footage of houses sold to the aggregate square footage of all houses to be sold in the phase.

## **Rev. Proc. 92-29: Alternative Cost Method of Accounting for Real Estate Developers**

Under the "alternative cost method" of Revenue Procedure 92-29, 1992-1 C.B. 748, a developer may allocate **estimated costs of common improvements** to the basis of lots sold despite the limitations imposed by IRC § 461(h). Developers must obtain permission from the Service to use the alternative cost method.

Common improvements must have the following qualities:

- (1) Be real property or real property improvement that benefits two or more properties separately held for sale;
- (2) The developer must be **contractually obligated or required by law** to provide the improvement; and
- (3) The improvement must not be depreciable by the developer

The common improvement has to be contractually obligated or required by the governing body of law. For example, an agreement to provide improvements in exchange for a building permit is a common improvement (see *Herzog Building Corp. v. Commissioner*, 44 T.C. 694 (1965)). A statement in a buyer's HUD report that the developer will provide improvements does not qualify as a contractual obligation (see *Rev. Rul. 76-247*, 1976-1 C.B. 217), nor does an oral promise to a buyer to provide

improvements (see *Bryce's Mountain Resort, Inc. v. Commissioner*, T.C. Memo. 1985-293 (1985)).

Common improvements vary depending on the type of development. Some normal examples of common improvements include:

- Streets
- Sidewalks
- Sewer lines
- Playgrounds
- Clubhouses
- Tennis Courts
- Swimming Pools

For any taxable year, the estimated cost of common improvements is equal to the amount of common improvement costs incurred under IRC § 461(h) plus the amount of common improvement costs the developer reasonably anticipates it will incur during the 10 succeeding taxable years. See Rev. Proc. 92-29, Section 2.02(1).

A developer may include in the basis of properties sold their allocable share of the estimated cost of common improvements without regard to whether the costs are incurred under IRC § 461(h). There is an important limitation, however. As of the end of any taxable year, the total amount of common improvement costs included in the basis of the properties sold may not exceed the amount of common improvement costs that have been incurred under IRC § 461(h). If the alternative cost statutory limitation prevents a developer from including the entire allocable share of the estimated cost of common improvements in the basis of the properties sold, the costs not included can be deducted in the subsequent taxable year(s) to the extent that additional common improvement costs have been incurred under IRC § 461(h). See Rev. Proc. 92-29, Section 4.01.

Which business division of the IRS that a taxpayer requests the use the alternative cost method provided by Rev. Proc. 92-29 depends on the taxpayer's business and size. The Large and Mid-Size Business Division (LMSB) generally serves corporations, S corporations, and partnerships with assets in excess of \$10 million. The Small Business/Self-Employed Division (SB/SE) generally serves corporations, S corporations, and partnerships with assets less than or equal to \$10 million, and individuals filing an individual federal income tax return with accompanying Schedule C.

Taxpayers must comply with certain requirements in order to use the Alternative Cost Method.

- (1) File a request with the Area Director (for SB/SE) or Director, Field Operations (LMSB) and attach a copy to return, in accordance with section 6.01 of Rev. Proc. 92-29 on or before the due date of the return for the taxable year in which the first lot is sold. The request to use the Alternative Cost Method must include:

- Developer's identifying information
  - Description of the project
  - Schedule showing the lots covered by the request and the costs to acquire such lots
  - Schedule showing the common improvements required to be provided and information concerning the estimated cost of such improvements, the cost allocable to each lot, and the estimated date of completion of the improvements
- (2) Sign a restricted consent extending the statute of limitations on assessment with respect to the use of the alternative cost method. The restricted consent procedures require:
- Developer must extend the statute of limitations for each year the alternative cost method is used
  - Limitations period must be extended to one year beyond the expected completion date of the project
  - Developer uses Form 921 (or 921A if a partnership) for this purpose
- (3) File an annual statement with the Area Director or Director, Field Operations (and attach copy to return) in accordance with section 8.02 of Rev. Proc. 92-29. The annual statement must include:
- Developer's identifying information
  - Date of expiration of the extended statute of limitations
  - Description of the project
  - Schedule showing an updated estimated cost of common improvements, the manner of allocating the costs among lots, the lots sold as of the end of the previous taxable year, the costs incurred under 461(h), and the costs included in the basis of lots sold

A developer that fails to substantially comply with the provisions of Rev. Proc. 92-29 **will not be permitted to use the alternative cost method** and therefore may not include common improvement costs that have not been incurred under IRC § 461(h) in the basis of properties for purposes of determining gain or loss from such properties.

Example – Statute of Limitations:

A developer (partnership) applied for Rev. Proc. 92-29 approval for calendar tax year 1998 and agreed to the statute extension as required. A six-year common improvement period was requested. The Form 921 consent was secured at the time that the approval was issued and covered tax years ending 1998, 1999, 2000, 2001, 2002, and 2003. Tax returns for all project years were filed timely. During 2004 the developer came under audit for the 2003 return. The audit was completed by late 2004. The agent found that major aspects of the development disqualified it for Rev. Proc. 92-29 treatment and proposed audit adjustments for all six project years (1998 through 2003). The 1998, 1999, 2000, and 2001 statutes for Rev. Proc. 92-29 adjustments expire April 15, 2005.

The statute of limitations for all project years is computed as follows:

- Projected completion year for the common improvements: 2003
- Return (1065) due date for project completion year: April 15, 2004  
Add one year to project completion year return filing date: April 15, 2005

	Date Return Filed *****	Normal Statute Expiration *****	921 Statute Expiration *****	Rev. Proc. 92-29 Statute Expiration
1998	April 15, 1999	April 15, 2002	April 15, 2005	April 15, 2005
1999	April 15, 2000	April 15, 2003	April 15, 2005	April 15, 2005
2000	April 15, 2001	April 15, 2004	April 15, 2005	April 15, 2005
2001	April 15, 2002	April 15, 2005	April 15, 2005	April 15, 2005
2002	April 15, 2003	April 15, 2006	April 15, 2005	April 15, 2006
2003	April 15, 2004	April 15, 2007	April 15, 2005	April 15, 2007

Example – Statute of Limitations:

Assume the same facts as above except that the developer has not yet filed the completion year (2003) tax return. The statute of limitations for all project years is as follows.

	Date Return Filed *****	Normal Statute Expiration *****	921 Statute Expiration *****	Rev. Proc. 92-29 Statute Expiration *****
1998	April 15, 1999	April 15, 2002	open	open
1999	April 15, 2000	April 15, 2003	open	open
2000	April 15, 2001	April 15, 2004	open	open
2001	April 15, 2002	April 15, 2005	open	open
2002	April 15, 2003	April 15, 2006	open	open
2003	not filed	open	open	open

Rev. Proc. 92-29 Section 10 provides that “If the first year in which the alternative cost method is improperly used is no longer open for assessment of a deficiency of tax, the

Commissioner may use her statutory discretion to change the taxpayer's method of accounting in a later year and impose an adjustment under section 481(a) of the Code." This allows the IRS to make a cumulative adjustment/correction for all barred years in the earliest open year.

Example – Allocation of Common Improvements:

A developer will build 20 units of three cost classes (5 condo units, 6 town home units, and 9 single family homes) on a tract of land. The developer is contractually obligated to provide the common improvements and estimates that the common improvements will cost \$1,400,000 (including the cost of land associated with the common improvements). The common improvements are allocated as follows: \$200,000 for the 5 condominium units, \$300,000 for the 6 town homes, and \$900,000 for the 9 single-family lots. The cost of the common improvements is not properly recoverable through depreciation by the developer. Common improvement costs are allocated as follows: 5 condo units @ \$40,000 each, 6 town home units @ \$50,000 each, and 9 single family lots @ \$100,000 each.

Example – Allocation of Common Costs Compared – Rev. Proc. 92-29 vs. IRC § 461(h):

A developer building 10 properties of equal value on a tract of land is contractually obligated to provide common improvements. The common improvements will benefit all the lots in the development equally. The developer estimates that these common improvements will cost \$1,000,000 (including the cost of the land associated with the common improvements). The cost of the common improvements is not properly recoverable through depreciation by the developer. Each lot's allocable share of the estimated cost of the common improvements is \$100,000 ( $\$1,000,000/10$  lots). In year 1, the developer incurs \$250,000 in common improvement expenses and sell 2 lots.

Under IRC § 461(h), the deduction would be \$50,000 ( $\$250,000/10$  lots =  $\$25,000 \times 2$  sales =  $\$50,000$  ).

However, per Rev. Proc. 92-29 the deduction in year 1 is \$200,000. ( $\$100,000$  allocation to each lot sold does not exceed the total IRC 461(h) limitation of  $\$250,000$ ).

Example – IRC § 461(h) Limitation:

Year 1: The development has 20 single-family lots and estimated common improvement costs are \$1,500,000. The application states that costs are allocated equally to each lot, therefore \$75,000 would be allocated to each lot ( $\$1,500,000/20$ ). During Year 1, \$300,000 in common improvement costs were incurred and five lots were sold.

Without the IRC § 461(h) limitation, the Rev. Proc. 92-29 deduction for common improvements for Year 1 would be \$375,000 (\$1,500,000/20 x 5 lots sold). However, the total costs incurred for the common improvements is \$300,000, thus the deduction is limited to \$300,000. The \$75,000 barred in Year 1 is carried forward to Year 2 provided the additional costs are incurred.

Year 2: \$600,000 in obligated common improvement costs were incurred and 6 lots were sold. The year 2 deduction consists of both the deduction for current year's sales and the unused Year 1 deduction carryforward.

450,000	6 lots sold x \$75,000
<u>75,000</u>	Barred amount from Year 1 sales
525,000	Total Deduction for Year 2

### Supplemental Request to Use the Alternative Cost Method of Accounting

There are many circumstances outside the developer's control (changes mandated by the EPA, the local municipality, etc. and/or damage to the construction site resulting from tornadoes, floods, etc.) that can result in project completion delays. A supplemental request pursuant to section 9.01 of Rev. Proc. 92-29 is required to extend the common improvement construction period past the original estimated completion date.

The IRS will respond to the taxpayer **within 45 days** of receipt of the supplemental request and notify the taxpayer of either approval or disapproval. An updated Form 921 (statute consent) must be secured. **The IRS response of approval/ disapproval of the supplemental request must be in writing.** Supplemental Requests are not appropriate for avoiding the required periodic adjustments for overstated estimated expenses versus what were actually incurred to date thus deferring the final year reconciliation, and adding new developments and/or expanding current projects.

### Annual Reports/Statements

Annual reports are required for every year that construction is occurring and estimated costs of common improvements are being claimed against sales income, pursuant to section 8 of Rev. Proc. 92-29. Annual statements are no longer required when any one the following occur:

- (a) The approval period expires. If all obligated costs are not incurred by the end of the expiration period, the developer has a change in method of accounting to account for common costs per IRC § 461(h). A new unit cost allocation is calculated based upon total actual costs incurred during the approved Rev. Proc. 92-29 period. A prior period correction is recognized for the difference in all deductions claimed under Rev. Proc. 92-29 vs. IRC § 461(h).

- b) All obligated common improvement costs are incurred. As the developer is no longer including estimated future costs in Cost of Goods Sold (COGS) the restricted Rev. Proc. 92-29 consent, secured when the application was processed, is no longer applicable. The Rev. Proc. 92-29 project file can be closed.
- (c) If all inventory is sold before all obligated expenses are incurred, the developer has a change in method of accounting to IRC § 461(h) in the year that the final unit is sold. A new unit cost allocation is calculated based upon total actual common improvement costs incurred. A prior period correction is recognized for the difference in all deductions claimed under Rev. Proc. 92-29 vs. IRC § 461(h).

On each annual statement, the developer reports revisions to the original estimate and re-computes the per unit allocations, reports prior and current obligated costs incurred, prior and current sales of units, prior and current Rev. Proc. 92-29 deductions claimed, and reports any corrections or revisions to prior information reported. The developer is required to adjust the production budget, replace estimated costs with actual costs, and present an accurate picture of the project. The developer is required to be able to substantiate the reasonableness/accuracy of the estimated cost figures that were submitted on the Rev. Proc. 92-29 application. In the initial years, estimated costs comprise a large part of the per unit cost allocations. As work on the development progresses and actual costs are incurred, the developer must recognize the variances and report the latest budget on the annual statement. As the project nears completion, the per-unit cost allocations used and prior period adjustments reported result in an ongoing reconciliation/correction of the timing differences.

## **Conclusion**

A construction contract that meets the requirement of a home construction contract is exempt from the percentage of completion method of accounting for both regular income tax and alternative minimum tax. Speculation homes, land developers, and some large homebuilders build homes that are not under a long-term contract, and long-term contract methods of accounting do not apply to such contracts. Revenue Procedure 92-29 allows a developer an alternative cost allocation of common improvements in an attempt to even out the gross profit of each lot produced over the life of the project.

## Chapter 8: Other Tax Issues In Construction

The construction industry is so broad and extensive that many issues found in other industries will also appear in construction cases. There are, however, some issues that are more closely identified with the construction industry. This chapter is intended to produce an awareness of those issues. The construction issues discussed do not compose an all-inclusive list.

### Accounting Method Issues

#### Improper Computation of the \$10 Million Average Annual Gross Receipts per IRC § 460

Taxpayers are not aggregating the gross receipts of all the related companies for this computation and, therefore, are improperly electing an exempt, long-term method of accounting, when the percentage of completion method (PCM) is required. The Internal Revenue Code requires the aggregation of the gross receipts from:

- All trades or businesses (whether or not incorporated) under common control,
- All members of any controlled group of corporations for which the taxpayer is a member, and
- Any predecessor of the taxpayer or of the entities in the prior two groups. I.R.C. § 460(e)(2).

Because a three-year average is involved, consideration of the gross receipts produced by the entities from each of these three groups for each of the three years is required. Aggregations of all gross receipts of all trades or businesses under common control include:

- Parent-Subsidiary group - When more than 50% ownership by one entity
- Brother - Sister group - When 5 or fewer owners own more than 50%

Aggregations of construction gross receipts for entities not under common control:

- 5% to 50% ownership of taxpayer requires inclusion of that owner's proportionate share of gross receipts according to percentage of ownership. (Attribution rules apply - indirect or direct ownership)

#### Example of Aggregation of Gross Receipts:

A small contractor teams up with a large contractor on a joint venture. The joint venture was set up as a partnership to construct property for a large government job. The small

contractor owned 51% of the joint venture, and the large contractor owned 49%. For the gross receipts test, determined at the joint venture level, 100% of the small contractor's gross receipts, 100% of the joint venture, and 49% of the large contractor's construction gross receipts exceeded the \$10 million. The joint venture was reporting income using the completed contract method, but is required to use the percentage of completion method per IRC § 460.

See IRC § 460(e)(2), IRC 460(e)(3) and Treas. Reg. § 1.460-3(b)(3).

### **Improper Computation of the \$5 Million Average Annual Gross Receipts per IRC § 448**

Taxpayers may improperly be using the cash method of accounting. As with IRC § 460 above, the aggregation rules apply to all entities under common control. IRC § 448 (a) prohibits the use of the cash method by a tax shelter. According to I.R.C. § 448(b)(3) and (c) , C corporations and partnerships with a corporate partner are allowed to use the cash method of accounting, if the average annual gross receipts of the entity do not exceed \$5,000,000.00

### **Gross Receipts are netted for the \$5 million (IRC 448) and \$10 million (IRC 460) Threshold**

The taxpayer may be using an improper method of accounting, if gross receipts have already been offset with expenses (other than returns and allowances), so that only the net amount is reported as gross receipts on the tax return. This netting may improperly reflect average annual gross receipts below the \$5 million and \$10 million thresholds per IRC § 448 and IRC § 460, respectively.

### **Retainages**

A specified amount is usually withheld from progress billings pending satisfactory completion and final acceptance of the project. The customer will withhold the retainage from the contractor (aka Retainages Receivable). The contractor will also withhold a retainage on the subcontractors (aka Retainages Payable).

When are retainages recognized in taxable income? This depends on the method of accounting used by the taxpayer:

- Cash: Income when received or upon constructive receipt
- Accrual: Income when received, due, or earned, whichever comes first. The retainages are earned as the work is performed. However, the taxpayer may elect to exclude the retainages until billable per Revenue Ruling 69-314.
- Completed Contract: Income when the contract is considered complete.

- Percentage of Completion: Included in the contract price as the job progresses.

When are Retainages reported as an expense? This depends on the method of accounting used by the taxpayer:

Cash: Expense when retainage is paid.

Accrual: Deductible when all events test has been met per IRC 461. However, if the taxpayer has elected to defer the retainages receivable per Rev. Rul. 69-314, it must also defer the retainages payable until payable.

Completed Contract: Expense when the contract is considered complete.

Percentage of Completion: Deductible and included in the cost-to-cost PCM computation when the all-events test has been met per IRC 461

### **Delayed Billings Under Accrual Method**

Under the accrual method, the taxpayer may delay billings or structure the billing entitlement in the contract in an attempt to defer reporting of gross receipts. In *Boise-Cascade Corp.* 530 F.2d 1367 (Ct. Claims 1976), cert. denied, 429 US 867 (1976), the Court determined that the accrual of income is based upon the work performed rather than upon billing entitlement.

### **Determining Completion under Completed Contract Method (CCM)**

Taxpayers using this method may defer completing the contract in an attempt to defer the reporting of the gross profit. The Regulations at § 1.460-1(c) provide a “bright-line” test in determining completion. The earlier of:

1. 95% of contract costs have been incurred and the customer has the intended use of the subject matter of the contract or
2. Final completion and acceptance.

Reviewing the year-end work-in-progress schedule would reveal the percent complete on each job. Any job that is 95% or more complete would require further investigation to determine if the contract meets the completing requirements above.

See Treas. Reg. § 1.460-1(c)(3).

### **Improper Use of the PCM or Completed Contract Method**

In the construction industry, many taxpayers provide construction management, engineering, and architectural professional services that are an essential part of the construction process. However, their contracts do not meet the definition of a long-term construction contract which involves the building, construction, reconstruction or rehabilitation of real property. In contrast, the general contractor and subcontractors are responsible for the actual construction, and are usually working under the direction or

advice of the construction manager, engineer, or architect. Because construction management, engineering, and architects provide services that do not meet the definition of a construction long-term contract, they can not report their income under any long-term contract method (i.e., completed contract or percentage of completion method). They can only report income under the cash or accrual method.

See IRC § 460(e)(4), Treas. Reg. § 1.460-1(d)(2), Rev. Rul. 70-67, Rev. Rul. 80-18, Rev. Rul. 84-32, and General Counsel Memo (GCM) 39803 for further guidance in this area.

### **Deferring Costs under Percentage of Completion Method**

Costs incurred (per IRC § 461) under the cost-to-cost percentage of completion method required by IRC § 460, determine the completion rate of the job. Costs incurred near year-end might not be recorded. This would reduce the percentage of completion, understating the income to be recognized from the job.

Costs of uninstalled materials might also be omitted from the numerator in the percentage of completion method. For generally accepted accounting principles (GAAP), this is appropriate. However, for tax purposes, direct materials are allocated to a long-term contract when dedicated to the contract. A taxpayer dedicates direct materials by associating them with a contract. This is accomplished by purchase order, entry on books and records, or shipping instructions.

See Treas. Reg. § 1.460-1(b)(8) and Treas. Reg. § 1.460-5(b)(2)(i).

### **Allocation of Indirect Costs**

Taxpayers sometimes fail to allocate the appropriate indirect costs to jobs. There are four separate Code sections or regulations under which costs should be allocated:

- IRC § 460 (c)(1) through (c)(5) applies to long-term contracts which do not meet the home construction contract or small contract exception per IRC § 460(e)(1). Treas. Reg. § 1.460-5(b) provides a direct link to IRC § 263A for the appropriate indirect costs to include in the percentage of completion method.
- IRC § 460(b)(3) allows taxpayers that fall under IRC § 460 (above) to elect the simplified production method. See also Treas. Reg. § 1.460-5(c).
- IRC § 263A applies to large home construction contracts that do not meet the exceptions at IRC § 460(e) (less than \$10 million gross receipts or job is expected to last less than 2 years). Speculation home builders and land developers must also allocate costs per IRC § 263A as “producers of property”.
- Regulation § 1.460-5(d) applies to small contractors (both residential and commercial) using the completed contract method.

For all of the above, construction period interest is capitalized per IRC § 460(c)(3) for all long-term contracts and IRC § 263A(f) for producers of property (land developers and speculative homebuilders).

Failure to allocate all appropriate indirect costs may increase or decrease the income to be reported using the percentage of completion method. This will produce the largest adjustment for completed contract method users, speculation home builders and land developers, because none of the costs are deductible for them until a later year (e.g., upon completion of the long-term contract or sale of the house or lot).

### **Production Period Interest**

Many contractors that meet one of the two exceptions of IRC § 460(e)(1) - home construction contracts or small contractor (less than \$10 million gross receipts and less than 2-year contract) do not capitalize construction period interest as required by IRC § 460(c)(3). The exceptions found in IRC § 460(e) only exempt the taxpayer from IRC § 460(a), (b), (c)(1), and (c)(2) - all other subsections of IRC § 460 apply. Thus, production period interest applies to all long-term contracts. Land developers and speculation homebuilders also must capitalize production period interest since they are required to allocate costs per IRC § 263A.

### **Improper Inclusion of Costs in PCM Computations**

The cost-to-cost method, required by IRC § 460, is used to determine the completion percentage of a contract which determines the amount of income to be reported in a taxable year.

The completion is determined by:

$$\frac{\text{Costs Incurred To date}}{\text{Total Estimated Costs}} = \% \text{ Complete}$$

The taxpayer might improperly include overstated estimates, include nondeductible costs, or allowances for contingencies in the total estimated costs figure that, in turn, reduces the percentage of completion. This understates the corresponding income to be reported on the contract.

Also, costs that are included in the total estimated costs figure may not be included in the numerator, i.e., the costs incurred. This also reduces the amount of income to be reported for a taxable year.

### **Improper Expense Recognition under the Completed Contract Method**

The taxpayer might improperly allocate costs from contracts that are still in progress to completed contracts, which accelerates the expense recognition. An unusually low gross profit on a job may be an indication of improper job allocation.

## **Homebuilder Building for Speculation**

This type of taxpayer might improperly deduct costs that are incurred as the house is built. All of these costs, direct and indirect, must be capitalized per IRC § 263 and IRC § 263A. The taxpayer is building an asset. Thus, the costs become the basis in the property, and are not recognized until the asset is sold.

George D. Carpenter, T.C. Memo. 1994-289- - A taxpayer building a house on speculation is required to capitalize the costs of building the house under IRC § 263A.

## **Common Improvements**

“Common improvements” are any real property or improvements to real property that benefit two or more properties that are separately held for sale by a developer (i.e., roads, sidewalks, sewer lines, playground, pool, etc.)

In general, under Section § 461, common improvement costs may not be added to the basis of benefited properties until the common improvement costs are incurred within the meaning of Section § 461(h).

Taxpayers may be improperly deducting common improvements costs as incurred, rather than allocating them to the basis in the lots.

Also, if a taxpayer elects the “alternative cost method” of Revenue Procedure 92-29, it may be deducting estimated costs of common improvements without being in compliance with Revenue Procedure 92-29. (See the Homebuilder and Land Developer Chapter for more information regarding Revenue Procedure 92-29.)

## **Income Issues**

### **Advance Payments**

Front-load billing is common in the construction industry. Many contractors want a percentage of their fee paid in advance before any work is performed in order to buy the materials necessary to perform the job. Under both the cash and accrual methods (using the “all events” test), these advance payments are reported in income when received.

### **Improper Computation of the Contract Amount under Percentage of Completion Method (PCM)**

Once the percentage of completion of a long-term contract has been calculated, it is applied to the total contract price to determine the amount of income to be reported. The contract price includes change orders, retainages, expected bonuses, and claim revenue. The taxpayer may not be including any one of these items as part of the

contract price, thereby understating the amount of income to be reported. The regulations also specify that, if any contingent amount is included in income for financial statement purposes, it is to be included for tax purposes.

See Treas. Reg. 1.460-4(b)(4)(B).

### **Claim Income under PCM**

Claim income is an amount in excess of the original contract price that the contractor seeks to collect from the owner (e.g., disputed change orders, costs associated with owner delays, errors in specification, contract termination). Under the percentage of completion method, the amount that the taxpayer reasonably expects to receive is included in the contract price, and is reported in income as the job progresses. Examiners should inspect final progress billing requests, legal files (correspondences, complaints filed with the court, etc.) and Schedule M-1 for claim income.

Disputes under the other methods of accounting are reported in income as follows:

- Cash - when amount is received
- Accrual - when amount is settled
- Completed Contract - depends on the facts of each dispute
- Taxpayer assured of a profit or loss – See Treas. Reg. § 1.460-4(d)(4)(ii).
- Taxpayer unable to determine a profit or loss – See Treas. Reg. § 1.460-4(d)(4)(iii).

### **Unreported Income**

Smaller contractors, not faced with bonding or similar requirements for financial statements and performance verification, might report income for only a portion of their work. For example, the contractor could erroneously report only the income reflected on the Forms 1099. Some contractors may be willing to work for 20% to 25% less on the condition that no Form 1099 is issued or that the payment is made in cash. This has an adverse effect on the industry, as well as compliance in general.

With the proliferation of check-cashing schemes, payment with a check is an insufficient control to validate income using bank deposit records. The auditor should look to some central element of the specialty contractor's business and measure that factor to confirm the reporting of gross income by an indirect method. With a smaller contractor, the auditor can also look at the owner's return, life-style, assets or county records information to gain a reasonable assurance as to the economic reality of reported income.

### **Other Compensation Income**

A contractor may receive an interest in a project for his or her services, rather than making an initial investment of capital. Inspecting the contractor's partnership returns

will frequently reveal an interest in a construction project. Review should be made of electronic databases (i.e., LEXIS, ChoicePoint) for public records. The contract between the owner and the general contractor will often specify what the general contractor is to receive in lieu of cash payment.

See IRC § 83.

### **Delayed Billings**

Depending on the method of accounting, the contractor might delay billings or the recording of receivables in an effort to defer the reporting of gross receipts. The auditor might consider selecting a sample of jobs and inspect the job folders to review the contract billing terms, progress-billing applications sent to the owner, and owner payment documents retained by the contractor in order to test income.

### **Other Income Omission Issues**

- Failure to report interest income earned on funds such as retainages, deposits, funds transferred from other escrow accounts
- Failure to report income from remote construction projects
- Failure to report income earned from claims subsequently settled by court decisions or arbitration

### **Subcontractor Improperly Deferring Income**

Subcontractors hired early in a project (e.g., land clearing, installation of cables or wiring, laying concrete slabs) may improperly defer the recognition of income under the completed contract method, because “final completion and acceptance” does not occur until the total job is complete. However, Regulation § 1.460-1(c)(3)(iii) states that final completion and acceptance of a contract with respect to a subcontractor occurs when the subcontractor’s work has been completed and accepted by the party with whom the subcontractor has contracted (usually the general contractor).

### **Scrap Sales**

The nature of the materials used, as in plumbing, heating, and air-conditioning, may lead to the issue of scrap sales. For example, copper piping and tubing that are cut for jobs may leave small pieces that cannot be used. The scrap is then sold to metal dealers. Also, as in other industries, excess job materials may be inventoried for a future job, returned to the vendor for credit, or applied to another job.

### **Built-In Gains Tax**

When a C corporation is converted to an S corporation, taxpayers using the completed contract method may be subject to a built-in gains tax. The value of the contracts in progress as of the day of conversion is computed under the percentage of completion

method and which would be subject to the built-in gains tax. The income that was earned while a C corporation, but not reported until the following year, is unrealized income at the time of conversion.

See Reliable Steel Fabricators, Inc., T.C. Memo. 1995-293.

### **Installment Sales**

IRC § 453 provides that dealer dispositions do not qualify for the installment sale calculation of income. Homebuilders and land developers, therefore, cannot use the installment method of accounting. IRC § 1237 does provide a limited exception in which a disposition of real property subdivided for sale will not be deemed to be held primarily for sale in the ordinary course of trade or business. However, no substantial improvements can be made to the property, and the property must have been held by the taxpayer for a period of 5 years.

See Raymond v. Commissioner, T.C. Memo. 2001-96.

### **Model Homes: Character of Gain in Sale And Leaseback Arrangements**

Homebuilders sometimes sell a model home and then lease it back for use in their sales activities. The homebuilder sells the model home(s) to an unrelated party for the lower of cost, or 80% of the fair market value. The homebuilder reports a loss on this sale. Then the homebuilder leases the property back from the unrelated party at 10% of the purchase price. The homebuilder retains the right to determine both the time of sale of the model home and the terms (price and buyer). The proceeds of the sale first repay the loan of the unrelated party, a contractual bonus, with any remainder to be paid to the homebuilder. Title has passed, but the homebuilder retains many significant ownership rights.

The essence of the transaction is that of a loan. The title to the unrelated party merely acts as security. Thus, the loss on the “sale” and the lease expenses would not be deductible.

See Frank Lyon Co., 435 U.S. 561 (1978); Commissioner vs. F.& R. Lazarus & Co., 308 U.S. 252 (1939).

### **Expense Issues**

#### **Per Diem - 50% Meals Disallowance on Out-Of-Town Travel**

Meals paid for out-of-town travel are subject to the 50% travel and entertainment limitation per IRC § 274(n). Employers may be paying their out-of-town employees a per diem rate with nothing being applied to meals, and deducting the total as lodging

expense. Revenue Procedure 2003-80, however, sets forth the rules for per diem allowances. Generally, a portion of the allowance must be treated as paid for meals.

### **Depreciation of Automobiles and SUV's**

For passenger automobiles, the total depreciation deduction (including the Section 179 deduction) that can be claimed is limited.

Passenger automobile defined: A passenger automobile is any four-wheeled vehicle made primarily for use on public streets, roads, and highways and rated at 6,000 pounds or less of unloaded gross vehicle weight. However, in the case of a truck or van gross vehicle weight is substituted for unloaded gross vehicle weight. It includes any part, component, or other item physically attached to the automobile or usually included in the purchase price of an automobile. I.R.C. § 280F(d)(5)(A)

SUVs (Sport Utility Vehicles) are commonly used within the construction industry. Revenue Procedure 2003-75 defines the term "trucks and vans" as passenger automobiles that are built on a truck chassis, including minivans and sport utility vehicles (SUVs) that are built on a truck chassis. If the taxpayer is depreciating SUVs, research (via internet or the manufacturer/dealership) may be necessary to determine the gross vehicle weight to determine if the passenger automobile depreciation limitation is applicable.

### **Personal Use of Business Assets**

Contractors in closely held businesses sometimes deduct expenses for improvements to a personal residence. These expenses are frequently deducted through cost of sales, along with other contract costs. If the taxpayer is a corporation and the expenses are incurred to improve a shareholder's residence, a potential dividend issue exists, and the expenses are not deductible. If improvements are made to an employee's residence, then a possible employment tax issue exists. Being able to understand the contractor's billing and job cost records is crucial to the examination of a contractor. Sampling invoices for deliveries to the contractor's residence or for excess building supplies charged to a job is an example of audit techniques for this issue.

### **Unreasonable Compensation**

Officer/owner compensation often fluctuates significantly. An argument may be made that the present-year compensation is due to artificially low compensation in earlier years. This argument may be valid, and will be sustained where the early years of the operation were used to build capital. However, if the operation is well established, and the profits of a high-volume year are being reduced through high compensation, the examiner should seriously consider raising the issue. Industry averages are also available through Web sites such as Bizstats.com. This issue is dependent upon the facts and circumstances of each case.

## **Double Deductions**

Double deductions can occur when the contractor uses a single-entry bookkeeping system. Some job costs may be both capitalized and expensed in the current period. Since the single entry bookkeeping system will allow duplications to occur, the auditor should consider using in-depth investigative techniques.

## **Interest Expense – Cash Method**

For a contractor on the cash method of accounting, interest expense on a construction loan is not deductible until it is paid. A construction loan differs from a conventional loan in that a construction loan usually does not require interim payments. Even the loan origination fees may be financed. These expenses are not deductible until the payments are made. The loan documents should be examined to determine the terms for making principal and interest payments, as well as verifying the actual payments made during the year.

See *Heyman v. Commissioner*, 70 T.C. 482 (1978), *aff'd*, 652 F.2d 598 (6th Cir. 1980).

## **Capitalization of Pre-development Costs**

A developer may purchase a parcel of property for future development. Pre-development costs must be capitalized and are not currently deductible. Several judicial decisions support this position:

John J. Reichel, 112 TC 14 - A real estate developer who purchased properties for development was required to capitalize related real estate taxes as indirect production expenses.

Lee D. Hustead, T.C. Memo 1994-374 - A developer was required to capitalize costs incurred to challenge the zoning of property.

Von-Lusk, 104 TC 207 - Property taxes and preliminary costs associated with the contemplated construction were required to be capitalized per IRC § 263A.

## **Contributions of Land and Facilities**

Land developers and building contractors often donate land, buildings, or other assets to state or local governments, charitable organizations, or civic organizations. These assets usually have appreciated in value, due to the passage of time and/or the development activity by the builder. Be alert to deductions of the fair market value of the donated property as a charitable contribution.

Examiners should consider the “donative intent” of the builder. A common practice is for state and local government agencies having control of zoning and building permits to require the developer/builder to set aside and donate land and facilities for some of the following uses: schools, parks, police and fire stations, government offices, medical facilities, community centers, water and sewer plants, roads, and maintenance buildings. If the developer/builder donated the asset due to a requirement of a government agency or the facility was used as a promised improvement in selling efforts to customers, then the requisite “donative intent” for a contribution deduction is missing. Without this intent, the non-deductible donation is a part of the cost of developing lots. In addressing this issue, examiners should inspect the builder’s correspondence and legal files, zoning and permit documents, minutes of government agency meetings, corporate minutes of the builder, newspaper articles, and the builder’s sales literature.

Examiners should be aware that developers/builders often allocate development costs only to the properties that will generate sales revenue. Thus, the donated property may only have the cost of raw land charged to it. The allocation of costs usually takes place in the early stages of development, while donations of property are made in the latter stages. You should be alert to ensure that a double recovery of cost is not allowed.

## **Losses**

There may be an improper inclusion of the total loss on a contract that is still in progress. Financial reporting (GAAP) requires the contractor to recognize the full amount of any anticipated loss in the current period, regardless of the degree of completion. However, for tax purposes, the loss is not deductible until the job is determined to be complete for taxpayers using the completed contract method. The loss incurred to date (not the total loss) is deductible for taxpayers using the PCM.

## **Abandonment Losses**

If a taxpayer abandons an asset, the loss is generally deductible to the extent of the taxpayer's adjusted basis in the abandoned property. To support an abandonment loss, the taxpayer must establish an intent to abandon the asset and must make some affirmative act of abandonment. The loss is deductible in the year the abandonment is sustained with regard to non-depreciable property.

In general, abandonment losses occur with "spec" homebuilders, real estate developers, and related-party entities more frequently than with other types of contractors. Some reasons for abandonment losses are due to lack of financing, lack of bonding, disapproval of zoning changes, cost overruns or, in the case of related parties, possible tax avoidance.

## **Related Party Transactions**

A contractor or subcontractor may incur expenses for improvements to his personal residence (or that of a friend or relative) or build a home for his personal use (or that of a friend or relative). These expenses might be applied to another job to disguise the costs, or the taxpayer might report the job separately, but “sell” the residence for cost. Potential issues are disallowance of personal expenses and/or dividend issues, if a corporation. The difference between the FMV and the actual “sales” price to the shareholder would be subject to constructive dividend rules.

Also, allocation of indirect costs not “charged” to the taxpayer/relative would result in a nondeductible loss per IRC § 267.

### **Severed Contracts**

For tax purposes, losses are not deductible until incurred. Under the completed contract method, none of the loss may be deducted until the contract is completed. Under the percentage of completion method, the loss is deducted as the job progresses. By improperly severing a contract, the taxpayer is recognizing the loss prematurely.

See Treas. Reg. § 1.460-1(e).

### **Bad Debts and Cancellation of Debt Income**

The typical bad debt issue must be reviewed when there are related party transactions involved. If one party has a legitimate bad debt, the other related party should have cancellation, or forgiveness, of debt income. Bad debts are deductible under IRC § 166, and cancellation of debt is income pursuant to IRC § 108. Be aware that the facts of bankruptcy or insolvency may impact the recognition of forgiveness of debt income. Also, net operating losses may have to be reduced if bankruptcy limits the recognition of forgiveness of debt income.

Bad debts require an inquiry into the following:

1. Debt or equity investment?
2. Whose debt is it? (Related party?)
3. Business or non-business?
4. Have the funds actually been transferred, or have only adjusting journal entries been made?
5. Has interest been charged and reported?
6. Do documents exist that support the transactions?

### **Warranty Reserves or Contingent Liabilities**

An accrual basis taxpayer may be deducting estimated warranty costs from a reserve account established to reflect a liability for future services:

- Reg. §1.446-1(c)(1)(ii) - Under the accrual method a liability is incurred in the taxable year in which all the events have occurred that establish the fact of the liability, the amount can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.
- IRC § 461(h)(1) - In determining whether an amount has been incurred, the all events test shall not be met any earlier than when economic performance occurs. Economic performance occurs when service or property is provided by the taxpayer.

Economic performance has not occurred with respect to estimated warranty costs, and contingent liabilities are nondeductible. The examiner should be aware that for GAAP these items are reportable, so there should be an M-1 adjustment for these items.

### **Model Homes**

The taxpayer is in the business of building and selling residential houses. To assist in its sales activity, the taxpayer may use certain houses as models and/or sales offices temporarily. Such use generates no rental income to the taxpayer. Revenue Ruling 75-538 provides guidance. It holds that a vehicle is not property used in the business (thus subject to depreciation) if it is used merely for demonstration purposes or is temporarily withdrawn from stock-in-trade. Model homes/sales offices are used for a small fraction of their expected useful lives, and the taxpayer ultimately expects to sell these houses. Although the taxpayer may be reluctant or unwilling to sell the houses while they are being used as a model home or sales office, they remain property held primarily for sale to customers and may not be depreciated.

See Rev. Rul. 89-25.

## **Tax Issues**

### **Accumulated Earnings Tax**

Closely-held entities are more likely to accumulate earnings and profits beyond the reasonable needs of the business in order to avoid income taxes on its shareholders than are large corporations. Each accumulated earnings case is unique. No pro forma guide for calculating a taxpayer's reasonable needs can be prepared. Reasonable needs that would usually be considered in any accumulated earnings case are the need for sufficient net liquid assets to pay reasonably anticipated, normal operating costs through one business cycle and sufficient net liquid assets to pay reasonably anticipated, extraordinary expenses and capital improvement financing. In addition, the following represents a non-exclusive list of specific items that should be considered for construction contractors:

**Working Capital necessary for Bonding Purposes** - The general rule of thumb is that working capital needs to be at least 10% of "backlog" for bonding purposes. A specific taxpayer's situation may result in a different percentage based on the bonding

company's requirements. Thus, this percentage should be determined on a case-by-case basis. "Backlog" (work program) is the sum of contracts in process, less the billings from those contracts, plus contracts not started.

**Equipment Needs** - Contractors who have high equipment needs will generally have a need to replace the equipment on a periodic basis.

The following information is included to assist an examiner in determining whether, during an examination of a construction company, an accumulated earnings tax issue may exist. Generally, when considering whether an IRC § 531 issue exists, examiners are advised to employ the Bardahl, Mead, or similar method used in determining the reasonable business needs. However an examiner must consider that, unlike most entities, a construction company normally needs to retain earnings and profits to assure adequate bonding capacity. Relevant court cases involving the accumulated earning tax and construction contractors are:

Ready Paving and Construction Co. v. Commissioner, 61 T.C. 826 (1974) – a paving contractor had permitted its earning to accumulate beyond the reasonable needs of its business. A 'modified" Bardahl formula was used with the case hinging on what items were and were not to be included in determining working capital.

Thompson Engineering Co. v. Commissioner, 80 T.C. 672 – A construction subcontractor was liable for the accumulated earnings tax. The IRS determined the taxpayers reasonable business needs by applying the "Bardahl" formula. The court agreed with the taxpayer that the Bardahl formula has "little or no value when applied to a mechanical contracting business that lacks a routine operating cycle." The bonding capacity, and not the Bardahl formula, is the major consideration in determining the taxpayer's business needs. This case was appealed and reversed – See 751 F.2d 191.

Peterson Bros. Steel Erection Co. v. Commissioner, T.C. Memo. 1988-381, 55 T.C.M. (CCH) 1605 (1988): the taxpayer, involved in the steel erection of high-rise buildings, was not liable for the accumulated earnings tax. The petitioner's ability to obtain a bond on a job when required is of primary importance and is clearly a reasonable need of the business. The fact that the petitioner was rarely required to provide a performance bond on its jobs is immaterial since it had to be prepared to provide a bond if required..

### **Alternative Minimum Tax**

Taxpayers who are not required to use PCM (per IRC § 460) or elect to use PCM for tax purposes may owe alternative minimum tax. IRC § 56 states that the PCM must be used for long-term contracts for alternative minimum tax purposes. Therefore, taxpayers on the cash, accrual, or completed contract methods must compute alternative minimum taxable income on the percentage of completion method.

Exceptions to the required use of PCM for AMT:

- Homebuilders - IRC § 56(a) applies to long-term contracts except for home construction contracts
- Small Corporations are exempt from AMT for tax years beginning after 1998. Small corporations are C corporations with average annual gross receipts of \$5,000,000 or less. They remain exempt in subsequent years until their average annual gross receipts exceeds \$7,500,000.

Many construction companies are required to prepare certified financial statements for bonding and lending purposes. Financial statements must be prepared on percentage of completion method. (Statement of Position 81-1) Thus, the difference between the percentage of completion method and the tax return method can easily be determined for alternative minimum tax purposes.

## **Employment Tax**

The use of subcontractors is common within the construction industry. Many taxpayers treat employees as subcontractors to avoid paying employment taxes. The agent may need to seek guidance from an employment tax specialist when confronted with potential employment tax issues. Back-up withholding can apply to subcontractors. The bargain sale of a house to an employee involving a discounted sales price could produce employment tax liability.

## **Conclusion**

Many issues are common to all industries. However, some issues are specific to the construction industry, due to the nature of the business and the special accounting methods available. Further facts and tax research will be necessary to develop the issues mentioned in this chapter.

## **Chapter 9: Income Probes**

### **Introduction**

The methods of accounting, discussed in Chapters 3 and 4, govern contractor income recognition. Although contractors earn most of their income from building projects, including new construction and remodeling, there are other potential sources of income related to construction, including:

- Sales of construction equipment
- Consulting fees
- Forgiveness of debt income
- Constructive dividends
- Scrap sales
- Interest income earned on retainages or deposits
- Income from court settlements

Sales may be generated in a variety of ways, including word-of-mouth, Web sites, newspapers, magazines, trade shows, showrooms, or model homes. Typically, a contractor will execute a contract detailing the total job costs and project specifications, as well as the method of payment. The contract may include provisions for retainages, which are usually kept by the general contractor until the project is complete. While the construction contract is an invaluable source of information as to the income from the job, it is also useful in determining the materials consumed, completion dates, job costs, gross profit, and change orders that could result in additional income from the job.

One of the most difficult tasks that an examiner faces is setting the scope of the income probes. This determination must be based upon the risk assessment that is completed during the pre-planning and initial phases of the examination. The initial interview is critical in establishing what type of construction is involved and how the contractor accounts for income, expenses, work in process, and the duties and responsibilities of key personnel. Without an understanding of the business operations, method of accounting, internal controls, and the involvement of the key personnel, the examiner will not be able to properly set the scope of the examination. Internal Revenue Manual (IRM) Section 4.10.3.2 offers guidance in the preparation and documentation of effective interviews. The evaluation of internal controls is discussed in IRM 4.10.3.4.

### **Understanding the Accounting System**

#### **General Techniques**

The initial interview is the best time to determine how the accounting system works and what types of internal controls are in place. Gaining an understanding of the business is critical because a contractor could have multiple businesses operating within the same entity. An example of this would be an electrical contractor who also operates a retail sales outlet. In this case, sales could be recorded on the cash basis for the service business, accrual for the retail business, and percentage of completion for the contractor business. Establishing the type of construction involved, the method of accounting for income and expenses, work in process, and the duties and responsibilities of key personnel are all areas to be covered in the interview.

## **The Construction Contract**

The construction contract is the keystone for understanding how income is determined. The contract will specify how much the contractor will be paid and when. This information will have an impact on income recognition issues as well as the profit to be recognized from the job. The contract may also provide information about retainage provisions, incentives, awards, penalties, and change orders. Contracts will also specify whether the terms are “cost plus” or based on a bid.

Part of the income probe will be determining if reported income is reasonable with respect to cost of goods sold. Industry standards from Websites such as Bizstats.com can also be used as a benchmark to determine if the reported gross profit is reasonable.

The contract could also be a starting point for comparing materials as specified per the contract to materials actually charged to the job. This might indicate materials being diverted for other use by the contractor or to small jobs that have no contract and were not recorded in sales. Comparing the “budgeted cost” to the “actual cost” in situations where losses or nominal net profits are reported is a good audit technique when reviewing contracts. Some municipalities have computerized building permit records that could be compared with the actual contracts or job costs.

Some specific examples that an examiner could use to test income from the contracts:

- Compare the board feet of lumber delivered to the square footage of the building. Guides are available that provide this information. Large variances should be investigated.
- Compare the cubic feet of concrete purchases to the size of the slab included in the contract.
- Compare the square footage of the roof area to the bundles of shingles purchased and delivered to the job site.
- Compare the number of major appliances, HVAC units, etc., to the size of the building.
- Compare the contractor’s gross profit to the industry standards.
- Courthouse research could show properties transferred but not accounted for in the contracts.

## **Minimum Income Probes**

The IRM at 4.10.4.3 discusses the requirement for examiners to consider gross income during the examination of all income tax returns. Certain minimum income probes are to be made regardless of the type of return filed by the taxpayer.

### **Minimum Income Probes for Non-business Returns:**

The minimum probes for income outlined in IRM 4.10.4.3.2 include questioning the taxpayer or representative regarding possible sources of income, other than those reported:

- Taxable sources
- Non-taxable sources
- Bartering activities

The responses to these questions concerning possible sources of unreported income should be summarized and referenced to the workpapers that document the interview questions. Internal information, such as the Currency and Banking Retrieval System (CBRS) which is used to track cash transactions over \$10,000 and Information Returns Processing (IRP), should also be analyzed to ensure that all business or investment activities are listed on the return. Consideration of possible bartering income is also part of the minimum income probes. Based upon the analysis of income, external sources (third parties) may be used to corroborate the information received or establish an understatement of income. Under Section 7602(c) of the Code, third party contracts may not be initiated before giving advance notice to the taxpayer that such contracts may be made as part of the examination. See IRM 4.10.4.5.3.6 for a discussion of the procedures to initiate third party contracts.

### **Minimum Income Probes for Individual Business Returns:**

IRM section 4.10.4.3.3 expands the minimum income probes to include an analysis to determine if reported income is sufficient to support the taxpayer's financial activities. There could be unreported income, overstated expenses, a simple math error, or a combination of these items that could indicate the taxpayers did not have sufficient funds to support their financial activities. Several audit procedures should be utilized:

- Prepare a preliminary cash transaction account (Cash-T) based upon the tax return data and updated with new information obtained during the examination. For contractors, the preliminary Cash-T will be modified by the job records showing work in process that may not be reported on the return, but may have a substantial economic impact. If the Cash-T is materially out of balance, further information from the taxpayer will be necessary.

- Tour the business sites and record any observations or comments about the business operations in the workpapers.
- Evaluate the internal controls to gain an understanding of the taxpayer's business operations. Conclusions reached by the analysis of internal controls should be documented in the workpapers. See the discussion following this section about the evaluation of internal controls.
- Reconcile the taxpayer's books and records to the tax return. If the taxpayer uses double entry accounting, a book-to-tax reconciliation should be available from the taxpayer.
- Analyze the personal bank statements and the business bank records. Normally the minimum analysis would be to compare the total deposits with the reported gross income. Bank statements can also provide information about other accounts, automatic transfers, etc.
- Based upon the information gathered, the scope of the examination of income will be expanded or contracted.

### **Minimum Income Probes for Corporations, Partnerships, S Corporations and Other Business Returns:**

According to IRM 4.10.4.3.4, the examination of gross income on a business return for corporations or other business entities should include the following steps at a minimum:

- Prior to contract, prepare a comparative analysis of the balance sheet and income statement using the assigned year and prior and subsequent years if available. This will assist in the identification of issues to be examined.
- Evaluate copies of the tax returns of significant shareholders or partners (greater than 50% direct or indirect ownership) for examination potential, related transactions, or possible diverted funds.
- Prepare a comparative analysis of the balance sheet and income statements including prior and subsequent years, if possible.
- Reconcile Schedules M-1 and M2 and the trial balance to the return.
- Analyze the adjusting journal entries and reconcile the trial balance to the general ledger.
- Analyze a significant balance sheet accounts which show substantial increases or decreases, especially those that relate to income, e.g., deferred revenue, reserves, shareholder loans.

The depth of the bank record inspection will depend on the internal controls, the analysis of the primary shareholder/partner's returns, and the judgment of the examiner. At this point, the examiner should have a solid basis for determining if there is potential for unreported income and if the books and records are reliable. When dealing with construction returns, the method of accounting is always important, because of the impact on income recognition. This could result in a technical adjustment to income.

## Internal Controls

The evaluation of internal controls is discussed in the IRM at 4.10.3.4. Examiners are required to evaluate the existence and effectiveness of internal controls for all types of business returns. Even in the small business environment, where the owner-managers control the entire operation, it is essential to evaluate internal control to determine the appropriate audit techniques to be used. The type of business, the records, and the owner's financial status should be considered as part of the evaluation of internal controls.

What exactly are internal controls in a small business environment? When would they be considered inadequate to the degree of requiring an indirect method? Does the lack of good internal controls mandate the use of an indirect method? Conversely, do good internal controls automatically negate the use of an indirect method?

The answer to these questions is for the most part a judgment call by the examiner. It would be rare that a sole proprietor would be denied unlimited access to the cash resources of the business. While there could be a record keeping system that incorporates a certain level of checks and balances, the credibility reverts back to the owner's willingness to adhere to the established procedures.

In the absence of legal requirements for contractors, such as bonding or government contracts, for the most part a sole proprietorship with no employees is considered to have very weak or nonexistent internal controls. This conclusion would normally require strong consideration of an indirect method during the course of the examination. The exception would be a result of extenuating circumstances justifying a decision not to pursue an indirect method.

The next level would be "weak" internal controls. This might occur where the owner has occasional or limited access to the cash resources of the business. An example might be a larger Schedule C with an in-house accountant. The staff prepares the majority of the banking transactions. The owner, however, has the opportunity on occasion to skim cash sales and circumvent the control procedures that are in place.

In situations similar to this example, deciding whether or not to pursue an indirect method would require several considerations.

- Type of business involved (some are more prone to cash transactions);
- The ease of skimming cash, e.g., a large number of unidentifiable customers versus a small number of traceable customers;
- Established gross profit ratios, e.g., the fact that the business is operating well below the normal gross profit ratios may indicate skimming practices are present;
- The taxpayer's standard of living, e.g., a higher standard of living than the amount of income reported may indicate potential skimming;
- Cash expenditures not reflected in the taxpayer's records that are identified by a courthouse records check; or

- A high percentage of cash expenditures for business or personal expenses and some (or all) are not reflected in the taxpayer's records.

The other end of the scale is a business with strong internal controls. This might be evidenced by an elaborate double entry record keeping system; periodic in-house audits; annual certified financial audits; an outside accountant who provides monthly write-up services; non-related owners with equal involvement in the business operations; or limited cash transactions with easily traceable customers. Under these circumstances, the general rule would be not to pursue an indirect method, and the exception would be where extenuating circumstances dictate otherwise.

The key steps to evaluating internal controls are:

- Understanding the control environment,
- Understanding the accounting system, and
- Understanding the control procedures.

First, the control environment is made up of the many factors that affect the policies and procedures of the business. The examiner must understand how the business operates. Interviewing the taxpayer (and/or the representative) and touring the business are integral steps. Second, gaining knowledge of the accounting system provides information about many of the day-to-day business operations. Finally, the control procedures are the methods established to assure that the business operates as intended. The separation of duties is the primary control procedure because it will reduce the opportunity for any one person to both perpetrate and conceal errors or irregularities. The greater the number of employees, and the more complex the business, the more likely some formal control procedures will exist.

In conclusion, the internal controls of a business must be evaluated and discussed in the workpapers as a mandatory item on every business return examination. The workpapers should include a statement regarding the accessibility to cash by the owner/manager, the quality of internal controls overall, and the effect the internal control environment had on the verification of income.

### **Audit Techniques for Evaluating Internal Controls**

The internal control system should be tested for compliance with the procedures as described in IRM 4.10.3.4.5.3. Observe a transaction through the entire accounting process. Look for consistency in recording similar transactions. At this point, the scope and depth of the examination can be determined. If the books and records are reliable, the examination can include direct testing of transactions, such as tracing specific items to receipts. However, if it is determined that the books and records are not reliable, the examination should include indirect analyses. Because the examination of the books and records will reveal the likelihood of material errors, or that transactions were valid, determining reliability through internal control analysis is a key step.

## Use of Indirect Methods

### Introduction

Smaller contractors, not faced with bonding or similar requirements for financial statements and performance verification, may improperly report income for only a portion of their work. For example, they might limit income to the amount reported on Forms 1099. Some contractors have been willing to work for 20% to 25% less on the condition that no Form 1099 is issued. This has an adverse affect on the industry as well as on the government.

With the proliferation of check cashing schemes, payment with a check is an insufficient control to validate income via bank deposit records. The auditor should look to some central element of the specialty contractor's business and measure that factor to confirm the reporting of gross income by an indirect method. With a small contractor, the auditor can also look at the owner's return, county record information, and life-style/assets to gain a reasonable assurance as to the economic reality of reported income. As always, the examiner's judgement will be required to determine if the examination should be expanded to include the use of indirect methods of verifying income.

### Indirect Methods - Overview

At some stage of all business return examinations consideration must be given to the use of an indirect method. Equally important is the proper workpaper documentation of the decision to pursue (or not to pursue) an indirect method of income reconstruction. With the passage of the Revenue Recognition Act of 1998, the examiner must document the likelihood of unreported income before proceeding with an indirect method:

#### **IRC § 7602(e) LIMITATION ON EXAMINATION ON UNREPORTED INCOME**

*The Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income.*

When the records are incomplete, or there are other indications that the books and records are not reliable, income may be estimated by using other methods such as analyzing building permits, commissions paid to the sales staff, or applying gross profit percentages to jobs. The decision to use other estimates of income or to expand the scope of the income probes should be made after evaluating the results of the initial income probes. The decision making process must be documented in the workpapers, and updated as information is received. The use of an indirect method of reconstructing income should be considered when:

- A review of the taxpayer's prior and subsequent year returns show a significant increase in net worth. In the case of a corporation or partnership, this determination is made on the shareholder's return or the partner's return.
- Gross profit percentages change significantly from year to year or are unusually high/low for that business.
- The taxpayer's business and personal expenses exceed the reported income per the return and attempts to reconcile material imbalances have failed.
- The taxpayer's bank accounts have unexplained items of deposit.
- The taxpayer does not make regular deposits of income, but uses cash instead.

### **Types of Indirect Methods**

Neither the Code nor the Regulations define or specifically authorize the use of indirect methods. The authority to challenge a taxpayer's income determination is seated in IRC § 446(b):

*If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.*

The application of the various indirect methods is outlined in detail in the IRM at 4.10.4.6.3 through 8 and includes:

- Bank Deposit Method
- Cash Transaction and Source and Application of Funds Method
- Net Worth Method
- Percentage of Markup Method
- Unit and Volume Method
- Potential Defenses to Indirect Method Computations

In addition to a discussion of the relevant case law and the indirect method computation, the IRM discusses each method in detail. In theory, each method applied properly should yield the same result. However, there are situations that indicate the use of a specific method may be more appropriate.

The *bank deposit* method is recommended when:

- The taxpayer's books and records are unavailable, withheld, or incomplete.
- The taxpayer deposits most income as verified during the examination.
- The taxpayer pays most business expenses by check.
- The taxpayer used the bank deposit method to report income.
- The taxpayer's records indicate numerous cash expenses.
- The assets and liabilities are stable from year to year.

- A large volume of unsorted bills, invoices and receipts are submitted in support of items appearing on a return.
- The taxpayer's books and records appear complete and accurate, but a method to probe for unreported income or confirm the accuracy of the books and records is needed.

The *Cash Transactions and Source and Applications of Funds* methods are recommended in the following situations:

- If the review of a taxpayer's return indicates that the taxpayer's deductions and other expenditures appear out of proportion to the income reported.
- The taxpayer's cash does not all flow from a bank account which can be analyzed for its source and subsequent disposition.
- There is little or no increase in the net worth of the taxpayer, yet, based upon expenditures of the taxpayer, it becomes apparent that the taxpayer has other sources of income.
- The taxpayer makes it a common business practice to convert receipts into cash for the purpose of paying claimed business expenditures.
- If only one or two years are under examination.
- The small amount of time needed to be expended, as compared with using the net worth method.
- The taxpayer has many transactions involving assets and liabilities.

The *net worth* method is generally recommended in the following situations:

- Two or more years are under examination.
- Numerous changes to assets and liabilities are made during the period.
- No books and records are maintained.
- The books and records are inadequate or not available.
- The books and records are withheld by the taxpayer.

The *percentage of markup* method is recommended when:

- When the inventories are a factor and the taxpayer has nonexistent or inadequate records.
- Where a taxpayer's cost of goods sold or merchandise purchased is from one or two sources and these sources can be ascertained with reasonable certainty. In addition, a reasonable degree of consistency as to sales prices exists.

The *unit and volume* method is recommended when:

- The examiner can determine the number of units handled by the taxpayer, and also knows the price or profit charged per unit.

Clearly, the examiner's judgment is a crucial factor in determining the best method to pursue when the examination indicates the use of an indirect method. With the exception of the unit and volume method, any of these methods would apply to construction returns. Construction activity results in the production of tangible personal property, so the cost of the materials can usually be determined. Most materials used in construction are not exotic, so pricing is generally not a barrier to determining job costs. For example, if the home builder constructed an average 2,000 square foot home, there would be 13,127 board-feet of framing lumber, 3,100 square feet of roofing material, 3,061 square feet of insulation, 15 windows, 12 interior doors, 2,085 square feet of flooring material, etc. The average material usage would give the examiner a benchmark to use for determining income based on costs. (Source: National Association of Home Builders, <http://www.nahb.org>) The Audit Technique Guides for Carpentry/Framing, Drywallers, and Masonry/Concrete also have standard usage formulas to help determine whether costs are reasonable.

As policy, when an indirect method results in an understatement over \$10,000, it is mandatory for the examiner to discuss the case with the group manager. The purpose of the discussion is to consider expanding the scope of the examination and to evaluate any elements of fraud. Fraud potential should always be considered in an examination when unreported income is an issue. The taxpayer's explanations or lack thereof may help distinguish between civil and criminal fraud. It is important to document the case file for the responses to interview questions, reliability of books and records, or any other indications of fraud.

## **Miscellaneous Income Sources**

Income may also arise from other sources. Some of the more common ones are:

- A contractor may have interest income from escrow accounts, retainage accounts, or deposits. Reconciling the IRP transcripts may reveal unreported interest income.
- Income from a remote construction project could be omitted. Generally, expenses will be accounted for, so a careful understanding of the books and records is crucial.
- It is not unusual for a contract to be involved in some litigation over complicated construction contracts. The income from claims that are subsequently settled by court decisions or arbitration may not be reported.

## **Conclusion**

There are several resources available to the examiner when the taxpayer's business is construction related.

A potential resource is the IRS Website, [www.irs.gov](http://www.irs.gov), which discusses various construction issues. This information is updated with court cases and other documents outlining the Government's position on various construction accounting issues. Because many construction businesses are sole proprietors, issues are found on individual and business returns. An understanding of the industry is vital for examiners to complete a quality examination.

Certain auditing techniques should always be applied when auditing a contractor. Special attention needs to be given to the possibility of unreported income. The contractor should be interviewed and asked to explain the operation of his or her business. The construction contract should be reviewed to see how income is to be received. Income probes should be performed. Other sources of income common to contractors should be investigated. And internal controls should be reviewed. If the results of these reviews indicate the probability of unreported income, indirect methods of determining income should be considered.

No magic formula exists to use in examining contractors' income tax returns. The examiner must use good judgment as well as innovative techniques when faced with either inadequate or non-existent books and records. Using other resources to estimate income can be sustained when the evidence is supported by increases in net worth or living expenses.

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## Chapter 10: Construction Joint Ventures

### Overview

A joint venture is composed of two or more businesses combining their resources to build one or more projects. Construction companies that lack sufficient capital, resources, bonding capacity, or technical expertise to be awarded certain contracts often find it necessary to form joint ventures. Other construction companies have restricted access to international or domestic markets. By forming joint ventures, construction companies can often overcome these market limitations or restrictions. Although these forms of business have both advantages and disadvantages, they are often necessary for the construction company's survival and growth in a highly competitive industry. .

### Types of Joint Ventures

Construction projects can be structured as joint ventures, that then are generally considered partnerships under IRC sections 761(a) and 7701(a)(2). Joint ventures are generally formed for one specific purpose (a job, a contract, or a project) with the intent of operating for a limited duration.

*IRC §7701(a)(2) PARTNERSHIP AND PARTNER.—The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term “partner” includes a member in such a syndicate, group, pool, joint venture, or organization.*

Such construction projects may also be formed as corporations or, under state law, as some other type of entity. Regardless of the form of the entity under state law, federal tax law applies to classify the entity for federal tax purposes.

The IRS and Treasury have published regulations for classifying business arrangements for federal tax purposes. These regulations became effective January 1, 1997. When classifying a business arrangement, first determine if there is a separate entity for federal tax purposes. A joint venture may create a separate entity for federal tax purposes if the participants (1) carry on a trade, business, financial operation, or venture and (2) divide the profits from the activity. Nonetheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. Whether a joint venture is a separate entity for federal tax purposes is a question of federal law. See Treas. Reg. § 301.7701-1.

*Treas. Reg. §301.7701-1. (a) Organizations for federal tax purposes—*  
*(1) In general. The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.*

*(2) Certain joint undertakings give rise to entities for federal tax purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.*

A separate entity conducting construction operations will generally be treated as a business entity under the new regulations. A business entity with two or more members is classified either (1) as an association taxable as a corporation or (2) as a partnership. Except for certain business entities that are defined as corporations, a business entity may elect to be treated as either an association or a partnership (an eligible entity). See *Treas. Reg. section 301.7701-2.*

*Treas. Reg. §301.7701-2(a) Business entities. For purposes of this section and §301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.*

The regulations provide default rules that classify eligible entities without requiring them to file elections. Unless it elects otherwise, a domestic eligible entity that is formed after January 1, 1997, is classified as a partnership, if it has at least two members. Unless it elects otherwise, a foreign eligible entity that is formed after January 1, 1997, is

classified as either (1) a partnership, if it has at least two members and at least one member does not have limited liability, or (2) an association, if all members have limited liability. Generally, an eligible entity in existence prior to January 1, 1997, maintains the classification it claimed under the classification regulations in effect prior to January 1, 1997. An eligible entity may elect to be classified other than as provided in the default rules or to change its classification by filing a Form 8832, Entity Classification Election, with the appropriate service center. See Treas. Reg. section 301.7701-3.

For financial statement purposes, investments in joint ventures are accounted for by each member of the joint venture under the cost method, the equity method, as a pro rata share, or the entity is consolidated with the investor's financial statements. For financial accounting purposes, the accounting method used to account for the construction company's investment in a joint venture, is based on the ownership percentage and the degree of control the construction company has over the venture. Inspection of the taxpayer's consolidated financial statements can provide the auditor with an extended view of the construction company's investment in joint ventures, because both incorporated projects and joint ventures are often consolidated. In addition, financial information of unconsolidated joint ventures is frequently disclosed in the notes to the financial statements.

Joint ventures classified as partnerships are generally required to file separate income tax returns (Form 1065). Individual partners or investors recognize a distributive share of partnership items (reported on Schedule K-1) from the construction joint venture on their income tax returns. Partnerships are formed as general partnerships or limited partnerships. A general partnership is an association where all partners have unlimited liability. A limited partnership is an association in which one or more general partners have unlimited liability, while one or more limited partners have limited liability.

## **Joint Venture Examinations**

Auditors examining construction companies that are involved in joint ventures should be aware of the unique issues regarding the formation, operation, and liquidation of joint ventures. The gross receipts of each joint venture needs to be considered in the rules of attribution in determining the member's eligibility to meet the small contractor's exception under IRC 460(e)(1). See Chapter 3 for additional information regarding the rules of attribution. Each member of a joint venture brings individual resources to a joint venture, and can be compensated in various ways.

Each party should be viewed independently. Such a review often raises questions and potential issues:

- What resources (assets, capital, services, etc.) were contributed by each party?
- What was the value and basis of the property contributed?
- Did a partner contribute appreciated property to the venture?
- Was the contributed property encumbered?
- What are the profit, loss and capital sharing ratios?

- Do the partnership allocations have substantial economic effect within the meaning of IRC section 704(b)?
- Have there been changes in the ownership structure?
- Have there been distributions or partial liquidations from the joint venture?
- What type of property was distributed and to whom?
- How has the construction company been compensated (cash, increase in capital interest, etc.) for its construction work?
- How does the construction company allocate its overhead or indirect expenses to joint venture projects?
- Are there related transactions (compensation payments, leases, loans, etc.) between the joint venture and the members of the joint venture?
- What method of accounting does the joint venture use?
- What effect do long-term contracts have on the allocation of income to incoming/outgoing partners?
- Has construction period interest been properly capitalized?

## **POTENTIAL JOINT VENTURE ISSUES**

Auditors that examine joint ventures deal with the common issues found in the examination of any form of construction entity. However, joint ventures (classified primarily as partnerships) can and do have unique tax issues. These issues often can be divided into three broad categories: formation, operation, and liquidation/distribution issues.

### **Formation Issues**

- Failure to file partnership returns (IRC sections 761, 6698).
- Capitalization/amortization of organization and syndication fees (IRC section 709).
- Contribution of construction services (by the construction company) in exchange for a capital interest in the partnership (Treas. Reg. section 1.721-1(b)(1)).
- Contribution of construction services (by the construction company) in exchange for a profits interest in the partnership when a predictable income stream exists. (Rev. Proc. 93-27).
- Deemed (money) distributions on the assumption of a partner's liability on property contributed (IRC section 752(b)).

### **Operation Issues**

- Allocation of income, gains, deductions, losses, etc., not having substantial economic effect. (IRC section 704(b)).
- Cancellation of indebtedness income (COD income) upon bankruptcy or insolvency (IRC section 61(a)(12), IRC section 108).
- Withholding tax on distributive share of partnership taxable income to a foreign partner (IRC 1446).

## **Liquidation/Distribution Issues**

- Distributions of cash in excess of basis in the partnership interest (IRC section 731, 752 and 741, 751).
- Interest expense deductions in connection with debt financed distributions (IRC section 163(h)).
- Disguised sales (IRC section 707(a)(2)(B)).

## **Conclusion**

In addition to the other construction industry tax issues, joint ventures, by the nature of the entity produce separate issues that need consideration.

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## Chapter 11: Employee or Independent Contractor

### Classification of Workers

An employer is required to withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment taxes on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors. Determining whether a worker is an employee or independent contractor is referred to as worker classification. This issue has become a major concern for businesses. Improperly classifying workers who are employees as independent contractors can cause tremendous liabilities. The federal payroll tax laws, the federal wage and hour laws, state unemployment insurance coverage laws, and state workers' compensation laws use different definitions of the term "employee." Be aware that a worker may be classified differently for purposes other than discussed here for federal payroll tax purposes.

Workers who perform services may be independent contractors, common-law employees, statutory employees (including corporate officers), or statutory nonemployees. For the construction industry workers generally will be either corporate officers, common-law employees, or independent contractors. Businesses generally provide benefits to their employees and must observe certain employee rights during employment. However, workers who are independent contractors are considered to be self-employed. Independent contractors also must determine whether workers who work for them are employees.

You determine whether an individual is an employee or an independent contractor under the common law by looking at the relationship of the worker and the business. The degree of control and the independence of that individual must be considered. Relevant facts generally fall into three categories that are used to make the determination. These categories are: behavioral control, financial control, and relationship of the parties. It is very important to consider all the facts and circumstances when making a determination, as no single factor can determine proper classification. Revenue Ruling 87-41, which identifies 20 common law factors to consider in determining whether a worker is an employee or an independent contractor, is merely an analytical tool and is not the legal test for making the determination. The legal test is whether the business has the right to direct and control the worker.

**Behavioral control** These facts show whether the business has a right to direct and control how the worker does the work for which he or she is hired. It includes the type and degree of *instructions* the business gives the worker and the *training* the business gives the worker. A worker is an employee when the business has the right to direct and control the worker. This control refers not only to the result to be accomplished by the

work, but also the means and details by which that result is accomplished. It is not necessary that the business actually direct or control the manner in which the services are performed; it is sufficient if the business has the right to do so.

*Instructions.* An employee is generally subject to the employer's instructions about when, where, and how to work. All of the following are examples of types of instructions:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals. In other cases, the task may require little or no instruction. In addition, instructions about the time and place are less important than directions on how the work is performed. The key consideration is whether the business has retained the right to control the details of worker's performance.

*Training.* An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods. If the business provides training about required procedures and methods, this indicates that the business wants the work done in a certain way, and suggests that the worker may be an employee.

Examples of factors related to this category.

- Instructions
- Oral or written reports
- Hiring, supervising, and paying assistants
- Training
- Order or sequence set

**Financial Control** Facts that show whether the business has a right to control the business aspects of the worker's job include:

- The extent to which the worker has unreimbursed business expenses.
- The extent of the worker's investment.
- The extent to which the worker makes services available to the relevant market.
- How the business pays the worker.
- The extent to which the worker has the opportunity to realize a profit or loss.

Independent contractors are more likely to have unreimbursed expenses than are employees. They generally have fixed ongoing costs that are incurred regardless of

whether they are working or not. Independent contractors are more likely to have a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status. They are generally free to seek out business opportunities, advertise, maintain a visible business location, and are available to work in the relevant market. Independent contractors can make a profit or loss.

If a worker is guaranteed a regular wage amount for an hourly, weekly, or other period of time, it usually indicates that a worker is an employee, even when a commission supplements the wage or salary. An independent contractor is often paid by a flat fee for the job. However, it is common in some professions, such as law, to pay hourly fees. In this case, other factors must be considered to determine whether the person receiving the fees is an employee of the business or an independent contractor.

Examples of factors related to this category:

- Significant investment
- Payment of business or traveling expenses
- Making services available to general public
- Payment by the hour, week, month
- Realization of profit or loss
- Furnishing of tools and materials

**Relationship of the parties:** Certain facts show the type of relationship, such as:

- Written contracts describing the relationship the parties intended to create.
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.
- The permanency of the relationship.
- The extent to which services performed by the worker is a key aspect of the regular business of the company.

If a worker is engaged with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence of an employer-employee relationship. In addition, if a worker provides services that are a key aspect of the regular business activity, it is more likely that the owner has the right to direct and control his or her activities.

The worker or business can ask the IRS to determine whether a worker is an employee by filing Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

Additional information on this topic can be found:

- In Publication 1779, *Independent Contractor or Employee*, which provides a consolidated explanation of the three categories Behavioral Control, Financial Control, and Relationship of the Parties.
- In Publication 15-A, Employer's Supplemental Tax Guide, concerning worker classification.
- At [www.irs.gov](http://www.irs.gov), clicking on Businesses from the home page, then Employment Taxes under contents.

Examples of factors related to this category:

- Right to discharge
- Right to terminate
- Integration
- Continuing relationship
- Services rendered personally

Examples of factors of lesser importance that fall within the three categories that will typically provide less useful evidence of whether a worker is an independent contractor or an employee.

- Full time required
- Doing work on employer's premises
- Set hours of work
- Working for more than one firm at a time

### **Examples of Employee or Independent Contractor Determination:**

Example 1: Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and worker' compensation insurance covering Jerry and others he engaged to assist him. She pays them an hourly rate and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. They are employees of Wilma White.

Example 2: Milton Manning, an experienced tile setter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others.

Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example 3: Wallace Black agreed with the Sawdust Co. to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal services as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount he has spent, including the payroll. The company gives him a check for that amount from which he pays the assistants, although he is not personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Co.

Example 4: Bill Plum contracted with Elm Corporation to complete the roofing on housing complex. A signed contract established a flat amount for the services rendered by Bill Plum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for Federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

Example 5: Vera Elm, an electrician, submitted a job estimate to a housing complex for electrician work at \$16 per hour for 400 hours. She is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive \$6,400. She also performs additional electrical installations under contracts with other companies, which she obtained through advertisements. Vera is an independent contractor.

### **Additional information to consider if taxpayer hires employees:**

If it is determined that the taxpayer has employees, the employer is required to obtain each employee's name and SSN and to enter them on Form W-2. This requirement also applies to resident and nonresident alien employees. The employer should request a copy of each employee's social security card and record the name and number of each employee exactly as it is shown on the employee's card. NOTE – There is no legal requirement that an employer physically review a social security card. The employee provides his SSN, address and withholding data on form W-4.

Remember, employees must have a social security number to be eligible for work in the United States. An Individual Taxpayer Identification Number (ITIN) cannot substitute for a SSN for an employee identification or for work. An ITIN is only available to resident and nonresident aliens who are not eligible for US employment and need identification

for other tax purposes. For further information, please refer to Publication 15, Circular E, Employer's Tax Guide.

### **Additional information to consider if taxpayer hires independent contractors:**

The taxpayer is required to file Form 1099-MISC, Miscellaneous Income, for each person to whom the taxpayer paid at least \$600 in rents, services (including parts and materials), prizes, and awards or other income payments. The reporting on Form 1099-MISC is only required when the payments are made in the course of a trade or business. The taxpayer is considered to be engaged in a trade or business if he (or the company) operates for gain or profit. For more information (including the rule for non-profit entities), please refer to the instructions for Form 1099-MISC.

### **Conclusion**

Whether to have employees or utilize independent contractors can be a valid and appropriate business choice. However, the classification of a worker as an employee or independent contractor is determined by the facts in each situation. No single factor determines the status of the worker, and some factors may be given more or less weight than others when making this determination.

When worker classification becomes an examination issue, "Section 530" relief must first be considered, because, without proper notification, reclassification cannot be enforced. Section 530 of the Revenue Act of 1978 (and as later modified by the Small Business Job Protection Act of 1996) provides businesses with relief from federal employment tax obligations if certain requirements are met. Before or at the beginning of any audit inquiry relating to employment status, an examiner must provide the taxpayer with a written notice of the provisions of Section 530. If the requirements of Section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the employment tax liability (and any interest and penalties attributable to the liability) of the business, not the worker, and reclassification cannot be completed.

Section 530 establishes a moratorium on the reclassification of workers as employees for purposes of the employer's employment tax obligations. Under section 530 there are two tests that must be met:

- Consistency test
- Reasonable basis test

For the consistency test to be met, the business must have filed all required Forms 1099 with respect to the worker for the period, on a basis consistent with the business's

treatment of the worker as not being an employee. Also, the business or a predecessor must not have treated the worker, or any worker holding a substantially similar position, as an employee at any time after December 31, 1977.

In order to meet the reasonable basis test, the business must have reasonably relied on the following factors in making the determination that the worker is not to be treated as an employee:

- judicial precedent; published rulings; technical advice memorandum, private letter ruling, or determination letter issued with respect to the business;
- past IRS audit of the business for employment tax purposes, if the audit began after December 31, 1996, and there was no assessment attributable to the business's employment tax treatment of workers holding positions substantially similar to the position held by the worker;
- longstanding recognized practice of a significant segment of the industry in which the business was engaged, or
- some other basis that is demonstrated as reasonable.

For an in-depth discussion of worker classification, see the training materials on determining employment status, "Independent Contractor or Employee?" Training 3320-102 (Rev. 10-96), TPDS No. 842361. For additional information concerning Section 530 relief, IRM 4.23.5 is available at <http://www.irs.gov>, key word Internal Revenue Manual. Also, refer to section 4.23.6 (the Classification Settlement Program) for worker classification cases and section 4.23.10 (Report Writing Guide for employment tax cases).

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## Chapter 12: Alternative Resolution

### Overview

The Revenue Reconciliation Act of 1998 sought to provide solutions to taxpayer problems in a more simplified and expedient manner. This focus has produced various programs in both LMSB (Large and Mid-Sized Business) and SB/SE (Small Business/Self-Employed) to facilitate resolution of taxpayers' issues at the earliest possible point.

### Industry Issue Resolution Program

This program was created to provide a mechanism outside the normal post-filing examination process to address frequently disputed tax issues that are common to a significant number of business taxpayers. Both LMSB and SB/SE divisions share operational responsibility, with assistance from Appeals, Chief Counsel, and Treasury. Prior to formal implementation, a pilot program resulted in the successful resolution of several issues by the issuance of published guidance, including issues directly affecting the construction industry:

- Impact fees – Revenue Ruling 2002-9 provides that impact fees paid by real property developers are added to the basis of the building.
- Certain costs of golf course construction – Revenue Ruling 2001-60 allows certain golf course land improvement costs to be depreciated.
- Heavy Equipment – Revenue Ruling 2002-35 discusses the reporting of payments to employees who own heavy equipment used by their employer.

As a result of the successful pilot program, Notice 2002-20 was issued to formalize the Industry Issue Resolution (IIR) as a permanent program, and Revenue Procedure 2003-36 provides procedures for business taxpayers, industry associations, and other interested parties to request guidance on business tax issues. Issues most appropriate to the program will generally have two or more of the following characteristics:

- Uncertainty about the appropriate tax treatment of a given factual situation
- Frequent, often repetitive, examinations of the same issue
- Significant taxpayer burden
- Impacts a significant number of taxpayers, either within an industry or across industry lines
- Factual determination is a major component and an understanding of industry practices and views would assist the Service

Issues that are not deemed suitable for the program include:

- Issues unique to one or a small number of taxpayers.
- Issues under the jurisdiction of Operating Divisions other than LMSB or SB/SE
- Issues regarding transactions that lack a bona fide business purpose or are completed with a significant purpose of reducing or avoiding federal taxes
- Issues involving transfer pricing or international tax treaties

The issue submission process does not involve a required format, but should include a description of the issue, why guidance is needed, the estimated number of affected taxpayers, and possible resolution options. The request will be available for public inspection and copying. A contact name and telephone number should be included. Issues can be e-mailed to [IIR@IRS.gov](mailto:IIR@IRS.gov).

LMSB, SB/SE, Counsel, and Treasury will screen and select the issues. After an issue is selected, a team will be formed to gather and analyze information, provide legal analysis, and propose a resolution. Examination of the selected issues will *not* be suspended while the issues are being considered in the program.

The resulting guidance will most likely take the form of a Revenue Ruling or Revenue Procedure that will permit taxpayers to adopt a recommended treatment of the issue on future returns. The expected IIR program benefits are:

- Establishment of a consistent position or safe harbor
- Reduction of burden and administrative costs for taxpayers and the IRS
- Promotion of customer and employee satisfaction

For more information on the IIR program, contact the LMSB Office of Pre-Filing & Technical Services. Information may be found on the LMSB Web site at: <http://lmsb.irs.gov/hg/pftg> or on the Digital Daily at: <http://www.irs.gov> under “Businesses” and “Industry Issue Resolution”.

## **Pre-Filing Agreements**

In January 2001, the IRS announced that the Pre-Filing Agreement (PFA) Program would be offered on a permanent basis to all LMSB taxpayers. Pre-filing agreements provide specific guidance on issues relating to a tax return before it is filed as a strategy to resolve disputes earlier in the examination process. Pre-filing agreements are applicable to all open cases and would apply to rollover, recurring issues, and current year transactions. The IRS published Revenue Procedure 2001-22 to provide the basic information for taxpayers interested in participating in the program. The revenue procedure is not intended to resolve issues that are more appropriately addressed through the private letter ruling process.

Pre-filing agreement eligibility depends on the following criteria:

- Availability of IRS and taxpayer resources
- Taxpayers subject to the jurisdiction of LMSB
- Return not yet filed
- Issues involve factual questions and well-settled principles of law and some international issues.
- Twelve excludible issues are detailed in Revenue Procedure 2001-22

The taxpayer is subject to the user fees only if the PFA is accepted. The fee structure is as follows:

- \$10,000 if the taxpayer has \$250 million or more in assets
- \$5,000 if the taxpayer has between \$50 and \$250 million in assets
- \$1,000 if the taxpayer has between \$5 and \$50 million in assets

The user fees are charged on a per issue basis, and must be paid within 30 days after being notified of selection. Generally, this is a nonrefundable fee. There is no prescribed form for a PFA request, but it is anticipated the request will be in the form of a letter addressing the requirements outlined in Section 4 of the Revenue Procedure. Either party may withdraw from the process at any time prior to the execution of the agreement, and further examination is neither impeded nor precluded. If an agreement is not reached, the parties can consider alternative industry resolution procedures following the filing of the return, or consider an early referral to Appeals. The LMSB Industry Director has jurisdiction over the final selection decision, and, if rejected, the decision cannot be appealed. Pre-filing agreements are in the nature of a closing agreement, and will be developed in consultation with the Chief Counsel's Office.

The intention of this program is to provide the taxpayer with a greater level of certainty regarding the examined issue at an earlier point in time than a post-filing examination. Internal resources can be better directed as a result of this program.

The Pre-Filing Agreement Program Web site is: [pfa.info@irs.gov](mailto:pfa.info@irs.gov).

## **Fast Track Mediation and Settlement**

The Appeals Division, with the assistance of LMSB and SB/SE, has developed procedures for taxpayers to resolve disputes through the Fast Track Mediation and Settlement process. This process is available for examination as well as collection issues, including Offer in Compromise, Collection Due Process, and Trust Fund Recovery cases. The purpose of the fast track program is to enable taxpayers and the IRS to work together in an expedited fashion to resolve outstanding issues while the case is still in Compliance's jurisdiction. The ultimate goal of the program is to decrease the overall time from the return filing date to the ultimate conclusion of the case. Mediation takes an average of 60 to 120 days. This can shorten the entire process by

months or years, depending on the particular case. This procedure is optional, and the taxpayer can choose either fast track mediation or the normal appeals process.

This collaborative process involves Compliance, the taxpayer and Appeals, and will be closed by a signed agreement on a Form 906. Any of the parties may withdraw at any time, and the taxpayer retains the traditional Appeal rights. The mediator cannot impose a resolution, and will not have settlement authority. The case is only resolved if the taxpayer and Compliance reach agreement on the issues. If the mediation is unsuccessful, a new Appeals Officer will be assigned to the case.

The taxpayer should be offered the opportunity to participate in Fast Track Mediation (FTM) at the point when all the issues have been raised and the case cannot be resolved. A brief summary of the issues along with the "Agreement to Mediate" form is needed to begin the process. Publication 3605 outlines the details of the mediation process. A formal unagreed report and a taxpayer protest is not required.

The joint LMSB/Appeals Fast Track Settlement program uses the mediation skills and delegated settlement authority of Appeals to resolve issues while the case remains under the jurisdiction of LMSB. The Appeals officer acts as a facilitator to develop and execute a settlement that is mutually agreeable by both the taxpayer and the LMSB team manager. Like the mediation process, the settlement process is designed to facilitate the resolution of cases in the most expeditious manner that is satisfactory to both the taxpayer and the IRS. Unlike mediation, Fast Track Settlement allows the parties to consider litigation hazards in resolving disputes.

In all cases, specially trained Appeals mediators will be assigned to the case, generally from the same geographic area, but not the same group where the case is assigned. The taxpayer may elect to use a non-Internal Revenue Service co-mediator. In this scenario, the taxpayer and the Appeals Team Manager will make the selection from any local or national organization that provides a roster of neutral parties. The selection criteria may include completion of mediation training, previous mediation experience, a substantive knowledge of tax law, or knowledge of industry practices. Each party will prepare and deliver a discussion summary of the issues for consideration by the mediator two weeks before the mediation session begins.

Ex parte contacts with the mediator outside the mediation session is prohibited. This is to ensure that one party is not in a position to exert undue influence on the mediator. This prohibition is intended to apply only to unsolicited contacts from one of the parties outside the mediation session, and is intended to ensure the mediator does not receive information undisclosed to the other party. All information concerning any dispute resolution communication is confidential and may not be disclosed by any party involved in the proceeding. If agreement is not reached, it is possible to request arbitration on an issue being mediated.

Fast Track Mediation works best for cases where the issues are fully developed, the taxpayer has stated its position in writing, and there are a limited number of unagreed issues. The following cases are excluded from the mediation process:

#### Excluded Fast Track Mediation Cases

- |   |  |
|---|--|
| Docketed Cases  | <ul style="list-style-type: none"> <li>• Taxpayer already exercised option to take case to court vs. FTM and / or other available alternatives</li> </ul>  |
| Absence of Legal Precedence and/or Conflicts between Jurisdictions  | <ul style="list-style-type: none"> <li>• Issues do not lend themselves to quick resolution, as they are "precedent" setting and require the standard Appeals / Tax Court process</li> </ul>  |
| Industry Specialization   | <ul style="list-style-type: none"> <li>• Hazard Settlements</li> <li>• Industry Specialization Program Coordinator and the ACI Coordinator must be involved in the decision-making process and will not be available for the Mediation Session</li> </ul>  |
| Appeals Coordinated Issues (ACI)  |  |
| Competent Authority Cases   | <ul style="list-style-type: none"> <li>• Involves issues arising between the US and a foreign country that are under the jurisdiction of the Asst. Commissioner, International</li> </ul>  |
| Service Center Penalty Appeals  | <ul style="list-style-type: none"> <li>• System already in place to expeditiously move these cases to Appeals</li> </ul>   |
| Service Center (streamlined) OIC cases  | <ul style="list-style-type: none"> <li>• Majority of the cases would not have had managerial involvement<br/><i>Note: Penalty Appeals Cases worked by field employees would not be excluded</i></li> <li>• Logistical restrictions (travel and budget)</li> <li>• Majority of the cases would not have had managerial involvement</li> </ul> |
| CAP case  | <ul style="list-style-type: none"> <li>• No Compliance personnel available to mediate Service Center OIC cases</li> <li>• "Five day" Collection Appeals Program (CAP)</li> </ul>   |
| ACS cases   | <ul style="list-style-type: none"> <li>• No compliance person available to mediate ACS cases</li> <li>• Majority of the cases would not have had managerial involvement</li> </ul>   |
| Cases involving solely the failure or refusal to comply with the tax laws because of moral, religious, political, constitutional, conscientious, or similar grounds | <ul style="list-style-type: none"> <li>• Issues do not lend themselves to quick resolution</li> <li>• See Reg. Sec 601.106(b) "Statement of Procedural Rules"</li> </ul>   |

At the conclusion of the mediation session, the Mediator will provide the “IRS Appeals Fast Track Mediation Customer Satisfaction Survey to the taxpayer and request their participation. This survey will be used to evaluate the process and capture feedback. More information on the Fast Track procedures is available from Publication 3605 and the Appeals Web site. If the business has assets under \$10 million, go to SB/SE Fast Track Mediation. If over \$10 million in assets, refer to Notice 2001-67 and the Fast Track Agreement Form for more information.

In summary, all of the alternative resolution methods discussed here were designed to provide improved customer service, business results, and employee satisfaction. The vision was to provide premier dispute resolution services utilizing innovative approaches to meet the needs of both the IRS and its customers. Feedback indicates the goal of providing an efficient and independent appeal process for all taxpayers has been greatly enhanced by these innovative programs.

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## Chapter 13: Electronic Filing and Paying of Business Taxes (“E-submissions”)



In the 21<sup>st</sup> Century an entire business can run electronically. So why not file and pay business taxes the same way? Now business taxpayers and tax preparers can file and pay by telephone, by Internet or by PC software. It's more economical, with less paperwork. It's more efficient, with increased accuracy. And it's more effective, since less time is spent filing tax returns and making payments, and more time focused on the business.

Most small business filing requirements can be submitted electronically. For example:

- Self-employed income tax returns (Form 1040, Schedules C, E and F)
- Partnership income tax returns (Form 1065 and most related forms)
- Employment tax returns (Forms 940/941)
- Certain information returns (e.g., Forms 1098, 1099, W2-G), using the
- Filing Information Returns Electronically (FIRE) system
- Income tax returns for Estates and Trusts (Form 1041)

### **Some Advantages of Going Totally Electronic**

- **Increased Accuracy:** IRS computers quickly and automatically check for errors or other missing information, making *e-file* returns more accurate and reducing the chance of getting an error letter from the IRS.
- **Quick Electronic Confirmation:** Computer *e-filers* receive an acknowledgment that the IRS has received their returns. Callers using TeleFile receive a confirmation number while they are still on the phone, letting them know that the TeleFile system has accepted their return.
- **Deletion of the Paperwork Through Electronic Signatures:** Taxpayers can create their own Personal Identification Number (PIN) and file a completely paperless return using their tax preparation software or tax professional. The taxpayer has nothing to mail to the IRS.
- **Easy Payment Options:** With Electronic Federal Tax Payment System (EFTPS) payments can be made from the convenience of the office or home, 24 hours a

day, 7 days a week, using the Internet, EFTPS PC software, or telephone. One must enroll in EFTPS to use the system.

### **e-file for Business**

**E-file for Business** will meet the needs of big or small businesses, or a self-employed individual. IRS *e-file* is available for:

- employment taxes
- information returns
- partnerships
- estates
- trusts
- corporations
- exempt organizations

### **Employment Taxes**

The IRS electronic Employment Tax filing program offers business taxpayers a variety of **paperless** options for filing Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and Form 941, Employer's Quarterly Federal Tax Return. Using this program, business taxpayers, reporting agents, software developers and transmitters can file Form 940 and Form 941 electronically. The program conducts security checks, builds records to be processed by IRS computer systems and sends electronic acknowledgments. Returns are transmitted nationwide via dial-up phone lines and menu driven software directly to the IRS where they are processed at the Tennessee Computing Center (TCC)/Memphis Submission Processing Center (MSPC).

Individuals using tax professionals to prepare their business returns should ask them about *e-file* for Business and electronic payment options.

IRS e-file for Business Partners are companies and providers the IRS has entered into cooperative marketing agreements to bring special offers and discounts for using *e-file* for Business products and services. The listing of Approved IRS e-file for Business Providers contains addresses and phone numbers including links to their Web sites. The list is updated as new providers are added. Go to [www.irs.gov](http://www.irs.gov) then click on **Businesses** under the **Contents** section. Now click on **Approved IRS e-file for Business Providers**.

### **Partnerships**

Section 1224, of the Taxpayer Relief Act of 1997, requires *e-file* partnerships with more than 100 partners (Schedules K-1) to file their return on magnetic media (electronically as prescribed by the IRS Commissioner). This law became effective for partnership

returns with taxable years ending on or after December 31, 2000. Partnerships with 100 or less partners (Schedules K-1) may voluntarily file their return electronically.

The current 1065 *e-file* program does not accept and process all partnership return types. Refer to Publication 1524 for additional information.

### **Filing Information Returns Electronically (FIRE)**

Electronic filing of information returns allows the following forms to be submitted:  
Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding  
Form 1098, Mortgage Interest Statement  
Forms 1099 (all)  
Form 5498, IRA Contribution Information  
Form 8027, Employer's Annual Information Return of Tip income and Allocated Tips  
Form W-2G, Certain Gambling Winnings  
Questionable Form W-4 (QWF)

The FIRE System allows high-speed transmissions and offers non-peak telephone hours. The system is operational 24 hours a day, 7 days a week.

Any filer of information returns may file their returns electronically. Any corporation, partnership, employer, estate and/or trust, who files 250 or more information returns for a calendar year must file electronically or magnetically. The 250-or-more requirement applies separately to each type of form.

For example, if a filer has 500 Forms 1098 and 100 Forms 1099-A, Forms 1098 must be filed electronically or magnetically, but not Forms 1099-A. The electronic/magnetic filing requirement does not apply if you request and receive a hardship waiver.

**TIP:** The IRS encourages filers who have less than 250 returns to file electronically or magnetically.

The format requirements for filing information returns electronically are the same as the requirements for filing on magnetic media. Publication 1582, Information Returns Vendor List lists vendors of products and/or services that may enable individuals to file information returns magnetically or electronically. Publication 1582 is for information only, and in no way implies IRS approval or endorsement of products or services. Check your telephone directory for service bureaus.

For further information refer to Publication 1220, Specifications for Filing Forms 1098, 1099, 5498 and W-2G Magnetically or Electronically or Publication 1187, Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding.

### **Electronic Federal Tax Payment System**

Electronic Federal Tax Payment System (EFTPS) is a tax payment system offered free from the U.S. Department of Treasury. Pay federal taxes electronically on-line or by phone 24 hours a day, 7 days a week. Visit [www.EFTPS.gov](http://www.EFTPS.gov) to enroll.

More than 4 million taxpayers are currently using the system. EFTPS is:

- Fast and economical
- Easy to use
- Convenient
- Accurate
- Flexible
- Convenience at Your Fingertips

EFTPS offers the convenience and flexibility of making tax payments through the Internet or by phone. Individuals can select how they want to make their payments. There are two primary payment methods, **EFTPS-Direct** and **EFTPS-Through a Financial Institution**. Some financial institutions may also offer the **Same Day** payment method.

**EFTPS-Direct** is an electronic payment method that allows individuals to access EFTPS directly to report your tax information. Individuals instruct EFTPS to move the funds from their bank account to the Treasury's account on the date they indicate. Funds will not move from a bank account until the designated day. The two payment methods under EFTPS-Direct are **EFTPS-OnLine (Internet)** and **EFTPS-Phone**. With EFTPS-Direct both methods are interchangeable.

Individuals electing to use **EFTPS-Through a Financial Institution**, will instruct their financial institution to electronically move funds from their bank account to the Treasury's account. Check with the financial institution for eligibility, services offered, and cost. Not all financial institutions offer this service.

Individuals can also pay their quarterly 1040-ES estimated taxes electronically using EFTPS, and they can make payments weekly, monthly, or quarterly as well as schedule payments for the entire year in advance.

Tax payments can be initiated 24 hours a day, seven days a week. As an added convenience, **EFTPS-Direct** allows payment scheduling to warehouse your tax payments. Businesses can schedule payments up to 120 days in advance of their tax due date, and individuals can schedule payments up to 365 days in advance of their tax due date. EFTPS will automatically make payments on the due date indicated.

In addition, EFTPS can make **ALL** federal tax payments, including income, employment, estimated, and excise taxes.

## EFTPS Enrollment

To participate in EFTPS requires enrollment. There are two ways to enroll in the program: apply online at [www.EFTPS.gov](http://www.EFTPS.gov) or call EFTPS Customer Service:

1-800-555-4477 or 1-800-945-8400

1-800-945-8900 or 1-800-733-4829 (TDD Hearing-Impaired)

1-800-945-8600 or 1-800-244-4829 (Español)

It takes only minutes to make a tax payment using EFTPS-Direct. It's much less burdensome than writing checks, getting signatures on checks and last minute trips to the bank.

Whether you use EFTPS-Direct or EFTPS-Through a Financial Institution is used, individuals are in control of initiating their payments. The tax due date remains the same and no government agency has access to the account.

An EFT Acknowledgement number is received to keep as a record of the tax payment. Enroll in EFTPS-OnLine to make a payment, cancel a payment, review payment history, and more. Easy to navigate, and it is secure with both a PIN and Internet Password combination.

Tax practitioners, accountants and payroll companies are discovering the added benefits of using EFTPS. EFTPS offers 4 easy ways to make payments for clients.

- **EFTPS-OnLine** - The Internet is used to make payments for the business or clients. Registration is not required for practitioners; however, taxpayers must be enrolled. Visit [EFTPS.gov](http://EFTPS.gov).
- **EFTPS-Phone** - Available to taxpayer or provider who wishes to make debit payments using the telephone.
- **EFTPS-Batch Provider** - Designed for payroll processors and others who wish to enroll their clients and submit batches of payments using Windows-based software.
- **EFTPS-Bulk Provider**-Designed for payroll processors who initiate frequent payments from and desire automated enrollment through an Electronic Data Interchange (EDI) compatible system.

To find out more, visit [www.irs.gov](http://www.irs.gov), and click on the e-file logo. You'll also find a listing of Approved IRS *e-file* for Business Providers at <http://www.irs.gov/efile/index.html>. To enroll or obtain more information about EFTPS, visit [www.eftps.gov](http://www.eftps.gov).

**File Smart...File Electronic**

*“The fast and accurate way to file ([www.irs.gov](http://www.irs.gov))  
and pay ([www.eftps.gov](http://www.eftps.gov)) your federal taxes.”*

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## Appendix 1 – Applicable Federal Tax Law & Guidance

Law	Topic
I.R.C. § 263	Capital expenditures
I.R.C. § 263A	Capitalization and inclusion in inventory costs of certain expenses
IRC § 446	General rule for methods of accounting
Treas. Reg. § 1.451-3	Provided the rules for long-term contracts prior to March 1, 1986, the date of enactment of section 460. These regulations continue to apply to <b>exempt</b> long-term contracts entered into <b>before</b> January 11, 2001. Exempt contracts are defined under I.R.C. § 460(e).
Treas. Reg. § 1.451-5	Advance payments for goods and long-term contracts
I.R.C. § 460	Special rules for long-term contracts
Treas. Reg. § 1.460	Regulations for reporting income on long-term contracts entered into <b>after</b> January 10, 2001
I.R.C. § 461	General rule for taxable year of deduction.
I.R.C. § 461(h)	Certain liabilities not incurred before economic performance
I.R.C. § 1001	Determination of amount of and recognition of gain or loss
I.R.C. § 1237	Real property subdivided for sale
Notice 89-15	Provides guidance through a series of questions and answers regarding the long-term contracts subject to section 460 – prior to the issuance of the final regulations issued under section 460.

# Appendix 1 – Applicable Federal Tax Law & Guidance

## Important Revenue Rulings and Revenue Procedures

Issue Date	Number	Summary and Impact of Ruling or Procedure
1/1/1966	Rev. Rul. 66-247	The costs incurred by a taxpayer in the construction of a house for speculative sale (including the cost of the land) must be capitalized regardless of the taxpayer's overall method of accounting
1/1/1969	Rev. Rul. 69-536	Real estate held for sale by a taxpayer cannot be inventoried in computing taxable income.
1/1/1969	Rev. Rul. 69-314	Accrual basis taxpayer is not required to include in income retainages receivable until the all-events test is met under the contract.
1/1/1970	Rev. Rul. 70-67	<b>Construction vs. Services:</b> An architect who draws the plans and supervises the work of construction cannot report income from contracts extending over more than one year on the completed contract basis.
1/1/1974	Rev. Rul. 74-104	Evaluation expenditures incurred in connection with the acquisition of existing residential property for renovation and resale are capital expenditures that must be taken into account as part of the cost of acquiring the property. However, if such expenditures do not result in the acquisitions of property they are deductible as losses in the taxable year the corporation decides not to acquire the property.
1/1/1980	Rev. Rul. 80-18	<b>Construction vs. Services:</b> A contract to provide engineering services does not qualify as a long-term contract because it does not require taxpayer to actually construct or build anything even though his services are functionally related to activities, which may be the subject of long-term contracts. Thus, such taxpayer is not entitled to use either the completed contract or percentage of completion method.
1/1/1981	Rev. Rul. 81-277	The payment by a contractor of money to a buyer in exchange for a release of the buyer's claim against the contractor for failure to fulfill the contract for construction of a plant constitutes a return of capital rather than gross income to the buyer. The cost basis of the plant is adjusted downward to reflect the payment.
1/1/1982	Rev. Rul. 82-134	<b>Construction vs. Services:</b> A taxpayer, who by contract furnishes engineering services and construction management to clients, is not entitled to use the completed contract method of accounting. Taxpayer primarily performs services and construction supervision and is not required to actually construct anything.

## Appendix 1 – Applicable Federal Tax Law & Guidance

1/1/1984	Rev. Rul. 84-32	<b>Construction vs. Services:</b> A painting contractor who paints industrial and commercial buildings, highways and railroad bridges, and industrial plants is not entitled to use the completed contract method of accounting. Taxpayer's contract is not a long-term contract because it does not require him to construct, build, or install anything.
12/29/1986	Rev. Rul. 86-149	Construction costs of completed homes and costs of construction in progress are capital expenditures under I.R.C. § 263. Taxpayers cannot inventory such costs under the LIFO inventory method.
2/27/1989	Rev. Rul. 89-25	Houses that a homebuilder used for models and/or sales offices were not subject to an allowance for depreciation.
4/13/1992	Rev. Rul. 92-28	I.R.C. § 460(e)(1) permits a taxpayer to use different methods of accounting for exempt and nonexempt contracts within the same trade or business.
10/25/1993	Rev. Rul. 93-70	An escrow agent that performs an oversight function with respect to a construction project and makes payments on behalf of the owner and general contractor is required to file information returns (Form 1099) for payments of reportable income.
6/20/1994	Rev. Rul. 94-38	Principles are set forth that define the capitalization of construction costs in connection with groundwater treatment facilities.
12/17/2001	Rev. Rul. 2001-60	Where the cost of land preparation in the original construction or reconstruction of a modern golf green is so closely associated with depreciable assets (such as underground drainage pipes) that the land preparation will be retired or replaced with those depreciable assets, the cost of land preparation may be depreciated over the recovery period of the associated depreciable assets.
2/15/2002	Rev. Rul. 2002-9	"Impact Fees" incurred by a taxpayer in connection with the construction of a new residential rental building are capitalized costs allocable to the building under I.R.C. §§ 263(a) and 263A.
7/1/1971	Rev. Proc. 71-21	Provides procedures under which accrual basis taxpayers may defer the inclusion in income of payments received (or amounts due and payable) in one taxable year for services to be performed in the next succeeding taxable year.
10/19/1987	Rev. Proc. 87-56	This revenue procedure specifies class lives and recovery periods for property subject to depreciation under the general depreciation system provided in I.R.C. § 168.

## Appendix 1 – Applicable Federal Tax Law & Guidance

4/27/1992	Rev. Proc.92-29	Provides procedure for a real estate developer to obtain the Commissioner's consent to use an alternative method (other than under I.R.C. § 461(h)) for determining when common improvement costs may be included in the basis of properties sold for purposes of determining gain or loss resulting from the sales.
6/5/1995	Rev. Proc. 95-27	Provides safe harbor for certain structural modifications to a building that will not be treated as a demolition under I.R.C. § 280B
1/8/2001	Rev. Proc. 2001-10	Qualifying taxpayers with average annual gross receipts of \$1,000,000 or less are excepted from an accrual method of accounting under I.R.C. § 446 and accounting for inventories under I.R.C. § 471.
5/6/2002	Rev. Proc. 2002-28	This procedure provides an exception from using an accrual method of account and accounting for inventories to qualifying taxpayers in certain eligible businesses with average annual gross receipts of \$10,000,000 or less.

## Appendix 1 – Applicable Federal Tax Law & Guidance

### Important Court Cases

Date Opinion Issued	Name of Court Case and Citation	Summary of Importance of Court Case
9/26/1983	<u>W.C. &amp; A.N. Miller Development Company v. Commissioner</u> , 81 T.C. 619 (1983)	Taxpayer improperly changed to a LIFO method of accounting for its home construction costs. The individual homes, which the taxpayer sold, were real estate and did not constitute “merchandise” within the meaning of Treas. Reg. § 1.471-1.
7/28/1986	<u>Homes by Ayres v. Commissioner</u> , 795 F.2d 832 (9 <sup>th</sup> Cir. 1986), <u>aff’d</u> , T.C. Memo. 1984-475	The taxpayer was not allowed to use the LIFO method of accounting for its completed homes and homes under construction because real property is not considered “merchandise. Tract home developers, as a matter of law, cannot maintain inventories for tax purposes.
2/24/1993	<u>Tollis v. Commissioner</u> , T.C. Memo. 1993-63, <u>aff’d</u> , 46 F.3d 1132 (6 <sup>th</sup> Cir. 1995)	Ordinary income vs. capital gain from the sale of real property. Taxpayers were in the trade or business of selling real estate and, therefore, they realized ordinary income, not capital gain, from their sales of parcels.
6/23/1994	<u>Carpenter v. Commissioner</u> , T. C. Memo. 1994-289	Taxpayer is not entitled to use the cash method of accounting for expenses related to construction of houses that were unsold at the end of the taxable year, but instead must capitalize the costs of construction of such unsold houses.
6/27/1994	<u>Walsh v. Commissioner</u> , T.C. Memo. 1994-293, <u>aff’d</u> , 1995 U.S. App. LEXIS 16764 (8 <sup>th</sup> Cir. 1995)	Ordinary income vs. capital gain from the sale of real property. Court held that the taxpayer was in the trade or business of selling real estate and that income from the sale of such property was thus ordinary.
8/8/1994	<u>Hustead v. Commissioner</u> , T.C. Memo. 1994-374, <u>aff’d without opinion</u> , 61 F.3d 895 (3d Cir. 1995)	Expenditures (legal expenses related to challenge of zoning variance) incurred in connection with land development must be capitalized per I.R.C. § 263A.
2/2/1995	<u>Von-Lusk v. Commissioner</u> , 104 T.C. 207 (1995)	Preliminary land development costs (obtaining building permits and variances, negotiating permit fees, property taxes etc.) were nondeductible capital expenditures per I.R.C. § 263A.

## Appendix 1 – Applicable Federal Tax Law & Guidance

9/16/1997	<u>Pierce v. Commissioner</u> , T.C. Memo. 1997-411	A taxpayer engaged in buying and developing land for sale to residential builders is not entitled to use the lower of cost or market method, an inventory method, because real property may not be inventoried.
2/9/1998	<u>Foothill Ranch Company Partnership v. Commissioner</u> , 110 T.C. 94 (1998)	<b>Sales Contract vs. Construction Contract:</b> The construction of the buildings or improvements to the real property did not have to be the primary subject matter of the contract in order for a taxpayer to use the percentage of completion method. It only had to be necessary for the taxpayer to fulfill its contractual obligations.
1/7/1999	<u>Reichel v. Commissioner</u> , 112 T.C. 14 (1999)	Real estate taxes paid by a real estate developer were required to be capitalized per I.R.C. § 263A, even though no positive steps to begin developing the parcels had occurred, because the taxpayer acquired the parcels with the intent to develop them.
8/30/1999	<u>Olstein v. Commissioner</u> , T.C. Memo. 1999-290	Lots purchased from a predecessor were capital assets because the property was not held for sale to customers in the ordinary course of the taxpayer's trade or business. Sale of these lots thus resulted in capital gain.
10/7/1999	<u>Hancock v. Commissioner</u> , T.C. Memo. 1999-336	Ordinary income vs. capital gain from the sale of real property. The eight lots sold by the taxpayer in liquidation of her real estate development business were in the ordinary course of her trade or business and thus the tax losses from the sales were ordinary losses.
7/17/2000	<u>Tutor-Saliba Corporation v. Commissioner</u> , 115 T.C. 1 (2000)	Disputed claims are part of contract price for percentage of completion method of accounting as soon as it is reasonably estimated that the claims would be received, not when the all-events test is met.
3/14/2001	<u>Hutchinson v. Commissioner</u> , 116 T.C. 172 (2001)	Pursuant to Rev. Proc. 92-29 (alternative cost method), the taxpayer could allocate estimated clubhouse construction costs to bases in the lots sold. Under the general economic performance rule, however, taxpayer could not include estimated future-period interest expense in the bases of the lots because neither law nor contract required taxpayer to obtain interest-bearing debt for such common improvements.

## Appendix 1 – Applicable Federal Tax Law & Guidance

4/17/2001	<u>Raymond v. Commissioner,</u> T.C. Memo. 2001-96	Taxpayer was denied the use of the installment method of accounting on homes the taxpayer built and sold in exchange for promissory notes because such sales were considered dealer dispositions.
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## Appendix 2 – Tax Methods of Accounting

<b>Available Accounting Methods for Long-Term Construction Contractors Required to Use the Percentage of Completion Method under I.R.C. § 460</b>	
Percentage of Completion Method (PCM)	I.R.C. § 460(b)(1)(A) and Treas. Reg. § 1.460-4(b) generally require that the PCM be computed utilizing the “cost-to-cost” method which is: $(\text{Total cumulative allocable contract costs incurred to end of taxable year} / \text{Total estimated allocable contract costs}) \times \text{Contract price} = \text{Cumulative gross receipts} - \text{Cumulative gross receipts from immediately preceding taxable year} = \text{Current-year gross receipts} - \text{Allocable contract costs incurred during current year} = \text{taxable income to be reported during the taxable year}$ . Upon contract completion, I.R.C. § 460(b)(1)(B) requires interest computed under the “look-back” method.
Simplified Cost-to-Cost Method	I.R.C. § 460(b)(3)(A) and Treas. Reg. § 1.460-5(c) provide an elective for determining the contract completion factor for taxpayers using PCM. Only three costs are used in determining the percentage of completion: <ul style="list-style-type: none"> <li>• Direct material costs</li> <li>• Direct labor costs</li> <li>• Depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the long-term contract</li> </ul>
Percentage-of-Completion – 10% Method	I.R.C. § 460(b)(5) – The taxpayer may elect to defer recognition of revenue under PCM until 10% of the estimated total contract costs are incurred and allocated. This election is unavailable if the taxpayer elected the simplified method mentioned above.
Percentage-of-Completion/Capitalized-Cost Method (PCCM)	A taxpayer may determine the income from a long-term construction contract that is a <b>residential construction contract</b> using either the PCM or the PCCM. Under the PCCM, this taxpayer must report 70% of the contract under PCM (as required by I.R.C. § 460) and the remaining 30% under a permissible exempt method (e.g., Completed Contract, exempt PCM, etc). See Treas. Reg. § 1.460-4(e). A residential construction long-term contract differs from a home construction contract in that a home construction contract involves buildings with four or fewer dwelling units, whereas a residential construction long-term contract involves buildings with more than four dwelling units. Definitions are found in I.R.C. § 460(e).

**Available Accounting Methods for Long-Term Construction Contracts  
Exempt from the PCM Reporting Requirement of I.R.C. § 460**

Cash Method	<p>The general rule requires the taxpayer to report income when received and deduct expenses when paid. This method is available for taxpayers that are not prohibited by I.R.C. § 448 and meet the requirements of Revenue Procedure 2001-10 or 2002-28.</p> <p>Revenue Procedure 2001-10 permits eligible small taxpayers (with average annual gross receipts equal to or less than \$1 million) to use the cash method when an accrual method would normally be required by I.R.C. § 471 due to inventory.</p> <p>Revenue Procedure 2002-28 extends the use of the cash method to certain qualifying taxpayers who are not prohibited by I.R.C. § 448 from using the cash method and who have average annual gross receipts of \$10 million or less.</p>
Accrual Method	<p>The general rule is that income is reported when due, earned, or received, whichever comes first. Under the accrual method of accounting, expenses are deductible when all events have occurred that establish the fact of the liability, the amount can be determined with reasonable accuracy, and not earlier than when economic performance has occurred.</p> <p>An accrual-method taxpayer may, however, elect the provisions of Revenue Procedure 71-21, which defer the inclusion in income of payments received in one taxable year for <b>services</b> to be performed in the next succeeding taxable year. This election is available only for advance payments received for <b>services</b>.</p>
Accrual with Deferred Retainages Method	<p>Revenue Ruling 69-314 allowed an accrual-basis taxpayer to elect to defer the inclusion in income of retainages withheld by the customer until final acceptance by the customer occurred as specified in the contract.</p>
Completed Contract Method (CCM)	<p>The general rule is that all income and expenses (both direct and indirect) related to a contract are deferred until the job is complete. Because of this deferral, this method is generally the one preferred by taxpayers who are exempt from using the PCM.</p>
Exempt-Contract Percentage-of-Completion Method (EPCM)	<p>A taxpayer who is exempt from the requirement to use the PCM under I.R.C. § 460 (using the cost-to-cost method) still may elect a similar PCM. The taxpayer must include in income the portion of the total contract price that corresponds to the percentage of the entire contract completed during the taxable year. However, the completion may be determined by using any method of cost comparisons, such as direct labor costs incurred to date to estimated total labor costs, or by comparing work performed with estimated total work to be performed (e.g., units of production). See Treas. Reg. § 1.460-4(c)(2).</p>

## **Nonautomatic Changes in Accounting Method**

The rules and procedures for obtaining IRS approval for taxpayer-initiated accounting method changes that do not receive automatic IRS consent are found in Rev. Proc. 97-27 (1997-1 CB 680). Generally, accounting method changes granted under Rev. Proc. 97-27 result in “audit protection” for taxpayers (i.e., the taxpayer will not be required to retroactively change the method in question in an earlier year because of an audit). However, subject to certain exceptions, once a taxpayer is contacted by the Service to schedule an audit, a request for change in accounting method can no longer be filed.

Both positive and negative Section 481(a) adjustments are included in taxable income ratably over a four-year period beginning with the year of change. However, if the entire adjustment is less than \$25,000, a de minimis rule permits taxpayers to take 100% of the amount, whether positive or negative, into account in the year of change. As a general rule, for Section 481(a) adjustments of less than \$25,000, taxpayers should use the four-year spread period for positive adjustments (increases to taxable income) and the 100% de minimis rule for negative changes (decreases to taxable income).

## **Automatic Changes in Accounting Method**

In Rev. Proc. 2002-9 (2002-3 IRB), the Service updated the rules for obtaining automatic consent to change an accounting method. Rev. Proc. 2002-9 clarifies, modifies, amplifies, and supersedes Rev. Proc. 99-49, the previous Rev. Proc. dealing with automatic change procedures. It also consolidates the automatic consent procedures for changes in several methods of accounting published subsequent to the publication of Rev. Proc. 99-49, and provides new automatic consent procedures for changes in several other methods of accounting. Taxpayers complying with Rev. Proc. 2002-9 are considered to have obtained the Service’s consent to change their method of accounting in accordance with IRC Section 446(e) and the regulations thereunder.

In general, Rev. Proc. 2002-9 is effective for tax years ending on or after Dec. 31, 2001.

### Appendix 3 – Construction Industry Associations and Resources

Name	Address	Purpose, Goals, Objectives
Associated Builders and Contractors <b>(ABC)</b>	<a href="http://www.abc.org/">http://www.abc.org/</a>	A national trade association representing about 23,000 contractors, subcontractors, and material suppliers. This website also provides license requirements by State
Associated General Contractors <b>(AGC)</b>	<a href="http://www.agc.org/">http://www.agc.org/</a>	The largest and oldest construction trade association.
American Institute of Certified Public Accountants <b>(AICPA)</b>	<a href="http://www.aicpa.org/">http://www.aicpa.org/</a>	The AICPA is the national, professional organization for all Certified Public Accountants. Its mission is to provide members with the resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients.
American Institute of Architects <b>(AIA)</b>	<a href="http://www.aia.org/">http://www.aia.org/</a>	The AIA is the voice of the architecture profession dedicated to serving its members; advancing their value; and improving the quality of the building environment. The AIA documents are standard forms in the building industry.
American Institute of Constructors <b>(AIC)</b>	<a href="http://www.aicnet.org/">http://www.aicnet.org/</a>	AIC is an organization established to help individual construction practitioners achieve the professional status they deserve.
American Subcontractors Association <b>(ASA)</b>	<a href="http://www.asaonline.com/">http://www.asaonline.com/</a>	ASA is comprised of professional constructors, suppliers, and service providers representing the construction industry through advocacy, leadership, education and networking
Blue Book of Building and Construction	<a href="http://thebluebook.com/">http://thebluebook.com/</a>	Provides a listing of over 1,000,000 general contractors, subcontractors, architects, engineers, etc by regional area.

Builder Online	<a href="http://www.builderonline.com/">http://www.builderonline.com/</a>	Comprehensive building information with numerous links.
Building Online	<a href="http://www.buildingonline.com/">http://www.buildingonline.com/</a>	Search over 100,000 building related sites. Links to top builders, top retailers, news, trade shows, contractor directories, home improvement tips, accounting and estimating software.
Construction Financial Management Association <b>(CFMA)</b>	<a href="http://www.cfma.org/">http://www.cfma.org/</a>	CFMA is a premier source of education and information about those aspects of financial management unique to the construction industry. There are over 7,000 members.
Construction Industry CPA Consultants <b>(CICPAC)</b>	<a href="http://www.cicpac.com/">http://www.cicpac.com/</a>	CICPAC is a national, not-for-profit association for CPA firms providing financial and consulting services to the construction industry.
Construction Management Association of America <b>(CMAA)</b>	<a href="http://cmaanet.org/">http://cmaanet.org/</a>	CMAA supports the professional construction managers in enhancing their performance and improving their business results. CMAA also provides information about the construction management practice.
Design Build Institute of America <b>(DBIA)</b>	<a href="http://www.dbia.org/">http://www.dbia.org/</a>	DBIA's mission is to promote the widespread and successful use of design-build project delivery. DBIA sponsors educational programs, publishes a Manual of Practice and Design-Build Contract Documents, and provides outreach to public and private facility owners.
Mechanical Contractors of America Association <b>(MCAA)</b>	<a href="http://www.mcaa.org/">http://www.mcaa.org/</a>	MCAA is an association of more than 2,200 mechanical, plumbing, and service contractors.
National Association of Homebuilders <b>(NAHB)</b>	<a href="http://www.nahb.org/">http://www.nahb.org/</a>	The NAHB is a federation of more than 800 state and local builder associations throughout the US. The mission of this association is to enhance the climate for housing and the building industry, and to promote policies that will keep housing a national priority.

Plumbing, Heating, Cooling Contractors Association (PHCC)	<a href="http://www.phccweb.org/">http://www.phccweb.org/</a>	PHCC is a nationwide organization with approximately 3,700 members. This association is the advocate for the plumbing, heating, and cooling contractors.
Secretary of State		Search the Secretary of State websites for any state to find information on companies, such as, the address, potential related companies, and the registering agent.
Securities Exchange Commission (SEC)	<a href="http://www.sec.gov/">http://www.sec.gov/</a>	Provides extensive information on publicly traded companies, including the 10-K, 10-Q filings
Taxpayer Website		Search for any construction company's website for annual reports, officers, headquarters, subsidiaries, etc.

## Trade Magazines

Title	Frequency of Publishing	Summary of Purpose/Information Included/Availability
Constructor	Monthly	Magazine published by the Associated General Contractors of America (AGC). The magazine can be downloaded, free of charge, from their website: <a href="http://www.agc.org/">http://www.agc.org/</a>
Builder	Monthly	Magazine published by the National Association of Home Builders (NAHB). <a href="http://www.nahb.org/">http://www.nahb.org/</a>
Building Design & Construction	Monthly	Focuses on the design and construction of nonresidential buildings – for architects, engineers, and construction managers. Articles can be downloaded, free of charge, from their website: <a href="http://www.bdcmag.com/">http://www.bdcmag.com/</a>
CFMA Building Profits	Bi-monthly	Magazine published by the Construction Financial Management Association (CFMA) <a href="http://www.cfma.org/">http://www.cfma.org/</a>

Journal of Construction Accounting & Taxation	Bi-monthly	Articles on financial and tax accounting published by RIA (Research Institute of America). RIA is a business unit of The Thomson Corporation which was formed with the merger of RIA, Computer Language Research (CLR), and Warren, Gorham, & Lamont (WG&L). <a href="http://riahome.com/">http://riahome.com/</a>
ENR (Engineering News Record)	Weekly	Magazine published by McGraw Hill Construction. Ranking of contractors by type and gross income. Plus, articles on companies and projects. <a href="http://www.enr.com/">http://www.enr.com/</a>

## Trade Publications

Date of Latest Edition	Title	Summary of Contents
Updated annually	PPC (Practitioners Publishing Company) Guide to Construction Contractors	Three-volume guide that discusses the industry in detail. The guide covers both financial and tax aspects.
Updated Annually	PPC (Practitioners Publishing Company) Guide to Real Estate	Three-volume guide that discusses the development of real estate in detail. The guide covers both financial and tax aspects.
Updated Annually	WG&L (Warren, Gorham & Lamont) Construction Controller' Manual	Provides insight to the complex accounting, tax, insurance, legal, and financial issues of the construction sector.
Updated Annually	Robert Morris Associates (RMA) Annual Statement Studies	Provides comparative financial data for all types of businesses organized by SIC/NAICS codes.
Updated Annually	CFMA Construction Industry Annual Financial Survey	The survey contains financial data organized by type of construction, dollar volume, and geographic region.

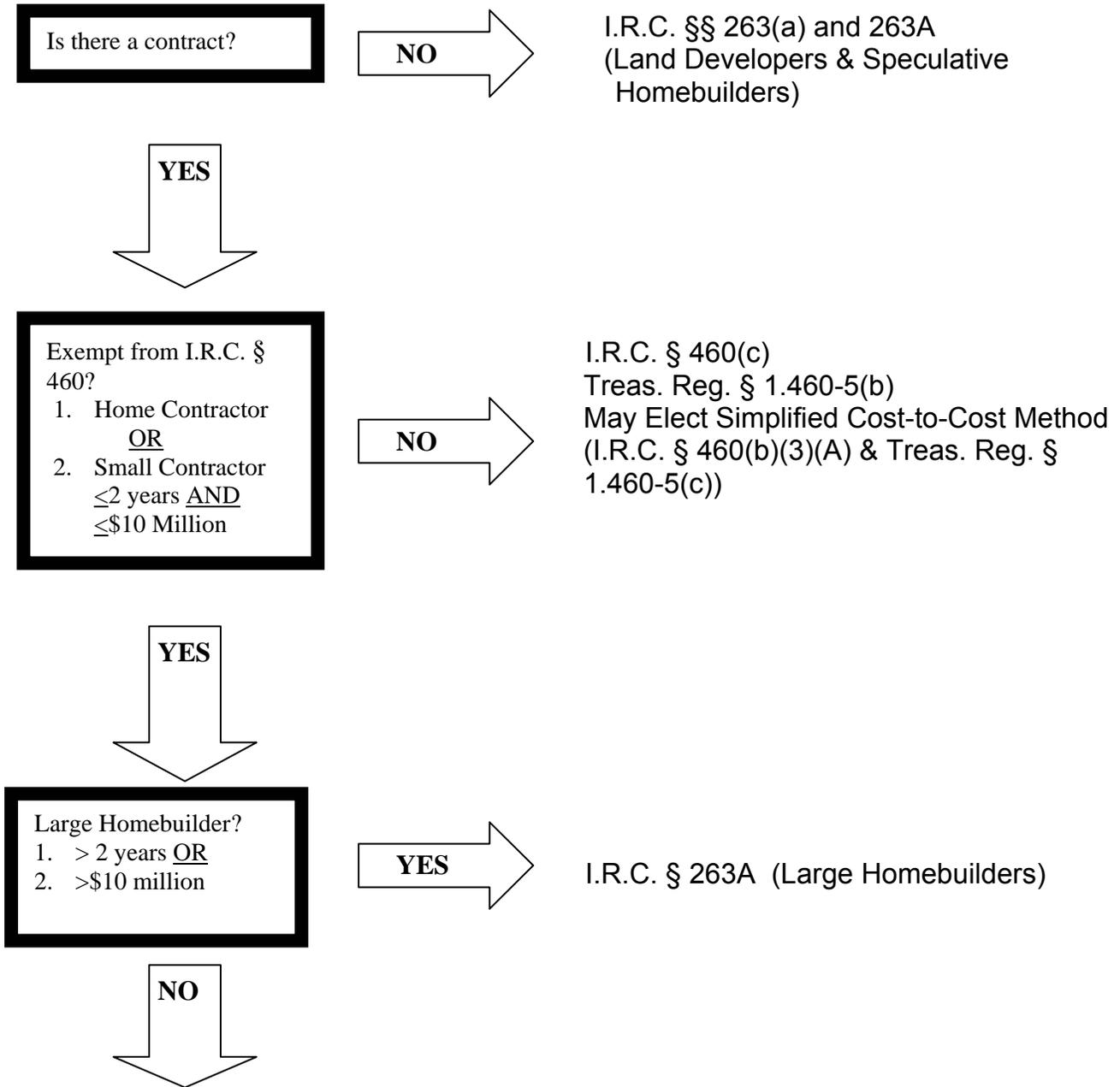
## AICPA Auditing Standards and Publications

Date of Issuance	Title	Summary of Information Included
<a href="#">Regularly Updated – not necessarily annual</a>	AICPA Construction Contractors	AICPA Audit and Accounting Guide.
<a href="#">Updated Annually</a>	<a href="#">AICPA Audit Risk Alert on the Construction Industry</a>	<a href="#">Nonauthoritative practice aids designed to be used as engagement planning tools. The alerts are resources for checking vital audit considerations that might otherwise be overlooked</a>

June 1953	ARB (Accounting Research Bulletin) No. 43 Government Contracts	Chapter 11 prescribes generally accepted accounting principles in three areas of accounting for government contracts. Section A deals with accounting under cost-plus-fixed-fee contracts. Section B deals with aspects of government contracts and subcontracts that are subject to renegotiation. Section C involves accounting for terminated war and defense contracts
October 1955	ARB No. 45 Long-Term Construction-Type Contracts	Describes the two generally accepted methods of accounting for long-term construction-type contracts: percentage-of-completion method and the completed-contract method.
July 15, 1981	SOP (Statement of Position) 81-1 Accounting for Performance of Construction-Type and Certain Production-Type Contracts	Provides additional guidance on the application of the generally accepted accounting principles set forth in ARB No. 43 & 45. SOP 81-1 establishes a strong preference for the percentage-of-completion method

# Appendix 4 – Cost Allocation

## COST ALLOCATION FLOWCHART



Small Contractors and Small Homebuilders:  
Treas. Reg. § 1.460-5(d) for Electing Completed Contract Method  
Treas. Reg. § 1.460-5(b) for Electing Percentage of Completion Method

**PRODUCTION PERIOD INTEREST IS ALLOCABLE UNDER ALL OF THE  
ABOVE UNDER I.R.C. §§ 460(c)(3) AND 263A(f).**

**COST ALLOCATION BY ITEM UNDER EACH METHOD**

	<b>Percentage of Completion Method required by I.R.C. § 460 &amp; 460(c) &amp; Treas. Reg. § 1.460-5(b)</b>	<b>Simplified Cost-to-Cost Method allowed by I.R.C. § 460(b)(3)(A) &amp; Treas. Reg. § 1.460-5(c)</b>	<b>Completed Contract Method allowed by Treas. Reg. 1.460-5(d)</b>	<b>Uniform Capitalization Rules in Code Section 263A (Large Homebuilders, Spec. Homes, Land Developers)</b>
Direct materials	Yes	Yes	Yes	Yes
Direct labor(Including subcontractors)	Yes	Yes	Yes	Yes
Indirect costs:				
• Repairs	Yes	No	Yes	Yes
• Maintenance	Yes	No	Yes	Yes
• Utilities	Yes	No	Yes	Yes
• Rent	Yes	No	Yes	Yes
• Certain indirect labor	Yes	No	Yes	Yes
• Materials & Supplies	Yes	No	Yes	Yes
• Small tools & equipment	Yes	No	Yes	Yes
• QC & Inspection	Yes	No	Yes	Yes
• Taxes other than income taxes	Yes	No	Yes	Yes
• Fin. Statement depreciation	No	No	Yes	NO
• Tax return depreciation	Yes	Yes	No	Yes
• Cost depletion	Yes	No	Yes	Yes
• Percentage depletion in excess of cost	Yes	No	No	Yes

	<b>Percentage of Completion Method required by I.R.C. § 460 &amp; 460(c) &amp; Treas. Reg. § 1.460-5(b)</b>	<b>Simplified Cost-to-Cost Method allowed by I.R.C. § 460(b)(3)(A) &amp; Treas. Reg. § 1.460-5(c)</b>	<b>Completed Contract Method allowed by Treas. Reg. 1.460-5(d)</b>	<b>Uniform Capitalization Rules in Code Section 263A (Large Homebuilders, Spec. Homes, Land Developers)</b>
• Contract General & administrative expense	Yes	No	Yes	Yes
• Non-Contract G&A expense	Yes	No	No	Yes
• Adm. Support departments	Yes	No	No	Yes
• Contract related officer salaries	Yes	No	Yes	Yes
• Non-Contract related officer salaries	Yes	No	No	Yes
• Insurance (including bonds)	Yes	No	Yes	Yes
• Pension, profit sharing, etc. except for past service costs	Yes	No	No	Yes
• Past service costs	Yes	No	No	Yes
• Direct R and D	Yes	No	No	Yes
• Rework, scrap, and spoilage	Yes	No	No	Yes
• Successful bidding expense	Yes	No	No	Yes
• Engineering and design	Yes	No	No	Yes
• Transportation costs	Yes	No	Yes	Yes
• Storage, handling, purchasing, and	Yes	No	No	Yes

	<b>Percentage of Completion Method required by I.R.C. § 460 &amp; 460(c) &amp; Treas. Reg. § 1.460-5(b)</b>	<b>Simplified Cost-to-Cost Method allowed by I.R.C. § 460(b)(3)(A) &amp; Treas. Reg. § 1.460-5(c)</b>	<b>Completed Contract Method allowed by Treas. Reg. 1.460-5(d)</b>	<b>Uniform Capitalization Rules in Code Section 263A (Large Homebuilders, Spec. Homes, Land Developers)</b>
related costs				
• Production period interest	Yes	No	Yes	Yes
• Any additional costs under cost plus or certain governmental contracts	Yes	No	No	Yes
• Marketing, selling, advertising, and distribution	No	No	No	No
• R & D not related to contracts	No	No	No	No
• Losses under Code Section 165, e.g. obsolescence of material, decline in value of assets, casualty losses, etc.	No	No	No	No
• Income taxes	No	No	No	No
• Costs attributable to strikes	No	No	No	No
• Repairs not associated with production equipment	YES	YES	YES	YES

## Appendix 5 – Definitions and Terminology

Term	Definition
ADVANCE PAYMENTS	Payments generally made to a prime contractor prior to the performance of any work under a contract. These payments help the contractor cover developmental and preliminary costs incurred prior to commencement of work.
ADVANCES ON CONTRACTS	A current liability on the books of contractors where billings on contracts exceed accumulated costs.
AGGREGATING (OR COMBINING)	The process of treating two or more agreements as one contract for the purpose of clearly reflecting income.
ASSEMBLAGE	Acquisition of contiguous properties by one owner for a specific purpose, such as the development of a housing tract.
AWARD	Notification given to a bidder informing him or her that his or her bid was accepted.
BACK CHARGES	Billings between parties, such as from owners to general contractors or general contractors to subcontractors, covering expenses, which, according to the contract, should have been incurred by the party to whom billed.
BACKFILL	Soil or other materials used to fill an excavation.
BACKLOG	The accumulation of unfinished jobs of a contractor, including those not started, measured by the amount of revenue expected to be received from them.
BETTERMENT	Improvement to real property, such as the addition of a sidewalk that increases the property's value. It's not a repair, restoration, or enlargement.
BID	A formal offer from a contractor, which specifies the price to be charged for completing, work in accordance with project specifications and contract requirements.
BID BOND	A bond issued on behalf of a contractor that provides for the payment of the difference between the contractor's bid and the next lowest bid if the contractor's bid is accepted and the contractor fails to enter into a contract or furnish such bonds as required by the contract.
BID-RIGGING	Any collusive action by contractors that restricts the competitive bidding process by manipulating the bids submitted on a project or projects (such as, inflating bid proposals or predetermining the lowest bidder).

<b>Term</b>	<b>Definition</b>
BONDING CAPACITY	The total dollar amount of the construction bonds (or maximum value of incomplete work) that a surety company will underwrite for a contractor.
BONUS	A premium paid to the contractor in excess of the basic contract price as a reward for meeting various goals stated in the contract; for example, completing the project prior to the contract completion date. The provisions for bonuses are stipulated in the bonus clause of the contract and are in contrast to the penalty clause.
BRIDGE LOAN	Short-term loan to cover the period between the termination of one loan and the beginning of another loan; for example, the period between the construction loan and the permanent loan.
BROKER	A party that acts as the general contractor for a project but subcontracts all of the construction work required under the contract.

BUILDING PERMIT	Permission granted by the local government to construct a building or to make property improvements.
BUILD-TO-SUIT	Method of leasing whereby the lessor agrees to make tenant improvements to the lessee's specifications in return for the lessee's long-term commitment to lease the space.
BUY-DOWN	Technique used to facilitate the sale of property. The buyer is offered a below-market interest rate on a mortgage loan for an initial number of years. The developer or other seller pays the lender the difference between the below-market rate and the market rate during the buy-down period, after which the borrower pays the full interest cost.
CERTIFICATE OF OCCUPANCY	Written authorization issued by a local government stating that the structure is ready and fit for occupancy.
CERTIFICATE FOR PAYMENT	Statements prepared by an architect to inform the owner of the amount due a contractor as a result of work completed on a project.
CHANGE ORDER	A modification of the provisions of a contract, such as a change in specifications or manner of performance that may be initiated by either the owner or the contractor.
CLAIMS	Amounts in excess of the original contract price that the contractor seeks to collect from the owner or others due to unanticipated circumstances; for example, owner-caused delays, errors in specifications, contract terminations, and disputed change orders.
CLASS A OFFICE BUILDING	Relatively new office building in a prime location, with a high occupancy rate and highly competitive rental rates.
CLASS B OFFICE BUILDING	(1) Older office building that has been fully renovated to modern standards that is in a prime location with a high occupancy rate and competitive rental rates. (2) Newer building that is not in a prime location
CLOSING STATEMENT	Also called a settlement statement. Detailed cash accounting of a real estate transaction. It is usually prepared by an escrow officer, broker, or attorney.
CLUSTER DEVELOPMENT	Subdivision development in which detached houses are built close together. It results in allowing little individual yard space.
COMMERCIAL REAL ESTATE	Income-producing property, such as shopping centers, offices, hotels, or apartments.
COMMITMENT	A promise to perform a certain act, such as making a

	loan.
COMMITMENT FEE	Fee paid for a written promise to make or insure a loan for a predetermined amount and on specified terms.
COMPLETED-CONTRACT METHOD	One of the two generally accepted methods of accounting for long-term contracts under which all contract income and all contract costs are deferred until the year in which the contract is finally completed and accepted.
COMPLETION BOND	A bond, generally given to the owner and the lender, guaranteeing completion of a project and the provision of funds to complete it.
CONSTRUCTION CONTRACT	Any contract for the building, construction or erection of or the installation of any integral component of, or improvements, to real property. A construction contract generally specifies the work to be performed and the terms of payment.
CONSTRUCTION CONTRACTOR	A person or entity that enters into an agreement to build, construct, or install improvements to real property according to the owner's specifications.
CONSTRUCTION IN PROGRESS	A current asset of contractors where accumulated costs exceed billings on a contract.
CONSTRUCTION LOAN	Mortgage loan used to finance real estate construction. It may include funds for acquiring land for the construction project and the permanent financing of the completed project.
CONSTRUCTION MANAGEMENT\CM	The function of managing and coordinating the construction of a project, including the negotiating of contracts with others to perform the construction work.
CONTRACT BOND	A bond to indemnify the owner against the failure of a contractor to comply with the requirements of a contract.
CONTRACT COST BREAKDOWN	A schedule showing the various elements and phases of work in a construction project and the cost of each.
COST-PLUS CONTRACT	A contract, which provides for reimbursement to the contractor of the costs incurred in completing the work plus some additional amount to compensate the contractor for profit, overhead, and performance. Different types of cost-plus contracts include cost-plus-fixed-fee, cost-plus award-fee, and cost-plus-incentive fee.
COST-PLUS-AWARD-FEE CONTRACT	A type of cost-plus contract in which the fee consists of a fixed-fee plus an amount which varies according

	to the level of performance of the contractor in areas such as cost savings and timeliness.
COST-PLUS-FIXED-FEE CONTRACT	A type of cost-plus contract in which the fee is usually a stipulated sum or a percentage of cost.
COST-PLUS-INCENTIVE-FEE CONTRACT	A type of cost-plus contract in which the fee is based on either cost savings or performance. It varies according to the level the contractor achieves in meeting such cost or performance criteria.
CRITICAL PATH METHOD (C.P.M.)	A method of scheduling construction activities according to sequence and interdependence. The sequence of activities that allows the project to be completed in the shortest time is called the critical path.
DELAYED BILLINGS	Billings from a contractor for which he or she was entitled to payment in previous billing periods.
DESIGN-CONSTRUCT CONTRACT (OR DESIGN-BUILD CONTRACT)	A single contract in which the contractor agrees to provide the design, procurement, and construction services necessary to complete a project.
DESIGN-MANAGE CONTRACT	A contract in which construction is performed by a number of independent contractors in a manner similar to the professional construction management concept.
DEVELOPER	Person or entity that prepares raw land for development. The developer may develop the land, and then sell it to a builder, an investor, or another developer.
DEVELOPMENT AGREEMENT	Agreement under California law by which local governments and developers can defend their respective interests during the development period. Such agreements can protect developers against changes in public policies that can cause delay or abandonment of a development project even though the developer has spent substantial funds for development.
DEVELOPMENT LOAN	Loan for off-site improvements, such as streets and utilities. (vs. Construction Loan)
DIRECT COST	Any labor, material, job overhead, or other cost that is directly attributable to a specific construction job.
DRAW	The amount of progress payments that is currently available to a contractor under a contract with a fixed payment schedule.
ENGINEERING	A contract for engineering services only, as opposed

CONTRACT	to the actual construction of a project.
ESCALATION CLAUSE	A provision in contracts providing for upward adjustments to be made in the contract price of certain items or elements of work when conditions affecting their cost change.
ESTIMATES	<p>These are estimated costs of a construction project. A project has three types of estimates during the evolution of the project. Conceptual estimates are generally made in the early phases of a project for the owner to consider whether the project is economically feasible. Detailed estimates are made after the design has been approved.</p> <p>These require a careful tabulation of all the quantities for a project or portion of a project (quantity takeoff or quantity survey). A definitive estimate is made after the initial approximate estimates become more defined and accurate as additional information is developed. Definitive estimates forecast the final project cost with little margin for error.</p>
FACTORY-BUILT HOUSES	Houses whose shells are factory-built and assembled at the building site to reduce construction costs.
FAST-TRACKING (OR PHASED CONSTRUCTION)	A system of scheduling the design and construction in such a manner that both phases progress simultaneously, with an appreciable reduction in the total time to complete the project.
FINAL ACCEPTANCE	The owner's acceptance of the project from the contractor upon certification by an architect or engineer that it has been completed according to contract requirements. Final acceptance usually precedes the date when the owner makes the final payment. The procedures to determine final acceptance will be specified in the contract.
FINAL INSPECTION	The final review or inspection of a project performed by an architect, engineer, or construction manager in order to certify that work has been completed according to the contract requirements, after which the final certificate for payment may be issued.
FINANCIAL ENGINEERING	The providing of assistance by the contractor to the client in arranging for the long-term financing of the project. This is an emerging feature in some large contracts, which requires the contractor to submit a financial package with his or her bid.
FIXED-PRICE CONTRACT (OR	

LUMP-SUM CONTRACT)	Agreement in which the contractor agrees to perform the required work in return for a fixed price stipulated in the contract.
FRONT-END LOADING	A common strategy used by contractors under which higher relative values are assigned to work to be completed in the early stages of a contract than to the work to be completed in the later stages. The result is that progress billings during the early stages exceed the actual value of the work done, causing the contractor's revenue from the project to be higher during the early stages than it otherwise would have been. See "Unbalanced Bid."
GENERAL CONTRACTOR	A contractor who contracts with an owner to be responsible for all of the construction work necessary to complete a project, even though subcontractors may be used to perform part of the work.
GUARANTY BOND	A type of bond guaranteeing that the contractor will complete the work according to the contract and/or pay all obligations. Also known as a "surety bond." If the bond guarantees completion of the work, it is referred to as a "performance bond" or "completion bond." If it guarantees payment of obligations, it is a "payment bond."

HARD DOLLAR COSTS	Cash outlays for land, labor, and improvements.
HISTORIC STRUCTURE	Pre-1936 building that qualifies for special rehabilitation tax credits as a historic structure under the Tax Reform Act of 1986. See IRC section 47(c)(1)(B).
HOLDBACK	A contract item that can be delayed in finalization. See "Retainage".
IMPROVEMENT BOND	Bond issued by public agency to finance the construction of improvements such as highways and streets.
INDIRECT COSTS	Generally, overhead expenses of the contractor that are not directly attributable to a particular construction project.
INVITED BID	A bid submitted by one of a selected group of contractors who have received an invitation to bid on a project, as opposed to bidding that is open to all qualified contractors.
JOB COSTS	Costs that can be allocated to specific jobs of a contractor (such as material, labor, and job overhead costs).
JOB OVERHEAD COSTS	See "Overhead Costs."
JOINT VENTURE	A cooperative undertaking, by two or more parties (contractors), operated as a separate business entity for the purpose of combining resources and sharing risks on a construction project.
KICKBACKS	Payments made without any legal obligation, usually to individuals in return for their influence in obtaining a contract.
LABOR AND MATERIAL PAYMENT BOND	A type of guaranty bond, which guarantees the owner that all costs of labor, material, and supplies incurred by the contractor in connection with a project, will be paid.
LABOR AND MATERIAL RELEASE	Document signed by laborers and material men waiving their rights under any mechanic's lien against the developer.
LETTER OF CREDIT	A document issued by a financial institution guaranteeing the payment of its client's debts up to a stated amount for a specific period.
LIEN	Legal claim against specific property of the owner to secure payment of amounts due to material suppliers or contractors, who are engaged in the construction of a project.
LIQUIDATED	Amounts stipulated in the contract, usually as a fixed

DAMAGES	amount per day, that the contractor is obligated to pay the owner as compensation for damages suffered as a result of the contractor's failure to complete the work within a specified time.
LOAN COMMITMENT	See "Commitment."
LOAN ORIGINATION FEES	Lender's charge for services in originating a mortgage. Such fees typically are 1 to 2 percent of the amount of the loan.
LONG-TERM CONTRACT	A building, installation, construction, or manufacturing contract, which is not completed within the taxable year in which it is entered.
LOT BOOK	Records maintained by a title company of recorded transactions affecting a particular property.
LUMP-SUM CONTRACT	See "Fixed-Price Contract."
MAINTENANCE BOND	A bond guaranteeing the owner that, for a specified time following the completion of a project (warranty period), any defects in workmanship or materials will be rectified. A one-year maintenance bond is normally included in the performance bond.

MECHANIC'S LIEN	A lien on real property in favor of persons supplying labor or materials for a building or structure, generally for the value of the labor or materials provided. A mechanic's lien also exists for professional services in some states. Clear title to the property cannot be obtained until the claim is settled.
NEGOTIATED BID	A bid proposal from a specific contractor (selected on the basis of reputation, past performance, quality of work, expertise, or other reasons) in which the terms and conditions are negotiated between the owner and contractor, as opposed to the competitive bidding process under which the lowest bid is sought from various qualified contractors.
OFFSITE COSTS	Expenditures incurred for the improvement of raw land that are not related to the construction of the building (such as, curbs, gutters, sidewalks, and streets).
OFF BALANCE SHEET FINANCING	Financing that does not appear on the balance sheet (such as, operating leases).
ONSITE COSTS	Expenditures incurred for the actual construction of a building.
OVERHEAD COSTS	May refer to either job overhead or operating overhead costs. "Job overhead costs" are direct costs of work, which can be allocated to a specific job, but they cannot be allocated to specific items of work within that job. "Operating overhead costs" are indirect costs of operating a construction business that cannot be allocated to specific jobs.
OWNER	The customer of a contractor, architect, or engineer who generally owns the right to the land on which the project is being built.
PAYMENT BOND	A bond guaranteeing payment of the contractor's obligations incurred in connection with a project. See "Labor and Material Payment Bond."
PENALTY CLAUSE	In contrast to the bonus clause, this provision of the contract provides for a reduction of the amount payable under a contract if the contractor fails to meet specified targets or project specifications.
PERCENTAGE-OF-COMPLETION METHOD--	One of the two generally accepted methods of accounting for long-term contracts in which the amount of gross income reportable in each year is that portion of the gross contract price which represents the percentage of the entire contract completed during the year.
PERFORMANCE	A guaranty bond executed by the contractor to protect

BOND	the owner against the contractor's failure to perform according to the terms of the contract. It is usually combined with a labor and material payment bond.
PHASED CONSTRUCTION	See "Fast-Tracking."
PRE-QUALIFICATION	The approval given a contractor under circumstances where an agency or owner requires bidders to meet certain standards. This approval then authorizes the contractor to submit a bid on the project.
PRIME CONTRACTOR	The general contractor or any major contractor who has a contract directly with the owner.
PROFIT CENTER	The unit, usually a single contract, used by a contractor to measure profit or loss for accounting purposes.
PROGRESS BILLINGS	Amounts billed by a contractor during the progress of work on a project. The amounts of the billings are determined in accordance with the terms of the contract, the amount of work completed, and the materials suitably stored. Change orders will affect the progress billings.

PROGRESS PAYMENTS	Payments made in response to progress billings.
PROGRESS SCHEDULE	Usually a diagram or other pictorial prepared by the contractor and updated monthly, showing the proposed and actual starting and completion times of the various elements or phases of work included in a project.
PROJECT MANAGER	An employee of the general contractor or contract manager who is responsible for all work performed on a project.
PUNCH LIST	A list prepared by the architect or owner near the completion of a project indicating items to be completed or corrected by the contractor.
QUANTITY TAKE-OFF (OR QUANTITY SURVEY)	A detailed compilation of the quantity of each elementary work item that is called for on the project. These are used in making project cost estimates.
RETAINAGE	Specified amount usually withheld from progress billings pending satisfactory completion and final acceptance of the project.
SEVERING (OR SEGMENTING)	The process of treating one agreement as two or more contracts for the purpose of clearly reflecting income.
SPECIFICATIONS (OR SPECS)	A technical description (along with working drawings) of the materials, workmanship, special construction methods, and standards required under a contract.
SUBCONTRACT	A contract between a prime contractor and a separate contractor or supplier to perform a portion of the work or supply materials for which the prime contractor is responsible to the owner.
SUBCONTRACTOR	A contractor who contracts with the general contractor or another prime contractor to perform a specific part of the work required on a project.
SUBCONTRACTOR BOND	Performance and payment bonds executed by a subcontractor and given to the prime contractor to guarantee the subcontractor's performance and payment of obligations required under the subcontract.
SUBSTANTIAL COMPLETION	The point reached in a project at which all major work has been completed. The remaining costs and potential risks of the contractor are insignificant.
SURETY	A person or organization, such as a bonding company, who promises in writing to make good the debt or default of another in return for consideration.
SURETY BOND	A legal instrument under which a surety (bonding company) agrees to answer to another party (the owner) for the debt, default, or failure of performance

	of a third party (the contractor).
TIME AND MATERIALS CONTRACT	A contract that generally provides for payments to the contractor based on the number of direct labor hours expended at fixed hourly rates plus the cost of materials. To cover indirect costs and profit, time (and sometimes material) is charged at marked-up rates.
TURNKEY JOB	A project on which the contractor is responsible to deliver a completed and operational facility.
UNBALANCED BID	A bid under which the contract price is disproportionately allocated to elements or phases of work on a basis other than that of cost plus overhead and profit. For example, front-end loading is the assigning of higher relative values to the work completed during the early phases of a project, or the assigning of higher profits to high quantity items under a unit-price contract.
UNIT-OF-DELIVERY METHOD	Under this method, revenue and cost of sales are recorded as units of work are delivered. This is most suitable to production-type contracts where many units of a product are produced in a continuous process (for example, aircraft).
UNIT-PRICE CONTRACT	A type of construction contract, which divides the work (or project) into various elements and fixes a price per unit for each element. Thus, payments to the contractor are based on the number of units of work performed for each element. This type of contract is particularly suited to projects where the quantities of work may vary substantially.

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