



BY RICH SHAVELL

How Contract Timing Impacts a Contractor's Taxes

Under the completed-contract method (CCM), the primary issues with dates has generally been determining when a contract ends. However, other circumstances must be considered for long-term contracts reported under the percentage-of-completion method (PCM), as well as contracts required to be reported under the look-back method and where the 10% method is elected. Further, contractors should also be aware of circumstances in which a contract's start date impacts the contractor's tax reporting.

This article will review the rules and regulations associated with a contract's start and end dates, which can significantly affect a contractor's federal income taxes.

Start-of-Contract Considerations

"Contract commencement" is the date when a contractor first incurs any allocable contract costs, which includes such items as design and engineering costs, but does not include bidding or contract negotiated costs.¹

In certain situations, when a contract is "entered into" – that is, the date when both the customer and contractor are legally bound to perform under the contract, even if there are unsatisfied contractual conditions² – may also have a tax impact.

PCM & the Small Contractor Exception

The small contractor exception to the PCM entails a two-part requirement:

- 1) The \$10 million average annual gross receipts threshold,³ and
- 2) A contract-by-contract determination.

So, the qualifying status of a small contractor alone doesn't mean that all contracts will be excepted from PCM reporting.

For instance, IRC § 460(e)(1)(B) states that the required use of the PCM doesn't apply to "any other construction contract entered into by a taxpayer who estimates (at the time such contract is entered into) that such contract will

be completed within the two-year period beginning on the contract commencement date of such contract..."

Regardless of qualifying as a "small contractor," each contract must be tested to ensure it qualifies under this two-year rule. If the work schedule exceeds two years, then that specific construction contract would not qualify. Theoretically, the taxpayer would have certain contracts with extended construction schedules reported under the PCM, while other qualifying contracts would be reported under a more preferable method, such as the CCM.

The test estimates the contract length starting from when the contract is entered into. The regulations provide that the "taxpayer's estimate of completion time will not be considered unreasonable if a contract is not completed within the estimated time primarily because of unforeseeable factors not within the taxpayer's control, such as third-party litigation, extreme weather conditions, strikes, or delays in securing permits or licenses."⁴

While the regulations indicate that a reasonable estimate should consider anticipated time for delays, rework, and change orders, not all factors can be reasonably estimated and known at the contract's outset. Therefore, these unforeseeable factors that extend a contract's actual completion beyond two years do not necessarily preclude the contract from qualifying for the exception to PCM reporting.

Knowing the commencement date is relevant to this estimating process. Documenting how and when incurred costs are allocated to the contract is critical for the contractor if faced with the prospects of a lengthy construction schedule.

Many contractors that qualify for this small contractor exception fail to document these issues on an ongoing basis, but may want to reconsider in light of *Basic Engineering, Inc. v. Commissioner*,⁵ a 2017 case in which the IRS challenged whether a taxpayer reasonably estimated if certain contracts would be completed within the requisite two-year period and therefore be reported under the PCM.

10% Method

Large and small contractors can exclude gross profit from contracts that do not reach 10% completion by the end of the year;⁶ however, the contract's commencement date and the initial allocation of costs can impact when the 10% threshold is reached. This can result in a deferral until the following year, when the 10% threshold is typically reached. This elected method does not apply for contractors using a simplified cost allocation method.⁷ Conversely, the elected 10% deferral method does apply under the look-back method.⁸

Other

While outside the scope of this article, note that a contract's start date can also affect production period interest allocations and the *de minimis* exception under the look-back method.⁹

End-of-Contract Issues Completion & Acceptance

According to current regulations,¹⁰ a contract is completed at the earlier of the following two dates:

- 1) When the contract's subject matter is being used by the customer (other than for testing) *and* 95% of allocable costs have been incurred; or
- 2) When final completion and acceptance of the subject matter by the customer occurs.

Determining the completion of a contract has nothing to do with timing of final payment under the contract. These regulations were issued after *Ball, Ball, and Brosamer, Inc. v. Commissioner*, one of the last cases focusing on the final completion and acceptance standard.¹¹ Prior regulations did not include the "earlier of" language or the 95% threshold.¹²

Additionally, the regulations do not consider contingent compensation, disputes, or costs (and revenue) related to supervising the customer's activities such as assembly or installation.¹³ Subcontractors should note that the regulations treat the GC as the customer and not the upstream party or owner.

In practice, the 95% threshold is relatively easy to monitor and serves as a practical expedient in many cases. However, no case has challenged the new regulations since adoption after *Ball, Ball, and Brosamer, Inc. v. Commissioner*.

Final completion and acceptance is based on all relevant facts and circumstances. Illustrative examples can be found in the regulations.¹⁴

PCM & Revenue Acceleration

For long-term contracts reported under the PCM, contract revenue not previously reported must be included in the year after the contract is completed.¹⁵

For example, if a \$1 million contract is 96% complete on December 31, 2016, then the contract balance of \$40,000 must be recognized in 2017 – regardless of whether the remaining work is completed in 2017.¹⁶

Look-Back Method

The look-back method is calculated upon contract completion, which can give rise to end-of-contract issues. The look-back method requires contractors to recalculate PCM contract income of the prior year(s) based on final contract values rather than on estimated revenues and costs reported in the prior contracting year(s). An interest charge is then paid (or refunded) for the corresponding tax re-determined based on the results of this computation.¹⁷

Look-back method computations can be voluminous and complex. Although there can be multiple reporting years per contract, the key point is that the trigger for the initial computations is when contract completion occurs.

CCM Timing Issues

Home Construction Contracts

The timing of reporting contract profits can also impact contractors with home construction contracts (HCCs),¹⁸ for which the CCM is permitted regardless of contractor size.¹⁹

A continuing area of controversy with the IRS is determining the subject matter of the HCC. For a large home community, a taxpayer might argue the subject matter is the entire community, a phase or subdivision, the lot of a single home, or the home's vertical construction.

There is also a question as to how the requisite land improvements affect this determination. Recently, two separate cases²⁰ have yielded different results on the matter. While the construction of ancillary community infrastructure and recreational facilities did impact the courts' opinions in both cases, certain issues remain ambiguous.

Moreover, the commercial construction industry continues to await updated regulations²¹ on this issue, but no new finalized guidance has emerged in the past 10 years.



Small Contractor Exception

As previously mentioned, small contractors have the ability to use the CCM under the small contractor exemption.²² When a contractor utilizing the CCM faces a dispute, additional regulations apply;²³ greater focus is placed on the contractor reporting adequate or accelerated income in the year of contract completion.

Summary

When a construction contract begins and ends can have a significant impact on a contractor's income taxes. To better understand these ramifications, CFMs should review with their tax advisor when and how to document their company's respective contract qualifications for more favorable tax treatment. ■

Endnotes

1. Treas. Reg. 1.460-1(b)(7).
2. Treas. Reg. 1.460-1(c)(2).
3. IRC § 460(e)(1)(B)(ii).
4. Treas. Reg. 1.460-1(f)(4)(i).
5. T.C. Memo 2017-26.
6. IRC § 460(b)(5).
7. IRC § 460(b)(5)(D)(i).
8. IRC § 460(b)(5)(D)(ii).
9. Treas. Reg. 1.460-1(b)(7).
10. Treas. Reg. 1.460-1(c)(3).
11. T.C. Memo 1990-454.
12. Treas. Reg. 1.451-3(b)(2)(i); removed by TD 8929, Long-term contracts, IRC § 460, 1/11/2001.
13. Treas. Reg. 1.460-1(c)(3)(iv)(B).
14. Treas. Reg. 1.460-1(j).
15. IRC § 460(b)(1).
16. This, of course assumes that a change order does not extend the contract with significant adjustments.
17. IRC § 460(b)(2).
18. See IRC § 460(e)(6) for definition of home construction contracts as well as comparison to residential construction contracts, which involve a larger number of units.
19. IRC § 460(e)(1)(A).
20. *Shea Homes, Inc & Subsidiaries v. Comm.*, (2016, CA9) 118 AFTR 2d 2016-5593, affg (2014) 142 T.C. 60. *The Howard Hughes Co, LLC*, (2014) 142 T.C. 355, affd on other issue (2015, CA5) 116 AFTR 2d 2015-6597.
21. The request to clarify the definition of home construction contracts as outlined in IRC 460(e)(6)(A) was issued in the 2005-06 Industry Issue Resolution Program (R-2005-81, Aug. 8, 2005) and has not been finalized.
22. IRC § 460 (e)(1)(B).
23. Treas. Reg. 1.460-4(d)(4).

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