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# Handling Claims & Disputes Under the PCM

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Despite efforts to ensure communication is clear and contracts are effectively worded, contractors often face the possibility of disputes and claims. As a result, CFMs must be familiar with proper accounting for these issues.

This article examines how disputes and claims are handled for tax purposes under the percentage-of-completion method (PCM).

## Contingent Compensation

Generally, the Internal Revenue Code (IRC) and Treasury Regulations require contractors to report contingent compensation from disputes and claims as early as possible.

A contractor that is involved in a dispute or claim must include the potential revenue when it is reasonably assured of receiving the contingent amount.<sup>1</sup> Moreover, the regulations covering contingent compensation for long-term contracts reflect as fundamental criteria for being reasonably able to predict that the contingent income will be earned when it is reported for financial statement purposes under GAAP.<sup>2</sup>

IRC §460(b)(1) requires a contractor that uses the PCM to include all income not previously reported under the contract during the first taxable year after a contract is completed. Elsewhere, regulations also state that the contractor must include contingent amounts in the contract price as soon as it can reasonably predict that the disputed amount will be earned.<sup>3</sup>

However, the regulations do not factor in when payment is received or when the dispute is resolved,<sup>4</sup> giving rise to two main concerns:

- 1) Estimated revenue must be included in income regardless of when the dispute is resolved and irrespective of when the revenue may be received; and
- 2) The GAAP methodology for recognizing contingent compensation, such as revenue from claims or disputes, may influence when these amounts are reported for tax purposes.

## All Events Test

For taxpayers other than those required to use the PCM, general tax rules usually delay the recognition of contingent compensation.

Under the “all events test,” income is includable in gross income when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy.<sup>5</sup> Under this doctrine, disputed claims are not accruable until a settlement is entered into or a judgement is rendered and all appeals are exhausted.

The applicability of this two-prong test was challenged and the Tax Court confirmed that the all events test does not apply to the PCM.<sup>6</sup> This leaves contractors in the unenviable position of potentially reporting taxable revenue that may never be received.

## IRS CIP Example: Claim Revenue Under a Long-Term Contract

An IRS Coordinated Issue Paper (CIP) that was issued in 1996 and revised in 2006 illustrates the IRS' perspective on the issue.<sup>7</sup> While the IRS no longer uses CIPs to communicate internal policy, they are still useful to understand internal IRS policies.

Take a look at the IRS example at right, which was excerpted from CIP: “Claim Revenue Under a Long-Term Contract,” July 20, 2006. The IRS states that additional revenue must be recognized for two reasons:

- 1) The contractor is entitled to additional revenues; and
- 2) The contractor reported additional revenues for financial statement purposes.

Presumably, the contractor would not have incurred the extra costs for the additional scope of work unless it expected to receive compensation to at least cover these costs. According to the CIP, this concept was previously addressed in a 1989 IRS Notice<sup>8</sup> (which served as an IRS statement of position on the PCM prior to the issuance of §460 regulations). The CIP states that this notice is still applicable for this purpose.



## IRS CIP Excerpt: Claim Revenue Under a Long-Term Contract

Contractor enters into a “long-term contract” with a client for the building, installation, or construction of property, scheduled for completion three years later.

During the course of construction, contractor performed additional work and incurred additional costs attributable to customer caused delays, errors in specifications and designs, unpriced change orders, or other unanticipated work. The contractor deducted these costs for tax purposes. Although client agreed to the additional work, the parties had not agreed to a price for the extra work performed. The parties will negotiate the price at a later time.

In determining the amount of gross income from the contract under section 460 for the taxable year at issue, the contractor used the original contract price in the PCM computations. Contractor did not increase the total contract price, for the revenue attributable to the additional work performed during the taxable year (“claim revenue”).

For financial statement purposes, however, contractor accrued additional income attributable to the additional work performed in accordance with the AICPA Statement of Position 81-1 “Accounting for Performance of Construction-Type and Certain Production-Type Contracts” (AICPA SOP 81-1). Paragraph 65 of AICPA SOP 81-1 establishes a standard for revenue recognition for claims: Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated

additional costs. Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of *all* the following conditions:

- a)** The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
- b)** Additional costs are caused by circumstances that were unforeseen at the contract date and are not a result of deficiencies in the contractor’s performance.
- c)** Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.
- d)** The evidence supporting the claim is objective and verifiable, not based on management’s “feel” for the situation or on unsupported representations. If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. The amounts recorded, if material, should be disclosed in the notes to the financial statements. Costs attributable to claims should be treated as costs of contract performance as incurred.

Paragraph 66 of AICPA SOP 81-1 allows an alternative to the above in that the contractor may defer recording revenue from claims until they have been received or awarded. If that practice is followed, the amounts should be disclosed in the financial statements.<sup>9</sup>

The concept that cost would only be incurred because reimbursement was assured or expected also applies for financial statement purposes, as stated in the example above.

Regardless of whether the additional revenue represents just the costs incurred or an amount that is both “probable” and can be reliably estimated (the general rule under GAAP), the regulations require that the additional amount be reported for tax purposes. While strict conformity between tax and

financial statement reporting is not always required, here is a specific exception for contractors using the PCM.<sup>10</sup>

The CIP also states that the absence of reporting additional revenue for a claim or dispute for financial statement purposes does not necessarily prevent the inclusion of additional revenue for tax purposes.<sup>11</sup>

*Author’s Note:* Keep in mind that the potential impact of FASB’s new revenue recognition standard and its unique

rules for claims and disputes as well as possible guidance from the IRS is still pending.

### **Implications**

Applying numbers to the previous example, let's say the contractor incurs \$100,000 additional costs for unanticipated work that has yet to be priced. The contractor originally estimated total costs of \$800,000 for the \$1 million contract, resulting in a total estimated gross profit of \$200,000, or 20%. At the end of the period, \$400,000 of costs to date were incurred (exclusive of the additional costs) resulting in 50% completion and earned revenues of \$500,000.

If additional revenue is included to the extent of the additional \$100,000 costs incurred, then the total estimated contract price under the PCM increases from \$1 million to \$1.1 million.

On the expense side, both the costs to date and total estimated costs increase by \$100,000. The percent complete has increased and more earned revenue will be reported, which results in a slightly decreased overall gross profit percentage (18.18% vs. 20%) and an increase in total gross profit at the end of the current period. This is because the increase in

percent complete is applied to a larger contract price resulting in more earned revenue and corresponding gross profit.

### **Summary**

When addressing claims and disputes for tax purposes, the CFM is often beset with difficult tradeoffs. Since financial statement results are often critical to acquiring surety capacity and credit, the impact of federal tax requirements on cash flow is always a concern.

Claims and disputes are prevalent in the industry, and the conformity requirement discussed means that revenue reported for financial statement purposes will impact taxes and cash flow.

The CFM must fully understand the impact of these tax and financial statement requirements to ensure, where feasible, both sides are optimized. ■

### **Endnotes**

1. 26 CFR 1.460-4(b)(4)(i)(B).
2. Ibid.
3. Recognize that this discussion is focused on the PCM. The completed-contract method is addressed more heavily in the Regs. See 26 CFR 1.460-4(d)(4).
4. 26 CFR 1.460-4(b)(4)(i)(B).
5. Treas. Reg. §1.451-1(a).
6. Tutor-Saliba Corporation v. Com. (2000) 115 TC 1.
7. CIP: "Claim Revenue Under a Long-Term Contract," July 20, 2006.
8. IRS Notice 89-15, 1989-1 CB 634, Q+A 31 at 642.
9. Excerpted from CIP: "Claim Revenue Under a Long-Term Contract," July 20, 2006.
10. 26 CFR 1.460-4(b)(4)(i)(B).
11. CIP: "Claim Revenue Under a Long-Term Contract," July 20, 2006.

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