

TAX CHANGES TO **BENEFIT**

BY RICH SHAVELL

CONTRACTORS

The construction industry faces unique tax requirements that can stymie even the best tax minds in the country. One group of dedicated contractors and tax professionals is keeping an eye on Congress and the Internal Revenue Service on behalf of the industry.

Associated Builders and Contractors' National Tax Advisory Group (TAG) along with the Construction Financial Management Association (CFMA) requested that the IRS consider a specific technical issue under the IRS's Industry Issue Resolution (IIR) program that affects certain subcontractors. This IIR process continues into 2006 after the IRS held an initial meeting in December 2005 with 14 representatives from the construction and real estate industries.

PAST SUCCESSES

In the mid to late 1990s, the IRS addressed how it pursued contractors that utilize the cash-basis method of accounting. The IRS had won several court cases on technical arguments that enabled the service to audit contractors. The result: significant audit assessments.

ABC and other construction associations worked with what the IRS then called its Construction Industry Market Segment Specialization Program (MSSP), and the IRS agreed not to specifically audit contractors based on these technical arguments. Two revenue rulings were issued in 2002 further clarifying the issue and supplying certain safe-harbor criteria.

Over the following five years Congress and the IRS addressed other issues impacting the construction industry, including:

- the elimination of the estate tax. However, without further legislation, the phase-out and one-year repeal (in 2010) is followed by a sunset provision that brings the estate tax back to the pre-2001 law;
- the reduction of the capital gains tax, which is set to sunset after 2010 when the current 15 percent rate will go back to the pre-2001 level of 20 percent; and
- the agreement, as noted, that the IRS would no longer pursue cash-basis accounting methods issues against contractors under audit.

ON THE TAX AGENDA

In addition to solidifying these key successes, other key tax issues would impact a significant number of contractors:

- increasing the small contractor exception threshold of \$10 million as found in Internal Revenue Code Section 460(e). If the construction contractor's average annual revenue is under this threshold, then the contractor can choose among several more favorable tax accounting methods for regular tax purposes including the completed contract method. If revenue exceeds this threshold, then the

contractor must use the percentage-of-completion method (PCM) for its long-term contracts.

This threshold was put in place in 1986 and has never been adjusted for inflation.

Consider that another division of the federal government, the Small Business Administration (SBA), currently considers contractors as "small," depending on the nature of the construction, at generally \$13 million to \$31 million of annual revenue, which is periodically reviewed and subject to public comment for amendments. (See www.sba.gov/size/sizetable2002.html.) ABC believes this standard is a good example to follow for thresholds that can be affected by inflation.

- eliminating the Alternative Minimum Tax (AMT) adjustment for long-term contracts to ensure that construction contractors obtain the full benefit of the 460(e) small contractor exception. Without this additional change, the entire benefit of the 460(e) threshold change cannot be fully realized.

When the federal tax laws were significantly changed under the Tax Reform Act of 1986, it was arguable whether the commercial construction industry would be impacted by the change requiring that long-term contracts be reported under the less favorable PCM.

At the time, Congress was anxious to limit perceived abuses by defense and aerospace contractors. The concern was that while significant financial statement income was being reported, little tax was being paid because income from long-term contracts was deferred under the completed contract method by certain large public companies.

Unfortunately, commercial contractors were impacted by the 1986 law changes. Many years later, proposed changes such as the two mentioned here—increasing the threshold for the small contractor exception and eliminating contractor AMT adjustments—are long overdue. These two changes would have a positive impact on over 95% of the nation's contractors.

Shavell, CPA, CCIFP, is president of Shavell & Company, P.A. CPAs and Consultants in Boca Raton and Stuart, Fla. Currently, he serves as chair of ABC's National Tax Advisory Group. For more information, visit www.shavell.net or call (561) 997-7242.