

**CONTRACTOR
ACCOUNTING
METHODS:**

The

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Choices

BY ERIC P. WALLACE



Construction

is one of the most difficult industries to understand from a tax perspective. Here's why:

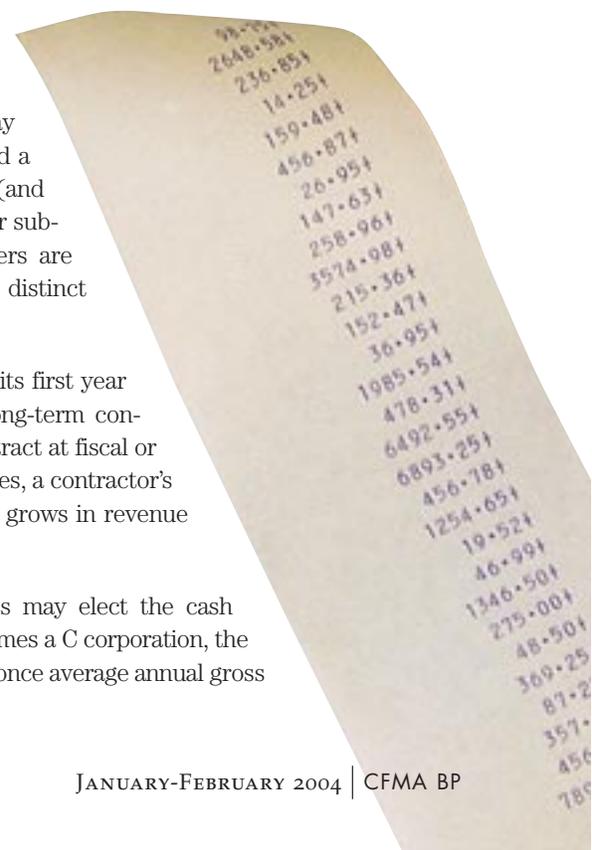
- 1) The number of available tax methods, each with revenue and cost recognition issues;
- 2) The effort necessary to change or correct method choices as a contractor's business changes;
- 3) The number and variety of sources for tax rules; and
- 4) The fact that the IRS, the courts, and Congress continually change their positions on or interpretations of these tax rules.

Numerous Choices? Maybe!

Depending on the size of its revenues and the types of contracts it undertakes, a contractor may need to choose both a method of accounting and a method of accounting for long-term contracts (and also several choices of accounting sub-routines or sub-treatments). Many contractors and tax preparers are confused about these two very different and distinct areas of consideration.

A contractor chooses a method of accounting in its first year of existence and a method of accounting for long-term contracts in the first year it has an uncompleted contract at fiscal or calendar year-end. However, unlike other industries, a contractor's accounting methods will evolve and change as it grows in revenue and types of contracts performed.

For example, a contractor just starting business may elect the cash method of accounting. If the contractor then becomes a C corporation, the tax code requires a change to the accrual method once average annual gross





receipts exceed \$5 million. When the contractor's average annual gross receipts exceed \$10 million, the tax code requires accounting for its contracts under the percentage-of-completion method (PCM).

As this simple example shows, a contractor's tax advisor must understand the *permitted, preferable, and correct* methods of accounting that may be elected, along with the choices for long-term contract treatment and the ways to address needed changes.

Any selection, whether correct or incorrect, will influence the tax position of a contractor for many years. Once selected, these accounting methods must be consistently applied on all subsequent tax returns unless permission to change has been obtained from the IRS, or unless the contractor is required to change by a specific law.

First Things First: Method of Accounting Choices

Every contractor, from the largest to the smallest, elects an overall method of accounting on its first filed federal tax return. Choices include:

- the cash method,
- the accrual method,
- the accrual excluding retentions method, and (possibly)
- the hybrid method(s).

Depending on the type, size, and length of the contract, various methods of accounting for long-term contracts are permitted, each with its own benefits and disadvantages. A contractor elects a specific long-term contract accounting method (possibly different methods for its exempt and non-exempt contracts) and also elects sub-treatments for the classification of contracts and the allocation of indirect costs.

Accounting for long-term contracts relates to the treatment method chosen (or as dictated by the rules and regulations of the tax code) in order to account for revenue and cost recognition for long-term contracts.

Diverse & Numerous Sources for Tax Rules

The tax rules related to accounting methods are not found in just one particular section of the IRC; rather, they are a compilation of various codes, regulations, notices, rulings, and court cases. The most important of these are briefly explained at the end of this article. These sources have been issued, changed, and updated over the years.

To better understand the accounting method options available, you need to understand certain key sections in the tax code.

IRC §446: The "Clear Reflection of Income" Standard

According to IRC §446, if no accounting method has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of income shall be made under such method as, in the opinion of the IRS, clearly reflects income.

IRC §446 gives the IRS broad discretion to require a particular method of accounting. The courts do not interfere with an IRS determination under §446 unless it is clearly erroneous. So, before any method is "elected" by the taxpayer, it must first pass the *clear reflection of income requirements* under §446. The chart on the last page compares the various accounting method choices in terms of revenue and cost recognition.

IRC §460: Accounting for Long-Term Contracts

IRC §460 begins by stating that, in the case of any long-term contract, the taxable income from such a contract shall be determined under the PCM. The exceptions to this are specified by §460(e). To understand the regulation, you must first understand how the IRC defines specific terms.

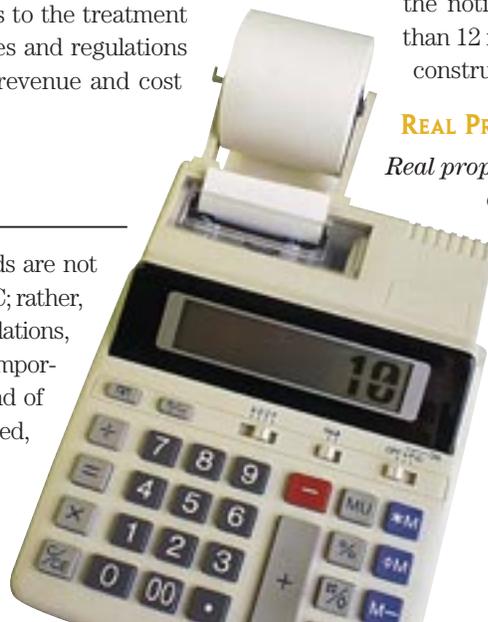
DEFINITION OF A LONG-TERM CONTRACT

IRC §460(f) defines a "long-term contract" 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 into." So, a contract started in December and completed in January for a calendar-year contractor is a long-term contract.

The contract may only last a week, but if it lasts over a fiscal or calendar year-end, it is a long-term contract. This negates the notion that a contract has to be longer than 12 months to be a long-term contract for construction contractors.

REAL PROPERTY REQUIREMENT

Real property means land, buildings, and inherently permanent structures (such as roadways, dams, and bridges) as defined in 1.263A-8(c)(3). 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



ACCOUNTING FOR LONG-TERM CONTRACTS: A GUIDE TO ABBREVIATIONS

- **POC – Percentage of Completion:** Revenue recognition is based on the use of one of the methods defined below. POC can be measured by costs, labor hours, labor dollars, a determination by an architect or engineer, or some other determinant.
- **PCM – Percentage-of-Completion Method:** Generally defined by §460; the measurement of revenues recognized is determined by costs-to-date compared to total estimated contract costs, as defined by 1.460-5(a), multiplied by the expected contract receipts, as defined by 1.460-4(a).
- **EPCM – Exempt Percentage-of-Completion Method:** In this method, the POC can be calculated by any measure of progress, such as units of performance (for example, miles of payment paved), labor hours, labor dollars, etc.
- **CCM – Completed-Contract Method:** Under this method, contract costs are deferred as an asset account, as dictated by 1.460-5(d), and progress billings are deferred as a liability until the contract is completed, as defined by 1.460-1(c)(3).
- **PCCM – Percentage of Completed Capitalized Cost Method:** Under this method, the contractor/taxpayer must determine income under a long-term contract using the PCM for 70% of the contract and the EPCM for the remaining 30%. This method is available for residential construction contracts.

intended to be permanently affixed to the real property, such as central heating and cooling systems.

IRC §460(e)(4) defines a “construction contract” as “any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvement of, real property.” Thus, a contract to install an integral component to real property can be subject to §460, even if the installation activity is not accompanied by any construction activity.

“CONTRACT” VS. “CONTRACTOR” WORDING

IRC §460(b) refers to “any long-term contract,” rather than referring to the contractor’s accounting method as a whole. This is an important distinction. For example, a contractor may report some contracts under the CCM under 1.460-4(d) (previously 1.451-3), but may be required to report other contracts under §460 using the PCM.

To reiterate: If the contractor elects a method of accounting for long-term contracts, it may be superseded by the requirement to use PCM reporting under §460 for some (or for all) contracts, depending on whether the exceptions of §460(e) are met and provided the method selected clearly reflects income. However, the requirement to use the PCM for some (or all) of its contracts does *not* change the contractor’s elected basic accounting method or elected method of accounting for exempt long-term contracts.

ACTIVITIES THAT DO NOT MEET THE DEFINITIONS

The IRS narrowly defines a construction contract. It must be “a contract for building, construction, . . . or improvement of real property.” This narrow and restrictive definition has been used by the IRS to deny long-term contract accounting methods to architects, engineers, and industrial and commercial painters, as well as to engineering services and construction management.

What method then, should these “activities” utilize? The answer is a regular method of accounting only (such as cash or accrual) and not a long-term method (such as the CCM or PCM). The IRS reasons that these professions do not build or construct anything; rather, they simply draw the plans and supervise the work of construction.

The IRS concludes that these professions are not entitled to report income from contracts extending over more than one year on the PCM or the CCM, because the work done by these types of taxpayers is in the nature of personal service.

The IRS calls these types of services “non-long-term contract activities.” Not only is the denial of long-term treatment applicable to these services, it is also applicable to contractors that perform these same activities. The IRS has “clarified” this as follows: If a construction contract includes the performance of any activity other than construction (for example, engineering and design, construction management, or architectural services) that is not incidental to or necessary for a long-term construction contract, the contractor must allocate a portion of the contract revenue and costs attributable to that activity.

And, the contractor would have to account for this activity under a permissible method of accounting other than a long-term contract method (typically, the straight accrual method).

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THE SMALL CONTRACTOR EXCEPTION

As stated earlier, the exceptions to the restrictive provisions of §460(a), requiring the use of the PCM, are specified by §460(e). These exceptions permit reporting of long-term contracts under one of the



methods described by 1.460-4(c): PCM, EPCM, CCM, or any other permissible method (according to §446 for construction contractors or §471 or 263A for homebuilders).

Specifically, a contract is not subject to the PCM if, under §460(e)(1)(B), the taxpayer estimates (at the time the contract is entered into) that “such contract will be completed within the two-year period beginning on the contract commencement date of such contract, and whose average annual gross receipts for the three taxable years preceding the taxable year in which the contract is entered into do not exceed \$10,000,000.” Both conditions must be met or the exception does not apply.

If a particular contract exceeds this two-year period, then IRC §460(b) applies to that contract, without regard to the contractor's average gross receipts. If a contractor meets the exception defined under §460(e)(1)(B), then the following methods are available for use in reporting its long-term contracts: cash, accrual, accrual excluding retentions, and/or the long-term methods of the PCM (if the contractor wants to elect this method), the EPCM, and the CCM.

Home Construction Contracts

IRC §460(e)(6) provides that a construction contract is a home construction contract if the taxpayer (including a subcontractor working for a general contractor) reasonably expects to attribute 80% or more of the estimated total contract costs, determined at the close of the contracting year, to the construction of: **1)** a dwelling unit or a building containing four or fewer dwelling units and/or **2)** improvements to real property directly related to the dwelling units and located on the site of the dwelling units.

Home construction contracts that meet the small contractor's exemption, as defined above, are exempt from both the requirements of §460 and the AMT requirements of §56(a)(3), with one exception. The only requirement for small home construction contractors under §460 is that construction period interest must be capitalized in accordance with §460(c)(3) when computing regular tax.

The result: As long as the clear reflection of income standard is met, small home contractors can utilize various methods, such as the cash method, the accrual method, accrual excluding retentions, accrual with cost reporting under either §471 or §263A, CCM, EPCM, or PCM.

Home construction contracts that do not meet the small contractor's exemption must capitalize production period interest in accordance with §460(c)(3). Other costs must be allocated to the contracts in accordance with the uniform capitalization rules of §263A.

Recap: What's Available

For all contractors, the available accounting methods (subject to §446) include: the cash method, the accrual method, the accrual excluding retention method, the hybrid method, the CCM, and the EPCM.

For these six methods, a contractor can elect to report its alternative minimum taxable income (AMTI) utilizing regular completion factors instead of the required simplified cost-to-cost method. Small homebuilders can use the accrual method, with certain costs capitalized under §471 and interest capitalized under §263A; large homebuilders can use the accrual method, with both costs and interest capitalized under §263A.

When accounting for long-term contracts and §460 applies, the possible choices include:

- the PCM under §460(b),
- the PCCM under §460(a),
- the simplified cost-to-cost method, and
- the 10% deferral, PCM, under §460(b)(5).

However, when accounting for long-term contracts and the exceptions to §460 apply, the possible choices can include those previously listed under the overall methods of accounting, plus:

- the completed-contract method (CCM),
- the percentage-of-completion method (PCM),
- the exempt percentage-of-completion method (EPCM), and
- the percentage of completed capitalized cost method (PCCM).

Changing Rules, Changing Methods

The IRS, the courts, and Congress are continually changing the laws or interpretations thereof related to contractor accounting methods and treatments. The release of the final §460 regulations on January 11, 2001, as well as several releases issued during 2002, added many new rules and restrictions. All contractors, whether small or large, must carefully review these regulations for required compliance or method changes. In addition, the permitted use of the cash method continues to evolve.





Once methods are elected, most changes cannot be made without IRS approval. If changes are not submitted in a timely manner, the contractor could face significant interest and penalties if the IRS determines that the method in use does not clearly reflect its income or if the contractor is not properly applying §460 PCM.

A change in method will require approval by the IRS. However, a change from the cash method to the accrual method is considered an automatic change under Rev. Proc. 2002-9. The IRS will grant a four-year §481(a) adjustment to a contractor changing from cash to accrual, even if this was a required change under §448 (“Limitations on Use of Cash Method of Accounting”) and the contractor failed to change, as long as the contractor changes before the IRS proposes an adjustment.

A change from the cash to the accrual excluding retention method will also be granted a four-year §481(a) adjustment; however, this is not considered an automatic change and application must be made under Rev. Proc. 97-27.

Tip: A Rev. Proc. 97-27 change can be applied for effective for the beginning of the contractor’s year (as opposed to a Rev. Proc. 2002-9 automatic change, which is effective for the following tax year). A Rev. Proc. 97-27 change must be filed by its tax year-end, whereas a Rev. Proc. 2002-9 change can be filed as late as the extended due date of the tax return.

THE FINAL §460 REGULATIONS

In the final §460 regulations, the IRS changed the opportunity for contractors to change an exempt long-term method, a classification of contract method, and the allocation method of job costing and take a four-year §481(a) adjustment. Effective January 11, 2001, any change in such methods is required to be reported under an immediate cut-off, as long as the contractor initiates the change.

This change modifies the provisions of Rev. Proc. 97-27 that had permitted a four-year spread. Currently, as under past rules and regulations, a misapplication of §460 for the PCM is required to be changed as a cut-off, as long as initiated by the contractor prior to an IRS proposed change.



Note: These rules create an interesting scenario. What would occur if a contractor wanted to change from the cash method to the accrual/CCM? It appears that the contractor would be granted a four-year §481(a) adjustment for the cash to accrual difference and an immediate cut-off for the difference between the accrual and the completed-contract

adjustment. In the first year, this could result in a positive §481(a) adjustment for the cash to accrual change and a negative effect for the accrual to CCM change.

Where to Go from Here

All contractors and their tax advisors must consider the accounting methods and choices (both elected and available) before deciding when and how to proceed. Selections must be made carefully, as the ramifications will be felt for many years.

The road to change has many hurdles, dead ends, and slippery slopes. My suggestion is that one should obtain a good road map before proceeding and/or employ a knowledgeable guide. **BP**

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See the following pages for important information on current rules, regs, and accounting method choices.



DO YOU KNOW YOUR RULES AND REGS?



In general, contractors and construction tax advisors must be familiar with the following IRC rules and regs that relate to accounting for long-term contracts:

- **IRC Reg. 1.460:** As of January 11, 2001, these regs regarding accounting for long-term contract treatment supercede the 1.451-3 regs. They discuss the CCM and the PCM and, in 1.460-5, present costing rules for both non-extended period contracts (less than two years to complete and applicable to contractors with less than \$10 million in average revenues), as well as extended-period contracts (greater than two years to complete and applicable to contractors with over \$10 million in average revenues).
- **IRC §460:** Effective for contracts after 1986, §460 generally requires the PCM for all long-term contracts unless said contract or contracts are covered by an exception. The difference between the PCM method under §460 and the EPCM permitted by the §460 regs relates to the types of job costs allowed or regulated and how percentage-of-completion (POC) is calculated. Under §460, many types of indirect contract costs are added to the formula in determining “percent complete” and only the cost-to-cost method of POC is permitted.
- **IRC §460(e)(1)(A):** Describes the home construction contract exception to the §460 PCM requirement.
- **IRC §460(e)(1)(B):** Describes the small contractor exception to the §460 PCM requirement.
- **IRC Reg. 1.460-6:** Describes the requirements and details the calculations for look-back calculations applicable to certain contractors. Look-back rules were implemented in §460 in order to prevent contractors from manipulating their POC recognition. The look-back rules require the contractor to either pay or receive interest for differences in what was estimated as “percent complete” once the contract is completed and accepted under the All Events Test and final gross profit amounts are known.
- **Notice 89-15:** This is the IRS guidance with respect to the application of §460, including PCM contract treatment,

changes to methods, exceptions for home construction, as well as the definitions of residential contract, small contractor, and more.

This notice was the basic source for most of the knowledge about §460 prior to the final §460 regs and can still be relied upon to answer questions not covered by the final §460 regs.

- **IRC §471 & Related Regs:** These list the required application of inventory costing for small homebuilders (less than \$10 million in revenue and contracts less than two years in length) with inventory.
- **IRC §263A:** This contains the uniform capitalization regulations applicable to speculative homebuilders not meeting the small homebuilder definition and to extended-period contract costing. It also details the applicability of interest capitalization and allocation to contractors. In general, the direct and indirect cost allocations under §263A are applicable to §460, as described in 1.460-5.
- **Revenue Ruling 92-28:** This ruling clarified and reiterates that §460(e)(1) permits a taxpayer to use different methods of accounting for exempt contracts under §460(e)(1) – which are not subject to mandatory use of the §460(b) PCM – and contracts under §460(a) – which are subject to mandatory use of the PCM within the same trade or business.

Accordingly, a contractor with both exempt and non-exempt contracts within the same trade or business may use a method of accounting other than the §460(b) PCM for all exempt contracts, even if it must use the §460(b) PCM for all non-exempt contracts.

- **Final §460 Regs:** Issued January 11, 2001, these supercede the §451 regs and partially supercede/supplement Notice 89-15. They detail the §460 requirements on long-term contracts and related activities. *There were many new concepts, applications, and rules introduced in these regulations and contractors should be familiar with them in detail.* The final §460 regs can be downloaded at www.irs.gov/pub/irs-regs/td8929.pdf.

In addition, the following IRC rules and regs relate to changes in accounting method:

- **Rev. Proc. 97-27:** Describes procedures regarding a contractor-initiated change in a long-term contract accounting method. Rev. Proc. 97-27 superceded Rev. Proc. 92-20 and Notice 89-15, Q&A No. 7; it permits a four-year §481(a) adjustment for such changes, instead of a retroactive adjustment.

Effective January 11, 2001, this was changed again by the final §460 regs. After this date, any change in a long-term contract treatment requires the use of a cut-off.

- **Rev. Proc. 2002-9:** Issued to enable compliance with the final §460 regs, section 7A is the portion applicable to contractors.

It is not applicable to exempt contract method changes, because Rev. Proc. 97-27 still applies. It was modified by Rev. Proc. 2002-19, which permits a one-year spread for negative §481(e) adjustments.

- **Revenue Procedure 2002-28:** Allows many contractors to use or change back to the cash method for either their regular method of accounting or for long-term contract treatments. Qualifying contractors must meet the Annual Gross Receipts Test and qualifying NAICS codes.

The automatic provisions of Rev. Proc. 2002-9, as modified by Rev. Proc. 2002-28, can be used to change the accounting method to the cash method.



REVENUE AND COST RECOGNITION FOR CONTRACTOR TAX METHODS

| METHOD | REVENUE RECOGNITION | COST RECOGNITION |
|--|--|---|
| Cash | As billings are received | As expenses are paid, except for depreciation and capitalization rules |
| Hybrid (Part Cash, Part Accrual Method) | Cash or accrual depending on the method elected | Could be cash or accrual: For example, the contractor could use the cash method for receipts and disbursements and accrual for inventory and payables related to inventory. |
| Accrual | Based on billing entitlement, or practically, such as on billings issued | Based on economic performance regulations of §461(h) |
| Accrual Excluding Retention | Based on billing entitlement or billings less retainages deferred under the contract Recognition of retainages, once entitled to receive | Based on economic performance regulations of §461(h) |
| Completed-Contract (CCM) | Billings or total contract price once contract is finished and accepted <i>See 1.460-4(d) for revenue recognition for disputed contracts.</i> | Costs are deferred as incurred. Specific costs are outlined in 1.460-5(d). Once completed, costs are closed out to expense. SG&A costs are expensed as incurred. <i>See 1.460-4(d) for expense recognition for disputed contracts.</i> |
| Exempt Percentage-of-Completion (EPCM) | Contract price (including change orders) multiplied by percent complete Percent complete determined by various alternative methods, such as: <ul style="list-style-type: none"> • Cost-to-cost • Labor hours to total labor hours • Various other permitted input and/or output measurements | Based on economic performance regulations of §461(h) Costs determined by 1.460-5(d). All costs are expensed as incurred. |
| IRC §460(b) Percentage-of-Completion Method (PCM) | Revenues determined by only the cost-to-cost formula | Based on economic performance regulations of §461(h) Costs determined by 1.460-5(b). All costs are expensed as incurred. |
| IRC §460(b)(3) Simplified Cost-to-Cost Method | Same formula as §460(b), except costs determined as outlined by §460(b)(4) or 1.460-5(c) | Based on economic performance regulations of §461(h) Job costs are direct material, direct labor and depreciation, amortization, and cost recovery on equipment directly used. All costs are expensed as incurred. |
| Reg. 1.460-4(e), §460(a) Percentage-of-Completion/ Capitalized-Cost Method (PCCM) | Use PCM formula as §460(b) with same type of costs for 70%, and use exempt contract method for the remaining 30%. | For 70%, same as the §460 PCM method, the balance of the contract is accounted for by the exempt-contract method. |
| IRC §460 10% Deferral Method | Same as §460(b) above, except that revenues and billings on all contracts with less than 10% complete, determined by the cost-to-cost formula, are deferred until greater than 10% complete. | Based on economic performance regulations of §461(h) All costs are expensed as incurred. All costs on contracts less the 10% complete are not expensed as incurred, but rather are deferred in an account similar to an inventory account. |

Note: Rev. Proc. 2002-28, which generally permits use of the cash method (as clarified by IRS Announcement 2002-45), also permits use of the cash method even when a specific method (long-term contract treatment or method) is retained. This introduces the possibility of a contractor using the cash-completed-contract method or the cash-POC method. Under these methods, the cash method is utilized for all completed contracts that were never uncompleted as of any filing year-end. The long-term method (CCM or PCM), based on an accrual underlying foundation, is utilized for any uncompleted contracts as of year-end.