

# TAX ISSUES FOR CONTRACTORS

Find out how proper planning of asset additions and tax accounting elections could significantly lower your taxable income.

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**N**AVIGATING THE COMPLEX TAX ACCOUNTING ISSUES for contractors can present many opportunities and also unwanted results without advanced planning and a thorough understanding of the options. The following are just a few of the items that mason contractors should be made aware.

## Recent Tax Changes for Depreciation

THE TAX ACT OF 2003 increased the maximum dollar amount that may be expensed under IRC 179 for property placed into service to \$100,000 for the years 2003, 2004 and 2005. After 2005, the deduction reverts back to \$25,000. Additionally, the maximum dollar limitation for property additions is increased to \$400,000 for the same period.

In addition to the increased asset expensing, the 2002 economic recovery legislation enacted bonus depreciation. These provisions accelerated depreciation deductions for 30% of the cost of the asset into the first year. In 2003, the bonus depreciation was increased to 50% for the same eligible property. Eligible property, whose use commences with the taxpayer, includes: A) property with a recovery period of 20 years or less; B) certain purchased computer software; C) certain water utility property; and D) qualified leasehold improvement property.

Residential and commercial real estate are effectively excluded from the bonus depreciation. However, leasehold improvements qualify for the bonus depreciation where the improvements are to the interior of the building, pursuant to a lease, and are for non-residential real property. Further, the improvements must be placed in service more than three years after the date the building itself was first placed in service. Accordingly, improvements made by a tenant who leases space in a newly constructed building would not qualify.

The new rules are illustrated as follows:

Taxpayer acquires a seven-year recovery period asset in 2003 at a cost of \$200,000. The taxpayer makes the election for IRC 179 expensing, and does not elect out of the bonus depreciation. The 2003 depreciation for the asset is as follows:

|   |                     |
|---|---------------------|
| <b>IRC 179 expensing</b>  | <b>\$ 100,000</b>   |
| <b>50% bonus depreciation</b><br><b>(\$200,000-\$100,000 X 50%)</b>   | <b>50,000</b>       |
| <b>Regular depreciation</b><br><b>(\$50,000 at 7yr. DDB, 1/2 yr.)</b> | <b><u>7,143</u></b> |
| <b>Total Depreciation</b>   | <b>\$ 157,143</b>   |

Procedurally, the taxpayer must elect asset expensing under IRC 179, whereas bonus depreciation is automatic, and no election is required. However, there may be instances where the taxpayer's circumstances dictate that

Significant **depreciation** deductions

are **available** this year.

the increased depreciation and asset expensing would be of greater value in future years rather than in the current year. In those instances, the taxpayer would simply not elect asset expensing under IRC 179, but would be required to *elect out* of the bonus depreciation. To elect out of the bonus depreciation, the taxpayer needs to attach a statement to the return, and must elect out of each class of asset based on recovery periods.

In situations where both new and used assets are acquired in the same year, the taxpayer can maximize the deductions if the election for expensing under IRC 179 is made for the used assets, and the bonus depreciation is taken for new assets. The computations of the bonus depreciation may not be consistent with the various state tax regulations.

#### IRC 460

IN 1986, Internal Revenue Code Section (IRC) 460 entered the scene and required the use of the percentage-of-completion method of accounting to be used for selected long-term construction and manufacturing contracts. The impact of these

rules was to accelerate income for a substantial number of contractors and manufacturers. The ability to manage cash flow by deferral of taxable income was significantly reduced, if not eliminated, for many taxpayers. The percentage-of-completion method requires the ratable recognition of income as the contract progresses, measured by costs incurred, without regard to actual contract completion or cash collections.

The ability to manage the impact of the income acceleration by utilizing elections and applying allowable deferral techniques is still available under the rules. The starting point is to understand that IRC 460 does not change the taxpayer's "normal" tax accounting method, but simply requires that the percentage-of-completion method be used for all long-term contracts that are not exempt under the rules.

The following represent exempt contracts:

- Home construction contracts.
- Long-term construction contracts, which are estimated to be completed within two years of commencement *and* the taxpayer's average gross receipts for the preceding three tax years does not exceed \$10 million.

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For exempt contracts, the following tax accounting methods are generally available:

- Cash receipts and disbursements
- Completed contract
- Accrual – two options
- Percentage-of-completion

Additionally, as IRC 460 defines a long-term contract as one that is not completed within the tax year that the con-

As a planning **technique**, the taxpayer should **consider**

changing their method of **accounting** to **percentage-of-completion** for the year prior to the year

IRC 460 is **expected** to apply.

tract commences, any contract that is completed within the same tax year is not subject to the rules requiring the use of the percentage-of completion method regardless of the taxpayers gross receipts. Special rules apply for manufacturing contracts.

### Cash Method vs. Completed Contract Method

Taxpayers other than “C” corporations – “S” corporations, LLCs, partnerships and proprietorships – whose average gross receipts are under the \$10 million threshold, should consider the cash basis for exempt contracts to allow a deferral of income recognition until receivables are collected. This could be a significant deferral for specialty contractors that have retainage receivable balances outstanding for extended periods. “C” corporations can use the cash method in those instances where average gross receipts are less than \$5 million.

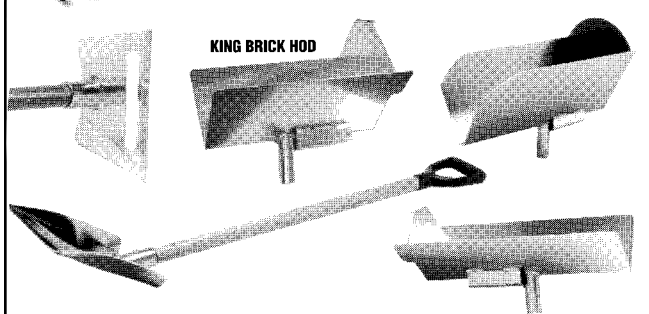
Contractors with numerous short-term contracts, including home construction contracts, will benefit by deferral under the cash method as opposed to the completed-contract method, which requires the recognition of contract income when the contract is completed, regardless of whether or not the receivables are collected.

Although the completed contract method allows deferral of all contract income until completion, completion usually occurs before the collection of remaining receivables and retainage, which in many instances will extend into the next tax year. Additionally, the method could cause “bunching” of taxable income in a marginally profitable year when the deferral reverses, resulting in higher tax rates and unusual strain on cash flow. Also, the completed contract method will not result in deferral for short-term contracts completed within the same tax year that they were started.

As previously indicated, IRC 460 does not trigger a change in accounting. As a result, when IRC 460 applies (i.e., taxpayer has exceeded the \$10 million threshold), the taxpayer will be required to use the percentage-of-completion method for all non-exempt long-term contracts started in that year, without the benefit of any “spread” for the additional income resulting from the new method, which would normally be allowed for accounting changes. Accordingly, the accelerated income resulting from the use of the percentage-of-completion method will be in addition to prior year contracts being recognized under the taxpayer’s normal tax accounting method (cash, completed-contract, etc.).

As a planning technique, the taxpayer should consider changing their method of accounting to percentage-of-com-

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pletion for the year prior to the year IRC 460 is expected to apply. This would allow a "spread" of the impact of the change over a four-year period as opposed to the bunching of income in one year. This approach should be considered in those circumstances where the taxpayer estimates that gross receipts will stay above the \$10 million threshold indefinitely.

### Special Elections

WHEN IRC 460 APPLIES, the computation of the percentage-of-completion method uses a fraction of the numerator, which is all costs incurred to date for the contract over the denominator, which is the total estimated costs that will be incurred for the contract. The rules require all costs associated with the contract, including overhead allocated and other related support costs, be included in the computation. The computation effectively recognizes revenues for costs incurred regardless of the actual "production" (physical completion) of the contract.

To mitigate this impact, the rules provide for two elections related to the computation of the percentage-of-completion, only one of which can be elected for each taxpayer: A) the "10%" election, which allows for no recognition of income for a contract until the percentage-of-completion reaches 10%; or B) the "simplified" cost-to-cost method, which excludes overhead and non-productive costs from the computation.

The 10% election allows start-up and mobilization to occur without income recognition. The simplified method allows the computation of the percentage-of-completion to be made using only direct materials, direct labor (including sub-contract costs) and depreciation. The simplified method excludes all allocated overhead and other non-productive costs from the computation. For most taxpayers, this method provides the better option, as including non-productive costs in the computation will accelerate income in most cases. For general contractors, the computation will be principally determined by sub-contract billings (those actually performing the work). For most specialty contractors, labor indicates production, and along with material costs, those two cost components more closely parallel contract progress. Use of the simplified method will help to avoid income recognition prior to contract production and progress billings. 

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