Taxes 5% Exam

IRC Section 460: The term “long-term contract” means 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.

Activities of construction industry segments:

a) General and Prime contractors
b) Subcontractors
c) Home builders and residential construction
d) Developers
e) Construction Managers
f) Manufacturers
g) Shipbuilders

Construction Industry Methods of Accounting

Versions of Percentage-of-Completion:

- Percentage of Completion-Capitalized Cost (PCCM)
- Exempt-Percentage of Completion (EPCM)
- Percentage of Completion 10-percent Method
- Simplified Cost-to-Cost Method
- Look-back Method

3 Other Common Methods:

- Cash
- Accrual
- Completed Contract Method

Completed Contract Method

- Qualifying contractors to defer the recognition of revenue earned on a contract until the year the contract is completed
- 2 Exceptions to using percentage of completion method
  - Small contractor exception
  - Home construction contract
- Percentage-of-completion method must be used for AMT calculations by small contractors using the CCM
- Contract is considered complete at the earlier of:
  - 95% of contract costs incurred
  - Final completion and acceptance of the property

Small Construction Contractor Exception

a) Construction contracts entered into by a taxpayer who estimates, when entering into the contract, that the job will be completed within two years of the contract commencement date
b) Company's average annual gross receipts for the three tax years preceding the tax year in which the contract is entered into do not exceed the limit under IRC Sec. 448(c)
   - $26 million for tax years beginning in 2020
   - Aggregation of related parties
   - Annual test so contractors may move in and out of small contractor status

Homebuilders and Residential Construction

- IRC Section 460(e)
- "Home construction contract"
  a) Any construction contract if 80% of the estimated total contract costs are reasonable expected to be attributable to activities with respect to:
     - Dwelling units contained in buildings containing four or fewer units
     - Improvements to real property directly related to such dwelling units and located on the site of such dwelling units
- "Residential construction contract"
  a) A contract that would qualify as home construction contract if it were not for the limitation on the number of units requirement (4)
- For purposes of testing home vs. residential contract, a townhouse or rowhouse is considered to be a separate building

Percentage of Completion Method

- The costs used to calculate the completion factor can be derived from the cost-to-cost method or the simplified cost-to-cost method.
- Under the cost-to-cost method, all direct and indirect costs that directly benefit a contract are compared with the direct and indirect estimated costs for that contract to calculate the completion factor.
- Look-back method compensates for timing differences resulting from the use of inaccurate estimates of contract costs and price.
- Direct costs include direct materials, direct labor, and subcontract expenses.
- Many indirect costs must be considered and some additional costs, such as construction period interest, must be allocated to contracts.

Exempt Contract Percentage-of-completion Method

- Contractors exempt under the small contractor exemption can elect to use EPCM
- Under the EPCM, the percentage of completion can be determined at the end of the tax year by using any method of cost comparison
- When calculating the percentage of completion under the EPCM by comparing the work performed to estimated total work, the criteria used must clearly reflect the earning of income under that contract.
- The taxpayer makes the election by using the EPCM for all long-term contracts entered into during the year on the taxpayer's original tax return for the election year.

Electing to Use the 10% Method

- Under IRC Sec. 460(b)(5), contractors using the PCM can elect to defer the recognition of gross profit under a long-term contract if, as of the end of the tax year, less than 10% of the total estimated contract costs has been incurred.
- For contracts that qualify, the gross profit can be deferred until the 10% threshold has been met.
- Once made, the election applies to all contracts and can be revoked only with permission from the IRS.
- A separate statement is not required to be attached to the tax return to make this election. The taxpayer makes the election by using the 10% method for all long-term contracts entered into during the year on the taxpayer's original tax return for the election year.

Look-back Method

- Requires contractors to re-determine profit or loss on a long-term contract at completion and compare it to what was previously reported
- Interest is computed on the tax differences and contractor is required to pay or entitled to receive
- Required for any percentage of completion method contracts
- This is not a “method” of accounting but a hypothetical determination of tax using the actual number, rather than the estimates used throughout the contract
- CCM will require AMT look-back calculation
- Reported on Form 8697 at the corporate or individual return

Look-back Method - Exceptions

1) De Minimis Exception
   a) Contracts completed within 2 years <u>and</u>
   b) Gross contract price lesser of $1 million or 1% taxpayer's annual gross receipts for the previous 3 years
   c) Mandatory exception – cannot include even if to contractor's benefit
2) Election to exclude contracts which cumulative taxable income for not vary by more than 10% for each tax year of the contract
   a) Election made with tax return for first year election is to apply and will apply to all subsequent years

Look-back Method - SMIM

- Simplified Marginal Impact Method used by passthrough entities which are not closely held and may be elected by other taxpayers.
- Closely held partnership is 50% or more of entity is owned directly or indirectly by 5 or fewer persons
- Simplification comes into play by applying the highest income tax rates under the regular and AMT regimes to the difference calculated under the same hypothetical re-calculations
- Overpayment ceiling equal to the total federal income tax liability for a tax year will apply (cannot create a net operating loss for a period)
- Election is made with the tax return for the first year the method will be applied and applies to all subsequent tax years

Look-back Interest Treatment

- Look-back interest is income tax for purposes of penalties and interest
- Interest received is considered taxable income
- Interest paid is treated as interest expense
  a) Corporations can deduct on return
  b) For individuals, including passthrough entities using SMIM, interest is considered personal interest expense – no deduction

Other tax considerations:

- Cost allocations and 263A
- Non-long-term contract activities
- Travel and per diems
- Severing and aggregating contracts
- Alternative Minimum Tax (AMT)
- Mid-contract change in taxpayer

Depreciation Considerations

- MACRS – Modified Accelerated Cost Recovery System
- Nonresidential real property 39 year life (straight line)
- Residential rental property 27.5 year life (straight line)
- Land improvements 15 year life (150% declining balance)
- Tangible personal property used in a trade or business 5 or 7 year life (200% declining balance)
- Additional first year depreciation (Bonus depreciation)
- Section 179 election
  - Earned income requirement
  - Taxable income requirement at business level
  - Placed in service qualifying property limitation
  - Maximum deduction limitation

Other Tax Strategies and Provisions

- Cost Segregation Studies
- Sec. 179D Energy Efficient Commercial Buildings Tax Deduction
- Tangible Property Regulations