Construction Executive

Tools to Help Contractors Defer Income Tax

By Don Singleton,Kenneth Padgitt | Tuesday, February 13, 2018

Last week, we covered tax techniques that create sought-after taxable temporary differences—taxable temporary differences and a DTL—for financial reporting related to construction contracts.

This week, we'll cover the several tools available to construction contractors to defer income tax liabilities. Often, these tools are not being used effectively—or even being taken advantage of at all. The tax code and regulations can be hard to understand.

Tools for Income Tax Deferral

For financial reporting, with few exceptions, contractors account for their long-term construction contracts using the percentage of completion method ("POC)" under Accounting Standards Codification 605-35. For tax reporting, as described below, larger contractors are required to use tax POC for their long-term contracts, unless the contract qualifies as exempt from POC reporting. There are significant differences between financial POC and tax POC (and the related exemptions) that can result in large tax deferrals.

Construction contractors have several powerful tools available to defer income tax liabilities. These tax deferring mechanisms are written into the code and regulations, but are not easy to decipher and perhaps harder to apply in practice. However, those who understand and take advantage of these deferral opportunities can push a substantial amount of income tax to future tax years. A clue to determining whether a contractor is taking advantage of these tools is found in the size and composition of the deferred tax liability on the balance sheet and its footnote disclosure in the financial statements. If the only item generating a DTL is the difference between financial and tax depreciation, it's likely that significant income deferral has been overlooked. In short, this means the contractor is paying too much too soon. Its current tax liability is too high, the tax being deferred to the future is too low, and its current cash position is smaller than it should be.

Here are some of the permitted deferral techniques that are often overlooked or misapplied.

Method of accounting

The accounting method elected can result in significant tax deferral. In the alternative, if the wrong method is selected, it could result in paying too much too soon. Contractors generally elect more than one method of accounting. For example, the contractor may have an overall method, such as the accrual

method, and different methods for accounting for non-exempt and exempt construction contracts. Therefore, the selection of the right method is fundamentally important and complicated. Here are some of the choices:

Percentage of completion method

This method applies to all long-term contracts not exempt from IRC Section 460. A contract is considered long-term if the contract's term spans over more than one tax year. Generally, tax POC is required to be used by "large contractors", which is defined as contractors with average annual gross receipts over $10 million for the past three years. (The Tax Cuts and Jobs Act, signed into law on December 22, 2017, made significant changes to the exemption from the tax POC method.)

It also recognizes revenue on the percentage of completion, determined by the total cost to date (numerator) divided by total estimated cost (denominator). This is referred to as the cost-to-cost method of determining the percentage of completion. One of the significant differences between financial POC and tax POC is the capitalization of indirect costs. Under tax POC, costs are to be allocated to contracts in a manner similar to IRC Section 263A (for inventory produced). This allocation will include certain expenses that are generally classified as general and administrative expenses and not allocated to contract costs for financial reporting. For indirect costs required to be allocated to contracts, the IRS permits allocation to both the POC numerator and the denominator. This may result in a taxable temporary difference (i.e. a DTL – which is a good result).

Cash method

This method can be an overall method of accounting for all revenue and expenses. Eligible taxpayers include:

- C-Corporations with average annual gross receipts over the past three years less than $5,000,000 (IRC Sec. 448); and
- Qualifying taxpayers with average annual gross receipts over the past three years of $10,000,000 or less. (The Tax Cuts and Jobs Act, signed into law on December 22, 2017, made significant changes to the threshold requirements.).

Under this method, revenue is recognized when cash is received and expenses are deducted when paid. This method will generally produce a taxable temporary difference (i.e. a DTL).

Accrual method

This method can be an overall method of accounting for all revenue and expenses including any exempt construction contracts. It is generally the worst method for contractors because billings in excess of cost and estimated earnings on uncompleted contracts (such as overbillings) will become taxable much too soon. Using this method, revenue is recognized the earlier of when earned or received. Expenses are deducted when the all-events test has occurred but not before economic performance has occurred. It

can exclude retainages receivable from income until final acceptance of work performed (Rev. Rule 69-314 (Page 64). Must also exclude any retainages payable from expenses. Generally, this method will result in a deductible temporary difference (DTA) – which is not the result you want. This can be viewed, in a manner of speaking, as an unnecessary prepayment of income taxes.

Completed contract method

This is generally the best method for qualifying contractors because it results in the greatest deferral of income. Revenue and costs incurred on a contract are not recognized until the contract is complete and accepted. Regulations require completion when 95 percent complete and owner occupies the real property. Use of this method is limited to certain contracts performed by "small contractors". This method is also available for contractors which are exempt from IRC 460. If permitted, use of this method will produce a DTL (which is what you want).

Exempt contract percentage of completion method

This method may be elected by contractors whose contracts are exempt from POC under Code section 460 (using the cost-to-cost method). This method is similar to the percentage of completion method described in "a" above, except the cost-to-cost method is not used to determine the percentage of contract completion. Instead, percentage of contract completion can be determined by any other method of cost comparison, such as:

- Direct labor costs to estimated total labor costs;
- Work performed method such as units of production; and
- Any method of cost comparison or work performed comparison that clearly reflects income.

Exempt Construction Contracts

Contracts that are exempt from POC under IRC Section 460 give the contractor an opportunity to defer income taxes by using a more favorable accounting method. The list below describes some exemptions from tax POC accounting that may result in substantial tax deferrals, assuming that a suitable election has been made for the exempt contract method of accounting:

Ten percent method

This is an election made to exclude from taxation any contract that is less than 10 percent complete.

Contracts performed by small contractors

To be exempt from POC under IRC Section 460 for contracts performed by small contractors, the average annual gross receipts for the prior three tax years must not exceed $10 million. It is estimated that upon commencement date, the contract will be completed in two years. It's important to note that effective Jan. 1, 2018, the definition of a small contractor has changed under the Tax Cuts and Jobs Act.

Percentage of completion/capitalized cost method

This exemption applies to residential construction contracts with more than four dwelling units. Under this exemption, 70 percent is accounted for under the tax POC, and 30 percent of the contract is exempt from POC and is accounted for under the company's normal method, as elected. A residential construction contract is a residential structure with more than four dwelling units and the average stay is more than 30 days (this would include such structures as apartments, barracks, dorms, assisted living facilities and prisons).

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