Updated planning opportunities for percentage-of-completion methods for construction

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The information provided herein is educational in nature and is based on authorities that are subject to change. You should contact your tax adviser regarding application of the information provided to your specific facts and circumstances.

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Agenda

- Welcome
- Definition of a Long-Term Contract
- What is the PCM (“Percentage-of-Completion”) Method?
- What costs can and cannot be included for tax?
- Various Methods Available
- Questions

Long-Term Contract Defined

- A long-term contract is any contract for either:
  - “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.” Section 460(e)(3).

    or,
  - The manufacturing of property if the contract isn’t completed in the tax year that the contract is entered into, and it satisfies either the unique-item or 12-month requirements. Reg. §1.460-1(b)(1).

- A contract for the manufacture of personal property is a manufacturing contract. In contrast, a contract for the building, installation, or construction of real property is a construction contract. Reg. §1.460-1(b)(1).

Required Usage of Percentage of Completion

Section 460(a) – Requirement that percentage of completion method be used.

- In the case of any long-term contract, the taxable income from such contract shall be determined under the percentage of completion method (as modified by subsection (b)).

What is the Percentage of Completion Method (PCM)?

- Generally, taxpayers must determine taxable income from long-term contracts using the percentage of completion method (PCM). IRC §460.

- Under the PCM, a percentage of completion is determined by comparing costs allocated to the contract and incurred before the close of the taxable year to total contract costs. §460(b)(1).

- Under this method, the taxpayer is generally required to include in income the portion of the total contract price that corresponds to the percentage of the entire contract that the taxpayer had completed during the year.

Percentage of Completion Method (PCM)

- When a contract is reported under the PCM, a net loss on the contract should be recognized as the contract is completed. This is true even though the actual costs incurred exceed the contract price and for GAAP purposes the loss will be recognized up front.

- The computation for determining the amount of income included in a tax year from a contract is as follows:

    1. Compute the contract's completion factor, which is the ratio of the <u>cumulative allocable contract costs</u> incurred by the taxpayer through the end of the tax year to the <u>estimated allocable contract costs</u> that the taxpayer reasonably expects to incur under the contract.

Percentage of Completion Method (PCM)

2. Compute the amount of cumulative gross receipts from the contract by multiplying the completion factor by the total contract price.

3. Compute the amount of current-year gross receipts, which is the difference between the amount of cumulative gross receipts for the immediately preceding tax year (the difference can be a positive or negative number).

4. Take both the current-year gross receipts and the allocable contract costs incurred during the current year into account in computing taxable income. Reg.§1.460-4(b)(2).

Construction Revenue Recognition Alternatives

- Percentage of Completion: Cost tax planning – other non-deductibles
- Percentage of Completion: Retainage payables and Pay-if-Paid
- Percentage of Completion: Capitalized cost method – residential
- Completed Contract: Home contracts
- 10% method
- Accrual Method of Accounting: Construction management (CM) or Service Contracts

Section 460 Application

- Deferring deductibility of job costs defers revenue!
- Contract costs are not deductible unless and until allowed by law!
- No cost shall be expensed before its time!

When Is Cost Incurred?

- Test to determine whether liability has been incurred (Section 461(h), Reg. §1.461-1(a)(2)):

    1. Have all events occurred that establish the fact of the liability?
    2. Can the amount of the liability be determined with reasonable accuracy?
    3. Has economic performance occurred with respect to the liability?

When Is Cost Incurred? (cont.)

- Reg. § 1.461-4(d)(6)(iii) provides that economic performance for property is deemed to occur when the property has been delivered or accepted, or when title of the property passes but no later than when the property is paid for.
- This is a method of accounting that must be elected with the first tax return having such items.
- The IRS is now allowing a requested change of this method of accounting.

Other Job Costs to Consider

- **Retainages Payable**
- **Subcontractor Payable with Pay-if-paid clause**
- Vacation accruals
- Deferred compensation accruals
- Contract warranty (rework) reserves
- Per diem meal exclusions: 40% of total full cost per diem – 20% is M-1
- Self-insured burden rates allocated to contracts
- M-1s such as entertainment, penalties, etc.
- Overallocated indirects – profit
- **CARES Act**
  - **Disallowed Expenses Paid with PPP Loan Funds**
  - **Employer Payroll Tax Deferral**

Other Job Costs to Consider (Good)

Retainage Payable

Allows the contractor to withhold contract payments from subcontractors until full acceptance and completion of the subcontractors' work by the owner or maybe even until the project is complete.

Other Job Costs to Consider (Better)

Pay-if-Paid

What if you could exclude from costs any accounts payable with subcontractors?

Example: Contractor receives an invoice from a subcontractor at year-end that is subject to the pay-if-paid clause. The owner does not pay the contractor before the end of the year. The expense is not allowed because we don't meet the all events test and your percentage of completion is slowed down!

Note: We advise that all clients have written documentation from legal counsel to determine if your standard contract is Paid-if-Paid or Paid-when-Paid.

Other Job Costs to Consider
(IRS gave us lemons let’s make some lemonade)

Disallowed Expenses used from PPP Loan Proceeds

Recent IRS Guidance provides that if it is reasonable expected that the PPP Loan will be forgiven, then the expenses related to these funds are disallowed.

Employer Payroll Tax Deferral

Is there an opportunity for contractors?

Percentage of Completion/Capitalized Cost Method (PCCM)

- Also referred to as the 70/30 Method or the Residential Job Method
- Taxpayers are "permitted" to account for long-term contracts that are **residential** construction contracts using PCCM.
- Under PCCM, the taxpayer must determine the income from a long-term contract using PCM for 70% of the contract, and its exempt contract method (cash, accrual, CCM, EPCM, etc.) for 30% of the contract. §460(e)(5), Reg. §1.460-4(e).
- Under PCCM, <u>a residential construction contract is a home construction contract</u>, except that the building or buildings being constructed contain more than four dwelling units. §460(e)(5)(B), Reg. §1.460-3(c).

Exempt Long-Term Contract Defined

Section 460(e) states that subsections (a), (b), and (c) (1) and (2) do not apply to:

1. Any **home** construction contract, or
2. Any other construction contract entered into by a taxpayer:

   i. Who estimates (at the time such 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**
   ii. Whose average annual gross receipts for the three taxable years preceding the taxable year in which such contract is entered into do not exceed $25,000,000.

Exempt Method from POC: Home Construction Contract

A home contract is any construction contract if 80% or more of the estimated total contract costs are **reasonably expected to be attributable** to construction activities with respect to:

1. Dwelling units contained in buildings containing four or fewer dwelling units, and
2. Improvements to real property **directly related** to such dwelling units and **located on the site** of such dwelling units

Dwelling units defined:

- A house or apartment used to provide living accommodations in a building or structure, but not including a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis (§168(e)(2)(A)(ii)(1)).

Exempt Method from POC: Home Construction Contract (cont.)

- "Transient": How is it defined?

  A dwelling unit was used on a transient basis if, for more than one-half of the days in which the unit was occupied on a rental basis during the taxpayer's taxable year, it was occupied by a tenant, sub-tenant, or series of tenants or sub-tenants each of whom occupied the unit for less than 30 days.

  The units must be used on a non-transient basis. Hotels, motels, fraternity and sorority houses, rooming houses, hospitals, nursing homes, sanitariums, rest homes, and trailer parks generally do not qualify.

Subcontractors

- The taxpayers to whom the home construction contract exemption is available include subcontractors working for a general contractor (Section 460(e)(5)(A)(ii)). This includes:

  - Pavers
  - HVAC
  - Etc.

Completed Contract Method (CCM)

- A taxpayer using the CCM to account for a long-term contract must take into account in the contract's completion year, as defined in §1.460-1(b)(6), the gross contract price and all allocable contract costs incurred by the completion year.
- Interest expense is still required to be allocated and capitalized to the CCM contracts. Section 460(e)(1). Such costs are not exempt from §460.
- Election on interest tracing: consider election not to trace –
  - Section 1.263-9(d).
- Workman’s compensation insurance is not required to be capitalized. Reg. Section 1.460-5(d)(2)(ii)(J).

When is a CCM Contract Complete?

- A contract is complete upon the earlier of :
  a) use of the subject matter of the contract by the customer for its intended purpose (other than for testing) **and** at least 95% of the total allocable contract costs attributable to the subject matter of the contract have been incurred by the taxpayer, **or**
  b) final completion and acceptance of the subject matter of the contract.

- Change orders will hold a job open.

- Unpaid retentions will <u>not</u> hold a job open.

What is the 10% Election Method

- The taxpayer is permitted to make an election under which the taxpayer doesn’t recognize income from and doesn’t take deductions from a long-term contract for any tax year, if at the end of the tax year less than 10% of the estimated total contract costs have been incurred. §460(b)(5).
- In the first tax year that the 10% threshold is met, the taxpayer takes into account all income and can deduct all costs from prior years under PCM.

10% Election Method (cont.)

- A taxpayer may make the election to use the 10% method for all long-term contracts **entered into during the tax year** of the election on the taxpayer's original tax return for the election year. Reg. §1.460-4(b)(6).
- This election can be made up to the filing date of the tax return.
- For look-back purposes, such costs are treated as being incurred at the same time as the 10% election.

Construction Management Services

- A construction management (CM) contractor is a party that enters into an agency contract with the owner of a construction project to supervise and coordinate the project.
- Like architect services, CM activities do not require the taxpayer to actually construct or build anything.
- Therefore, income from CM contracts will not be required or allowed to be taken into account under Section 460 or a construction method of accounting. The taxpayer must use the accrual method of accounting. Underbillings are not taxable, but overbillings are taxable (however, there are usually none).
- The CM may not guarantee the project maximum cost. If such a guarantee is made, income from the CM job must be taken into account under §460 due to the acceptance of construction risks.

Joint Venture – Accounting Method

- Accounting methods specific to contractors must be elected in the first year of a joint venture!

Product Demonstration – Let’s see the Math

Submit your questions through the Q&A

Thank you

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