

Taking Another Look at Look- Back



WHY IT'S TIME FOR CHANGES IN THE CURRENT LAW

BY TOM WALENCHOK

Most contractors, as well as their tax advisors, are all too familiar with the burdensome and complex rules relating to the computation of look-back interest. The burden also extends to the Internal Revenue Service (IRS), which must provide training and sufficient resources in order to properly enforce the requirements. Based on their complexity and relevance, these rules should be either drastically altered or abandoned altogether.

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THE ORIGIN

The look-back rules are courtesy of the Tax Reform Act of 1986, which initially was developed to target perceived tax abuses in the major defense and aerospace industries. Rather than addressing those specific issues, the government cast a wide net capturing many construction contractors.

The 1986 act requires the use of the percentage-of-completion method (PCM) for long-term contracts. Contractors, with few exceptions, must compute taxable income based on the percentage of costs incurred compared to the total estimated



costs of the project. The resulting percentage—when multiplied by the total contract value—determines the amount of revenue to be recognized.

The PCM, however, is not an exact science. Rarely will costs be incurred exactly as estimated throughout the project. In situations when total contract costs are underestimated, a contractor will report contract revenue greater than what was actually earned during the period. The reverse is also true. In addition, contract values typically will be adjusted during the course of a project, which may lead to over- or under-recognition of revenue.

When revenue is either over- or under-recognized, taxes will be over- or under-reported for the period. The look-back rules attempt to compensate a contractor for the time value of money on projects when taxable income is over-reported while also compensating the government for the time value of money when taxable income is under-reported.

It is important to note that the total income, throughout the life of the contract, does not change, and amended tax returns are not required to be filed. This is an interest computation based on the difference between taxable income as originally reported using estimates and a computation of the amount of taxable income that would have been reported if it were possible to use actual figures at that time.

See the chart (p. 49) for an example of a contractor that is required to use the PCM and has completed only one contract, which was open for a three-year period.

There is no difference in the total amount of income. Because the income was under-reported in years one and three, the contractor would owe the government interest for those years. Because the income was over-reported in year two, the government would owe the contractor interest for that year. The net of these is required to be reported in the year the contract is completed.

In theory, this seems like a good idea. The taxpayer is entitled to interest on the tax that was overpaid, and the government is entitled to interest on any tax that was underpaid. In practice, it's not as simple. Many factors come into play, which make this look-back computation onerous and time consuming.

APPLICABILITY

Internal Revenue Code Section 460(f) defines a long-term contract as:

“any contract for the manufacture, building, installation or construction of

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	Total Income from the Contract		
	As Reported	As Re-computed for	
		Look-back	Over/Under-reported
Year 1	\$100,000	\$120,000	\$(20,000)
Year 2	150,000	120,000	30,000
Year 3	70,000	80,000	(10,000)
Total Income	\$320,000	\$320,000	\$0

property if such contract is not completed within the taxable year in which such contract is entered into.”

If a contractor's year-end is Dec. 31, any contract entered into during the year that was not completed by Dec. 31 is considered a long-term contract and the PCM and look-back applies. A few exceptions to the general rule exist. The PCM is not required for:

- home construction contracts; or
- any contract expected to be completed within two years by a taxpayer whose average annual gross receipts for the three preceding tax years do not exceed \$10 million. The look-back method may be required for alternative minimum taxable income in these situations.

A de minimus exception also provides that a contract will not be subject to look-back if the contract is completed within two years of the commencement date, and if the gross contract price does not exceed the lesser of \$1 million or 1 percent of the average annual gross receipts of the taxpayer for the previous three years. In addition, the government took some steps to attempt to reduce the burden on contractors with the Taxpayer Relief Act of 1997, which allows taxpayers to elect not to apply the look-back rules to contracts in which the cumulative taxable income reported is within 10 percent of the cumulative taxable income that would have been reported under look-back. Although the attempt was intended to provide some relief, the provision adds an additional calculation that may, in the end, increase the time needed for compliance.

THE INTEREST CALCULATION

Determining which contracts fall under the look-back requirements is the easy part. Next, the interest must be calculated using the following three steps:

Step 1: For each contract that closed during the year, the percentage-of-completion

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calculation must be revised to substitute the actual contract value and actual total costs for the estimated amounts originally used. This process must be performed for each year the contracts were open.

Step 2: The tax liability must be recalculated based on the new income amounts arrived at while performing Step 1.

Step 3: Interest must be computed based on the hypothetical over- or under-payment of tax arrived at in Step 2.

THE PROBLEMS

In theory, look-back may have some merit; however, many common issues make compliance with the rules difficult. For example:

- Complying with Step 1 is a simple process if a contractor completes one or two contracts a year and the duration of those contracts spans only a few years. However, when a contractor completes a significant number of contracts in a given year, determining which contracts are subject to look-back requirements and recomputing the percentage-of-completion calculations becomes difficult to manage.
- The calculation must be performed for every year in which the contracts subject to look-back were open. It's not uncommon for contracts to span more than one

year. Changes in tax law and tax forms add to the difficulty of complying with this requirement.

- The effect on alternative minimum tax also must be considered. The recalculation of the percentage-of-completion amount may force a taxpayer into, or take a taxpayer out of, an alternative minimum taxable situation. In years when the taxpayer utilizes an alternative minimum tax, net operating loss or tax credit, the calculation becomes even more tedious.
- The recomputation of the tax liability is a cumulative calculation. It must be compared to the tax liability computed as of the last application of the look-back method. This becomes a recordkeeping nightmare.
- If the taxpayer carried back a net operating loss in a previous year and Step 1 changes the loss available for carryback, the tax effect on the year that the loss was carried back to also must be recomputed.
- The owners of closely held pass-thru entities (S-Corporation, Partnerships and Trusts) must apply the look-back method at the individual level. This creates additional reporting requirements for each owner.

Additionally, several parties monitor the accuracy of a typical construction contractor's estimates. Surety companies and banks regularly compare the contractor's bids and percentage-of-completion schedules to how the contracts actually closed. Significant differences are scrutinized to determine the cause of any adjustments.

This adds pressure to report earnings as accurately as possible and mitigates the need for the look-back rules because the hypothetical differences are typically immaterial and the IRS has other enforcement mechanisms to deal with egregious underreporting.

When tax law becomes so complicated and time consuming the average taxpayer finds it particularly onerous, it is time for a "re-look." The look-back rules are unrealistic and present an undue burden on the taxpayer without return for the IRS. Congress should examine these rules and challenge their requirements or consider repealing these laws.

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