Looking Back Might Get You Cash

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Recently, I asked a contractor and a prospective client if he had done a look-back on his completed contracts this year to see how they may affect his taxes. He laughed, and told me that he considered looking back as seeing how far back he could move some machinery without hitting anything.

He is not alone. In fact, the IRS estimates that 71% of taxpayers that are required to do look-back calculations don't do it. Further, of the approximately 29% of those that actually perform look-back calculations and actually file the requisite form; the IRS estimates that 84% have errors in them. This means that of those required to perform look-back, less than 5% of taxpayers are filing the required forms and have the correct results in them. With the high incidence of errors and non-compliance with look-back, the IRS is stepping up its enforcement of this requirement.

All taxpayers with long-term contracts can expect their look-back calculations to be scrutinized by the IRS. The audit guide for tax examiners dedicates almost 20 pages to this topic alone. With increased emphasis on this little-known and drastically underreported and error-prone area, many small to mid-sized contractors can be overwhelmed by the considerable amount of record-keeping and reporting requirements that this methodology requires.

Who has to calculate look-back?
Generally, look-back must be done by all taxpayers that are required to report their income from long-term contracts under the percentage-of-completion method (PCM) for regular or alternative minimum tax (AMT) purposes. Under the Internal Revenue Code, the IRS considers a long-term contract to be any contract that spans two tax years. Under this rule, it is possible for a two month contract to be considered a long-term contract. Therefore, it is reasonable to conclude that the majority of those who have long-term contracts, irrespective of size, will have to at least consider the potential impact of these requirements

How is look-back calculated and reported?
The starting point for all taxpayers using PCM is the reporting of taxable income or loss based on estimated costs and contract prices for each year that the contracts are in progress. In the tax year a contract is completed, the taxpayer is able to make a determination of the actual contract costs and price. The taxpayer then "looks back" at each of the preceding years and compares the estimated amounts reported with the actual results. They then calculate the difference in tax owed based on the estimated and the hypothetical amount of tax that would have been owed based on actual results. If the look-back method shows an underpayment of taxes, the taxpayer owes interest on that amount. If the opposite is true, and the taxpayer overpaid, they are entitled to receive interest on the amount of overpayment.

The application of the look-back method does not mean that a taxpayer must amend their prior year returns. This does not increase or decrease the amount of contract income earned over the life of the contract. It is simply a hypothetical comparison showing what would have been reported and paid if the ending contract costs and price were known during the years in which estimates were used.

If this comparison shows underpayments, form 8697 must be attached to your current year tax return. The interest owed is considered another tax and is part of the current year tax liability. This is an important point to consider with underpayments; it is deemed a failure to file, with the additional penalties and interest associated with it, to not file the form 8697 when an underpayment exists. On the other hand, overpayments, resulting in interest due to the taxpayer are also filed on the form 8697. It is filed separately with the IRS by the date you are required to file your income tax return (including extensions). This interest received is considered to be interest income in the year in which the taxpayer receives it, and must be reported as such.

How much do I owe? How much can I get?
Interest on overpayments or underpayments are calculated from the original due date of the return, disregarding extensions. The term runs through to the filing date of the current year return. Interest is compounded daily, using rates published by the IRS.

Are there any exceptions?
The exceptions that are noted below are generally applied to each contract individually. It is important to maintain good records that show that you considered the look-back provisions for each contract and how they qualify for any of the following exceptions.

The look-back method applies only to long-term contracts that straddle two or more tax years, as noted above. It does not apply, however to contracts that are exempt from PCM, such as qualifying home construction contracts and contracts expected to be completed within two years by a “small contractor”. For the purposes of look-back, a small contractor is one whose average annual gross receipts for the three tax years preceding the contract year are $10 million or less.

There is also a “de minimis small contract exception” which exempts a taxpayer from look-back if the contract is completed within two years and has a gross contract price that does not exceed the lesser of $1 million or 1% of the contractor’s average gross receipts for the three tax years preceding the current year. For example, if the average gross receipts for the three previous years were $55 million, the contract must be for less than $550,000 and have taken less than two years to complete to qualify for this exemption.

Finally, the contractor can elect not to apply the look-back method if, for each contract year, the amount reported for that contract is within 10% of the cumulative taxable income or loss when doing a look-back using the actual contract price and costs. This election is automatic, meaning that it will be automatically approved when applied for, and will apply for all of the tax years going forward to those contracts for which these circumstances apply. Electing out of it, however, is considered to be a change of accounting method and requires approval of the Tax Commissioner to make the change. This is important to consider, as some elect to do this to avoid having to pay interest on prior year underpayments. In future years, however, it will block these same taxpayers that have overpaid on contracts that fall in this set of circumstances from collecting interest that would normally be due to them.

What can I do?

The single easiest thing that can be controlled by taxpayers is to have good, accurate estimates of what a contract will cost and set the price of the contract with a clear relationship to the cost. Any good estimate will take into account both the direct and indirect costs of completing a contract. This is not an easy task in the current environment of fluctuating prices and extremely aggressive bidding for contracts. An excellent tool for analyzing the accuracy of job estimates is a gain/fade analysis. This can be used to analyze the results from a single contract to groups of contracts. The analysis can be done by estimator, project, market segment or project manager. This can also help you evaluate how a project is progressing and what its impact will be on you from year to year.

Managing change orders is a critical part of the differences that arise between the estimated and actual contract costs and price. Change orders are a fact of life, especially in the construction field. Unforeseen circumstances, changes in design or materials result in changes made to the original contract. These changes will affect the PCM reporting that is done while the contract is in progress as well as the results of the look-back calculations that are applied when the contract is completed. By ensuring that change orders go through the same processes as bids, good cost estimates and the price of the change order should be able to take some of the uncertainty out of the picture when considering look-back implications.

Finally, consistently analyze completed contracts that must be reported using PCM and applying look-back methodology. Remember the 71% of taxpayers that don't perform look-back and fail to file? Odds are good that you have not been doing this. By taking action now to implement the continuous process of considering PCM and the implications of applying the look-back methodology, a more proactive approach to this situation is possible.

What's Next?

Hill, Barth & King can assist you with your needs. This important element of your tax situation cannot and should not be ignored. We can assist you in getting caught up by reviewing your contract results and tax returns. We can help you plan ahead by assisting you in the implementation of job gain/fade analysis to review estimate accuracy as well as project performance. We can also suggest improvements to your accounting processes to ensure that all direct and indirect costs are properly included in your PCM calculations. And when each contract is completed, we can facilitate the application of the required look-back methodology and filings. By implementing these processes, we can take a complex web of interrelated processes and identify opportunities that may be missed.

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