

Look-Back Method Attracting Interest From IRS

Contractors who fail to perform look-back calculations when required, or make the calculations incorrectly, may be subject to additional taxes and penalties. That's the result of closer scrutiny being paid to the look-back issue following a declaration by the IRS in late 2004 that look-back compliance was an "emerging issue."

Why Look Back?

Contractors who use the percentage of completion

method (PCM) to account for long-term contracts generally must apply the look-back method upon completion of each contract. Under PCM, a contractor reports its taxable income or loss on jobs in progress based on estimated costs and contract prices.

Once a job is complete and the actual costs and contract price become known, the contractor "looks back" at each prior tax year the project was in process and calculates

Year-End Planning - Continued from page 1

Continued on page 4

speeds up cash flow and pinpoints problem projects that can be better structured in the future.

TAX PLANNING

Evaluate prepaying expenses: Prepaid expenses present another planning opportunity although this is an area where financial reporting planning and tax planning may conflict. Prepaid expenses such as deposit premiums on insurance policies are generally excluded by sureties in calculating adjusted working capital. Consequently, for financial reporting purposes, it may make sense to minimize prepaid expenses at year end. However, tax regulations allow for the expensing of prepaid expenses in certain cases in the year paid, accelerating tax deductions. Therefore, both financial and tax considerations must be addressed in determining whether it makes sense to prepay an expense in December or wait until January to make the payment.

Utilize the "manufacturing deduction." The definition of "manufacturer" under AJCA includes activities such as construction, engineering, and architectural services. The new deduction is 3% of qualified production activities income (QPAI) or taxable income (adjusted gross income for individuals) in 2005 and 2006, 6% in 2007 through 2009, and 9% in 2010 and thereafter. The deduction is further limited to 50% of wages paid during the calendar year and can be used against both regular tax and the alternative minimum tax (AMT).

Expense equipment purchases (Section 179 expensing election): The timing of equipment purchases is also important. Generally, equipment with a useful life beyond the taxable year must be capitalized. However, the Section 179 expensing election allows a current deduction for assets that otherwise would be subject to normal depreciation rules. Under AJCA, Congress extended the \$100,000 deduction through 2007. Indexed for inflation, the Sec. 179 deduction for 2005 is \$105,000. But for tax years beginning after 2007, this amount is scheduled to drop back to \$25,000 per year. The moral of this lesson: schedule major capital equipment purchases before 2007 when the greatest tax benefits are available, if possible.

Non-qualified deferred compensation plans: Last year's tax law ushered in new rules for nonqualified deferred compensation plans that apply to compensation deferred after 2004, affecting timing of initial deferral elections, changes to elections, timing of distributions, and how benefits are funded. It is important to determine whether your plans are covered by the new rules and how to bring them into compliance by December 31.

Understand your accounting method: When it comes to year-end tax planning, a key issue is understanding what accounting method your company uses for income tax purposes. While the percentage of completion method is generally the standard for financial reporting purposes in the construction industry, there are a number of different methods available for income tax purposes depending upon a company's size and the type of work performed. Understanding what method you utilize will impact decisions you make prior to year end.

Consider AMT: The impact of alternative minimum tax (AMT) must also be considered when doing year-end tax planning. AMT is an alternative way of calculating taxes whereby certain adjustments are made to regular taxable income to arrive at alternative minimum taxable income. The most common adjustments for contractors pertain to the accounting for long-term contracts, accounts receivable, and depreciation of fixed assets. Tax is calculated under both methods and the taxpayer pays the higher amount. Failing to consider the impact of AMT can lead to unpleasant surprises on April 15. While AMT may not always be avoidable, it can be anticipated and its impact minimized with proper planning.

Year-end tax planning strategies and financial statement presentation are both key to a company's continued success. Used as complementary tools, they have the potential to maximize a contractor's financial health and strengthen their ability to do business going forward. Work with your accountant to make sure you are optimally positioned for year-end.

Look Back - Continued from page 3

the amount of tax owed if he or she had used actual figures rather than estimates. If the look-back method reveals an underpayment of taxes in a previous tax year, the contractor owes interest on that amount. If the contractor overpaid, however, he or she is entitled to receive interest on the overpayment.

Each tax year, the contractor computes look-back interest for all contracts completed during that year which were started in an earlier year. Depending on the net result, the contractor either owes interest or is entitled to a refund. Additional look-back calculations may be required if the contractor incurs additional costs or receives additional revenues after the contract completion year.

The look-back method doesn't require a contractor to amend tax liability on prior years' returns. Any previous underpayments or overpayments are reconciled in the year the contract is completed. But since the use of estimates during the life of the contract results in acceleration or deferral of the contractor's tax liability, the look-back interest compensates the contractor or the IRS for these timing differences.

When to Look Back?

The look-back method applies only to long-term contracts - that is, contracts that straddle two or more tax years - subject to PCM. It doesn't apply, therefore, 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." (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's also a "de minimis small contract exception," which exempts a long-term contract from the look-back rules if it (1) is completed within two years and (2) has a gross contract price that doesn't exceed the lesser of \$1 million or 1% of the contractor's average annual gross receipts for the preceding three tax years.

Finally, contractors can elect not to apply the look-back method if, for each contract year, the amount reported is within 10% of the cumulative taxable income or loss determined using the actual contract price and costs.

Is There an Easier Way?

Calculating look-back interest can be a painstaking, time-

consuming process, so the tax regulations provide an alternative called the simplified marginal impact method (SMIM). Rather than recalculate tax liability for each tax year subject to the look-back method, the contractor determines underpayments or overpayments for prior years using an assumed marginal tax rate (generally, the highest rate in effect for the relevant year).

Pass-through entities - such as S corporations, partnerships, and LLCs - are required to use SMIM if they're not closely held. C Corporations, individuals and owners of closely held pass-through entities may elect to use SMIM. Electing pass-through entities apply SMIM at the owner level rather than at the entity level.

Although SMIM can ease a contractor's administrative burden, contractors considering an SMIM election should be sure to understand its implications. For one thing, once the election is made, it's irrevocable. Also, while there's no limit on the amount of interest a contractor must pay, SMIM places a ceiling on a contractor's overpayment refunds.

Looking Ahead

Contractors can expect the IRS to scrutinize their look-back calculations, so it's in their best interests to be sure these calculations are done correctly. According to the IRS, common errors include:

- Treating net operating losses (NOLs) incorrectly. If the look-back method increases or decreases an NOL that was carried back to a previous year, interest should be computed beginning with the NOL generating year, not the NOL carry-back year.
- Using the wrong interest rates. For look-back purposes, interest rates are adjusted annually, not quarterly.
- Improperly computing look-back interest at the pass-through entity level when it's required to be computed at the owner level.
- Making filing errors. Contractors should pay interest owed by attaching Form 8697 to their tax returns. Form 8697 refund requests should be filed separately.
- Failing to report cumulative changes to look-back taxable income and look-back tax liability properly for each redetermination year.

The look-back rules are complex. Contractors who are uncertain about whether they're required to calculate look-back interest or whether they're doing it correctly should consult their ABA relationship partner.

MISSION STATEMENT

"Our Mission is to be our clients' most trusted and valued advisor, accomplishing this through creativity, innovation, insight, integrity and care. We are committed to providing the highest quality accounting, tax and consulting services." **Anchin, Block & Anchin LLP - Going Beyond the Expected**

U.S. Treasury Circular 230 Disclosure: If any tax advice is contained in this communication or attachments, it is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax related penalties under federal, state, or local law, or (ii) promoting, marketing or recommending to another party any matters addressed herein.

Anchin, Block & Anchin LLP, Accountants and Consultants, Construction Digest, Vol. 8, No.4 4th Quarter 2005 The *Construction Digest* is published quarterly by Anchin, Block & Anchin LLP, Accountants and Consultants, 1375 Broadway, New York, NY 10018. Telephone (212) 840-3456. A service for clients, business associates and staff, the *Digest* contains articles which are general in nature and based on sources which are believed to be authoritative. Specific applications would require consideration of all facts and circumstances by qualified professionals. The firm will be pleased to provide additional details upon request. No part of this newsletter may be reproduced or utilized in any form or by any means without written permission from Anchin, Block & Anchin LLP.