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# Can IRS regulation make you a better contractor?

**BARRY LEASURE**

When most business owners think of taxes and the Internal Revenue Service, they generally don't perceive them as benefits to their businesses. These perceptions may be well-founded since a hefty percentage of a business' earnings are paid to the IRS and attempts to be compliant can be complicated and expensive. Sometimes tax law does not equate with common sense, and everyone has gone through some frustration. There is, however, some helpful information for a contractor's business that can be gleaned from the tax process, specifically the IRS' look-back calculation requirement.



Leasure

Under the Internal Revenue Code's section 460, the IRS requires construction contractors with more than \$10 million in revenue to calculate the taxable income of their commercial contracts using the "percentage of completion" method. Most contractors with less than \$10 million in revenue do not need to use this method for regular tax purposes but will need to for alternative minimum tax purposes; there are some exceptions for C corporations.

The percentage of completion method is basically recognizing a percentage of the expected price of contracts that are uncompleted at the end of a company's fiscal year as revenue. For example, if a contractor incurs 50% of the expected costs of a job, then it must recognize 50% of the contract price as revenue, regardless of whether it has billed or collected for that contract. This requires some estimating by contractors as to what they believe the total revenue and costs will be at the end of the project.

Understanding the contractor is estimating what the total profit will be, the IRS requires a look-back calculation when the job is complete. If, based on the final results, the contractor underestimated the profit on a job when calculating the percentage complete in prior years, the IRS will make the contractor pay for the time value (interest expense) of the tax underpaid in that year. If the contractor overestimated the profit, the IRS will refund the contractor for the interest income of the overpayment of taxes in previous years.

This is an arduous calculation for con-

tractors and their advisers, which nets little revenue for the IRS. Many experts feel the calculation could be eliminated.

So, what's the possible benefit? The upside is that even though the IRS doesn't get much out of this exercise, contractors can learn a great deal about their business from the process.

For instance, when a tax professional calls a contractor client with news of a forthcoming refund as a result of a look-back calculation, it is normally perceived as good news, but is it? If contractors consistently receive annual look-back refunds, that means their jobs are not as profitable as originally projected.

There could be a couple of reasons for this. The contractor is underestimating the costs required to complete jobs during the bidding phase; or there are execution problems in the management of projects.

Most contractors know one bad job can ruin their profitability for the year and, in some cases, can put them out of business.

Shoring up the estimating and project-management functions helps prevent such "blow up" projects. Savvy sureties and bankers also consider the look-back calculation when evaluating the strength of a contractor.

Ultimately, is it better to pay the IRS at the end of the year as a result of the look-back calculation? Mostly, yes; however, there are some issues to consider. First, by overestimating income, a contractor is basically borrowing from the government at a 7% interest rate. That's great if you're in a cash crunch, but not so great if you have money sitting in a money market account earning a much lower rate. Also, underestimating your income may indirectly limit your lending and bonding capacity by making your company appear financially weaker than it is. You don't want to pay too much, but a modest amount owed to the IRS shows a contractor has a realistic approach to estimating costs and a firm control of contract management.

The details of the look-back calculation are complicated, but the concept is simple. When jobs are complete, contractors need to review projects to see if they did as well as expected. The IRS makes contractors do the calculation to keep them honest; contractors can use it to make themselves better.

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