Congress Needs to Increase Threshold for Completed Contract Method

BY ROBIN WORD AND RICH SHAVELL

In the early 1980s, the government had serious concerns with defense and aerospace contractors deferring taxes by extending contracts with small items like hammers and toilet seats. Congress attacked their tax accounting method choices and 20 years ago, at the end of 1986, Section 460 was added to the Internal Revenue Code.

Section 460 defined long-term contracts as "any contract for the manufacture, building, installation or construction of property that is not completed within the taxable year the contract is entered into." By definition, a contract started on New Years Eve and completed a few days later in January became a long-term contract.

Section 460 of the code also mandated that, unless exempt, all long-term contracts must use the percentage-of-completion method (PCM) for income tax reporting. Under the PCM, income from long-term contracts is reported based on estimates of job completion, typically accelerating income. The two primary exceptions to this general rule include:

- any home construction contract; or
- any other construction contract entered into by a taxpayer who estimates the contract will be completed within two years; and, whose average annual gross receipts for the three previous taxable years do not exceed $10 million.

The second exception enables contractors to choose any accounting method including the completed contract method (CCM). Under the CCM, profits from contracts are not reported until the contract is complete.

This method more clearly reflects taxable income because it is based on accurate final results. Because the typical contractor does not realize profits on contracts until retainage (5 percent or 10 percent) is received at contract completion, the CCM is the optimal method for matching contractor profits with tax payments. Retain-

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age is an amount held back from payments to contractors to assure work quality. To address retainage and the typical slow payment of receivables contractors prefer to use the CCM.

However, the CCM is not an option if average annual gross receipts exceed $10 million. This code section 460(e) threshold of $10 million has not been adjusted since its inception and has never been adjusted for inflation.

The Consumer Price Index (CPI) was 109 in 1986 and in 2006 it reached 200, an 83 percent increase. The standard deduction on personal income tax returns has increased from $3,670 in 1986 to $10,300 in 2006. Further, the Small Business Administration's small contractor size limit has gone from $17 million to $31 million.

If the section 460(e) $10 million requirement were similarly indexed, it would have risen to $18 million, but the construction industry still faces an unchanged Section 460(e) limitation.

Escalation in material prices has been impacting the construction industry for several years. Copper, steel, wood products, gypsum and concrete all have seen dramatic increases. And, the industry now faces the impact of gasoline and petroleum-based product price increases. Material price escalation increases the total price of contracts, but does not necessarily correlate to an increase in the contractor's bottom line.

Labor costs also have increased and have been exacerbated by the shortage of qualified workers in many trades. A contractor with gross revenues of $5 million in 1986 would expect gross income to be approximately $9.2 million in 2006 based on the increase in CPI. However, because the industry has faced severe price escalation, this small contractor's gross revenue would be more than $10 million—clearly not what Congress intended.

In fact, it is arguable whether the rule changes in 1986 were intended to affect commercial contractors. The impetus for the changes was perceived abuses by heavy manufacturing (aerospace and defense), not the commercial construction industry. The concern was that while significant financial statement income was being reported, little tax was being paid because income was deferred under the CCM by certain large public companies.

Congress changed the overall tax reporting method rather than directing changes at the manufacturing industry. The fix at the time was to permit an exception for small contractors. Today, that old fix, along with the current definition of smaller contractors, needs fixing.

If a contractor is forced to continually pay tax on profits not yet received (i.e., because of accounts receivable and retainage) they must charge more because more capital is required to meet these obligations. On the other hand, if a contractor can better match taxes to receipt of actual profits he may be able to work at a lower capital cost.

It's time for Congress to elevate and index the Section 460(e) threshold and let more contractors report their taxes using more appropriate tax methods.

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