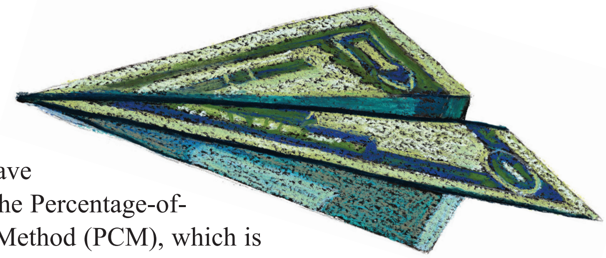
By Richard R. Shavell, CPA, CCIFP
Chairman, ABC National Tax Advisory Group
Shavell & Company, P.A.,

Let's Keep As Much Money As Possible in the Business This Year



The tax rules affecting contractors are unique and at times complex. A fundamental point is that revenue recognition for tax purposes is based on each contract - not simply choosing an overall method. By examining each contract and the opportunity to choose alternative methods for the jobs, you can benefit from significant tax deferrals. This approach can have an impact on both larger and smaller contractors.

Generally, the six available methods, depending on your circumstances and the underlying work are:

- Percentage-of-Completion (PCM)
- Completed Contract Method (CCM)
- Cash receipts and disbursements (Cash)
- Accrual
- Accrual without retainage
- Percentage-of-Completion-Capitalized-Cost Method (PCCC)
- Percentage-of-Completion Method (PCM)

Many construction companies have migrated to the Percentage-of-Completion Method (PCM), which is what the IRS wants you to use. This method tends to accelerate income under the premise that revenue and profit should be recognized over the life of the job based on the work that is completed at each year-end. The estimated profit on each job is recognized based on the percentage of that job's costs incurred. Importantly, the profit that is partially recognized is based on certain estimates.

Think about this: the more costs incurred on a job then the more income that must be recognized. That's because the increment in costs causes an increase in percent complete and thus an increment in profit. While this method may be a good option for reporting income on your financial statements it certainly is not the optimal choice when having to pay taxes. The objective is to eliminate as many jobs that fall under the PCM. What are the choices?

Small Contractors Do Have More Choices

In 1986 Congress defined small contractors as those generating average annual revenues under $10 million. ABC's National Tax Advisory Group wants this threshold updated and indexed for inflation. These "small" contractors have several choices including all those listed above.

The Completed Contract Method (CCM) is the optimal choice. CCM permits you to report all profit once the job is completed and accepted. Under the CCM true profit follows the timing of profit recognition (i.e. all net cash has been received).

continued on page51

Rich Shavell, CPA, CCIFP is President of Shavell & Company, P.A. CPAs and Consultants in Boca Raton and Stuart, FL. Rich has been an advocate for contractors over the last twenty years presenting comments before the IRS on proposed regulations and testifying before the House and Senate on behalf of ABC. Currently, Rich serves as Chair of ABC's National Tax Advisory Group. Locally he serves on our Chapter's Legislative Committee and Rich is the 2005 winner of the South FL Business Journal's Excellence in Accounting Award in Construction. For more information visit www.shavell.net or call (561) 997-7242.

Let's Keep As Much Money As Possible in the Business This Year

continued from page 14

The Cash Method is simply reporting income when received and expenses when paid. Not all small contractors can use this method such as C Corporations with revenue in excess of $5 million. This is the simplest of methods and probably the easiest to manipulate. The IRS had targeted this method and after successfully litigating the issue in the 1990s the IRS issued Revenue Procedures in 2002 outlining when the cash method can be used with relative impunity.

Under the Accrual Method, in general terms, income is recognized when invoices are issued (i.e. entitled to the income) and expenses are recognized when the liability arises (i.e. legally owe the payable). Next, hidden in an old Revenue Ruling, there is a special election to use this same method but to exclude retainage on certain contracts until the retainage is received.

But you need to watch out for the Alternative Minimum Tax (AMT). The AMT takes back some of the benefit of the difference between PCM and these more beneficial methods available to smaller contractors. It is almost always beneficial to use one of these alternative methods rather than the PCM.

The last major method choice is the Percentage-of-Completion-Capitalized-Cost (PCCC) method. Under this special method the taxpayer computes income under two methods and uses a percentage of each. The PCCC method typically only applies to contracts where the subject matter is residential (not home) construction projects such as apartment buildings.

Home Construction Contracts (HCC)

If the subject matter of a substantial portion of a contract is for home construction then the contract is not reported under the PCM and you can elect to use the more favorable completed contract method. This is the case regardless of the size of the contractor. ABC's Tax Advisory Group, in May 2005, proactively asked the IRS to review this issue. At the time of this writing it is anticipated that a Revenue Ruling will be issued in 2007 amplifying the definition of HCCs.

Defer Taxes to Increase Cash Flow

By deferring as much as possible and keeping these dollars in the business the contractor can gain a double benefit. Consider both your cost of working capital and your company's internal rate of return. This is reason enough to review the tax impact of your tax method options and thereby keep as much money in your business as possible.