LONG-TERM CONTRACTS:
New Accounting Regulations

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After years of controversey between the IRS and the construction industry over long-term contract regulations, the Service has issued new regulations. These long-term contract regulations, which should be known and understood by all contractors, clarify the handling of several problem areas, offer tax-deferral opportunities, and pose the problem of more restrictive cost-allocation requirements.

The New Long-Term Contract Regulations

Briefly, the regulations liberalize the definition of contracts that qualify for reporting under the long-term contract methods, and the rules relating to the use of the completed-contract method are expanded and clarified. Guidelines are provided for recognition of income and costs on contracts involving claims and disputes, for severing and aggregating contracts, and for allocating costs to both complete and incomplete contracts. In addition, the preamble to the regulations states that the continued use of the completed-contract method of accounting for income tax purposes is permitted regardless of the manner in which long-term contracts are treated for financial reporting purposes. The new rules liberalize the application of the percentage-of-completion method and allow the use of different methods by the same taxpayer in certain situations.

Traditional Methods of Accounting

To put the new regulations into proper perspective, the methods of

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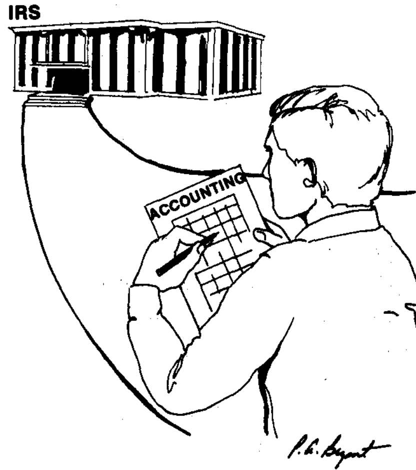

accounting available to contractors should be reviewed. These options include the cash, accrual and two long-term contract methods.

- Under the **cash** method all items constituting gross income are generally included for the taxable year in which they are actually or constructively received. Expenditures are deducted in the year in which they are actually made.
- In using the accrual method, revenues are included in income when earned under the terms of the contract. Costs and expenses are deducted from revenues as incurred.
- The **long-term contract methods** are percentage-of-completion and completed-contract. Under the **percentage-of-completion** method income is recognized on long-term contracts as work progresses, based on the percentage of the contract which has been completed. Costs and expenses are deducted as incurred. Under the **completed-contract method** income is reported only in the year in which the contract is finally completed and acceptance has occurred. Costs allocated to the contract are deducted from gross income in the year of completion.

Opportunities for Contractors

Because the regulations provide specific guidelines and definitions for long-term contracts and for handling disputed and separable contracts, the contractor is now in a better position to plan for tax payments and deferrals. This situation offers a new opportunity to understand and handle cash and tax positions.

Definition of a long-term contract. The new definition and eligibility requirements for long-term-contract accounting both clarify and liberalize the previous regulations: To be classified as a long-term contract, a building, installation or construction contract need now only be incomplete as of the close of the taxable year. Manufacturers are included in the new regulations and are afforded long-term status if:

- the contract calls for the manufacture of a unique item not normally carried in finished goods inventory, or
- the manufacturing process will normally require more than twelve months to complete.

Because the new definition makes it easier for a contract to be considered long-term for tax purposes, more taxpayers are able to take advantage of the tax deferrals inherent in the completed-contract method. Contractors not using this method might now be encouraged to convert.

Disputed contracts. The new regulations eliminate confusion on the completed-contract method by providing specific rules for resolving owner claims, contractor claims

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and counterclaims. Each type can be simply defined:

— *Owner claims* are disputes arising from the owner's desire to have the original contract price reduced or to have additional work performed.

— *Contractor claims* are disputes arising from the contractor's desire to increase the amount paid to him after the work is completed.

— *Counterclaims* are disputes arising when a contract is complete and both owner and contractor claims exist.

The tax accounting treatment for each type of dispute under the new regulations is as follows:

(1) Where there are owner claims, and profit or loss on the contract cannot be assured, defer all income and costs until year in which dispute is resolved; if profit is assured, however, report gross contract price reduced by amount of dispute and all costs incurred in the year contract is completed (without regard to the dispute). Also report additional income or cost in year in which dispute is resolved. If a loss is assured, report gross contract price and total costs incurred, both reduced by the amount of dispute, in year contract completed (without regard to dispute). Previously unrecognized income and cost is to be reported in year dispute is resolved.

(2) If the contractor claims the contract is completed, the entire amount of gross contract price and all costs incurred must be reported in the year of completion without regard to dispute. Additional income and cost of the dispute are reportable in year dispute is resolved. The regulation also says that if additional work is to be performed as a result of the dispute, the year in which the dispute is resolved is the year in which such work is completed.

Disputed contracts have been a

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sening job coordination situation.

That's the reason many subs aren't getting productivity or making money . . . it's poor planning and job coordination by the general.

DIMENSIONS: Given that trend, job control by the subcontractor would be more important than ever, wouldn't it?

CONNOR: Yes, and this must be done on a weekly basis. Control is only as good as the reports coming in from the field and they must have true production figures . . . manhours against the unit costing and the estimate, that sort of data, so you can make a determination.

We have our forms, but it still falls to the foreman in the field giving full information. And that's the superintendent's responsibility, to keep track of costing on a weekly basis.

DIMENSIONS: Good people are good people are good people. How much emphasis do you place on picking good people?

CONNOR: The true meaning of management, as I see it, is delegating proper responsibility to all segments of the business, and that means picking the right man for the right job. So my answer is total emphasis. There are just too many decisions that need to be made and that I don't hear about. You have to get good people-and give them the opportunity to make and learn from their decisions.

As a result, I can now travel and never have to call the office. On out of town trips, I never call the office, but I do notice other contractors doing it constantly. It's like therapy to them; they're nervous and want to be in on every decision so they keep calling.

DIMENSIONS: Dick, what is it about contracting that keeps you in it?

CONNOR: That's easy. Every day is different; it's impossible to get into a rut. And then there's the challenge of making a profit. That's what it's all about, isn't it? □

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traditional battleground between the IRS and the construction industry. By providing detailed rules for the treatment of disputed items, the regulations eliminate the confusion and uncertainty of the past and provide the contractor with a firm basis for tax planning.

Severing and aggregating contracts. The new regulations state that an agreement may be severed (which means treating an agreement as several contracts) or aggregated (treating several agreements as one contract) depending on the facts and circumstances of the situation and customary commercial practice within a trade or business.. The older regulation was silent on this subject.

Generally, an agreement will not be severed unless it contemplates separate delivery or acceptance of portions of the construction or there is no business purpose for entering into a single contract. However, separate delivery and acceptance of portions of the construction do not necessarily require severing of a contract. Agreements will generally not be aggregated unless they could be treated as one contract under customary commercial practice or no business purpose exists for entering into several agreements rather than one.

While they provide more guidance than the old regulations, the new rules allow some room for planning. The central point is that the contractor must be aware of these rules and take them into account early in the contracting process. In cases where the proper treatment is not entirely clear, the contractor should develop and maintain the information necessary to support the desired results at the time the contract is executed.

Other Methods

Contractors on the percentage-of-completion method can use certain techniques to ease conversion to the completed-contract method. A different method may be used for

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each new contract as long as the method used clearly reflects income and is used consistently throughout the life of that particular contract. Thus, the regulations include a certain degree of flexibility for contractors using the percentage-of-completion method, which is especially useful for tax planning.

Percentage-of-Completion Method. Under the new rules, the percentage completed on a contract can be determined under either of two basic methods:

- a ratio of costs incurred to date to total estimated contract costs, or
- a ratio of total work performed to date to total estimated work to be performed.

When the cost ratio method is employed, any cost-comparison method may be used (e.g., total direct and indirect, total direct, direct labor costs).

Dual Methods. The concept of using different accounting methods for contracts in the same trade or business is added by the new regulations. They state that any method of accounting chosen must be consistently applied to all long-term contracts, *except* that one method may be used for long-term contracts of "substantial duration" and another method for long-term contracts of less than "substantial duration." While "substantial duration" is not defined, examples indicate that three months is not substantial but fifteen is.

The time standard for differentiating between contracts can be developed by each contractor in accordance with particular facts and needs. Care should be used in developing this standard which must be consistently adhered to after adoption.

The use of dual methods may present significant planning opportunities to the contractor having difficulties obtaining the maximum benefits from the corporate surtax exemption under the completed-contract method. Using the accrual method for shorter contracts may produce sufficient annual income for surtax exemption purposes, while using the completed-contract method for longer contracts provides tax deferral for major income contracts.

Pitfalls for Contractors

Cost allocable to contracts. The regulations contain one serious drawback: New rules for the allocation of costs to contracts utilizing the completed-contract method. Because these regulations are more specific as to what costs are properly allocable to a long-term contract and what costs are charged to normal overhead, IRS challenges to cost allocations can be anticipated.

In general, contractors using the completed-contract method must allocate direct material and labor costs to the long-term contract. Direct material costs include the costs of materials which become an integral part of the project and those consumed in building the project. Direct labor costs include the cost of labor which can be identified or associated with a particular long-term contract—basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payrolls and unemployment taxes.

Certain indirect costs—other than direct material and labor costs which are incidental but necessary to fulfill the contract—must also be allocated to long-term contracts. Examples of these contract costs are:

— rental of equipment or facilities
— indirect labor and contract supervisors' wages
— depreciation on equipment and facilities reported for financial statement purposes including repair and maintenance expense
— compensation paid to officers attributable to services performed on contracts (other than incidental or occasional services)
— costs of insurance incurred to perform the contract (insurance of equipment)

Certain indirect expenses, however, need not be allocated. Examples of these costs are:

— marketing and selling expenses including bidding expenses
— interest
— normal general and administrative expenses (G&A—legal and accounting)
— depreciation on idle equipment and depreciation for tax purposes in excess of the amount for financial reports
— pension and profit-sharing contributions and other employee benefits.

The new regulations state that indirect costs can be allocated by either specific identification or by the use of an appropriate burden rate.

Because of the significant and potential exposure of these regulations, contractors must review their past allocation treatments to develop an appropriate strategy.

Adoption or Change of Method

A taxpayer may adopt any one of the available methods for the first year in which long-term contracts

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are present. But once adopted, permission is required to change methods used for tax purposes.

Because of the more liberal interpretations included in the new regulations, many contractors may wish to change to a long-term contract method or make some change in their current application of these methods. In addition, the more restrictive rules on cost allocation may force many contractors to change their historical allocation methods. With the exception of the flexibility provided contractors currently using the percentage-of-completion method and the technical application of the rules for disputed contracts and severing or aggregating contracts, most changes will require permission. Application for permission to change must be made within the first 180 days of the year for which the change is to be effective.

Ten-Year Spread. If a company faces substantial tax exposure by changing its accounting method to comply with these new regulations, a ten-year spread of the tax effects can be applied for. Assuming the percentage-of-completion method has been employed for more than ten years, the Service softens the harshness of double reporting by permitting the contractor to deduct from taxable income 10 percent of the amount of the adjustment due each for ten years. By using this technique contractors can better digest any financial impact these regulations may have on their business.

Conclusion

With the exception of the allocation of certain costs for contractors using the completed-contract method, the new long-term contract regulations appear favorable to contractors. These regulations, by clarifying the handling of historical problem areas and liberalizing the definition of long-term contracts, enable the contractor to more readily evaluate these former problem areas in terms of their tax impact, making it easier to develop a strategy. □

Budget Cuts Hit Public Building

Because delays or cancellations on construction projects are the least politically disruptive short-term adjustment that a state or local government can make to balance its budget, billions of dollars worth of state and local building are expected to be curtailed in 1976.

And the recession, high borrowing costs and inflation have led half the country's state and local governments to do just this.

Economists have noted that New York City is a symptom of local government fiscal problems rather than an exception. They say that operating costs have jumped an average 12.5 percent during the past decade while revenues have increased only 12 percent.

As local government debt has doubled in 10 years, state and municipal budget planners have apparently decided to prune construction allocations rather than the more politically explosive route of increased taxes and service reductions.

A survey by Engineering News-Record shows that 23 states significantly reduced their dollar volume of awards from 1975 to 1976.

A Joint Economic Committee of Congress, in a study made early last year, concluded that 25 states and 71 local governments plan to cut their capital construction budgets by about $1 billion in the fiscal year that began last July 1.

New York City, where a study projected that some 230,000 craft jobs will be permanently lost, has a three-year moratorium on all new construction and has suspended 46 ongoing projects.

In California, with building trades unemployment approaching 35 percent at year's end, outlays went from $240 million to only $88 million last year, and further cuts may be in store for the coming fiscal year.

Michigan, Georgia, and Virginia faced budget deficits for the current fiscal year and have frozen all new capital construction. Maryland halted transportation construction projects last November.

Texas, which apparently had escaped most of the recession's pounding, is now apparently leveling off in available dollars, and there is a decline of work volume due next year.

It appears that Ohio and Illinois top the states that have maintained fiscal fitness through the recession. Ohio approved the highest appropriations in its history for the coming year, some $690 million for capital construction, buildings, and higher education projects.

Illinois construction jumped from $100 million in fiscal 1975 to $285 million in fiscal 1976, and the state legislature is expected to raise bonding authority by $70 million for new construction projects.

Despite the pessimism over public spending and the cash-shortages effecting many private plans, most industry economists still see a gradual improvement in construction.

Architects—whose ranks have an unemployment rate of some 50 percent—see some increased rumblings of activity among private clients. And they see a great deal more fast-tracking on projects because of the inflation-cash feature.