On Long Term Accounting

The IRS Hasn’t Given Up in Its Efforts To Collect Taxes on Multi-Year Jobs as Latest Ruling Claims Painting Contractors “aren’t contractors”

Many in the construction industry see it as a ploy to crack the industry’s united front.

The controversy boiling in Washington DC right now is the recent effort by the Internal Revenue Service to deny painting contractors the right to traditional long term accounting methods through an IRS claim that painting contractors are not, in fact and deed, contractors.

The upshot of the IRS ruling produced a quick combination among the Association of the Wall and Ceiling Industry-International (AWCI), the Painting and Decorating Contractors of America (PDCA) and the American Subcontractors Association (ASA). For the past two months, the three construction associations have battled the IRS at The White House, the Treasury Department, and at the IRS itself.

Comes to Head . . .

Concerned with changing long term contracting methods in the construction industry, the IRS ignited the latest collision by citing Section 1.451.3(b)(1) to deny an industrial painting contractor the right to qualify in using a long-term contract method of accounting.

Although the painting contractor—who was not named in the incident—performed industrial and commercial painting services, the IRS claimed the contractor was ineligible for long-term contract accounting methods by virtue of the fact a painting contractor isn’t
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That’s what kicked off AWCI, PDCA and ASA in a quick, furious counter attack.

Current regulations allow the use of a long-term contract accounting method for “building, installation and construction” activities not completed in the same taxable year as that begun in. Contractor methods revolve around two basic approaches—completed contract method and the percentage-of-completion method. If the IRS ruling were allowed to stick, the painting contractor would thus be denied both long term accounting systems. Presumably, the only thing left would be some form of cash accrual accounting system—which would produce significantly more income tax exposure for the contractor.

What makes this latest effort by the IRS so sensitive is the view by many construction people that the probe is merely one to establish a precedent and then set up conditions wherein the IRS might be able to pick off contractor groups for modified accounting procedures.

Furthermore, the IRS Revenue Ruling 84-32—the one that denied the painting contractor the right to use long term accounting—is retroactive and applies to all open years. Normally, the statute of limitations expires after three years, but is often extended by agreement. If more than 25% of gross income is omitted (for example, by application of this ruling) the statute remains open for six years.

“The continuing hostility of the IRS with respect to the completed contract method,” said Touche Ross & Company, “is further illustrated by their position that the use of a long-term contract method by a painter constitutes a ‘Category A’ method of accounting.”

A “Category A” method of accounting is one that is “specifically not permitted to be used by the taxpayer by the code, regulations, or by a decision of the Supreme Court of the United States.

In effect, if the taxpayer—in this case, the painting contractor—doesn’t voluntarily request permission to change his accounting method (presumably to the cash or accrual method) before being notified that an exam will
take place, he’ll be required to report the full impact of the change in accounting method required by the IRS in the year of the examination.

Contractors Excluded . . .

A few years ago the construction industry warded off a similar thrust by the IRS. At that time, the problem really was large defense contractors who were using the long-term method to extraordinary tax advantage. Congress allowed the IRS to disallow these methods — but specifically excluded construction contractors from being denied long term contract methods.

This recent action by IRS would indicate strongly that despite the obvious intent of Congress the IRS is determined to chip away at contractor use of long term contracting.

Impact on Contractors . . .

Many subcontractors wonder just what the flap is all about over long term contracting . . . and whether or not such a change in accounting procedures would have much impact on their business.

Not too many contractors are involved in the matter. The ones who are, are involved in jobs that take more than one or two years to build. Because the profit realization on such a long term job is almost impossible to determine, contractors seek to avoid excessive tax exposure by following a percentage-of-completion method or by completed contract method.

What the IRS is after is to get the taxes up front as soon as the work is completed at the end of the current tax year. Contractors oppose IRS moves to end long term contract accounting because they feel they would need to pay taxes on projected or estimated profits, a chancey tax situation at best.

Tax collectors don’t like the long term methods because the taxpayer can manipulate the income and profits into the current year when the job is finished, thus getting a distinct tax benefit. Many of the large government contractors — not construction contractors — were playing this tax game like an electric organ and avoiding huge tax sums.

That’s why congress moved recently to abolish this kind of long term ac-
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counting procedure. But construction contractors were specifically excluded from this congressional action. Now the IRS by regulation has moved against construction contractors, too.

Actually, the move against the painters is not an isolated case. Earlier the IRS published three similar rulings covering engineering, architectural and construction management contracts. In each ruling the taxpayer had no contractual obligation other than one of three services.

The IRS successfully held that none of the contracts represented the necessary “construction, building, installation or manufacturing” responsibilities necessary for long-term accounting eligibility. This new ruling clearly implies that other activities absolutely essential to the physical completion of a construction contract may not be eligible for long-term accounting. IRS has confirmed to the Associated General Contractors (AGC) that “dirt hauling” is being studied as the next subject matter of a ruling which may be published in the future.

Subsequent rulings such as 84-32 and its three predecessor rulings can be expected to be used if the IRS attempts to require contract divisions in the future. For example, if a general contractor also performs as a subcontractor for any of the prohibited activities under a single separate contract he is required to report income from that contract by using a non long-term contract method, i.e., cash or accrual.

It has been suggested that the IRS may take a future course of action in which it would divide an overall contract into different contracts depending on the activities being performed and report income accordingly. This second possibility is not now a requirement but the first—asking in a separate contract capacity in one of the prohibited activities—is.

Rulings processes take considerable time, but subcontractors should keep in mind that rulings primarily reflect an IRS position that the service is willing and ready to litigate. The eventual disposition of completed contract reporting will take a considerable period of time.