Down economy is good time for contractors to rethink tax opportunities

The construction industry has been hit as hard as any by the recession, now in its second year. Many small construction companies have ceased to exist while others have dramatically downsized in order to survive.

One of the few financial bright spots for construction companies is that the recession offers some a rare opportunity to take advantage of tax saving opportunities.

To fully understand the tax opportunities, it's helpful to examine the rules affecting contractors.

In an attempt to help small businesses, Congress passed the American Recovery and Reinvestment Act of 2009. A provision in the law enabled small businesses with a net operating loss in 2008 to elect to offset this loss against income earned in up to five prior years. To qualify, a small business had to have no greater than an average of $15 million in gross receipts over a three-year period ending with the tax year of the net operating loss.

This change allowed many construction companies to recoup prior tax bills and generate an influx of cash to help survive the recession in 2009. So what happened? For many, this cash is gone and most construction companies are still in a survival mode where cash flow is critical.

A deferral of paying taxes is almost as good as receiving a refund. A change in how a small construction company accounts for its long-term contracts can provide such an opportunity, resulting in improved cash flow.

A contractor normally has a minimum of at least two methods of accounting: an overall method and one or more methods for long-term contracts. Generally, a long-term contract is any contract for the manufacture, building, installation, or construction of property where the contract is not completed within the taxable year in which it was signed.

Internal Revenue Code Section 460 generally requires a taxpayer to determine the income from a long-term contract using the "percentage-of-completion method." The percentage-of-completion method requires a taxpayer to include in income the portion of the total contract price that corresponds to the percentage of the entire contract that the taxpayer completed during the taxable year. Therefore, under the percentage-of-completion method, a contractor is required to pay taxes on the gross profit of a long-term contract that is not yet completed. Paying taxes on the gross profits of incomplete contracts puts a cash flow strain on companies because often taxes are paid before profits are collected.

IRC Section 460(e) provides two exceptions for requiring the use of the percentage-of-completion method for long-term contracts: home construction contracts and the "small contractor exception."

In order to meet the small contractor exception, two requirements must be satisfied. First, at the time the contract was entered into, it must have included an estimate that it would be completed within a two-year period beginning on the commencement date of the contract. Second, the contactor's average annual gross receipts for the three taxable years preceding the year in which the contract was entered into did not exceed $10 million.

If a construction company meets the small contractor exception, then the completed contract method may be used for accounting for long-term contracts rather than the percentage-of-completion method. Under the completed contract method, the taxpayer does not report income until a contract is complete, thus deferring the income taxes on the gross profit of a long-term contract until the year the contract is completed.

In determining the tax benefits of utilizing the small contractor exception of IRC Section 460(e) and accounting for long-term contracts under the completed contract method, one must take into consideration the Alternative Minimum Tax (AMT). When calculating AMT, the percentage-of-completion method must be used when accounting for long-term contracts. Corporations with average annual gross receipts of $5 million or less qualify for exemption from AMT. After the first year of qualification, the corporation will continue to qualify as long as average gross receipts do not exceed $7.5 million.

In these difficult times during which many construction companies have seen their revenues decrease, the small contractor exception may now be available to many contractors that could not meet the $10 million gross receipts test in the past. Meeting the exception and using the completed contract method to account for long-term contracts could mean additional cash flow in the form of tax deferrals.

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