

# Additional Deductions, Potential Refunds and Tax Tips

BY ANITA SHECKELLS

AND CLAUDIA WOLTER

**As the tax season approaches, construction companies should focus on some tax laws that may be advantageous to them.**

## **NEW DEDUCTION ALLOWED FOR CONSTRUCTION COMPANIES**

The American Jobs Creation Act of 2004, passed in October, allows a deduction that equals a portion of the taxpayer's qualified production activities income for the year.

Qualified production activities income is defined as domestic production gross receipts less direct costs related to those receipts less an allocable portion of costs not directly associated with the receipts.

Domestic production income specifically includes income from construction activities performed in the United States, as well as income from engineering and architectural services for construction projects in the United States. For this pur-

pose, construction activities include activities directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation includes structural improvements but not mere cosmetic changes such as painting.

For tax years beginning in 2005 and 2006, the deduction is 3 percent of the lesser of taxable income or qualified production activities income. The deduction increases to 6 percent for years beginning in 2007 through 2009 and further increases to 9 percent for years beginning in 2010 and later. The deduction cannot exceed 50 percent of the W-2 wages paid by the company during the calendar year that ends in the company's tax year for which the deduction is claimed.

For regular C-Corporations, the deduction is allowed against taxable income. For individuals, the deduction is allowed against adjusted gross income. Additional rules apply to pass-through entities such as S-Corporations, LLCs, partnerships, etc. The amount of the deduction is determined at the shareholder, member or partner level based on the proportionate share of the entity's qualified production activities income. There are special rules for applying the 50 percent wage limitation at the individual level, and the related regulations have not been issued to date. The deduction is allowed for purposes of the alternative minimum tax (AMT).

As is often the case, the new tax rules are complex and have to be addressed on a case-

by-case basis. Contractors should consult a tax adviser to determine if their companies can benefit from this new deduction.

#### A COMPANY MAY HAVE A HIDDEN TAX REFUND

Pay close attention to the look-back interest rules. The Internal Revenue Service has recently identified noncompliance with look-back interest rules as an emerging issue. Emerging issues are significant areas of noncompliance.

The IRS formed a team to develop guidance to assist its personnel with affected cases. If a company is not currently filing Form 8697, Interest Computation under the Look-Back Method for Completed Long-Term Contracts, and has contracts that are not completed in the same tax year they are started, the company may be targeted as noncompliant.

The look-back interest rules fall under Internal Revenue Code Section 460 dealing with long-term contracts. For tax pur-

poses under this code, a long-term contract is a contract for the manufacture, building, installation or construction of property not completed in the year it commenced. Income for long-term contracts generally must be recognized under the percentage-of-completion method, which involves recognizing income on the estimated percentage a contract was completed during the tax year.

Contractors with average gross receipts during the prior three tax years that are less than \$10 million are not required to use the percentage-of-completion method and, therefore, may use a method such as cash, completed contract, etc. These contractors are generally still required to recognize income under the percentage-of-completion method for long-term contracts for AMT purposes.

Taxpayers must perform a look-back interest computation in the tax year in which a contract is completed to compensate for any under- or overestimation of income from the contract in any previous year the contract was in process. After performing the calculation of the difference in recognized income, the taxpayer must recalculate income tax liability in all previous years in which the contract was in process to determine the difference in the tax liability.

The difference in the tax liability is then considered an under- or overpayment of taxes in the previous years and the IRS published rates of interest are applied to the under- or overpayment of taxes. The taxpayer will either receive a refund of interest or be required to pay interest on the difference in the tax liability.

Here is an example to clarify this confusing subject:

	12-31-02	12-31-02 at 12-31-03, all facts being known
(a) Contract amount	\$1,000,000	\$1,000,000
(b) Costs to date	\$400,000	\$400,000
(c) Costs to complete	\$450,000	\$500,000
(d) Total estimated gross profit (a-b-c)	\$150,000	\$100,000
(e) Percent complete (b/(b+c))	47%	44%
(f) Recognized gross profit (d*e)	\$70,500	\$44,000

The example illustrates how a \$50,000 cost overrun in this project changes the income that should have been recognized on this job by \$26,500. Now, assuming a tax rate of 40 percent, the following is the look-back interest calculation:

Overestimation of profits	\$26,500
Overpayment of taxes (all facts being known)	\$10,600
Interest refund on \$10,600 of taxes paid one year early	\$490

## A contractor that has not filed a Form 8697 for prior years opens that income tax return for audit by the IRS after the statute would have normally exempted it from being examined.

Therefore, a \$50,000 underestimation of costs on this job can result in an interest refund of almost \$500.

Every contractor and contract yields a different result. A \$50,000 overrun on one

job may yield \$500 in interest, but on another job, it could yield much more or possibly less. Too many variables exist to make any generalizations. Some variables are as follows:

- profitability of the job;
- estimated percentage complete in previous year;
- actual percentage complete in previous year (calculated when job is completed);
- number of years the contract was in process;
- overall tax situation of the taxpayer;
- tax rates in effect in each year; and
- interest rates in effect in each year.

Form 8697, Interest Computation under the Look-Back Method for Completed Long-Term Contracts, is the form used to report the under- or overpayment in taxes and the resulting interest. Many contractors are not filing this required form and are not complying with the law. Failure to file this form is considered failure to file a complete return, and the IRS can assert that the statute has not begun to run on the income tax return.

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If a company's contracts often experience profit fade, a contractor could quite possibly be due a refund of interest for taxes "prepaid" in relation to this look-back computation. Conversely, if the costs are inflated early in the job for anticipated issues that may arise, taxes may be deferred to future years and interest may be due for the deferral of taxes.

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**Sheckells and Wolter** are shareholders with the accounting and consulting firm of **KAWG&F, P.A.** For more information, call (410) 828-2727 or email [asheckells@kawgf.com](mailto:asheckells@kawgf.com) or [cwolter@kawgf.com](mailto:cwolter@kawgf.com).