

APPEALS
INDUSTRY SPECIALIZATION PROGRAM
SETTLEMENT GUIDELINES

INDUSTRY/SPECIALTY AREA: Construction/Real Estate

ISSUE: Claim Revenue Under A Long-Term Contract

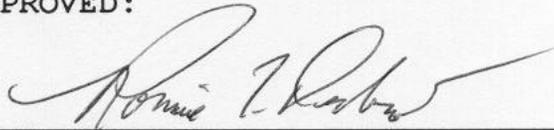
COORDINATOR: Stephen L. Howard

TELEPHONE: (972) 308-7316

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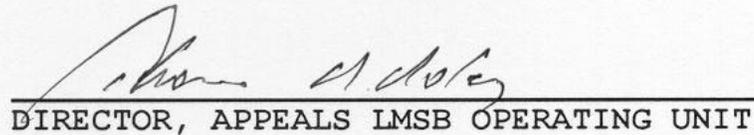
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SETTLEMENT GUIDELINES

Claim Revenue Under A Long-Term Contract

STATEMENT OF ISSUE

Whether a taxpayer must include "claim revenue" in the total contract price in determining the gross income from a long-term contract under I.R.C. § 460 for the taxable year at issue.

EXAMINATION DIVISION POSITION

FACTS

The Examination Coordinated Issue Paper provides a typical scenario in the industry to illustrate the issue.

On January 1, 1994, Contractor, a calendar year taxpayer, enters into a "long-term contract" (as defined under IRC §460(f)) with a client for the building, installation, or construction of property scheduled for completion in January of 1997. The contract does not involve home construction, and Contractor's average annual gross receipts from 1992 through 1994 exceeded \$10,000,000.

In 1995, during the course of construction, Contractor performed additional work and incurred additional costs attributable to customer caused delays, errors in specifications and designs, unpriced change orders, or other unanticipated work. Contractor deducted these costs for tax purposes. Although the client agreed to the additional work, the parties had not agreed by year's end to a price for the extra work performed. The parties will negotiate the price at a later time.

In determining the amount of gross income from the contract under I.R.C. §460 for its 1995 taxable year, Contractor used the original contract price in the I.R.C. §460 computation. Contractor did not increase the total contract price, for purposes of I.R.C. §460, for the revenue attributable to the additional work performed during 1995 ("claim revenue"). For book purposes, however, Contractor included the claim revenue in the total contract price based upon the standards contained in the American Institute of Certified Public Accountants (AICPA) Statement of Position 81-1.

CONCLUSION

The facts here indicate that at the end of 1995, it was reasonable to conclude that Contractor would be paid for the additional work. Contractor must include "claim revenue" in the total contract price in determining the gross income from a long-term contract under IRC §460 for the taxable year at issue.

DISCUSSION

The genesis of this issue is in the conflicting objectives of the construction contractor to:

- adjust performance under the contract to solve problems encountered in the construction itself,
- while maintaining a steady pace of construction to meet projected completion dates.

That is, the contractor cannot shut down construction each time there is a change order so that timely payment can be assured for whatever the change order involves. On the other hand, it would not be prudent for a contractor to proceed with the original plans when professional judgment dictates that some sort of change to the original contract would avoid problems and/or produce superior results.

For background purposes, it is helpful to consider how the AICPA has dealt with the "claim revenue" issue in published guidance. The AICPA defines "claims" as follows:

Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs.

Audit and Accounting Guide, Construction Contractors, (New York, American Institute of Certified Public Accountants, Inc.) Statement of Position 81-1, pp. 109-157, at paragraph 65. [referred to herein as AICPA SOP 81-1].

AICPA SOP 81-1 then describes the circumstances for which it is appropriate to include claims in the calculation of total contract price for financial statement purposes:

. . . Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all the following conditions:

- a. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
- b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.
- c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.

d. The evidence supporting the claim is objective and verifiable, not based on management's "feel" for the situation or on unsupported representations.

If the foregoing requirements are met, revenue from a claim should be recorded only to the extent the contract costs relating to the claim have been incurred. . .

AICPA SOP 81-1 further provides that costs attributable to claims should be treated as contract costs when incurred [if the claims have met the above requirements, of course]. Note that such included costs will serve to increase both the numerator and the denominator in the calculation of the actual percentage of completion to date.

What are the income tax implications of the AICPA's guidelines for financial statement purposes? After all, numerous differences are frequently encountered in reporting for financial statement purposes and for income tax purposes, and those differences are reconciled on Schedule M-1. In this case, the recognition of claim revenue in financial statements is strong evidence that such claim revenue can be "reasonably estimated" for the income tax return.

The only acceptable method of accounting for long-term contracts entered into on or after 7/11/89 [and not falling into one of the exceptions, intended generally for smaller taxpayers], is the percentage of completion method described in IRC §460. Treas. Reg. §1.460-6, adopted 10/12/90 by Treasury Decision 8315, is of particular relevance to the "Claim Revenue" discussion:

Reg. §1.460-6(c)(2)(vi). *Amount treated as contract price-* (A) *General rule.* The amount that is treated as total contract price for purposes of applying the percentage of completion method and reapplying the percentage of completion method under the look-back method under Step One includes all amounts that the taxpayer expects to receive from the customer. Thus, amounts are treated as part of the contract price as soon as it is reasonably estimated that they will be received, even if the all-events test has not yet been met.

(B) *Contingencies.* Any amounts related to contingent rights or obligations, such as incentive fees or amounts in dispute, are not separated from the contract and accounted for under a non-long-term contract method of accounting,. . . Instead, those amounts are treated as part of the total contract price in applying the percentage of completion method and the look-back method. ...Similarly, a portion of the contract price that is in dispute is included in the total contract price at the time and to the extent that the taxpayer can reasonably expect the dispute will be resolved in the taxpayer's favor (without regard to when the taxpayer receives payment for the amount in dispute or when the dispute is finally resolved).

Treas. Reg. §1.460-6(c)(2)(vi) arguably effects a significant change in accounting for claim revenue in the long term contract scenario (versus the standard that would be

applicable under general accrual accounting principles). Treas. Reg. §1.460-6(c)(2)(vi) employs a mere "reasonable expectation" standard (i.e., claim revenue is included in total contract price at the time and to the extent the taxpayer can **reasonably expect** the dispute will be resolved in the taxpayer's favor). Treas. Reg. §1.460-6(c)(2)(vi) does not employ the long-standing "all events" test of Treas. Reg. 1.451-1(a). Treas. Reg. 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. See also Treas. Reg. §1.446-1(c)(1)(ii)(A) and Treas. Reg. §1.451-3(d)(3).

A taxpayer challenge to the validity of Treas. Reg. §1.460-6(c)(2)(vi) was addressed by the Tax Court in Tutor-Saliba Corporation v. Commissioner, 115 T.C. No. 1 (July 17, 2000). In Tutor Saliba, the Tax Court rebuffed the taxpayer's argument that Treas. Reg. §1.460-6(c)(2)(vi) was invalid because it preempted the long-standing all events test governing the accrual of income. The Tax Court first noted that Congress did not explicitly state, in section 460 or in the legislative history, that the all events test should not apply with respect to long term contract accounting for contingent items such as claim revenue. However, the Tax Court held that, because section 460 presents a self-contained method of accounting for long-term contracts, no explicit statement regarding the all events test was necessary. The Tax Court stated that the section 460 approach to the percentage of completion method was a statutory modification to the deferral of income previously permitted under the completed contract provisions of Treas. Reg. §1.451-3(d)(3), which incorporated aspects of the all events test under the completed contract method. The Tax Court noted that Congress was free to change the method of accounting with respect to long-term contracts without explicitly stating that the all events test was not to be utilized. Thus, the Tax Court upheld the validity of Treas. Reg. §1.460-6(c)(2)(vi) as a reasonable interpretive regulation, not plainly inconsistent with the section 460 percentage of completion methodology enacted with the Tax Reform Act of 1986.

Another important point involves an analysis of how the "reasonable expectation" standard of Treas. Reg. §1.460-6(c)(2)(vi) compares with the four factors (discussed above) described in AICPA SOP 81-1. Does the inclusion of Claim Revenue in the total contract price for financial reporting purposes necessarily require the same treatment for Federal income tax purposes?

The answer is almost certainly "Yes". Consider the 4 factors of AICPA SOP 81-1: that there be a legal basis for the claim; that the additional costs were unforeseen and not the contractor's fault; that the additional costs are identifiable, determinable and reasonable; and that the evidence is objective and verifiable. If this AICPA standard is met, there is strong likelihood that the "reasonably estimated" standard articulated in Reg. §1.460-6(c)(2)(vi) would also be met.

The Coordinated Issue Paper also notes that contractors do not routinely incur additional costs unless there is a reasonable expectation that such costs will be reimbursed

(reimbursement with added profit margin is usually anticipated, but they would expect to at least receive reimbursement of costs). Such expected reimbursements are to be included in the total contract price at the point in time that reimbursement is expected. See IRS Notice 89-15, 1989-1 CB 634, Q & A 31 @ page 642. Presumably there could be situations wherein the contractor felt compelled to make adjustments to contract specifications and the owner later refused to pay. Nonetheless, at the end of the year in which the funds were expended, if it is reasonably estimated that the contractor will be reimbursed, such amounts should be included in the total contract price. If payment is later refused or disputed, the amount should be deducted from the total contract price in the later year.

"Disputes" can include anything from a pro forma "claim denied" (with all parties aware that the claim will be paid in due course), to arbitration, litigation and appeals therefrom. Not all "disputes" can be regarded as refusals to pay, and each will require separate consideration. For example, many governmental agencies (governments are frequently the "owners" in long-term contracts) have a long & slow approval (sometimes political) process for changes to their contracts.

MECHANICS OF ANY ADJUSTMENT.

Any proposed Examination Division adjustment should depend on the manner in which the Claim Revenue amounts were reported on the income tax return. In all likelihood, there will be more involved than just reversing Schedule M-1 adjustments. *IRS Notice 89-15*, supra, at Q & A 19 describes the computation of

reportable gross revenue for a contract, in general as follows:

Contract revenue for this year = $(TCR \times PC) - I$
where

TCR = the total amount of revenue that the taxpayer expects to receive with respect to the contract;

PC = the cumulative percentage of the contract that has been completed as of the end of the taxable year;

I = the total cumulative amount of contract revenue required to be included in gross income in all preceding taxable years.

Q & A 20 then describes the computation of PC:

. . . the percentage of the contract considered completed as of the end of the taxable year is equal to the ratio of (a) the total cumulative amount of costs allocable to the contract and incurred in the taxable year and in all preceding taxable years, to (b) the total amount of costs allocable to the contract that the taxpayer expects to incur. . .

Both Q & A 19 & 20 caution that total estimated contract revenue and total estimated contract costs can (and likely will) change from year to year.

The Examination Coordinated Issue Paper concludes that the contractor must include this "Claim Revenue" in the total contract price in determining the gross income from a long-term contract, at least to the extent of the additional costs incurred. When including this amount, it must be remembered that any adjustment will involve a recomputation of the POC; it is not just a matter of adding "Claim Revenue" to Gross Receipts.

SETTLEMENT GUIDELINES

Settlement will depend on facts & circumstances. If the taxpayer has reported the claim revenue by increasing total contract price for financial reporting purposes, the government's position is greatly enhanced. This does not mean that further investigation or documentation is unnecessary. If the taxpayer can show that it will not be paid for the additional costs, exclusion of the claim revenue may be proper.

It is anticipated that taxpayers (and their representatives) will argue that look-back computations, applied when the contract is complete, will compensate the government for any estimating errors or omissions of claim revenue. Some argue that the look-back method is appropriately conservative and avoids the payment of tax on income that may not be collected for some time. This argument has a certain equity appeal, but the look-back method may only partially compensate the party (either government or taxpayer) that was deprived of the use of tax money. The look-back method only corrects for timing differences, not permanent differences in tax liability that result from over/under estimation of contract price and costs. Therefore, the look-back method does not replace the requirement to properly estimate total contract price and contract costs in reporting income under the percentage of completion method for each year of a contract.

It should be noted that a change to the time a taxpayer consistently reports income or deducts expenses is a change to the taxpayer's method of accounting, subject to the provisions of IRC §§ 446 and 481. Thus, a change in the way that claim revenue is reported could potentially be a change in accounting method.

For instance, if the taxpayer has consistently excluded claim revenue from total contract income in computing income under the percentage of completion method and the examiner's adjustment proposes to include claim revenue in total contract income, such change would likely constitute a change of accounting method. Similarly, where the taxpayer has consistently excluded additional expenses from the numerator and denominator of the completion percentage and the examiner proposes to include the additional expenses in the numerator and denominator of the completion percentage, such change might also constitute a change of accounting method. Although the change of accounting method issues are not addressed in the Examination Coordinated Issue paper, they may be raised in the revenue agent's report. Any change of accounting method

concerns can be addressed when you contact the Appeals ISP coordinator.