

# Tips and Traps for Look-Back Computation

By Phillip McCarty, CPA



The look-back is a complex area of tax law that can cause compliance errors and missed opportunities. Filed on IRS Form 8697, "Interest Computation Under the Look-Back Method for Completed Long-Term Contracts," the look-back is a hypothetical recalculation of a contractor's taxable income based on the actual performance of its completed jobs.

Look-back does not result in an adjustment to the contractor's previously reported taxable income or require an amended return. It does, however, result in the refund or payment of interest depending on the accuracy of the contractor's applicable job estimates. Contractors assessing their business opportunities and risks related to look-back compliance should consider the answers to the following questions about requirements and standards.

## Which contractors are subject to look-back?

Any contractor that has long-term contracts with a requirement to report income on the percentage of completion under Internal Revenue Code (IRC) Section 460 is required to comply with the look-back rules. The IRS devotes an entire chapter of its "Construction Industry Audit Techniques Guide" to look-back compliance. Nevertheless, the requirements frequently are paid little attention or ignored completely.

The statute of limitations for look-back refund claims generally is six years from the due date of the tax year in which the job closed. Many contractors subject to look-back have received look-back refunds in the six-figure to seven-figure range— including those with experienced significant fade on large multiyear jobs.

## Which jobs are subject to look-back?

The application of look-back is determined on a contract-by-contract basis. To be subject to look-back, a contract must meet the requirements of a long-term construction contract under IRC Section 460. Contracts started and completed during the same tax year are not considered long-term construction contracts. The tax rules for determining the completion date of a contract differ from U.S. generally accepted accounting principles (GAAP) rules, often resulting in an earlier completion date for tax purposes.

Additionally, even if a contractor has long-term construction contracts, there are additional exemptions to look-back applicability, including the following:

- Home construction contracts.
- Contracts started in a year during which the contractor qualified as a small contractor. Generally, this includes contracts estimated to be completed in two years and started during a year in which the contractor's average gross receipts for the three preceding tax years did not exceed \$10 million.
- Small contracts that have a gross contract price less than the lesser of \$1 million or 1 percent of the contractor's gross receipts for the prior three tax years.

- Contracts for which an election not to apply look-back applies. The IRC provides a permanent and binding election not to apply look-back on contracts with a gross profit that does not vary more than 10 percent from the gross profit estimated in each of the prior tax years. This election may be valuable for large contractors who typically experience slight pickup on their jobs. However, the election actually increases the compliance costs of look-back requirements.

### How is the look-back calculation applied?

If a contractor determines it is subject to look-back requirements and has jobs that are subject to look-back requirements, it is required to perform the look-back calculation. It is important for contractors to apply look-back based on the tax treatment of determining gross profit on their jobs and not GAAP.



Many contractors use the percentage-of-completion method for GAAP, but percentage of completion is different for tax purposes. There are additional tax adjustments such as depreciation and reserves embedded in the GAAP calculation that are not deductible for tax purposes. Some payables that are embedded in the GAAP calculation have not met the all-events test required for inclusion in the tax calculation. Finally, the 10 percent method, if elected, must be addressed in the look-back calculation.

*Contractors subject to look-back requirements are required to perform the look-back calculation.*

### Additional Look-Back Opportunities and Pitfalls

- The applicable interest rate used to compute the payment or refund due is redetermined on the anniversary of the tax return due dates. Also, a different interest rate applies to C corporations on recalculated income amounts exceeding \$10,000.
- The election of the simplified marginal impact method does not require taxpayers to recalculate their hypothetical taxable income for previous tax years. Rather, the highest assumed marginal tax rate for a C corporation is applied to the calculated change. The method is beneficial for nonclosely held S corporation shareholders and partners who are required to file the look-back as individual taxpayers.
- The impact of post-completion additional income or expenses on previously reported look-back filings should be properly addressed. Possible large refunds may result for contractors with significant rework requirements, claims paid, or change orders denied.



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## Proceed With Caution

Compliance with the look-back requirements is very cumbersome and, depending on facts and circumstances, the cash-flow effect can be significant. Contractors should consider whether their systems and processes are adequate to capture and organize the necessary data to comply.

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