DO YOU LOOK-BACK? IRS FORM 8697 AND THE LOOK-BACK METHOD

Form 8697 assures that neither the taxpayer nor the IRS will lose the "time value of money" on income taxes that should or should not have been paid on income from long-term contracts.

CHAD MADDOX, CPA, CVA

This article discusses the unique characteristics of IRS Form 8697 and the calculations required to complete the look-back method for completed long-term contracts. In contrast to parts of the Internal Revenue Code, the look-back method for completed long-term contracts is a fairly simple concept: one pays the IRS interest on income taxes paid for a long-term contract on which one underestimated the gross profit in any certain year. More importantly the IRS will pay interest on income taxes paid on long-term contracts on which gross profit was overestimated in any certain tax year. Form 8697 assures that neither the taxpayer nor the IRS will lose the "time value of money" on income taxes that should or should not have been paid on income from long-term contracts.

Percentage-of-completion accounting, along with the look-back requirement, recognizes that income from long-term contracts is subject to estimates and the taxpayer's assumptions about the future may be wrong. Since the taxpayer and the IRS must rely on estimates to calculate taxable income, there needs to be a provision that "looks back" to the estimate and determines whether that estimate produced taxable income in the correct amount. The look-back calculation protects both the IRS and the taxpayer from miscalculations of estimated gross profit. Although the correct amount of income tax will be paid when the contract finishes, this allows the IRS or the taxpayer to recoup interest as a result of these miscalculations.

The real "diamond in the rough" here is that most contractors are usually optimistic. The reason for the optimism is that the contractor is typically trying to put its best foot forward for financial statement purposes, which is a detriment to income tax liability because it produces more taxable income. This is not to say that the contractor is misstating cost-to-complete for financial statement purposes. Often the contractor is estimating the cost-to-complete and planning to perform certain areas of a job perfectly but such a result does not materialize as a result of factors outside the contractor's control. Therefore, if the contractor is overly optimistic on jobs for a certain year, then it is not only eligible, but required, to file a Form 8697 and receive a check for interest on income taxes that were overpaid for that year.

CHAD MADDOX is Director of Auditing and Accounting for Shelton & Company, CPAs, P.C. He has responsibility for firm compliance with all current accounting and auditing rules and regulations. He has extensive construction accounting experience, having worked exclusively with contractors for over six years.

Requirements

The requirements for filing a Form 8697 are as follows:

1. Form 8697 is filed for each tax year in which a long-term contract entered into after February 28, 1986 is completed, accounted for using either the percentage-of-completion

method or the percentage-of-completion-capitalized cost method for federal income tax purposes.
2. Form 8697 must be filed for any tax year in which the contract price or contract costs are adjusted for one or more of these long-term contracts from a prior year.

Exceptions. Exceptions to the above requirements are as follows:

Certain construction contracts. The look-back method does not apply to the regular taxable income from:

- Any home construction contract (as defined in IRC Sec. 460(e)(6)(A)) or
- Any other construction contract entered into by a taxpayer: (a) who estimates the contract will be completed within 2 years from the date the contract begins and (b) whose average annual gross receipts for the 3 tax years preceding the tax year in which the contract is entered into do not exceed $10 million. See IRC Sec. 460(e).

However, the look-back method does apply to the alternative minimum taxable income from any such contract that must be accounted for using the percentage-of-completion method for alternative minimum tax purposes. See IRC Sec. 56(a)(3) for details.

Small contracts. There is also a small contract exception: the look-back method does not apply to any contract completed within 2 years of the contract start date if the gross price of the contract does not exceed the smaller of :

- $1 million or
- 1% of the taxpayer's average annual gross receipts for the 3 tax years before the tax year of contract completion. See IRC Sec. 460(b)(3)(B) for details.

De Minimis cases. There is also an election in certain de minimis cases for contracts completed in tax years ending after August 5, 1997. The look-back method does not apply in the following cases if the election is made:

- In the completion year if, for each prior contract year, the cumulative taxable income (or loss) actually reported under the contract is within 10% of the cumulative look-back income (or loss).
- In a post-completion year if, as of the close of the post-completion year, the cumulative taxable income (or loss) under the contracts is within 10% of the cumulative look-back income (or loss) under the contract as of the close of the most recent year in which the look-back method was applied to the contract (or would have been applied if the election had not been made).

Once this election is made it applies to all contracts completed during the election year and all later tax years, and may not be revoked without IRS consent. If the election is not made with the return, then it may be filed within 6 months after the due date of the tax return.

When look-back method is to be applied. A taxpayer may also elect not to apply the look-back method for a contract required to be included in the calculation until the first tax year in which at least 10% of the estimated total contract costs have been incurred. This, as stated previously, is an election that may be done and it is also for all contracts for the election year and later tax years.

If there are adjustments to a contract price or contract costs after the contract is completed, for any reason, then one must apply the look-back method in the year such amounts are properly taken into account, even if no contract is completed that year.

THERE ARE TWO METHODS AVAILABLE WITH WHICH TO APPLY THE LOOK-BACK METHOD. ONE METHOD IS THE REGULAR METHOD AND THE OTHER IS THE SIMPLIFIED MARGINAL IMPACT METHOD.

Small contractors

Caution: it may appear that the look-back is only for large contractors. However, as discussed above, any taxpayer subject to AMT is also required to apply the look-back calculation. For example a subchapter S corporation on the completed-contract method is subject to the look-back because of the AMT adjustment that must be made for the percentage-of-completion calculation. Therefore, even if a contractor is not considered a "large contractor" or the accounting method for income tax purposes is not the percentage-of-completion method, the look-back method still applies.

The "calculation"

The following is an example of the calculation required to complete Form 8697. As a simple analysis let's say that a taxpayer, required to file under the look-back method, completed only one contract this year. The final contract price, which finished in 2002, was for $1 million dollars and the final cost totaled $800,000. In the previous year, 2001, the taxpayer had an estimated contract price of $1 million and estimated total cost of $600,000, with cost-to-date of $400,000. In 2001, the taxpayer, under the percentage-of-completion method, would have recognized $666,667 of revenues earned, which would produce $266,667 of gross profit. With "perfect" information, the taxpayer would have only recognized $500,000 of rev-

EXHIBIT 1 Simplified Marginal Impact Method

Reduction in gross profit	$166,667
Multiplied by the taxpayer's highest tax rate (personal in this case)	39.1%
Decrease in tax	$65,167

enues earned and $100,000 of gross profit. This would be a reduction of gross profit recognized for that year of $166,667. This is a significant reduction in gross profit for that year. The taxpayer's estimate produced more taxable income for the taxpayer, and after final analysis, was unwarranted. Later in this article, the impact of the interest check that would have been received in this situation is explained.

Applying the look-back method

There are also two methods available with which to apply the look-back method. One method is the regular method and the other is the simplified marginal impact method. As can be ascertained from the title, the simplified marginal impact method is the method that is the "simplest" to apply.

Regular method. The regular method requires the taxpayer to take any increase or decrease in income as a result of the look-back and adjust taxable income for that year. The look-back calculation must be shown on a schedule that identifies each completed long-term contract and the calculations used to derive the total increase or decrease shown on line 2 of Form 8697. See Appendix A where Form 8697 is reproduced. After determining the "correct" taxable income for any certain year the taxpayer then figures an income tax liability based on the new taxable income with the income tax rates in effect for the year of the look-back calculation. The taxpayer then compares the new income tax liability to the tax liability shown on the income tax return for that year or the adjusted income tax liability for any previous look-back calculations for that year. The increase or decrease is then used to compute the interest to be refunded or paid as a result of the previous calculations. The interest rates to be used for years January 1, 1995 to March 31, 2003 can be found on page 5 of the instructions to Form 8697. After March 31, 2003, the interest rate to be used is the applicable overpayment rate under IRC Sec. 6621(a)(1) in the revenue ruling published quarterly in the Internal Revenue Bulletin. The interest calculation is performed on a daily basis from the date the income tax return was due for the year of the look-back until the year the income tax return is due for the completion year of the contract. The interest rate in effect for any year is the rate in effect at the due date of the income tax return for the look-back period and, if the contract spans over more than one tax return, then you change the interest rate on the due date of the income tax return.

Simplified method. The simplified marginal impact method is used only by pass-through entities required to apply the look-back method at the entity level and taxpayers electing to use the simplified marginal impact method. The election is made in the year in which the taxpayer would prefer to use this method and applies to all look-back applications for year of election and all later years, unless the IRS consents to a revocation of this election. Pass-through entities not considered to be closely held must apply the look-back at the entity level. For a pass-through entity to be closely held, 50% or more (by value) of the interest is held directly or indirectly by five or fewer persons. The biggest difference between the "simplified" method and the regular method is that the taxpayer, whether calculating the look-back for regular income tax or the alternative minimum tax, must use an assumed marginal tax rate, which is generally the highest statutory rate in effect for the year of the look-back application, when calculating income tax liability for that year. This is in contrast to the regular method, which requires the taxpayer to refigure income tax liability on the income tax return for that year with the new information. If there is an increase or decrease (up to a limit of income tax liability for previous years) in tax, then interest is calculated in the same manner as described for the regular method of applying the look-back calculation. In order to guard against the taxpayer receiving interest on income tax that was never paid, there is an item on line 6 termed an overpayment ceiling. The overpayment ceiling is the amount of tax paid by the taxpayer for the year in question as adjusted for any prior applications of the look-back.

The interest calculation. Using the facts from the example discussed previously (the "calculation"), which stated that there had been a reduction in gross profit from the look-back calculation of $166,667, the amount on which to calculate interest is computed as shown in Exhibit 1.

Exhibit 1 also assumes that the taxpayer is a K-1 recipient of a pass-through entity that has elected to use the simplified marginal impact method. The interest calculation is performed on the decrease in tax assuming that the taxpayer had paid tax equal to that amount for the year in question. The interest rate to be used is the one in effect on April 15, 2002, which is 6%, and the interest is compounded daily using that rate until April 15, 2003. This interest calculation on a daily basis results in an interest refund check of $4,029. As you can see, this is a considerable amount of money that should not be ignored by any taxpayer that may overestimate gross profit on contracts in progress.

Conclusion

The entire look-back process can be performed in conjunction with the job close-out analysis contractors perform on their estimating process and performance. This allows the taxpayer to possibly receive a benefit from this process if the taxpayer has been overly optimistic when figuring cost-to-complete for any certain tax year. There are two sides to every situation and the other side of this situation is that the taxpayer will owe the IRS interest if the converse is true and the taxpayer has been overly pessimistic when figuring cost-to-complete. The end result is that the taxpayer is required to perform this calculation if certain requirements are met, which are set forth in the instructions to IRS Form 8697, but many taxpayers are unaware and thus missing a possible opportunity to recoup interest on income taxes that were overpaid. ■

Form **8697**
(Rev. November 2002)
Department of the Treasury
Internal Revenue Service

Interest Computation Under the Look-Back Method for Completed Long-Term Contracts

▶ See separate instructions. ▶ Please print or type.

OMB No. 1545-1031

Attachment Sequence No. **97**

For the filing year beginning , and ending . See page 2 of the instructions.

Name

A Identifying number

Fill In Your Address Only If You Are Filing This Form Separately and Not With Your Tax Return

Number, street, and apt., room, or suite no. If a P.O. box, see page 3 of the instructions.

City or town, state, and ZIP code

B Check applicable box to show type of taxpayer:
☐ Corporation ☐ S corporation
☐ Individual ☐ Partnership
☐ Estate or trust

C If you were an owner of an interest in a pass-through entity (such as a partnership or an S corporation) that holds one or more long-term contracts to which this interest computation relates, enter the name and employer identification number of the entity. Attach a schedule if there is more than one such entity.

Name of entity

Employer identification number

Part I Regular Method

	Date of each prior year to which interest computation relates: (a) Year ended mo. ---- yr. ----	(b) Year ended mo. ---- yr. ----	(c) Year ended mo. ---- yr. ----	(d) Totals (Add columns (a), (b), and (c).)
1 Taxable income or loss for the prior years shown on tax return (or as previously adjusted) before net operating loss or capital loss carrybacks (other than carrybacks that must be taken into account to properly compute interest under section 460) (see page 3 of the instructions). If you were required to file Form 8697 for an earlier year, enter adjusted taxable income for the prior years from line 3, Form 8697, for the most recent filing year that affects the prior years .				
2 Adjustment to income to reflect the difference between: **(a)** the amount of income required to be allocated for post-February 1986 contracts completed or adjusted during the tax year based on the **actual** contract price and costs, and **(b)** the amount of income reported for such contracts based on **estimated** contract price and costs. See page 3 of the instructions and attach a schedule listing each separate contract, unless you were an owner of an interest in a pass-through entity reporting this amount from Schedule K-1 or a similar statement				
3 Adjusted taxable income for look-back purposes. Combine lines 1 and 2				
4 Income tax liability on line 3 amount using tax rates in effect for the prior years (see page 3 of the instructions) . . .				
5 Income tax liability shown on return (or as previously adjusted) for the prior years (see page 3 of the instructions). If you were required to file Form 8697 for an earlier year, enter the amount required to be reported on line 4, Form 8697, for the most recent filing year that affects the prior years				
6 Increase or decrease in tax for the prior years on which interest is due (or is to be refunded). Subtract line 5 from line 4.				
7 Interest due on increase, if any, shown on line 6 (see page 3 of the instructions)				
8 Interest to be refunded on decrease, if any, shown on line 6 (see page 3 of the instructions).				
9 Net amount of **interest to be refunded to you.** If line 8, column (d), exceeds line 7, column (d), enter the excess. File Form 8697 separately; **do not** attach it to your tax return (see page 3 of the instructions)				
10 Net amount of **interest you owe.** If line 7, column (d), exceeds line 8, column (d), enter the excess. Attach Form 8697 to your tax return. See page 4 of the instructions for where to include this amount on your return . . .				

For Privacy Act and Paperwork Reduction Act Notice, see page 5 of the instructions. Cat. No. 64598V Form **8697** (Rev. 11-2002)

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Part II Simplified Marginal Impact Method

	Date of each prior year to which interest computation relates: (a) Year ended mo. ---- yr. ----	(b) Year ended mo. ---- yr. ----	(c) Year ended mo. ---- yr. ----	(d) Totals (Add columns (a), (b), and (c).)
1 Adjustment to regular taxable income to reflect the difference between: **(a)** the amount of such income required to be allocated for post-February 1986 contracts completed or adjusted during the tax year based on **actual** contract price and costs, and **(b)** the amount of such income reported for such contracts based on **estimated** contract price and costs. See page 4 of the instructions and attach a schedule listing each separate contract, unless you were an owner of an interest in a pass-through entity reporting this amount from Schedule K-1 or a similar statement				
2 Increase or decrease in regular tax for prior years. Multiply line 1 in each column by the applicable regular tax rate (see page 4 of the instructions)				
Note: *For prior years beginning before 1987, skip lines 3 and 4 and enter on line 5 the amount from line 2.* **3** Adjustment to alternative minimum taxable income to reflect the difference between: **(a)** the amount of such income required to be allocated for post-February 1986 contracts completed or adjusted during the tax year based on **actual** contract price and costs, and **(b)** the amount of such income reported for such contracts based on **estimated** contract price and costs. See page 4 of the instructions and attach a schedule listing each separate contract, unless you were an owner of an interest in a pass-through entity reporting this amount from Schedule K-1 or a similar statement				
4 Increase or decrease in alternative minimum tax (AMT) for prior years. Multiply line 3 in each column by the applicable AMT rate (see page 4 of the instructions)				
5 Enter the **larger** of line 2 or line 4. See page 4 of the instructions if either amount is negative				
Pass-through entities: *Skip line 6 and enter on line 7 the amount from line 5.* **6** Overpayment ceiling. For each column in which line 5 is a negative number, enter your total tax liability for the prior year, as adjusted for past applications of the look-back method and after net operating loss, capital loss, net section 1256 contracts loss, and credit carryovers and carrybacks to that year. For each column in which line 5 is a positive number, leave line 6 blank and enter on line 7 the amount from line 5				
7 Increase or decrease in tax for the prior years on which interest is due (or is to be refunded). Enter the amount from line 5 or line 6, whichever is smaller. Treat both numbers as positive when making this comparison, but enter the amount as a negative number				
8 Interest due on increase, if any, shown on line 7 (see page 4 of the instructions)				
9 Interest to be refunded on decrease, if any, shown on line 7 (see page 4 of the instructions)				

10 Net amount of **interest to be refunded to you.** If line 9, column (d), exceeds line 8, column (d), enter the excess. File Form 8697 separately; **do not** attach it to your tax return (see page 4 of the instructions)	
11 Net amount of **interest you owe.** If line 8, column (d), exceeds line 9, column (d), enter the excess. Attach Form 8697 to your tax return. See page 4 of the instructions for where to include this amount on your return	

Signature(s) Complete this section **only** if this form is being filed separately.

Sign Here	Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. Signature(s)	Date		
Paid Preparer's Use Only	Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
	Firm's name (or yours if self-employed), address, and ZIP code			EIN Phone no. ( )