

## **New Tax Ruling Provides Tremendous Benefit to Contractors**

The IRS has handed a nice present to accrual-basis government contractors performing under cost-reimbursable contracts. It recently issued Technical Advice Memorandum (TAM) 200803017, which deals with the general rule for inclusion of income in a particular tax year. For certain contractors, this TAM allows for deferral of accrued (unbilled) revenue under cost-reimbursable contracts until such a time that the revenue is actually billed. The old methodology required recognition of the revenue at the time the costs were *incurred*. This article will discuss the application of this memorandum to the affected contractors.

### **Accounting Methodology for Books and Taxes**

There are two general methods of accounting for the internal books and records of a company as well as for tax purposes: the accrual-basis and cash-basis methodologies. There can be a tremendous time lag between the recognition of income and expense item under the two methodologies. Revenue on the accrual basis is recognized when *earned*, while under the cash basis it is recognized when *collected*. Expenses under the accrual method are recognized when *incurred* while under the cash basis when actually *paid*.

Most contractors maintain their internal books and records on the accrual basis methodology as required by Generally Accepted Accounting Principles (GAAP). GAAP is also the basis for incurred costs that are utilized for the pricing of and reimbursement under government contracts. In addition, for tax purposes, many contractors also utilize the accrual-basis methodology, though certain contractors are eligible to utilize the cash-basis methodology. This new ruling applies to those utilizing the accrual-basis methodology for tax reporting purposes.

## **Accrual Accounting for Cost-Reimbursable Contracts**

For accrual-basis contractors performing under cost-reimbursable contracts, revenue is recognized at the time actual costs are *incurred* (both direct and indirect) plus an applicable portion of the fee earned (whether fixed and/or award fee). Billings however, are generally prepared using actual direct expenses incurred, provisional indirect rates, and a portion of the fee. The difference between the revenue recognized based on actual costs and the amounts billed represents unbilled receivables on the contractor's balance sheet.

A process must be followed by the contractor before they are actually in a position to bill for their actual indirect rates. First, the year must be completed and an incurred cost submission must be prepared. Next, the DCAA or other cognizant audit agency would have to perform an incurred cost audit. Finally, indirect rates for that year need to be finalized. This process can take years to complete. Thus, a significant time lag can occur between when the costs are incurred (and the accrual-basis revenue recorded) and when the actual billings are sent.

## **Previous Tax Accounting**

Under previous tax law, accrual-basis taxpayers would recognize the revenue, and pay the applicable taxes, in the year the costs were actually incurred for this unbilled revenue. This was in spite of the fact that it could be many years before the contractor actually billed for and collected the cash on these amounts. Unfortunately, this situation adversely impacts the cash flows of the contractors for two reasons: (1) because they were paying actual expenses in excess of the amount they were being reimbursed for by

the government; and (2) having to pay income taxes on this differential today, but not collecting the cash for several years.

### **New Tax Guidance**

Under this new Technical Advice Memorandum, contractors will not have to recognize the revenue, for income tax purposes, until such a time that the invoice is prepared. This will not occur until the audit process is complete by DCAA or the cognizant auditors.

### **Final Thoughts**

This is, in my opinion, a very fair and equitable change for contractors. Paying taxes today on income that may not be collected for many years into the future is contrary to the concept of matching the payment of taxes with billing and collection of fees. Under the new TAM, contractors can expect to see a tax saving, and even a potential substantial savings for certain contractors, from the deferral of these taxes.

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