



Business Management Advisory

For Precision Custom Manufacturers

AC24

FILE: ACCOUNTING AND FINANCE

SECTION 460(f) OF THE INTERNAL REVENUE CODE

SUMMARY

The purpose of this Section 460(f) of the Internal Revenue Code is to properly divide the "income earned" on a particular job that is worked on during two taxable years (say 1996 and 1997). Generally, this is a complex and often misunderstood task.

There is a three step process to comply with Section 460(f) and make the financial statements correct:

1. Determine the amount of income earned on the job in the current year (we'll use 1996).
2. Determine the amount of income (or loss) reflected on the books (on an accrual basis).
3. Make a journal entry to correct the difference between 1 and 2 above. (I know this sounds like complicated accounting talk, but the example that follows will make all easy to do in practice).

EXAMPLE

The following is only one job but assumes (in order to illustrate all the possibilities) that three different amounts have been received from the customer in 1996: Case #1, zero; Case #2, \$25,000; and Case #3, \$50,000.

Here are the facts as of year end — 12/31/96:

1. Selling price of job started 10/12/96 — \$100,000
2. Costs to date in 1996 — 40,000
3. Estimated costs to complete in 1997 — 20,000
4. Amount received (three assumptions as above). Start with Case #1 — Zero

Important: The four numbers above are all that is required for each job to make the correct computations.

STEP #1 — Amount of income earned in current year

Complete as shown below:

- | | |
|---|------------------|
| (a) Selling price | \$100,000 |
| (b) Determine estimated cost to complete job: | |
| Cost in 1996 | \$ 40,000 |
| Estimated in 1997 | <u>20,000</u> |
| Total cost to complete | <u>60,000</u> |
| (c) Estimated profit | \$ <u>40,000</u> |
| (d) Divide "cost in 1996" (\$40,000) by "total cost to complete" (\$60,000) to determine "percent of job completed" in 1996 | 2/3 |
| (e) Multiply "estimated profit" (\$40,000) by "percent of job completed" (2/3). This is "amount of income to be reported in 1996" | \$ <u>26,667</u> |

IMPORTANT: The \$26,667 is always the same no matter how much of the \$100,000 selling price has been received (or billed).

STEP #2 — Determine the amount of income (or loss) reflected on the books

If books are on a cash basis then convert to an accrual basis (book all unpaid costs).

	Case		
	#1	#2	#3
a. Amount received	\$ -0-	\$25,000	\$50,000
b. Costs in 1996	<u>40,000</u>	<u>40,000</u>	<u>40,000</u>
Income (loss) on books	<u>(\$40,000)</u>	<u>(\$15,000)</u>	<u>\$10,000</u>

* Remember, whether billed or received will give the same result (see Step #3).

STEP #3 — Make a journal entry (J.E.)

Your accountant will make the J.E. Here is the way the J.E. is done.

	Case		
	#1	#2	#3
Step #1 - Income 1996	\$26,667*	\$26,667*	\$26,667*
Step #2 - Income (loss) on books	<u>(40,000)</u>	<u>(15,000)</u>	<u>10,000</u>
Increase income	<u>\$66,667</u>	<u>\$41,667</u>	<u>\$16,667</u>

* **Most Important of All:** *The income amount* which will be reflected on the profit and loss statement and as taxable income on the tax return, *is always the same* (no matter how much of the job has been billed or actually received): **\$26,667**.

In accounting terms, the credit (\$66,667, \$41,667 or \$16,667), part of the journal entry, goes to income. The debit part (the same \$66,667, \$41,667 or \$16,667) goes to the balance sheet as an asset. The journal entry assures you that only the right amount (in this case \$26,667 for 1996) is reported as income for tax purposes.

Let's assume that Step #1(c) shows a loss as follows:

- (a) Selling price \$100,000
 (b) Determine estimated cost to complete job:

Cost in 1996	\$ 70,000	
Estimated in 1997	<u>35,000</u>	
Total cost to complete		<u>105,000</u>

- (c) Estimated loss \$ (5,000)

In this example, there is no income to report in 1996. The loss will be reported in 1997, the year the job is completed.

The information here is by no means complete, it is merely a synopsis of key points. Each individual should carefully analyze their own situation and discuss it with their tax advisor so that full advantage can be obtained from current tax legislation.

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