BY RICH SHAVELL

Construction Tax Accounting Methods & Choices: An Overview

Accounting for income from construction contracts is not always easy or straightforward. Some methods can accelerate income, while others allow a contractor to legally defer income. As we review the options, consider three overriding issues:

1) Is the construction contractor considered "small" for tax purposes?

2) Is the contract short-term (i.e., started and completed during the tax year) or long-term?

3) Does the nature of the work performed fall within a specialized category (e.g., residential or home construction contracts (HCCs))?

If a contractor's annual gross receipts average less than $10 million (based on the prior three years of receipts),[1] then it is considered a small contractor. While a small contractor can choose which method it uses for regular tax purposes, it may want to use the completed-contract method (CCM) or the cash method to better match profit reporting to cash flow.

Completed-Contract Method

Under the CCM, profits from long-term contracts are reported when the contract is completed. In a typical scenario, if a contractor starts a job in Year 1 and completes the contract in Year 2, then zero profit is reported in Year 1 and 100% is reported in Year 2. For many contractors, profit is typically received at the end of the job when the final retainage payment is received.

Cash Method

Under the cash method, revenues are reported when received (deposits) and expenses are reported when paid (disbursements). The IRS doesn't usually favor the cash method because of the concern that it may be relatively easy to manipulate by delaying cash deposits and accelerating expense payments at year-end. Regardless, the cash method is available to small contractors.[2]

The cash method is also available to large S corporations to use as their "overall" method and can thereby apply it to short-term contracts. For large contractors, long-term contracts are generally subject to the percentage-of-completion method (PCM) (see below).[3]

Accrual Method

The accrual method reports revenues and expenses based on invoicing. If billing invoices are issued, then the revenue is reported regardless of when cash is received. And, expenses are generally reported when invoices are received regardless of when vendors are paid.

This method may cause income to be reported prior to corresponding net cash actually being in-hand.

Accrual with Deferred Retainage

For short-term construction contracts (or for small contractors using the accrual method for long-term contract purposes), a special election permits deferral of retainage receivable that may still be outstanding at year-end.[4] But according to the IRS, if a contractor has retainage payable, then it must also defer those expenses until the following year.[5]

The contractor's revenue size is not a deciding factor; all contractors can elect this method for contracts that are not long-term contracts.

Percentage-of-Completion Method

As a general rule, the PCM is required for commercial contractor's long-term contracts unless an exception applies.[6] The PCM is similar to financial statement reporting and is based on work performed, which in many cases may cause an acceleration of income compared to when net cash for the job is actually received.

There are minor variations in cost allocations for tax purposes as compared to Generally Accepted Accounting Principles (GAAP).[7] But from a practical perspective, tax and book PCM computations are generally the same – that is, until the FASB's new revenue recognition rules become effective for GAAP purposes in 2018 and 2019.[8]

It's important to note that residential and HCCs are afforded special exemptions from the PCM. The difference between residential construction and HCCs is based on the number of units; generally, condominiums and apartment buildings are considered residential construction.[9]

If the work qualifies as home construction, then the contractor may elect a method of its choice (generally the CCM).[10] Again, revenue size is not a factor, so large contractors working on these types of contracts qualify for favorable treatment.

Percentage-of-Completion Capitalized Cost Method

If the work qualifies as residential construction, then a contractor may use a hybrid 70/30 method known as the percentage-of-completion capitalized cost method (PCCM). Here, the result under the PCM is multiplied by 70%, and the result under the elected method (such as the CCM) is multiplied by 30%.

At the period end in Year 1, the CCM typically yields zero profit recognition and thus 30% of the PCM income is deferred under the PCCM.[11]

10% Method

The 10% method is a *de minimis* election that allows a contractor to defer the results on jobs that are not at least 10% completed under the PCM at the end of the year.[12] The deferred amount will be picked up in the year in which at least 10% of the costs have been incurred, which may, for example, be Year 2 of a three-year contract.[13]

Alternative **Minimum Tax**

Beyond the scope of this article is the Alternative Minimum Tax (AMT), which generally states that the PCM will apply to long-term contracts for AMT purposes.[14] The AMT "takes back" a portion of the benefit of certain deferrals achieved by small contractors for regular tax purposes.

However, the AMT adjustment for long-term contracts is not applicable to all contracts (e.g., it does not apply to HCCs).[15]

Conclusion

CFMs should recognize that there are both elections and required methods of reporting construction contract revenues and expenses. Those elections and requirements should be periodically reviewed and evaluated with the company's external construction CPA, who may be able to assist in maximizing tax deferrals. ■

Endnotes

1. IRC § 460(e)(1)(B)(ii).
2. IRC § 460(e).
3. IRC § 460(a).
4. Rev. Rul. 69-314.
5. ISP Construction and Real Estate, March 8, 2002, Retainage Payable.
6. IRC § 460(a).
7. For a recap, see Practitioners Publishing Company, Construction Contractors, Chapter 4, "Comparison of Cost Allocation Methods," Exhibit 4-6.
8. See FASB's Accounting Standards Update No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date.* For up-to-date information on this topic, visit *www.cfma.org/revenue-recognition.*
9. IRC § 460(e)(6)(A)(i).
10. IRC § 460(e)(1)(A).
11. IRC § 460(e)(5).
12. IRC § 460(b)(5)(B)(i).
13. IRC § 460(b)(5)(B)(ii).
14. IRC § 56(a)(3).
15. Ibid.

RICH SHAVELL, CPA, CVA, CCIFP, is President of Shavell & Company, P.A., a full service CPA and consulting firm specializing in serving contractors based in south Florida.

Rich has testified on issues affecting contractors before Congress and the IRS. He is a past winner of the *South Florida Business Journal* award for CPAs in construction, real estate, and tax categories.

Rich joined CFMA in 1990 and has served the association in various capacities. He was Chair of CFMA's Tax and Legislative Affairs Committee, is a current member of CFMA's Emerging Issues Committee, and serves on the Board of the South FL Chapter of CFMA.

Phone: 561-997-7242
E-Mail: info@shavell.net
Website: www.shavell.net