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Choose the Right Methods of Accounting to Optimize Tax Strategies

By Jim Lundy and Michael Varnell | Tuesday, March 29, 2022

The construction industry is uniquely complex in regard to the myriad available tax methods of accounting. Selecting the appropriate method is a critical first step for optimizing tax strategies.

A contractor determines the appropriate method of accounting for a long-term construction contract based on the nature and terms of each contract. In general, the determination is made in accordance with Internal Revenue Code (IRC) section 460 Special Rules for Long-term Contracts (IRC § 460).

The term "long-term" is often considered to be a contract that lasts a long period of time. Actually, the duration of the contract is irrelevant for classification purposes. The term "long-term contract" refers to any contract for the manufacture, building, installation or construction of property that is not completed within the taxable year in which it was entered.

Typically, contractors must use the percentage of completion method (PCM) to report taxable income from long-term contracts. However, if a contractor can meet one of the exceptions of IRC § 460, including non-long-term contracts completed in the same tax year as they are started, they may use any of a number of other methods.

The exceptions are for home construction contracts—with four or fewer units per structure with an average stay of more than 30 days— or small contractor contracts. “Small contractors” are determined using the “gross receipts test":

- For example, the average annual taxable gross receipts for the three taxable years preceding the year the contract was entered into did not exceed $26 million ($27 million for 2022); and
- At the time the taxpayer enters into the contract, it is estimated that the contract will be completed within a two-year period of the commencement date.

If a contract or contractor meets one of the exceptions to using PCM, they can use any allowable method. As a result, many contractors use as many as four methods in a single tax return.

In total, the IRS Construction Industry Audit Technique Guide, as revised in April 2021, illustrates the following ten tax methods of accounting:

1. CASH

Generally, the cash method of accounting is an acceptable method for construction contractors with average gross receipts less than $26 million over the prior three years. Under a cash-basis method, contractors report income when it is either actually or “constructively” received and deduct expenses when paid.

2. ACCRUAL

For tax accrual purposes, a contractor would report income when the right to receive the income is fixed; generally, when billed—even if “overbilled.” As a result, this is generally the least tax-advantaged method to use. Generally, accrual uses a series of “all events” tests to determine when rights are established and, therefore, a transaction must be recorded. Under the accrual method of accounting, expenses are deductible when all events that establish the fact of the liability have occurred.

3. HYBRID

The IRS has recognized a limited exception to the accrual method that allows a contractor to defer recognizing income from advance payments until the year after the contractor receives the payment. Treas. Reg. § 1.451-5 generally allows accrual method contractors to defer advance payments for goods or construction services.

4. ACCRUAL EXCLUDING RETAINAGE

If the contractual terms state the customer will pay the contractor the retainages withheld when completion and final approval occurs, the contractor does not have a fixed right to the income and, therefore, doesn’t have to include that portion in taxable income. In turn, retainage the contractor holds back on subcontractors is not deductible until the accrual basis “all-events” have occurred.

5. COMPLETED CONTRACT METHOD

Contractors may elect the completed contract method (CCM) to account for their exempt contracts. Under CCM, all contract income and contract-related expenses (direct and indirect) are deferred until the year of contract completion. Because of this tax deferral, this is generally the method preferred by most contractors. The taxable year of completion occurs the earlier of:

- When the contractor incurs at least 95% of the total allocable contract costs attributable to the subject matter of the contract and the customer uses the subject matter of the contract for its intended purpose (other than for testing); or
- Completion and final acceptance of the subject matter of the contract.

6. EXEMPT CONTRACT PERCENTAGE OF COMPLETION

A contractor that is exempt from the requirement to use contract percentage of completion (PCM) may elect an exempt contract percentage of completion (ECPM), which is a simplified method of determining the percentage of completion such as:

- Direct labor costs incurred to date to total estimated labor costs; and
- Comparing the work performed on the contract with the estimated total work.

7. PERCENTAGE OF COMPLETION COST-TO-COST METHOD

IRC § 460 requires contractors with average annual revenues of more than $26 million ($27 million for 2022) over the prior three years to account for long-term contracts using the PCM, unless they meet one of the exceptions noted earlier. The default method of calculating PCM for tax purposes is the cost-to-cost method. Cumulative contract costs incurred through the end of the taxable year are divided by the total estimated contract costs.

8. PERCENTAGE OF COMPLETION SIMPLIFIED COST METHOD

For contractors that are not required to use the cost-to-cost method (under $26 million), a taxpayer can elect to determine a contract's completion factor based on only certain components of costs versus all allocated costs.

9. PERCENTAGE OF COMPLETION 10% METHOD

A contractor may elect to defer recognition of revenue under PCM until the contractor incurs 10% of the total estimated allocable contract costs. Every contractor subject to PCM should make this election.

10. PERCENTAGE OF COMPLETION CAPITALIZED COST METHOD FOR RESIDENTIAL CONSTRUCTION

Residential contracts include nursing homes, retirement, and assisted living, prisons and dorms (four or more units per structure with an average stay of more than 30 days). The PCM capitalized cost method allows the residential construction contractor to report 70% of the contract under the PCM and report the remaining 30% under any exempt method (e.g., completed contract method or cash).

RECOMMENDATION

Many contractors follow the financial statement method of accrual and, as a result, miss tax planning opportunities available by deferring revenue recognition under other tax methods of account. By routinely reviewing their contract portfolios and any new contracts, contractors can ensure they are using the optimal tax methods and maximize tax deferral strategies. Using the optimal tax method allows contractors to plan and manage cash flow more effectively by aligning tax payments with revenue from the underlying contracts.

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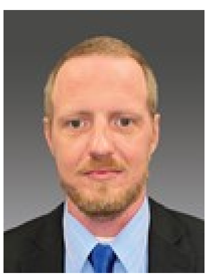

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