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Revised IRS Construction Industry Audit Technique Guide: Factors to Consider

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Much has changed on the landscape of tax accounting for construction contracts and contractors in the past few years. The revised Construction Industry Audit Technique Guide issued by the IRS in 2021 contains the most recent set of updates. Following are some highlights of some of the most impactful tax accounting changes for the construction industry.

Methods & Revenue Recognition

Average Annual Gross Receipts Test for Small Taxpayers

The average gross receipts test performed to be considered a small taxpayer was rewritten for tax years beginning after 2017. If average gross receipts are not properly calculated, a taxpayer might incorrectly elect an exempt long-term method of accounting, when the percentage of completion method is required. In the case of an income tax audit, this is an item that could be easily picked up and result in substantial adjustments to income.

The headlining change was the increase in the average prior three years' gross receipts from $10 million to $25 million (indexed for inflation). For some taxpayers, this is straightforward; but for those with interests in other businesses or investments, additional revenue streams may now need to be included in gross receipts.

Before the change, the definition of gross receipts excluded items not derived in the ordinary course of a trade or business, including interest, dividends, rents, royalties, annuities, and receipts from the sale or exchange of capital assets. As a result of the change, those items are now included. Taxpayers must also include parent-subsidiary gross receipts (one owns >50% of another), brother-sister gross receipts (5 or fewer owners own >80% of multiple ventures or 5 or fewer owners own the exact same >50% of multiple ventures) and the taxpayers' proportionate share of ventures for which they own between 5 and 50%.

Small Construction Contractors Becoming Large Construction Contractors

When a small construction contractor whose average annual gross receipts for the three prior taxable years was less than $25 million becomes a large contractor (i.e., passes the $25 million revenue threshold), it is required to use a cut off method of accounting and to evaluate the method utilized on a contract-by-contract basis. If the previously small construction contractor was using an exempt method for a job in year 5, it must continue to use an exempt method until the job is completed, even if it is deemed to be a large construction contractor in year 6. In year 6 the percentage of completion method must be used for any new jobs started.

If, in a later year, the contractor's average annual gross receipts for the three prior taxable years fall back below $25 million, the same rules apply. Jobs started in year 6 using the percentage of completion method must continue with this method until completion, and the taxpayer can use the exempt method to compute new contracts.

Improper Use of the PCM or Completed Contract Method
From subcontractors to general contractors to professional services such as construction management, engineering, and architecture, it is important to know that only those activities pertaining to the actual construction of a job are permitted to use the accounting methods for long-term contracts, such as the percentage of completion method and the completed contract method. Construction management, engineering, and architecture services do not meet the definition of a long-term construction contract; and they are thus not permitted to use these methods of accounting.

Gross Receipts–Netting of Expenses
In calculating gross receipts to determine the proper classification as either a large or small contractor, the taxpayer may offset gross receipts only with applicable returns and allowances. No other offsets are allowed. Improper netting of other expenses would reduce the average gross receipts, potentially shifting the contractor's classification, resulting in an improper method of accounting being used for tax purposes. Caution must be used when reviewing the gross receipts test, making sure to only include gross receipts less any applicable returns and allowances.

Expense Items:

Section 179
While the IRS has subjected additional asset types to the Section 179 deduction, certain items common to contractors still are not allowed to be fully expensed. Most notably, a $25,000 limitation is in place for vehicles deemed to be SUVs. By definition, an SUV is a 4-wheel vehicle primarily designed and used to carry passengers over public streets, roads, or highways and rated at more than 6,000 but not more than 14,000 pounds gross vehicle weight. Special consideration must be made when capitalizing vehicle fixed assets. While it may be sufficient for book purposes to have a fixed asset addition with the description "SUV," additional information should be included (such as the vehicle year, model, and trim) so the proper tax depreciation expense can be calculated and reported. The taxpayer must also make sure to use the Gross Vehicle Weight Rating (GVWR) rather than any other measurement, such as curb weight.

Cash Method Interest Expense
Taxpayers utilizing accrual basis accounting are generally allowed to deduct conventional loan interest as it is accrued or paid. Once the taxpayer has established the liability, the interest can be determined with reasonable accuracy; and the interest accrues economically (time passes while the taxpayer has the funds in hand).
On the other hand, for taxpayers utilizing cash basis accounting, interest on construction loans is deductible only when paid. Due to the nature of the loan and the general lack of an interim payment schedule, the terms of the loan should be reviewed to make sure that the payments being made are recorded to principal and interest appropriately.

Losses
Another common item—both because of the nature and the economy of the construction contracting business—is accrued losses on open contracts. While it is appropriate to accrue and recognize a current loss on uncompleted contracts for financial statement purposes when the loss is first calculated, the same rules do not apply for tax purposes. This will result in an unfavorable adjustment for the taxpayer. The taxpayer will recognize the loss depending on the method of accounting utilized. If the taxpayer recognizes long-term contracts under the percentage of completion method, only the loss incurred to date will be recognized for tax purposes. If the taxpayer recognizes long-term contracts under the completed contract method, the loss will not be allowed until the contract is more than 95% complete and the customer uses the subject matter of the contract for its intended purpose.

Uninstalled Materials Costs
With more contractors adopting Topic 606 for financial statement purposes, taxpayers must understand if adjustments are being made to contract costs with respect to uninstalled materials. Uninstalled materials will not be recognized for financial statement purposes until they are installed or used on the contract. For tax purposes, uninstalled material costs are allocable under the percentage of completion method as both costs incurred to date and total contract costs, once the liability is incurred for the materials. This recognition for tax purposes results in an increase in the contract percentage of completion and thus higher recognized gross profit.

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