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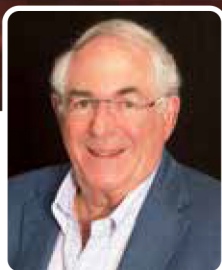
Why the IRS Audits
Small Contractors

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By Steven Bankler, CPA

Why the IRS Audits Small Contractors

Small building contractors are no strangers to IRS audits. It's a fact of life for some, given how complicated accounting methods and project billing can be. Certain activities and factors, however, are sure-fire audit triggers, including the following:

Using the wrong accounting method

Eligible small contractors making an average of \$25 million or less in annual gross receipts in the past three years can now use a more tax-friendly accounting method for projects that are not yet complete. However, there's an important exception: The threshold is determined on a controlled group basis, which means that if the contractor is under common ownership with several other companies, it might not be eligible. You must also pass the IRS gross receipts test to ensure your receipts within the past three years do not exceed the threshold. Plus, any contracts that began before 2018 need to continue under the prior applicable accounting method.

Your alternative minimum tax rate (AMT).

Owners of pass-through entities need to keep an eye on how their personal income can affect their business accounting method

and tax rate. Switching to a more advantageous accounting method outlined above may not be possible if you, as the business owner, are subject to the AMT. Non-residential contractors are required to recognize revenue under the percentage-of-completion method for AMT. A common audit trigger in this area is the sudden growth of the business. In 2020, the volatility of the marketplace produced plenty of surprises. Be careful if business growth was one of them.

Subcontractors.

As a builder that hires subcontractors, it's essential to adhere to independent contractor guidelines that allow your partners to pay taxes independently. If the IRS suspects you may be misclassifying employees as subcontractors, you may be facing steep payroll back taxes and penalties. And, if you're a subcontractor yourself, it's important to pay taxes on long-term construction projects not when the entire project is finished but when your part of the job is complete. Failing to do so is a common audit trigger.

Excess deductions.

The IRS looks for specific triggers that offer clues of potential excess deductions. They can include deducting a small business vehicle claiming 100% business use and declaring losses year after year. Some deductions will be unique targets for the 2020 tax year. Those may include home office deductions (since so many of us are suddenly working from home) and business deductions on expenses paid for

with forgiven federal Paycheck Protection Program (PPP) funds. That last point is a key one. Since businesses are not taxed on forgiven PPP loan proceeds, the expenses paid with those proceeds are not also deductible. "This results in neither a tax benefit nor tax harm since the taxpayer has not paid anything out of pocket," the U.S. Department of the Treasury has stated. But those expenses are usually deducted on your returns, so it's crucial to re-evaluate your usual tax strategy. .

Local sales-and-use taxes.

Homebuilders are subject to incredibly confusing sales-and-use taxes. Each project may require different tax considerations, and those considerations may vary from state to state. Common audit triggers include:

- *Mixing taxable with non-taxable work into single charges (resulting in the entire work needing to be taxed, called the mixed services rule).*
- *Failing to use current contract pricing terms (which can result in over-collecting taxes from the customer).*
- *Using standardized industry contracts that aren't customized for local tax provisions.*

If any of these areas feel familiar—notably if you received PPP funds or experienced business volatility this past year—ask your tax advisor if you're heading down the path for an auditor one-on-one.

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