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ACCOUNTING

New Rules of Construction Accounting

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If you're a reputable construction contractor, there's no doubt you're precise with measurements, equipment, project timelines and other aspects of the business. But bookkeeping? Accounting? Tax strategies? Those areas aren't likely in your wheelhouse. So let this be a reminder that you need to evaluate your method of accounting every year based on the projects you have in the works.

Here's why: The accounting methods allowed for small businesses in the construction industry changed in recent years. The definition of a small business changed, too. Eligible small contractors can make up to $26 million in annual gross receipts in a three-year period (as of 2021). That threshold was $5 million not long ago and, once it was changed as part of the Tax Cuts and Jobs Act of 2017 (TCJA), a whole new world of tax savings opened for additional contractors.

If you engage in long-term home construction contracts or other contracts that span across two tax years (but not longer), it's a big deal. Small contractors who qualify under the $26 million threshold can now use a cash method of accounting for tax purposes. The cash method is considered the most straightforward or "real-time" option because revenue is recorded when received, and expenses are recorded when vendors are paid. In short, you're not taxed on income before you've received it, as you may be with the traditional accrual method.

A completed contract method is also a possibility for small contractors. The approach is best for projects that span two tax years because it allows the contractor to defer all project revenue expenses and profit for the completion of the project. Additionally, small contractors now have flexibility in deducting certain capitalized costs, including inventory expenses and certain building materials or other items the IRS considers merchandise used in products sold to customers. Under the nonincidental materials and supplies method (NIMS), direct materials are deducted when they are sold. That means that you can deduct these inventory costs in the same year your project completes so that you can offset that income.

The more traditional accrual method of accounting that large contractors are still required to follow requires tax payment on projects while they progress (not necessarily as money exchanges hands). The most common type of accrual accounting is the percentage-of-completion method.

There are circumstances in which small contractors might still choose the accrual method. Manufacturing contracts and non-home-construction contracts that span more than two years must use the accrual method. Plus, if you have related businesses or your company is a flow-through business with losses allocated to passive investors, your ability to utilize small-business taxpayer accounting methods like the cash method could be questioned.

In short, you must pass the IRS gross receipts test to ensure your receipts within the past three years do not exceed the threshold. That's not as easy as it sounds. The IRS explains, "for purposes of the small business exemption, all taxpayers are subject to the section 448(c) gross receipts test. Taxpayers that would not otherwise apply the section 448(c) gross receipts test should apply it as if they were a corporation or a partnership, but should treat themselves as the type of entity that they actually are when applying sections 52(a), 52(b), 414(m), and 414(o) of the Code. For example, a taxpayer that is a partnership without a corporate partner should still apply the section 448(c) gross receipts test for purposes of section 163(j), but apply the partnership definition of controlling interest for purposes of the aggregation rules under §1.52-1(c)(2)(iii) and (d)(2)(iii) of the Income Tax Regulations."

Clear as mud, right? Your personal alternative minimum tax rate (AMT) may also affect your ability to use a simplified accounting method. Plus, although it's more complicated, the accrual method has its benefits when it comes to providing a more accurate financial snapshot of the business for potential financing, investors, buyers, or partners.

Before changing your method of accounting, talk to a tax advisor about the AMT factor and other concerns. The correct IRS forms must be completed, and some taxpayers must secure IRS consent before changing accounting methods for tax purposes.

It's ironic that moving to a simplified accounting method can be this complicated, but that's the IRS. A qualified tax advisor can help you decide what method of accounting is suitable for your projects and budgets. Do be sure, though, to reconsider the methodology annually. While a cash method may offer advantages for tax purposes, for instance, accrual accounting might be better for other financial reasons. The pros and cons of each method should be weighed carefully. With expanded options come added considerations, and some of those considerations can be too complicated to master on your own.

Steven Bankler has more than 45 years of experience in the accounting industry. Steven's expertise liesin consulting, planning, tax, and asset protection as well as exit strategy services for closely held businesses. He also provides litigation support (both as a testifying expert witness and a consulting expert), business negotiations and estate planning. Visit www.bankler.com for additional tax strategy tips and to learn more about Steven Bankler, CPA, Ltd.