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WHICH ACCOUNTING METHODS FOR SMALL CONSTRUCTION CONTRACTORS ARE ALLOWED FOR TAX PURPOSES? WHICH IS BEST? A DECISION HEURISTIC HELPS CHOOSE

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ABSTRACT

Many tax preparers still have difficulty determining and properly communicating the allowable tax accounting methods and bookkeeping procedures needed for small construction contractors, especially those having partially completed contracts at year-end. For many small construction contractors, the Internal Revenue Code is confusing and even court opinions give mixed signals as to which accounting method is permissible. This paper provides a discussion on the allowable methods of tax accounting and provides a decision heuristic to simplify the choice of allowable methods. The paper also offers suggestions about bookkeeping procedures.

I. INTRODUCTION

For many small construction contractors, the Internal Revenue Code is confusing with regard to which accounting method they are to use. Even court opinions give mixed signals as to which accounting method is permissible (Ansley-Sheppard-Burgess Co. v. Commissioner, 104 TC 367 and Thompson Electric, Inc. v. Commissioner TC Memo 1995-292). Many people—tax preparers, consultants, company controllers—still have difficulty determining and properly communicating the allowable tax accounting methods and bookkeeping procedures needed for small construction contractors.

This paper is written to clarify the tax accounting methods available to small construction contractors—those defined as having less than $10,000,000 of average annual gross receipts over the past three years—with significant inventories as construction-in-progress or work-in-process (WIP) at year-end. Also, this paper will discuss what should be presented on the balance sheet at year-end under the varying tax accounting methods chosen by the small contractor. Further, this paper will recommend some bookkeeping procedures or strategies that are helpful for the tax preparer, including the information that should be properly presented on the tax return and the taxpayer's balance sheet. It will also facilitate the appropriate choice of an accounting method, by the use of a decision heuristic.

II. METHOD OF ACCOUNTING – THE BASIC RULES

I.R.C. § 446(c) generally allows a taxpayer to select the method of accounting it will use to compute its taxable income.

I.R.C. § 446(b) provides that the selected method must clearly reflect income. In addition, Reg. §1.446-1(c)(2)(i) requires that a taxpayer use an accrual method of accounting with regard to purchases and sales of merchandise whenever §471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under §1.446-1(c)(2)(ii). Choosing a method of accounting that clearly reflects income sounds simple enough but may pose many not-so-simple questions:

1. If construction contractors have significant partially completed contracts at year-end, can they expense current-year costs for partially completed contract costs?
2. If a construction contractor takes partial payments for completion of certain phases of construction, can those cash payments be deferred until the contract is fully completed?
3. If a contractor arranges cash payments by a trust agreement only upon completion of the project and the contractor is the trustee of the trust, can revenue recognition be deferred until the project is completed?
4. If the contractor constructs only residential homes (i.e. High-rise townhome complex) rather than home commercial construction contracts, are there special tax methods of accounting needing to be followed?
5. Can a construction contractor with significant inventories at year-end be a cash-basis taxpayer for tax purposes?
6. Are there special tax accounting methods allowed for construction contractors that assist in deferring taxable income recognition?

1. METHOD USED FOR TAXES MUST BE METHOD USED ON THE BOOKS

The tax code requires that the method of accounting for tax purposes be the method used by the taxpayer to keep the books, the Internal Revenue Code states,

"General Rule. —Taxable income shall be computed under the method of accounting which the taxpayer regularly computes his income in keeping his books." IRC §446(a). [Italics added].

Taxpayers have to be careful when using a computer software program. For example, QuickBooks Pro® automatically creates accounts called accounts receivable and accounts payable. If you use their accounts, accounts receivable is included in income and accounts payable are included as expenses. Use of receivables and payables in an accounting system is accrual accounting. I.R.C. § 446(a) would thus, require the contractor to be on an accrual basis of accounting. If the taxpayer is trying to use a cash method of accounting, care should be taken to make sure receivables and payables are kept on a separate standalone system not integrated as part of the books.

The above statement is further clarified in the following,

"The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items." Reg. §1.446-1(a)(1).

When the taxpayer has construction-in-progress (CIP), work-in-progress (WIP), or construction inventory at year-end, it states,

"In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work-in-progress, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year." Reg. §1.446-1(a)(4)(i). [Italics added]

With regard to accounting for inventories, the code states,

"Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. IRC §471(a) [Italics added]

The term "merchandise" found in Treasury Regulation §1.446-1 does not only mean "retail merchandise", it also means "construction merchandise". Construction merchandise is defined as items that are transferred to customers or incorporated into the product. Thus, construction materials—cement, bricks, drywall, framing wood—supplies, labor, etc. not yet legally transferred to the customer at year-end is considered merchandise, thus needing to be considered as inventory at year-end.

The treasury regulation explanation implies that regardless of which method of accounting is chosen by the taxpayer, partially-completed construction contracts at year-end will have to be accounted for under an inventory or holding account method and released into "Cost of Goods Sold" as a tax deduction either at the sale of the construction project to the customer or on a completed-contract method. This recognition issue is the nub of the difficulty for many small construction taxpayers—when do the construction costs paid or incurred become an allowable tax deduction?

III. CONSTRUCTION CONTRACTS

Under IRC §460(a), Special Rules for Long-Term Contracts, the construction taxpayer is required to use the accrual method of accounting and percentage-of-completion method for construction of projects that are deemed "long-term" in nature under the tax law. However, there exists an exception for certain small construction contractors under this code section. The exception or exemption from the required percentage-of-completion method of accounting is allowed for the following construction contractors:

(e) *Exception* for certain construction contracts.

> "Any home construction contract, or any other construction contract entered into by a taxpayer—who estimates that such contract will be completed within the 2-year period beginning on the contract commencement date of such contract, and whose average annual gross receipts for the 3 taxable years preceding the taxable year in which such contract is entered into do not exceed $10,000,000." IRC §460(e)(1).

Taxpayers who meet the requirements of the exception are exempt from the specialized percentage-of-completion method of accounting for construction contracts. The taxpayer is then allowed to use what are referred to as the "normal methods" of accounting.

IV. NORMAL METHODS OF ACCOUNTING

The normal methods of accounting refer back to the accounting methods allowed prior to the passage of IRC §460 in March 1, 1986. Those normal methods are as follows:

1. The cash method—now for taxpayers whose average gross annual receipts does not exceed $1,000,000
2. The hybrid method—using the cash method for expenses which are not inventoriable (business, professional licenses, supplies, etc) and completed-contract method for project costs.

3. The completed-contract method—as described in treasury regulation §1.460-4(d).
4. The percentage-of-completion method—as described in treasury regulation §1.460-4(b).
5. The accrual method and variations—income is included when billable and costs are deducted when incurred, as described in Reg. 1.446-1(c)(ii).

The appropriate method of accounting can be determined by using the decision heuristic and is intended to provide guidance for small construction contractors.

V. USE OF THE CASH METHOD OF ACCOUNTING (HYBRID METHOD REQUIRED)

The cash method generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. §1.446-1(c)(1)(i).

Revenue Procedure 2001-10 states,

> the Commissioner of Internal Revenue will exercise his discretion to except a qualifying taxpayer with average annual gross receipts of $1,000,000 or less from the requirements to use an accrual method of accounting under §446 of the Internal Revenue Code and to account for inventories under §471...This revenue procedure applies to taxpayers (other than a taxpayer described in §448(a)(3)) with "average annual gross receipts" of $1,000,000 or less (as defined in section 5.01 of this revenue procedure)("qualifying taxpayers"). Revenue Procedure 2001 – 10, I.R.B. 2001-2 (Dec. 06, 2000).

This revenue procedure allows certain construction contractors to simply use the cash method of accounting, if they so choose. Qualifying construction contractors are those with $1,000,000 or less of average annual gross receipts. However, moderating this new revenue procedure is the embedded requirement that the taxpayer comply with the "Cost of Materials" definition found under Treasury Regulation §1.162-3. This same revenue procedure states,

A taxpayer described in section 3 [referring to scope] that does not want to account for inventories must treat merchandise inventory in the same manner as a material or supply that is not incidental under section 1.162-3.

> Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is

> made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year... Treasury Regulation §1.162-3, [Italics added]

When Revenue Procedure 2001-10 was released, there was a collective sigh of relief for CPAs and small construction contractors that have struggled to determine whether they must file on an accrual basis or whether they could continue, as many started, as a cash-basis taxpayer (Jennings, Robert, 2001).

Revenue Procedure 2001-10 clarified and established an understanding of how the above stated regulation is to be interpreted. This interpretation would impact small construction contractors with partially completed contracts at year-end, and who otherwise qualify for the cash method of accounting under Revenue Procedure 2000-10. Revenue Procedure. 2001-10, paragraph 4.02 clarifies,

> Under Treasury Regulation §1.162-3, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer's business. For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year in which the taxpayer sells the merchandise or finished goods. Thus, under the cash method, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the inventoriable items, whichever is later. Rev. Proc. 2001-10, paragraph 4.02, [Italics and bold added]

Presently, if the construction contractor, or any trade or business for that matter, meets the less than $1,000,000 average annual gross receipts test, the cash method of accounting may be used. However, if significant unsold inventories, such as construction-in-progress or work-in- progress (WIP) exist at year-end, the cash payment for such costs is not deductible until the year that project is completed and sold! Thus, it is more than likely that a hybrid method and not a pure cash method will be required.

VI. ALLOWABLE TAX ACCOUNTING METHODS

Generally, the accounting methods available now for small construction contractors with partially completed long-term contracts at year-end are as follows:

1. Cash Method (CM) (Only available to those with gross receipts of $1,000,000 or less and no Work in Process, per IRC §446(c)(1); amplified under Rev. Procs. 2000-22, 2001-10.

2. Cash Method +Completed-Contract Method (CMCCM), per IRC §446(c)(1), as restricted under Reg. §1.446-1(a)(4)(i).
3. Accrual Method +Completed-Contract Method (PCCCM), per IRC §446(c)(2); guided by special accounting method under IRC §460(e); Reg. 1.460-4(d).
4. Accrual Method +Percentage-of-Completion Method (PCM), per IRC §446(c)(2); guided by special accounting method under IRC §460(b); Reg. 1.460-4(b).

VII. LONG-TERM CONTRACTS

For construction contractors, any contract for the "building, installation, or construction of property, if the contract is not completed within the tax year in which the contract is entered into is deemed a long-term contract." IRC §460(f)(1). [Italics added]

This point of tax law is sometimes confusing to some people who might believe that a "long-term contract" is a contract requiring greater than one year to complete or operating cycle, whichever is longer. As stated earlier, Reg. 1.460-4(d), allows the taxpayer with partially- completed contracts, who meets the IRC §460(e) exception, to use completed-contract method of accounting. This method is often preferred because the completed-contact method (CCM) allows management control over which year to recognize taxable income. A long-term contract is any contract for the building, installation, or construction of property not completed at year- end. The definition of long-term contracts is further proscribed in a couple of Revenue Rulings published by the Internal Revenue Service (Rev. Ruls. 70-67, 80-18, and 82-134).

The IRS states that contractors providing services in the construction industry, such as architects, engineers, and even construction management services firms cannot use completed- contract method (CCM) of accounting for income taxes. Specifically, service contracts are not long-term contracts, even though they might be partially completed at year-end. Further, the Revenue Rulings state definitively that these professional services "were not required to actually construct, build, or install anything, even though their services are functionally related to activities that may be the subject of long-term contracts" (Rev. Rul. 84-32).

Once a taxpayer has been identified as qualifying to have long-term contracts, a proper method of tax accounting is required. Below is a discussion of the general tax accounting methods available for the small construction contractor with average annual gross receipts of $10,000,000 over the past three years with partially completed contracts at year-end.

VIII. CASH METHOD (CM)

The cash method of accounting allows the taxpayer to record all revenues and expenses when actually received or constructively received, and not necessarily when earned, and permits a deduction when paid, not necessarily when incurred. Even with the release of these revenue procedures, construction contractors will still have to be careful with the costs of partially- completed contracts at year-end.

Even prior to these revenue procedures many companies accounted for construction activity using the cash method. Such construction companies will usually continue using the cash method but must make adjustment for projects not completed at year-end, or the companies will not be in compliance with allowable tax accounting methods. Use of the cash method plus completed-contract method for partially completed projects is called the hybrid cash method. Under this hybrid cash method, inventory or work-in-progress (WIP) accounts and deferred revenue accounts are used for the partially completed projects.

When construction costs for partially completed projects at year-end exist, these construction costs are deemed to be “inventory,” and thus, “an income producing factor” for the taxpayer. And because these construction costs or “inventory” are not incidental but rather material in determining gross income, such costs must be capitalized as materials, supplies, or “inventory” and not expensed as cash is paid for them. Therefore, long-term construction contract costs related to a partially completed project at year-end must be capitalized and the costs expensed upon sale of the related construction project.

By using construction loans to build the property and then selling it under contract, the contractor is able to defer the recognition of cash receipts from the customer for whom the long- term contract relates. A contractor who takes progress payments for the construction will have a different result; any cash received will be required to be recognized as income.

Another method of deferring recognition of cash paid upfront or during a progress-billing arrangement is to have the progress payments made to an escrow or trust account that is released to the contractor at the end of the construction project. Under an escrow or trust agreement that requires the taxpayer to repay if the contract is not fully executed, income does not accrue to the construction contractor taxpayer. (See A.M. Brown, SCt, 4 USTC 1223). The fact that the taxpayer is or could be the trustee over the restricted funds does not affect this accrual rule as long as the funds are not used for the taxpayer’s own benefit. (Cedar Park Cemetery Assn., CA- 7, 50-2 USTC 9376).

IX. CASH METHOD – COMPLETED CONTRACT METHOD (CMCCM)

A pure cash method of accounting (CM) is not allowed for contractors because partially completed construction contracts at year-end create significant inventories, thus, requiring accrual method of accounting. Reg. §1.446-1(a)(4)(i) states, "in all cases in which the production ...of merchandise of any kind, is an income producing factor..." the accrual method of accounting must be used. Even IRC §448(c), allowing C corporations the cash method of accounting, does not exempt them from the proper accounting for partially completed contracts.

When construction costs for partially completed projects at year-end exist, these construction costs are deemed to be "inventory," and thus an income producing factor for the taxpayer. And because these construction costs for partially completed projects are not incidental but material to determining gross income, such costs must be capitalized as materials, supplies, or "inventory" and not expensed until the project is sold to the client customer. Construction projects, even under the cash method, using completed-contract method (CMCCM), must aggregate all construction costs—materials, labor, and IRC §263A overhead— to the asset account work-in progress (WIP). These costs are then expensed when the project is sold.

X. HYBRID METHOD – ACCOUNTANT ADJUSTMENTS AND BOOKKEPING SUGGESTIONS

Prior to the sale of the construction project, the construction costs should be accumulated in an asset account called Work in Process. Until the project is sold for cash under the cash method (CM) of accounting, the taxpayer "holds on" to construction costs, not taking any deductions for materials, labor, or allocable overhead.

Most taxpayers in this category, residential, home, and other small commercial construction contractors, keep their books using a software platform like QuickBooksPro®. The progress payments from the contractor's customer and the construction costs are all recorded using the cash method of accounting. The small contractor taxpayer is not sophisticated and usually does not desire to pay for an accountant to keep track of the required tax reporting procedures. The tax advisor should request the contractor customer to print out or provide a zip- disk of information of construction projects by "class." The tax advisor then needs to separate the partially completed contracts costs this year into separate work-in-progress (WIP) asset accounts for each partially-completed contract.

The tax advisor then adds the prior year's deferred construction costs to the current reporting year by closing out the prior year Work in Process accounts, presuming that the small construction contractor projects are completed.

The subtracting of partially completed long-term contract's cash disbursements of the current year and the adding of the cash disbursements from the prior year can be easily performed on spreadsheets. These spreadsheets provide workpapers and bridging-evidence documents between what the client contractor has on record at year-end and the proposed adjusting entries required to be journalized into the client customer's accounting system. These workpapers will also record the reconciling amounts for items that differ between the client taxpayer's cash-basis books and the tax return's cash method, using completed-contract method (CMCCM) of accounting. The tax advisor's bridging workpapers are then used the next tax year to properly include the prior year's deferred expenses to the next year's allowed expenses for "cash basis" completed-contract method.

Even though the client contractor used a purely cash receipts and cash disbursements approach to record transactional activity, the required adjustments to capitalize partially- completed contract costs at year-end is permissible. Under the lengthy treasury regulation regarding permissible accounting methods, it states,

XI. HYBRID METHOD – TAXPAYER METHOD OF BOOKKEEPING

Prior to sale of the construction project, the construction costs should accumulate in a construction work-in-progress (WIP) inventory account and only be released as construction costs in the period the project is sold, and cash is received. Construction costs that straddle year- end must be placed into a WIP inventory account reported on the taxpayers' company balance sheet. The only deductions to recognize for any given year are the released WIP accumulated costs of construction for those projects sold during the current tax year and, of course, all other allowable cash deductions for related trade or business expenses.

If the taxpayer is keeping his own books using QuickBooks®, he should set up the following accounts:

- WIP - Construction,
- WIP - Lots, and
- WIP - Interest.

Each lot or project should be set up as a separate job or customer. Each loan should be set up as a separate payable under current liabilities. All expenses should be separated by job, when paid, and should be put into a work-in-progress (WIP) account for either construction costs, lots, or interest.

Upon the sale of a house or project, the sale should be recorded as a journal entry as follows:

Cash	XXXX
Closing Costs	XXX
Commissions	XXX
Note Payable (loan)	XXXX
Sales	XXXXXX

QuickbooksPro® provides a pre-programmed report under the "Reports" category called "Profit and Loss Mid-Stream by Job." This report will pull-up the balances in the three WIP accounts described above. These balances in the WIP accounts should be closed in a journal entry that would look like the following:

Cost of Construction Sold	XXXXXX
WIP—Construction Costs	XXXX
WIP—Lots	XXX
WIP—Interest	XX

To make this work, you must be sure to use the "job" column and fill in the job or customer name on every entry both in the journal entries and when writing checks or making deposits.