

Understanding Tax Accounting for the Construction Industry



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The IRS continues to scrutinize the “tax gap” — the amount between taxes that are voluntarily paid and the amount the tax agency believes is actually due.

To this end, the IRS has issued a series of documents to provide better understanding of the tax code. One example is specifically directed at the construction industry.

The IRS emphasizes instances where taxpayers failed to report, or under-reported, income from construction activities. This applies to individual workers as well as contractors and subcontractors. The following are the highlights:

Accounting Methods

Generally, income and expenses are calculated using either the cash method or the accrual method of accounting. “Either method must clearly reflect a consistent treatment of income and expenses from year to year,” the IRS notes.

Many construction businesses use two different tax accounting methods: one for long-term contracts and an overall method for all other items, which is often the accrual method.

1. Accrual accounting: This method requires reporting income in the year earned and expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year. Two commonly used accrual methods are used in the construction industry:
 - Under the “completed contract method,” all income and expenses from a contract are reported when the project is completed and accepted by the customer.
 - With the “percentage of completion method,” income is reported proportionate to the costs incurred to date as compared to total estimated costs for the contract.

2. Cash accounting: As the name implies, cash receipts are reported as income when received and expenses are reported when paid. For this purpose, receipt occurs when a contractor has unrestricted access to income. Contractors who are able to receive money in one year, but chose to defer receipt, must include the cash as income in the earlier year.

Note that construction businesses operating as a C corporation, or a partnership with a C corporation as a partner with average annual gross receipts exceeding \$5 million, may not be allowed to use the cash accounting method.

Deductible Expenses

It is well-established that a construction business can deduct ordinary and necessary business expenses. An “ordinary” expense is one that is common and accepted in the construction business. A “necessary” expense is one that is helpful and appropriate for the construction business. Note: The expense does not have to be indispensable to be considered necessary.

Several common business expenses that may be deducted in the year they are incurred are:

- Utilities;
- Car and truck expenses;
- Advertising;
- Employee salaries;
- Trade association dues;
- Rent expense;
- Supplies;
- Continuing education;
- Small tools expected to last one year or less;
- Steel toe work boots; and
- Business licenses.

The cost of business assets that are expected to last more than one year must be capitalized and depreciated over their useful lives. Some examples of these assets include:

- Cement mixers;
- Compressors;
- Ladders;
- Other heavy machinery; and
- Buildings and real property.

Be aware that personal expenses such as clothing that can be worn off the job site, fines and penalties, and the non-business use of vehicles or computers, can't be deducted. Other expenses, including certain meal and entertainment expenses, may be deductible in part or only if certain conditions are met. As always, timely and accurate bookkeeping of these expenses is key to compliance.

The onus is on you to comply and stay up to date with current tax codes and regulations.