

What makes construction accounting one of the most complicated industries from a tax perspective?

It could be that: a) as a contractor there are numerous issues and tax method choices available that are dictated by different sections of the Internal Revenue Code, b) even though you have already selected an initial method, there are various tax rules that may require changes to this method, c) the efforts necessary if the original method needs to be changed or corrected, d) the need to keep up-to-date on any and all changes imposed by the IRS and other law making bodies that affect these tax rules. These and many other issue makes construction accounting a unique, complicated and time consuming task.

Original Method Selection

A contractor must choose a method of accounting in the first year of existence. Another method must then be selected the first year there is a long-term contract. When the first tax return is filed a method of accounting must be selected. This method will be determined based on a variety of factors. The type of entity the company was organized as, the amount of gross

revenue, and type of contracts performed. Methods can you choose from:

- Cash
- Accrual
- Accrual excluding retentions
- Hybrid

When to recognize revenues and costs will be determined under each of the above methods.

Long-Term Contracts

Just what is a long-term contract? What t What the Internal Revenue Code “IRC” defines as a long-term contract may be different from your ideas of what “long-term” is. The “IRC” defines a long-term contract as “any contract for the manufacture, building, installation or construction of property if such contract is not completed within the taxable year in which such contract is entered into”. According to this definition, if a contractor who is a calendar year taxpayer (year end December 31) starts a contract in December and completes it in January, the contract is a long-term contract. Why? The contract was not completed “within the taxable year”. So what does this mean? Now a method of accounting for long-term contracts must be chosen. These methods are different from the choices you have already selected from above.

How to Account for Long-Term Contracts

POC - Percentage of Completion	Revenue recognition is based on the use of one of the methods defined below. POC can be measured by costs, labor hours, labor dollars, a determination by an architect or engineer or some other determinant
PCM - Percentage of Completion Method	Generally defined by section 460; the measurement of revenues recognized is determined by costs-to-date compared to total estimated contract costs, as defined by 1.460-5(a), multiplied by the expected contract receipts, as defined by 1.460-4(a)
EPCM - Exempt Percentage of Completion Method	In this method, POC can be calculated by any measure of progress, such as units of performance (for examples, miles of pavement paved), labor hours, labor dollars, etc.
CCM - Completed Contract Method	Under this method, contract costs are deferred as an asset account, as dictated by 1.460-5(d), and progress billings are deferred as a liability until the contract is completed, as defined by 1.460-1(c)(3)
PCCM – Percentage of Completed Capitalized Cost	Under this method, the contractor/taxpayer must determine income under a long-term contract using the PCM for 70% for the contract and the EPCM for the remaining 30%. This method is available for residential construction contracts

Need for a change?

Now that you have selected your initial accounting method and you have tackled your first long-term contract, it's smooth sailing from this point. Right? Wrong! There are various sections in the IRC that may require you to change your method yet again. Depending on the methods selected there are several tests to be performed on your average annual gross receipts that may necessitate a change in method in order to comply with tax rules. Some of these changes are automatic and do not require approval from the IRS, others require IRS approval. If not done properly or timely, the IRS may assess significant penalties and interest.

Continually changing rules

Be it the IRS, Congress or the courts, the laws and interpretations governing contractor accounting methods are continually changing. The latest changes made final on January 11, 2001 added many new rules and restrictions. No matter what size contractor you are, you need to be familiar with these rules and regulations, as the selections will impact your tax position for years. Not only do you need to understand the different methods for accounting for long term contracts you need to be familiar with issues such as the small contractor exception, real property requirement, definition of a construction contract or a home construction contract. All of which fall under different sections of the IRC and are frequently changing.

Conclusion

As you can see, the choices available for construction contractors are numerous and complicated. It is important to consider all laws and regulations before selecting your accounting method(s).