Critical Issues Involving Taxation of Construction Contractors

TCC4/25/V1-P1

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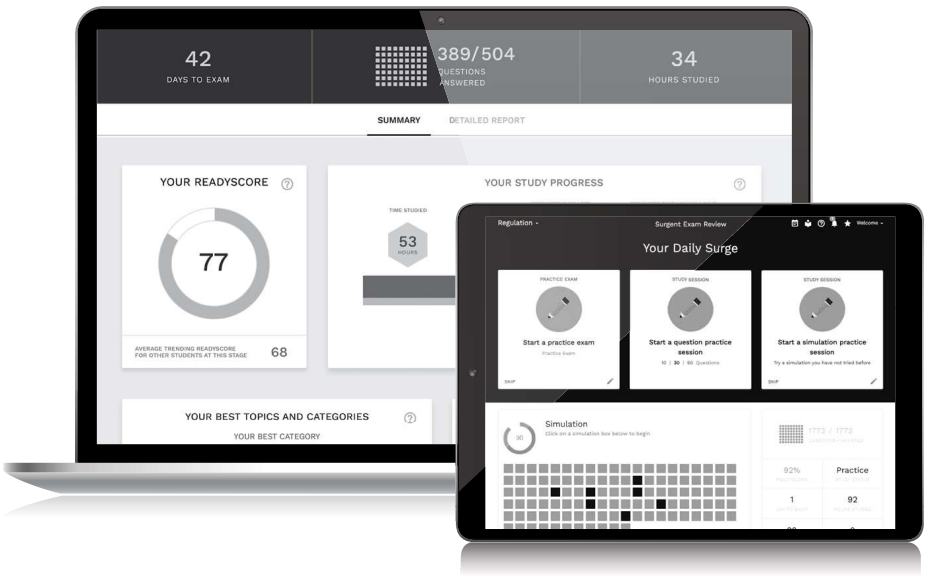

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The Impact of Key Tax Legislation on the Construction Industry

The Impact of Key Tax Legislation on the Construction Industry

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Recognize the impact the Tax Cuts and Jobs Act (TCJA) has had on the construction industry; and
- Identify when the cash method of accounting may be used for long-term contracts.

I. Impact of the TCJA on the construction industry

A. Tax accounting methods for long-term contracts

In general, most contractors must use the percentage-of-completion method for long-term contracts (§460(a)). Starting in 2018, contractors that have average annual gross receipts (measured by the prior three tax years) of $25 million ($31 million for 2025) or less are allowed to use the completed-contract method as long as the particular contract is estimated to be completed within the two-year period beginning on the contract commencement date (§460(e)(1)(B)). This change has ultimately allowed many smaller contractors to defer revenue into later years.

It should be noted that this exception is applied on a contract-by-contract basis. The same taxpayer may have some contracts that qualify for the completed-contract method (because they are expected to be completed within two years), while others must be accounted for under the percentage-of-completion method (because they cannot be completed within the two-year timeframe). This could create administrative burdens that outweigh the tax benefits provided by the deferral of revenue under this code section. It should also be noted that a qualifying taxpayer may decide to use the percentage-of-completion method anyway in order to more closely match GAAP basis financial statements.

B. Alternative minimum tax

One of the provisions of TCJA was the elimination of the alternative minimum tax (AMT) for C corporations. Most contractors organized as C corporations benefit from this change since one of the most important AMT adjustments is the difference between the contractor's normal method of accounting for long-term contracts (cash, accrual, or completed-contract method) and the percentage-of-completion method. After the TCJA, most C corporation contractors using methods other than the percentage-of-completion method no longer have to make this AMT adjustment.

For tax years beginning after 2025, there is a change in the calculation of the corporate AMT. Going forward, a corporation's adjusted financial statement income is reduced by any deductions for intangible drilling and development costs (IDCs) allowed in computing the corporation's taxable income. Also, adjusted financial statement income will disregard any depletion expenses for property that are taken into account on the corporation's applicable financial statement with respect to the IDCs of that property.

It should be noted that for tax years after 2022, under §55(b)(2), corporations with a three-year average annual income (adjusted financial statement income or AFSI) in excess of $1 billion are subject to a 15 percent corporate alternative minimum tax. S corporations are exempt from this tax. However, since this

only affects very large organizations, most C corporations are still benefiting from the elimination of the AMT. For foreign corporations, Notice 2024-10 provides rules for determining the AFSI of a U.S. shareholder when a controlled foreign corporation (CFC) pays a dividend to the U.S. shareholder or another CFC. Notices 2024-10 and 2023-64 give guidance for determining the applicable financial statement for this purpose of a corporation included in a consolidated tax return.

Note:

S corporations and partnerships are still required to pass through any AMT adjustment to their shareholders/partners/members. In addition, contractors operating as sole proprietorships are still required to consider AMT at the individual tax level.

C. Depreciation

Section 168(k), more commonly referred to as bonus depreciation, increased from 50 percent to 100 percent for qualified fixed assets placed in service after September 27, 2017, and before 2023. At that point, under the TCJA, bonus depreciation began to decrease over time:

2023	80 percent
2024	60 percent
2025	40 percent

With the passage of the One Big Beautiful Bill Act (OBBBA) in 2025, 100 percent bonus depreciation was generally restored and made permanent for property acquired after January 19, 2025. Specified plants acquired and planted or grafted after January 19, 2025, also qualify for 100 percent bonus depreciation. It should be noted, however, that qualified property acquired before January 20, 2025, is still subject to the prior bonus depreciation rates for the year the property is placed in service (40 percent for 2025 and 60 percent for 2024).

For the time being, construction equipment dealers and contractors can benefit. Both new and used assets qualify. (Under previous regulations, only new equipment was eligible for bonus depreciation.) This will go a long way in removing the concern many contractors have of purchasing either new equipment or used equipment. Heavy highway and other capital-intensive contractors will benefit from the significantly increased amount of depreciation they will be able to take.

In many instances, the benefit of §179 expensing was temporarily reduced due to the enhanced bonus depreciation provisions discussed above. However, under the OBBBA, the maximum amount a contractor can expense under §179 has been increased to $2.5 million for 2025 and the phaseout threshold has been increased to $4 million.

D. Section 199A deduction

Section 199A created a new deduction for sole proprietors, S corporation shareholders, and partners of partnerships (including LLCs). The exact calculation of this deduction is complex and beyond the scope of this course. It is generally 20 percent of the lesser of qualified income or taxable income but may be subject to limits based on wages and qualified property related to the qualified trade or business. Since many, if not most contractors function as sole proprietors, S corporations, or partnerships, this particular change resulting from the TCJA has become very beneficial to the construction industry.

It should be noted that the OBBBA made the §199A deduction permanent and increased the phaseout thresholds to $150,000 for married taxpayers filing jointly ($75,000 for all others) starting in 2026. This should make the deduction even more lucrative for taxpayers going forward.

Note:

The §199A deduction is not available to C corporations.

E. Net operating losses

1. C corporations

For those contractors operating as C corporations, recent legislation has added some restrictions on the utilization of net operating losses.

Net operating losses generated prior to 2018 may generally be carried back two years and carried forward 20 years. There is a 100 percent of taxable income limitation.

Net operating losses generated in 2018, 2019, and 2020 may generally be carried back five years and carried forward indefinitely. If the losses are utilized after 2020, there is an 80 percent of taxable income limitation. If they are utilized before 2021, there is a 100 percent of taxable income limitation.

Net operating losses generated after 2020 have the following rules:

- Net operating losses can no longer be carried back to prior taxable years.
- However, they may be carried forward to future taxable years indefinitely.
- The net operating loss deduction allowed in any given year is limited to 80 percent of the contractor's taxable income.

2. S corporations and partnerships

For S corporation shareholders and partners in a partnership, losses must make it through four distinct loss tiers to be deductible. These loss tiers are as follows:

a. **Basis (§1367 and §705)** – Losses may only be taken to the extent of basis.

b. **At risk (§465)** – Losses may be taken only to the extent that a taxpayer has adequate amounts at risk. The amounts at risk generally consist of cash and property contributed to the activity plus recourse debt and qualified nonrecourse debt.

c. **Passive (§469)** – Passive losses may only be taken to the extent of passive activity income.

d. **Overall limit on business losses (§461(l))** – Losses may be taken at the individual level only up to an inflation adjusted yearly limit ($626,000 for married taxpayers and $313,000 for individuals in 2025). Any losses beyond this limit may be carried forward as an NOL subject to an 80 percent-of-taxable-income limitation (§172). It should be noted that the OBBBA made the overall limit on business losses permanent. It is no longer set to expire at the end of 2028.

F. Meals and entertainment deductions

Beginning in 2018, no deduction is allowed for:

- Entertainment, amusement, or recreation expenses;
- Membership dues for clubs organized for business, pleasure, recreation, or other social purpose; or
- Facilities or portions of those facilities used in connection with any of the items noted above.

It should be noted that restaurant meals in 2021 and 2022 are not subject to the normal 50 percent limit. These meals may be deducted in full (§274(n)(2)(D) and IRS Notice 2021-25). Starting in 2023, the 50 percent limitation applies once again.

Starting in 2026 under the OBBBA, employer-provided meals are nondeductible if they are: (1) excludable from an employee's income under §119(a); or (2) for food and beverages that qualify as a de minimis fringe benefit to the employee under §132(e). For 2025, an employer may continue to deduct 50 percent of expenses for food, beverages, and related facilities that are furnished on business premises primarily for employees (e.g., company cafeteria, executive dining room, etc.).

G. Business interest deduction

The TCJA limited the deduction for business interest. In order to understand this provision, we need to define small contractors and large contractors. Contractors may be excluded from this limitation if they meet the definition of a small taxpayer. A small taxpayer is defined as having $25 million ($31 million for 2025) or less in average gross receipts based on a prior three-year average. The gross receipts test is aggregated for entities under common control.

It should be noted that starting in 2025, there is a change in the calculation of the business interest deduction limitation due to the OBBBA. At this point, adjusted taxable income will correspond to earnings before interest, taxes, depreciation, and amortization (EBITDA) on a tax basis, rather than to earnings before interest and taxes (EBIT) on a tax basis (which is how the calculation was made before the passage of the bill).

For larger contractors, there is an exemption from this limitation for electing real property trades or businesses.

A real property trade or business for this purpose is a trade or business is described in §469(c)(7)(C) and includes the following activities:

- Development;
- Redevelopment;
- Construction;
- Reconstruction;
- Acquisition;
- Conversion;
- Rental;
- Operation;
- Management;
- Leasing; and
- Brokerage.

Construction is one of the trades or businesses that the business interest deduction limitation does not apply to if the taxpayer makes this election. If this election is made by the contractor, they will then be required to depreciate their fixed assets using the alternative depreciation system (ADS) rather than the more traditional general depreciation system (GDS). Depreciable lives under ADS are longer than GDS. Therefore, the contractor will have to determine whether it is advantageous to deduct more interest expense but less depreciation in a given year or take full depreciation but have their interest deduction limited.

H. Choice of entity

Now more than ever, due diligence needs to be done by the CPA regarding a contractor's choice of entity:

- C corporation – No AMT (for most C corporations), limitations of net operating loss utilization, and a flat 21 percent income tax rate.
- S corporation and partnership – The ability to utilize the 20 percent §199A deduction as previously discussed.

Therefore, in certain instances, especially one where the shareholder/partner/member is in a "heavy" AMT situation, it may make more sense to make this new contractor a C corporation rather than the more traditional selection of a partnership/LLC or an S corporation.

II. Inflation Reduction Act

A. Introduction

The Inflation Reduction Act of 2022 contained several provisions that both directly and indirectly affected the construction industry. We highlight several of these items here.

B. Nonbusiness energy property credit

For nonbusiness energy property placed in service prior to January 1, 2022, a credit used to be available equal to 10 percent of the amount paid or incurred by an individual taxpayer for qualified energy-efficiency improvements installed during the taxable year and the amount of the residential energy property expenditures paid or incurred by the taxpayer during the taxable year. The previous version of the credit was also subject to a lifetime limitation. The Inflation Reduction Act expanded and extended this credit.

Note:

The nonbusiness energy efficient home improvement credit is repealed by the OBBBA and any property place in service after December 31, 2025, is ineligible for the credit. Therefore, taxpayers have a limited time to take advantage of the credit.

According to §25C(c), qualified energy-efficiency improvements include any energy-efficient building envelope component if:

- The component is installed in or on a dwelling unit located in the United States that is owned and used by the taxpayer as their personal residence;
- The original use of the component commenced with the taxpayer; and
- The component could reasonably be expected to remain in use for at least five years.

Per §25C(d), residential energy property expenditures are expenditures made by the taxpayer for qualified energy property that is:

- Installed on or in connection with a dwelling unit located in the United States that is owned and used by the taxpayer as the taxpayer's principal residence; and
- Originally placed in service by the taxpayer.

The Inflation Reduction Act made the following modifications to this credit:

- Increased the nonbusiness energy property credit from 10 percent to 30 percent of the amount paid or incurred by the taxpayer for qualified energy-efficiency improvements installed during the taxable year and the amount of the residential energy property expenditures paid or incurred by the taxpayer during such taxable year;
- Repealed the requirement that residential energy property expenditures must be made with respect to the taxpayer's principal residence;
- Repealed the lifetime credit limitation and imposed an allowable credit of $1,200 per taxpayer per year, including annual limits of:
  - $600 for credits related to residential energy property expenditures, windows, and skylights; and
  - $250 for any exterior door ($500 aggregate limit for all exterior doors).
- Created a $2,000 annual limit for amounts paid for specified heat pumps, heat pump water heaters, and biomass stoves and boilers; and
- Increased the credit to $150 for amounts spent for a home energy audit, defined as an inspection and written report with respect to a dwelling unit that is located in the United States and owned or used by the taxpayer as the taxpayer's principal residence that:
  - Identifies the most significant and cost-effective energy-efficiency improvements with respect to such dwelling unit, including an estimate of the energy and cost savings with respect to each such improvement; and
  - Is conducted and prepared by a home energy auditor that meets the certification or other requirements specified by the Secretary in regulations or other guidance.

While this credit does not directly affect contractors, it may be valuable to customers.

C. Residential energy-efficient property credit

The residential energy-efficient property credit (REEP) allows taxpayers to take an individual tax credit for solar electric, solar hot water, small wind energy, full cell, biomass fuel property, and geothermal heat pumps installed in homes. The Inflation Reduction Act extended this credit and increased the applicable percentage of the taxpayer's qualified expenditures as follows:

- 26 percent for property placed in service before January 1, 2022;
- 30 percent for property placed in service after December 31, 2021, and before January 1, 2026

The OBBBA made it so a taxpayer may not claim this credit with respect to any expenditures made after December 31, 2025.

D. Energy-efficient home credit

Eligible contractors have a credit they can take advantage of when they construct qualified new energy-efficient residences. Prior to the Inflation Reduction Act, the new energy-efficient home credit was only available for new energy-efficient homes acquired by a homeowner before January 1, 2022. The

maximum credit amount was also limited to $1,000 or $2,000 per dwelling unit (based on certain criteria). The Inflation Reduction Act extended the new energy-efficient home credit to new energy-efficient homes acquired prior to July 1, 2026. It also modified and increased the maximum credit amount per dwelling unit to $500, $1,000, $2,500, or $5,000 depending on certain criteria.

The OBBBA terminated the credit early. This credit may not be claimed for any qualified home acquired after July 1, 2026.

E. Accelerated depreciation deduction for energy-efficient commercial buildings

The Inflation Reduction Act modified the depreciation deduction available for energy-efficient commercial buildings in the following ways:

- Lowered the minimum 50 percent efficiency requirement in reducing total annual energy and power costs to 25 percent;
- Replaced the statutory dollar amount ($1.88 in 2022) with an applicable dollar value multiplication factor, set at $0.50 and increased by $0.02 for each percentage point cost reduction over 25 percent (multiplication factor is capped at $1.00); and
- Maximum deduction amount is limited to the total deduction a building can claim less deductions claimed with respect to the building in the preceding three years.

Under the OBBBA, the energy-efficient commercial building deduction is terminated for property beginning construction after June 30, 2026.

F. Commercial Clean Vehicle Credit

As a result of the Inflation Reduction Act, contractors who purchase a commercial clean vehicle may be able to take advantage of an up to $40,000 credit for vehicles with a GVWR of 14,000 pounds or more. The credit is calculated as follows:

- Credit for 100 percent electric vehicles is the lesser of 30 percent of basis or incremental cost; and
- Credit for hybrid vehicles is the lesser of 15 percent of basis or incremental cost.

A $7,500 credit is allowed for vehicles weighing less than this. While a business may generally take advantage of the commercial clean vehicle credit (§45W) or the new clean vehicle credit (§30D), the commercial clean vehicle credit may be more advantageous. Unlike the new clean vehicle credit, the commercial clean vehicle credit is not subject to the following limitations:

- AGI limitations;
- Limitation on cost of the vehicle;
- Requirement that final assembly must occur in North America; and
- Battery minerals and component requirements.

Under the OBBBA, the commercial clean vehicle credit may not be claimed for a qualified vehicle acquired on or after October 1, 2025.

III. Corporate Transparency Act

A. Beneficial ownership reporting

As a result of the Corporate Transparency Act (CTA), foreign entities are generally required to report beneficial owners to FINCEN. For this purpose, the following definitions are used:

- **Domestic reporting companies** are defined as:
  - Corporations;
  - Limited liability companies; and
  - Any other entity created by the filing of a document with a secretary of state or any similar office under the law of a state or Indian tribe.
- **Foreign reporting companies** are defined as:
  - Corporations, LLCs, or other entities formed under the law of a foreign country "registered to do business in any U.S. state or in any tribal jurisdiction, by the filing of a document with a secretary of state or any similar office under the law of a U.S. state or Indian tribe."

On March 21, 2025, FINCEN issued an interim final rule that exempts all domestic reporting companies from reporting. Foreign reporting companies are still required to report either within 30 days of when the rule is published or by the effective date of their U.S. registration. Perhaps most interestingly, U.S. persons associated with foreign entities are also exempt from reporting. While this interim rule relieves the compliance burden for many entities, it is important for practitioners to continue to monitor the provisions in this area until a final rule is published.

The FINCEN website also lists 23 specific entities that are exempt from reporting:

1) Any issuer of securities that is: (A) an issuer of a class of securities registered under §12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l); or (B) required to file supplementary and periodic information under §15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d));[1]
2) U.S. governmental authorities;
3) Any bank as defined in: (A) §3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); (B) §2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)); or (C) §202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a));[2]
4) Federal or state credit unions as defined in §101 of the Federal Credit Union Act;
5) Bank holding companies as defined in §2 of the Bank Holding Company Act of 1956 or any savings and loan holding company as defined in §10(a) of the Home Owners' Loan Act;
6) Any money transmitting business registered with FinCEN under 31 U.S.C. 5330 and any money services business registered with FinCEN under 31 CFR 1022.380;[3]
7) Any broker or dealer as defined in §3 of the Securities Exchange Act of 1934 that is registered under §15 of that Act (15 U.S.C. 78);
8) Securities exchanges or clearing agencies as defined in §3 of the Securities Exchange Act of 1934 and registered under §§6 or 17A of that Act;
9) Certain other types of entities registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934;
10) Certain types of investment companies as defined in §3 of the Investment Company Act of 1940 or investment advisers as defined in §202 of the Investment Advisers Act of 1940;
11) Certain types of venture capital fund advisers;
12) Insurance companies defined in §2 of the Investment Company Act of 1940;
13) State-licensed insurance producers with an operating presence at a physical office within the United States, authorized by a state, and subject to supervision by a state's insurance commissioner or a similar official or agency;
14) Commodity Exchange Act registered entities;
15) Any public accounting firm registered in accordance with §102 of the Sarbanes-Oxley Act of 2002;
16) Certain types of regulated public utilities;
17) Any financial market utility designated by the Financial Stability Oversight Council under §804 of the Payment, Clearing, and Settlement Supervision Act of 2010;
18) Certain pooled investment vehicles;
19) Certain types of tax-exempt entities;
20) Entities assisting a tax-exempt entity described in 19 above;
21) Large operating companies with at least 20 full-time employees, more than $5 million in gross receipts or sales, and an operating presence at a physical office within the United States;
22) The subsidiaries of certain exempt entities; and
23) Certain types of inactive entities that were in existence on or before January 1, 2020, the date the Corporate Transparency Act was enacted.

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1 31 CFR 1010.380(c)(2)(i).
2 31 CFR 1010.380(c)(2)(iii).
3 31 CFR 1010.380(c)(2)(vi).

There are generally three different types of reports that may be filed – an initial report, an update report, or a correction to a prior report. Updates must generally be filed within 30 days.

Beneficial owners fall into two categories:

1. An individual who directly or indirectly exercises substantial control over the reporting company. Substantial control is generally based on the power that an individual has over the reporting entity. The FINCEN website says that a senior officer of an entity will always be deemed to have substantial control. Also, anyone who directs, determines, or exercises substantial influence over important decisions of the reporting entity is deemed to have substantial control.
2. An individual who directly or indirectly owns or controls 25 percent or more of the ownership interests of the reporting company. The term ownership interests is all-encompassing, including stock ownership, ownership through more complex arrangements, and indirect ownership.

In addition to reporting beneficial owners, company applicants must be reported for any entity formed in 2024 or later. A company applicant is someone who helps a company file formation papers with the secretary of state, like a law firm. Simply filing the initial report on the FINCEN website would not make one a company applicant. However, filing the articles of organization with the secretary of state would make one a company applicant.

Practitioners should examine each state's rules around the unauthorized practice of law (UPL) before assisting clients with CTA reporting. CPAs should not help clients or their companies meet the CTA reporting requirements without first consulting with outside legal counsel and their professional liability insurance company to ensure that their actions are not in violation of UPL rules.

Taxation of Long-Term Contracts

Taxation of Long-Term Contracts

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Recall the sections of the Internal Revenue Code (IRC) impacting the construction industry in general and long-term contracts in particular;
- Recognize how the IRC impacts specialized sectors of the construction industry, such as homebuilders and residential construction;
- State how a contractor qualifies for the small contractor exemption and the advantages it presents the contractor;
- Recognize the different methods of income recognition from long-term contracts available when the contractor qualifies for the small contractor exemption; and
- Identify the qualifications for the 10 percent deferral election.

I. Introduction

There is little question that taxation for contractors is among the most complicated and difficult areas to be in compliance (especially in comparison to other lines of business). The construction industry has many tax issues, some of which are shared with other lines of business and some of which are unique to contractors. This chapter will concentrate on those issues unique to the construction industry.

II. Taxation of long-term contracts

The authoritative source for taxation of long-term contracts is IRC §460. This section generally provides for the use of the percentage-of-completion method for recognizing revenue from long-term contracts with some exceptions (which will shortly be discussed). One point must be made here and will be discussed throughout this section is that generally (but not in all situations) contractors will want to avoid falling under the provisions of IRC §460 since this will usually result in an acceleration of recognizing taxable income as compared to other method that are available for measuring income from long-term contracts.

A. What is a long-term contract as defined by IRC §460?

"(A)ny contract for the manufacturing, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into."

We will now present a couple of examples illustrating this concept.

Example 1: Spencer Contractors enters into a contract with construction work commenced December 26, 20X2, and completed on January 9, 20X3. Spencer's taxable year-end is December 31. Even though the contract was only two weeks in duration, the fact that the work was not completed within the 20X2 taxable year indicates this is a long-term contract and the provisions of IRC §460 apply to this particular contract.

Example 2: Judy Contractors enters into a $50 million contract. Work commenced on January 2, 20X3, and construction is completed on December 30, 20X3 (Judy's year-end is December 31). Although this is a large contract money-wise that is in progress for almost a complete year, the fact that work was completed within the 20X3 taxable year indicates that this is not considered a long-term contract and the provisions of IRC §460 do not apply to this particular contract.

This is considered a short-term contract whose revenue recognition will be discussed later in this chapter.

Furthermore, IRC §460 notes that in addition to the long-term provision, a contract must be a construction (as opposed to a manufacturing) type of contract in order to fall under this section.

What is a construction contract as defined by the Code? "(A)ny contract for the building, construction, rehabilitation of, or the installation of any integral component to or improvement of real property." The difference between construction and manufacturing is that construction is performed related to real property while manufacturing is related to personal property.

IRC §460 provides specific (but not limited to) examples of the term real property:

- Buildings;
- Dams;
- Roads; and
- Similar-type property.

There are three types of construction contracts and one type of contractor that are generally exempt from the provisions of IRC §460:

1. Home construction contracts.
2. Residential construction contracts.
3. Certain other specifically exempt contracts.
4. Those contractors who qualify for the small contractor exemption.

B. Home construction contracts

According to §460(e)(1)(A), home construction contracts are granted a special exemption from the requirement to use the completed-contract method.

A home construction contract is any construction contract where 80 percent or more of the estimated total contract costs as of the close of the tax year in which the contract was entered into are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of: (1) dwelling units contained in buildings containing four or fewer dwelling units (with each townhouse or rowhouse treated as a separate building); or (2) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.[1] It should be noted that for the purposes of this definition, each townhouse or row house should be treated as a separate building.

[1] IRC §460(e)(5); Treas. Regs. §1.460-3(b)(2).

It should also be noted that for the purposes of the 80 percent test the costs of off-site work are treated as contributable to the construction of the house included in the definition. Off-site work includes:

- Sidewalks;
- Roads;
- Sewers; and
- Other common features not located on the site of the dwelling.

The definition of homebuilding we have just been discussing applies to the general (prime) contractor. The question then raised is, are the subcontractors (roofers, plumbers, electricians, etc.) working on the same homebuilding also exempt from IRC §460?

The answer appears to be YES! Although the Department of the Treasury has not specifically commented on this issue, the CPA profession has generally accepted the position of exempting subcontractors, similar to the general homebuilder.

Accordingly, contractors (both general contractors and subcontractors) who perform both commercial work (subject to IRC §460) and homebuilding (exempt from IRC §460) must be able to segregate revenues earned and costs incurred between the two lines of business to potentially reduce the associated tax liability for the current year.

For taxation purposes, there are four types of homebuilders. First, we must determine the classification of the builder:

1. Contract builder – Home construction is performed under the terms of a contract; and
2. Spec builder – Home construction is performed without a contract and sold at a later date.

Next, we need to determine if the homebuilder qualifies as a small contractor (three-year average gross receipts of $25 million [$31 million for 2025] or less) or does not qualify as a small contractor (three-year average gross receipts greater than $25 million [$31 million for 2025]). We will now present the tax attributes for the four categories of homebuilders:

- Contract builder – qualifies as a small contractor:
  - Revenue recognition – May use the cash method, accrual method, completed-contract method, or a hybrid.
  - Cost capitalization – The rules are substantially similar to commercial contractors including the requirement to capitalize production period interest (see IRC §460(c)(3)).
  - Alternative minimum tax – Does not apply.
- Contract builder – does not qualify as a small contractor:
  - Revenue recognition – May use the cash method, accrual method, completed-contract method, or a hybrid.
  - Capitalize costs – Required to capitalize interest [see IRC §460(c) (3)]. Account for other costs under the uniform capitalization rules (UNICAP) under IRC §263A.
  - Alternative minimum tax (AMT) – Does not apply.

- Spec builder – qualifies as a small contractor:
  - Revenue recognition – Should utilize the deferred accrual method, which to a large extent is the completed-contract method signifying that no income is recognized until closing occurs. This would be demonstrated when there is a transfer from the builder to the buyer.
  - Cost capitalization – Should capitalize costs as it existed before TAMRA '88 (which is substantially the same as IRC §460 with a few exceptions), including the requirement to capitalize production period interest.
  - Alternative minimum tax (AMT) – Does not apply.
- Spec builder – does not qualify as a small contractor:
  - Revenue recognition – Should utilize the deferred accrual method, which to a large extent is the completed-contract method signifying that no income is recognized until closing occurs. This would be demonstrated when there is a transfer from the builder to the buyer.
  - Cost capitalization – Exempt from the cost capitalization rules under IRC §460 but are subject to the capitalization rules under IRC §263(A). It should be noted that this is not a major issue as the two sections regarding cost capitalization are basically the same.
  - Alternative minimum tax (AMT) – Does not apply.

Note:

A few observations regarding homebuilder taxation:
- AMT never applies to homebuilders.
- Taxation of homebuilders is generally more favorable as compared to commercial builders.
- Spec builders generally receive the most favorable tax treatment.
- Production period interest must be capitalized under all circumstances.

C. Residential construction

In addition to homebuilding, the OBBBA added residential construction as exempt from the requirement to use the percentage-of-completion method.[2] Residential construction contracts are defined as contracts other than home construction contracts for which 80 percent or more of the total estimated costs under the contract are reasonably expected to be attributed to the building, construction, reconstruction, or rehabilitation of, or improvements to real estate directly related to and located on the site of dwelling units, as defined by §168(e)(2)(A)(ii).[3]

Examples of residential contracts include:
- Apartments;
- Dormitories;
- Barracks;
- Prisons; and
- Nursing homes.

[2] IRC §460(e)(1)(A) effective July 4, 2025. Note that this was also generally true under TAMRA '88 for prior periods.
[3] IRC §§460(e)(4) and (e)(5)(B); Treas. Regs. §1.460-3(c).

Residential construction is taxed as follows:

- Revenue recognition – Required to use a special method of recognizing revenues from their long-term contracts known as the 70/30 percentage-of-completion/capitalized-cost method. Under this method, 70 percent of the contract is reported on the percentage-of-completion method, while for the remaining 30 percent, the contractor may utilize their normal method. Their normal method may be the completed-contract method, the cash method (subject to the restrictions detailed later in this chapter), or the accrual method. However, for all contracts entered into in tax years beginning after July 4, 2025, large contractors are no longer required to use the percentage-of-completion method or the 70/30 method. In other words, the normal method of accounting will generally be available.
- Cost capitalization – The rules of IRC §460 apply (to be discussed in Chapter 3).
- Alternative minimum tax (AMT) – Must be calculated using the 100 percent percentage-of-completion method. No alternative minimum tax adjustment is required for any residential construction contract entered into during a tax year beginning after July 4, 2025.

Note:

As we noted in Chapter 1, beginning in 2018, the alternative minimum tax (AMT) does not apply if the contractor operates as a C corporation.

D. Specifically exempt construction activities

As the result of various revenues issued by the IRS, the following four construction-related activities are exempt from IRC §460:

1. Industrial and commercial painters;
2. Engineers;
3. Architects; and
4. Construction management-type services.

If a contractor is engaged in both exempt (for example, painting) and nonexempt (for example, road building) activities they must be able to segregate revenues earned and costs incurred between the two lines of business in order to reduce their potential tax liability for the current year.

E. Small contractor exemption

Many of the contractors that CPAs work for or represent will be exempt from the provisions of IRC §460 because they qualify for the small contractor exemption.

Why would a contractor want to be eligible for this exemption? Because they would be entitled to utilize other methods of recognizing revenue from long-term contraction outside of the percentage-of-completion method, which may allow them to defer the recognition of taxation income.

Even though the small contractor is exempt from most provisions of IRC §460, it must still:

1. Capitalize production period interest; and
2. Compute the alternative minimum tax (AMT) using the percentage-of-completion method.

How can a contractor be eligible for the small contractor exemption? Only if they meet all three of the following conditions:

1. The contract must be considered a construction-type contract not a manufacturing type of contract as the latter is not eligible for the small contractor exemption;
2. The contract cannot last longer than two years (as originally estimated by the contractor); and
3. The contractor's average annual gross receipts for the three taxable years preceding the current taxable year in which the contract is entered into cannot exceed $25 million ($31 million for 2025). For instance, when preparing a contractor's calendar 20X4 return, they would use 20X3, 20X2, and 20X1 when making the gross receipts determination.

Note:

The $25 million gross receipts limit noted in condition 3 represents an increase as a result of the Tax Cuts and Jobs Act which increased the limit from $10 million to $25 million (adjusted for inflation) allowing many more contractors the opportunity to report under the small contractor exemption.

It should also be noted that this test is not a "once failed, always failed" test. If a contractor's receipts exceed the threshold for year 1, but then the same contractor's annual gross receipts fall at or below the threshold in year 2, any nonexempt jobs started in year 2 could be reported under the contractor's normal method of accounting (i.e., completed-contract, cash, or accrual) assuming the contractor qualifies to use these other methods. In other words, a contractor could fail to meet the exception one year but then meet the exception the next year.

And finally, it should be noted that the $25 million limit is adjusted for inflation. For tax year 2025, the limit is $31 million.

We will now review these three conditions in more detail.

1. Construction-type contract

The first requirement deals with the type of work performed by the contractor. The basic difference between a construction-type contract and a manufacturing-type contract is that the former deals with real property while the latter deals with personal property.

2. Two-year completion test

The second requirement to make a contractor eligible for the small contractor exemption requires that a contract be completed within two years from when it started.

- **Start date** – When the contractor first incurs any allocable costs other than costs attributable to bidding on the contract.
- **Completion date** – When the contract would be completed under the definition of the completed-contract method. Basically, this occurs when the customer uses the subject matter of the contract and at least 95 percent of the expected total contract costs have been incurred, or final completion and acceptance of the subject matter of the contract occurs.

This test is applied when the contract is entered into. It is strictly an estimate, and the burden of proof is on the contractor to be able to document how long it will take to complete the project.

It should be noted that this issue applies to individual contracts, not to the contractor as a whole. If any particular contract fails to meet the two-year test, it is not eligible for the small contractor exemption and must use the percentage-of-completion method to measure taxable income.

Therefore, a contractor may find that in a given year, some of its contracts may have to be accounted for using the percentage-of-completion method while others will be exempt and accordingly, may use other methods.

Note:

Once the contractor makes a determination concerning the two-year test for an individual contract, they must continue to use the method chosen at the beginning of the contract even if facts and circumstances change while the job is in progress. In other words, they are not required to change their method while the job is in progress.

3. $25 million gross receipts test

The third requirement to make a contractor eligible for the small contractor exemption involves the condition that their annual gross receipts for the previous three years do not exceed $25 million ($31 million for 2025). There are two key issues that must be considered:

1. The definition of gross receipts (for purposes of applying the test); and
2. How to apply the test.

What should be included in gross receipts? Gross receipts under §448 generally includes all receipts (with some exceptions as will be detailed next) from the active conduct of all trades or business, including related parties. Accordingly, the definition of gross receipts is not limited to construction-related activities.

What gross receipts are excluded?

- Sales returns;
- Sales allowances;
- Interest, dividends, and rents received that are not in the ordinary course of business;
- Proceeds from loans made to the contractor;
- Loan repayments from loans made by the contractor;
- Receipts from a sale not in the ordinary course of business; and
- Proceeds from the sale of capital assets.

The issue of determining which entities to include is probably the most difficult part of this test. The test deals with entities under common control, which also brings into play the rules of attribution (common ownership). The rules of attribution cover such areas as:

- Family;
- Parent-subsidiary; and
- Brother-sister ownership.

All of the above people must be taken into consideration to assure all required entities are included when determining total gross receipts.

Although a complete analysis of these attribution rules is beyond the scope of this course, a brief discussion of the issue is worth mentioning since so many construction entities are family-owned:

> An individual is considered the owner of any interest owned directly or indirectly by or for his or her spouse. Also, a parent is considered the owner of any interest owned directly or indirectly by minor children (under the age of 21). The reverse is also true. The minor child is considered the owner of the parents' interest. The result will be the same if the child is age 21 or older, but only if one of the parties has effective control (i.e., over 50 percent) before this attribution.

The IRS has issued regulations which define two groups of entities that must be included in the gross receipts test. The first group is all trades or businesses that are under common control. Entities treated as a single employer will be included in this group. This includes all controlled entities whether corporations, partnerships/LLCs, or sole proprietorships.

The second group deals with attribution of gross receipts for those entities under common control. For this group, a taxpayer has to include a proportionate share of all construction-related gross receipts for any person who has a 5 percent or greater interest in the taxpayer. In addition, the taxpayer must include its proportional share of construction-related gross receipts for any person in whom the taxpayer has a 5 percent or greater interest. Ownership is determined as of the first day of the test year. The test includes interests, as determined using the principles of constructive ownership, in any:

- Corporation;
- Partnership (including LLCs);
- Estate;
- Trust; or
- Sole proprietorship.

Because this test is to determine whether the income from construction contracts is subject to reporting using the percentage-of-completion method, included in this test are construction-related receipts from all trades or businesses of the entities as we just discussed. This is determined using the method of reporting that the taxpayer used for tax purposes (i.e., cash, accrual, or completed-contract).

Gross receipts include the gross contract price, whether or not it is a long-term contract. It also does not matter whether the taxpayer is a general contractor or a subcontractor. It will not include the cost of material supplied by the entity for whom the contract is being performed unless the purpose for this type of arrangement is to reduce the contractor's gross receipts. Any gross receipts between the related parties are eliminated.

The only restriction in this test is that it involves long-term contracts only. If a contractor fails this test, it will not change the reporting of any income or expense that is not derived from long-term contracts.

In real-life practicality, this means that the following will not be required to use the percentage-of-completion method (unless the percentage-of-completion method is the contractor's normal method of accounting):

- Contracts that commence and are completed in the same tax year;
- Home construction;
- Residential contracts; and
- Construction-management.

A few more observations concerning this test:

- A contractor that fails the $25 million test ($31 million for 2025) is not required to file a change in accounting method with the IRS. In fact, a change in method should not be filed. Requesting a change would establish the percentage-of-completion method as the contractor's normal method and thus eliminate any other method of accounting, even for exempt contracts.
- The three-year average annual gross receipts rules follow the contract, not the contractor. Therefore, the contractor may find that in some years, they will have to report revenue from some of their long-term contracts under IRC §460 (percentage-of-completion) while others may be accounted for under other methods.
- If in a given tax year a contractor falls at or below the $25 million ($31 million for 2025) threshold, all new jobs started in the subsequent year will not be required to be reported using the percentage-of-completion method as long as the three-year average annual gross receipts remains at or under $25 million ($31 million for 2025). These particular jobs can be reported under the contractor's normal method of accounting (cash, accrual, or completed-contract method).

Tax planning tip:

It is quite obvious that the rules surrounding the annual three-year average gross receipts test are complex. Even though the TCJA significantly raised the level of three-year average annual gross receipts (from exceeding $10 million to exceeding $31 million for 2025) that would require the contractor to use the percentage-of-completion method, the issues of related parties detailed above make this an important issue involving more contractors than the CPA profession may realize.

The key to this test is the timing of receipts with the objective of being at or below the $25 million ($31 million for 2025) limit. If a contractor properly plans for receipts, it may be able to qualify for the benefits of or avoid the pitfalls associated with passing or failing, respectively. Since the test determines gross receipts based on the method used for tax reporting, the time for testing is during year-end preliminary planning (say, in November and the beginning of December assuming a December 31 year-end). At that time, you can determine whether receipts need to be delayed or accelerated. This will depend on the timing of prior years.

III. Income recognition methods for small contractors

When a contractor qualifies for the small contractor exemption (as previously discussed), it is exempt from the requirement of IRC §460. The taxpayer is then allowed to use normal methods of accounting. Accordingly, there are a number of methods available to the small contract to measure revenue from their long-term contracts. These include:

- The percentage-of-completion method;
- The completed-contract method;
- The cash method; and
- The accrual method.

A. The percentage-of-completion method

Even though a small contractor may be exempt from IRC §460, which requires the use of the percentage-of-completion method, if they should desire, the contractor may utilize this method.

1. Advantages

Since the contractor is required to utilize this method for U.S. GAAP financial statement reporting purposes, they will not have to maintain two sets of books – one using the percentage-of-completion method for U.S. GAAP financial statement reporting purposes and one (completed-contract, cash, or accrual) for tax reporting purposes.

The amount of alternative minimum tax (AMT) adjustment may be minimized (discussed later).

2. Disadvantages

The additional time and expense for the contractor related to internal costs and the cost of the outside CPA in keeping books and records under the percentage-of-completion method (as compared to the other methods).

There may be an acceleration of recognizing taxable income over the use of the other methods.

B. The completed-contract method

Under this method, the contractor is able to defer any recognition of taxable income until the contract is considered complete. The major concern the contractor has in utilizing this method is determining completion. As a general rule, completion takes place when:

- 95 percent of the total contract costs have been incurred;
- Final completion and acceptance of the subject matter contract occurs; or
- There is a final acceptance and completion of the contract. For example, occupancy could be an indication of completion (demonstrated by obtaining an occupancy certificate).

1. Advantage

In most instances, the best method available is one that will allow the deferral of recognition of taxable income.

2. Disadvantages

Even though there is a deferral of recognizing taxable income in the current period, in the following tax period, this method will require a contactor to recognize taxable income during that period even though cash flow and working capital may have been negatively impacted (especially if multiple projects have to be reported in the same tax year).

Losses on any contracts cannot be deducted until the contracts are completed and the income is recognized for tax purposes.

The contractor will be required to keep two sets of books – FASB ASC 606 for U.S. GAAP financial statement reporting purposes and completed-contract for tax reporting purposes.

In many instances, AMT will be an important consideration (discussed in Chapter 3).

It has been reported that the IRS is scrutinizing possible misuse of utilizing this method. Some of those misuses include:

- Improper computation of the $25 million ($31 million for 2025) gross receipts test.
- Improper recognition of losses on contracts.
- Issues involved in considering contracts uncompleted as of the year-end.
- Warranty work categorized as construction costs and used as a reason to keep a job open.
- Outstanding change orders used to keep a job open.
- Improper consideration of AMT.

3. Example

We will now provide a simple, straightforward example demonstrating the advantages of the completed-contract method.

Example: Norman Contractors commenced their Job #101 on January 5, 20X1. The job is anticipated to be completed by June 30, 20X2; accordingly, it must be accounted for as a long-term contract (assuming Norman has a December 31 tax year-end). For U.S. GAAP financial statement reporting purposes, Norman records revenue as per FASB ASC 606 and for tax reporting purposes, he uses the completed-contract method. As of and through December 31, 20X1, the following was associated with Job # 101:

Total contract price	$ 1,200,000
Total anticipated contract costs	800,000
Total anticipated gross profit	$ 400,000
Total costs incurred through December 31, 20X1	$ 500,000

Accordingly, as of December 31, 20X1, the percentage of completion is ($500,000/$800,000)	62.5%
General & administrative expenses incurred in 20X1	$ 100,000
For U.S. GAAP financial reporting purposes using the FASB ASC 606	
Gross profit ($400,000 x 62.5%)	$ 250,000
General and administrative expenses	(100,000)
Taxable income	$ 150,000
For income tax reporting purposes using the completed-contract method:	
Gross profit	$ -
General and administrative expense	(100,000)
Taxable loss	($ 100,000)

By utilizing the completed-contract method rather than FASB ASC 606, Norman was able to defer $250,000 of taxable income from 20X1 to 20X2. Assuming a 30 percent tax rate for federal and state taxes, Norman can defer paying $75,000 of taxes.

C. Cash method

Under this method, income is recognized when cash is received (or when there is constructive receipt) and expenses are deducted when paid. In order to qualify for the cash method, the small contractor is required to meet two conditions:

1. Use of the cash method does not significantly distort income (if the contractor had in fact used the accrual method). Accordingly, if a contractor has a significant difference between their receivables and their payables, they would not be able to use the cash method since this would result in a distortion of taxable income; and
2. If the contractor is a C corporation or a partnership with a C corporation as a partner, if must meet a three-year average of no more than $25 million in gross receipts ($31 million for 2025).

It should be noted that prior to 2018 and the implementation of the TCJA, if a taxpayer had a three-year average of greater than $5 million of gross receipts, they were precluded from using the cash method.

Note:

A cash basis taxpayer is subject to constructive receipt as we noted above. This means that a taxpayer is subject to tax in the current year if they have unfettered control in determining when items of income will or should be paid. Unlike actual receipt, constructive receipt does not require physical possession of the item of income in question.

One area that could cause problems for the contractor using the cash method is how to report its inventory. The IRS has ruled that a contractor who owns inventory as of year-end is able to deduct the materials and supplies in the later of:

- The year the items are provided to a customer; or
- The year the goods are actually paid for.

1. Advantages

The cash method is simple, thereby saving the contractor both time and potential fees paid to the outside CPA. It also creates a deferral opportunity by managing billings and acceleration of payment of costs.

2. Disadvantages

Contractors must spend cash to claim deductions and delay receipts to defer income, which is counter to smart business planning.

There may be an acceleration of recognizing taxable income over the use of other methods (i.e., the completed-contract method).

There may be misuse in utilizing this method (using this method not in accordance with the conditions just mentioned).

A declining construction economy could result in large tax bills in down years due to the inevitable reversal of income deferrals.

In many instances, AMT is still an important consideration (discussed later).

D. The accrual method

Under the accrual method, the contractor recognizes:

- Revenue, similar to other entities, is recognized when it is billed; and
- Costs and expenses are deducted when incurred.

However, as we will shortly discuss, this method is rarely used by the construction industry.

1. Advantage

The accrual method offers simplicity to the contractor – they are able to use the same method used to keep their internal books and records, thereby saving the contractor both time and potential fees paid to the outside CPA.

2. Disadvantages

No other method accelerates the recognition of taxable income since income is recognized when it is billed.

Accrued losses on contracts are not deductible until the job is complete.

The contractor may be required to keep two sets of books – FASB ASC 606 for U.S. GAAP financial statement reporting purposes and accrual for tax reporting purposes.

In many instances, AMT is still an important consideration (discussed later).

3. Retention exclusion

It should be noted that there is an election the contractor can make which makes the accrual method more desirable.

A contractor can make an election of not recognizing retainage until it is received. Retainage receivable is very common in certain types of contractors and making this election will allow the postponement of paying tax on some income until the contractor receives the cash as the result of collecting the retainage to pay the taxes. The downside to making this election is that retainage payable (amounts held back from the contractor's subcontractors) is not recognized (deducted) until it is actually paid, so accordingly, an analysis must be made whether it will be advantageous for the contractor to make this election.

IV. Percentage-of-completion method required

A. Nonexempt contracts

If a contract is not exempt, IRC §460 requires the use of the percentage-of-completion method to determine the amount of taxable income to recognize from that contract.

IRC §460 requires the use of the percentage-of-completion method for construction contracts not completed in the tax year which they were entered (i.e., long-term contracts). Under this method, a taxpayer recognizes revenue over the life of the contract. Taxpayers include in income a portion of the total contract price based on costs incurred and allocable to the long-term contract. As such, the taxpayer computes a completion factor, which is:

- The ratio of costs incurred through the tax year-end (numerator) to estimated total contract costs (denominator).
- Next, the taxpayer computes cumulative gross receipts from the contract by multiplying the completion factor by the total contract price.
- Next, the taxpayer subtracts its gross receipts recognized through the end of the prior year from its cumulative gross receipts at year-end (§1.460-4(b)(2) provides that current-year costs incurred on the contracts are then deducted from the year's gross receipts to arrive at gross profit).

It should be noted that the percentage-of-completion method used for tax reporting purposes is almost identical to FASB ASC 606 used by U.S. GAAP for financial statement reporting purposes with one important distinction which involves loss contracts (where estimated total costs of the contract are determined to be greater than the estimated total revenue).

For GAAP purposes – a loss is recognized in full in the period when it is determined that the contract will recognize a loss.

For tax purposes – the taxpayer will continue to recognize income from the contract using the percentage-of-completion method.

We will now present a straight-forward example of the percentage-of-completion method.

Example: Ralph Construction begins a $2 million contract on October 1, 20X1. The contract is expected to be completed on May 31, 20X2. Ralph uses the percentage-of-completion to recognize gross profit from this contract. The following financial information is related to this contract as of and for the period ending December 31, 20X1 (Ralph's tax year-end).

Total contract price	$2,000,000
Total estimated costs	1,200,000
Anticipated gross profit	$ 800,000
Costs incurred during 20X1	$ 350,000

Percentage complete as of December 31, 20X1: 29.2%

Accordingly, Ralph will report the following as of and for the year ending December 31, 20X1:

Revenue ($2,000,000 x 29.2%)	$ 584,000
Costs incurred (from above)	(350,000)
Recognized gross profit	$ 234,000

B. Simplified cost-to-cost method

IRC §460(b)(I)(A) generally requires the cost-to-cost method to determine completion (as we previously discussed). However, IRC §460(b)(3)(A) provides an elective simplified cost-to cost method for determining the degree of contract completion for taxpayers required to use the percentage-of-completion method. Under this method, only the following costs are used in determining the percentage-of-completion:

1. Direct materials;
2. Direct labor; and
3. Depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the long-term contract.

A couple of other considerations related to this method:

- For purposes of this method, subcontractors are considered either direct labor or direct materials which must be included in both the numerator and denominator.
- If the taxpayer uses the simplified-cost-to-cost method for regular reporting purposes, it must use it also for AMT and look-back purposes (both discussed later).

1. Advantage

It really is a simpler calculation (due to less costs involved in both the numerator and the denominator) as compared to the normal calculation under IRC §460.

2. Disadvantages

This method is significantly different from U.S. GAAP for financial statement reporting purposes thereby requiring to contractor to maintain two sets of books.

The contractor cannot utilize the 10 percent deferral election.

C. The 10 percent deferral election

Under IRC §460(b)(5), a contractor utilizing the percentage-of-completion method may make an election. This election, known as the 10 percent deferral method, allows a contractor, if, as of a year-end, total costs incurred for a particular job are less than 10 percent of total estimated costs to be incurred on the job, to defer the recognition of any taxable income until the job is a least 10 percent complete (which will usually occur the following tax year).

If the contractor makes this election, it should be noted that the same rules apply for both AMT and look-back purposes, whereby if gross profit is deferred for regular tax purposes, it will also be deferred for AMT and look-back purposes.

Note:

The rules governing AMT and look-back will be discussed in future chapters.

Preparers of contractor tax returns should recognize that using the 10 percent deferral method is one of the best means available to defer recognizing taxable income.

1. Advantage

It does create a deferral of usually one year of recognizing taxable income.

2. Disadvantage

Cannot be used if the contractor utilizes the simplified cost-to-cost method discussed above.

3. Example

We will now present a straightforward example of the 10 percent deferral method.

Example: Singer Contractors enters into a long-term contract on February 1, 20X0. The following is a history of financial activity regarding this contract:

	20X0	20X1	20X2
Cumulative incurred costs	$ 80,000	$ 600,000	$ 1,200,000
Total estimated costs	$ 1,200,000	$ 1,200,000	$ 1,200,000
Percentage complete	6.67%	50.00%	100.00%
Total contract price	$ 2,000,000	$ 2,000,000	$ 2,000,000
Revenue recognized	-0-	$ 1,000,000	$ 2,000,000
Costs recognized	-0-	600,000	1,200,000
Gross profit recognized	$ -0-	$ 400,000	$ 800,000
Deferred gross profit	$ 53,360		

Since less than 10 percent of the total estimated costs were incurred at the end of 20X0, no gross profit needs to be recognized.

By making the 10 percent deferral election, Singer was able to defer recognizing taxable income of $53,360 ($2,000,000 – $1,200,000 × 6.67%) from 20X0 to 20X1. Assuming a 30 percent tax rate (for both federal and state income taxes), Singer was able to improve their current cash flow by approximately $16,000.

Note:

As we mentioned earlier, the 10 percent deferral cannot be used if the contractor elects to use the simplified cost-to-cost method.

V. Short-term contracts

We have spent this entire chapter discussing revenue recognition and long-term contracts. However, how should a contractor recognize revenue from their short-term contracts (those that do not pass over their tax year-end)?

They would use the taxpayer's normal method of accounting, which would be either the cash basis or the accrual basis.

VI. In conclusion

There are many difficulties in staying in compliance with IRC §460 and other tax provisions associated with long-term contracts.

A contractor could very easily face the following situation:

- He or she may be required to report a number of their contracts using the percentage-of-completion method because the contract length was greater than two years (and accordingly is not eligible for the small contractor exemption).
- Some contracts may be reported on the completed-contract method because those particular contracts were less than two years in length, or they were homebuilding contracts, and the contractor was in compliance with the other provisions which allowed him or her to use the completed-contract method.
- Some of the contracts may be defined as residential construction requiring the contractor to use the 70-30 hybrid method previously discussed.
- While finally, some contracts may be defined as short-term allowing the contractor to use their normal method of accounting (either the cash basis or the accrual basis).

It is important for the CPA to analyze each contract to determine if a method is available to create a tax deferral opportunity and postponing the payment of taxes until a later date. Deferring these payments will always go a long way in improving the contractor's cash flow needs.

Without a thorough knowledge of the rules we just discussed, it would be very likely that the tax preparer will make significant errors and very well either cause the contractor to overpay their taxes in a particular year or underpay their tax which, upon IRS audit, could result in additional tax due in addition to significant interest and penalties.

VII. Practice exercise

Use the following brief exercise to review what you have learned. Solutions are on the following page.

True or False:

1._____A long-term contract is defined as one that takes more than one year to complete.

2._____A spec builder is defined as a type of home contractor where work is performed without a contract and sold at a later date.

3._____The alternative minimum tax (AMT) never applies to contracts defined as home construction contracts.

4._____Residential type of contracts are required to report revenue from their long-term contracts using the completed-contract method.

5._____In order to be eligible for the small contractor exemption, a contractor's average gross receipts over the past three years cannot exceed $31 million for 2025.

6._____The basic difference between a construction-type contract and a manufacturing-type contract is that the former deals with real property while the latter deals with personal property.

7._____If a contractor qualifies for the small contractor exemption, it may not use the accrual method for measuring revenue from long-term contracts.

8._____If a contract is not exempt, IRC §460 requires the use of the percentage-of-completion method to determine the amount of taxable income to recognize from that contract.

9._____One advantage of the using the accrual method for measuring revenue from long-term contracts is that no other method defers the recognition of taxable income since income is recognized when it is billed.

10.____A short-term contract is defined as one that does not pass over the contractor's tax year-end.

VIII. Practice exercise solutions

1. False
2. True
3. True
4. False
5. True
6. True
7. False
8. True
9. False
10. True

Tax Cost Capitalization and Allocation Issues Facing the Contractor

Tax Cost Capitalization and Allocation Issues Facing the Contractor

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Identify the major differences regarding cost capitalization rules between U.S. GAAP, exempt contracts, and nonexempt contracts; and
- Recognize the five basic rules concerning cost allocation for tax purposes.

I. Introduction

Similar to U.S. GAAP when preparing financial statements, the issue of which costs to capitalize and which may be currently expensed (deducted) is a major concern to the contractor when preparing its tax return. Although many costs are similar between U.S. GAAP and tax (per IRC §460), a number of these costs have a different treatment. In addition, tax law differentiates between regular (nonexempt) contractors and those that qualify as small (exempt) contractors.

In addition to being exempt from the requirement to utilize the percentage-of-completion method for its long-term contracts (as we discussed in Chapter 2), qualified small contractors are generally exempt from the cost capitalization rules of IRC §460. An important exception to this rule is that they are required to capitalize interest incurred during the construction period.

Additionally, even though the qualified small contractor is exempt from most provisions of IRC §460, they are still required to capitalize direct and indirect costs incurred in the performance of the contract. In contrast, any costs incurred not related to the performance of the job are exempt from capitalization.

If a contractor is not a qualified small contractor, many more indirect costs must be capitalized. The chart below provides further details clarifying this distinction.

II. Comparison of cost allocation rules

We will now present a comparison of cost allocation rules under the following three categories:

1. U.S. GAAP – Per FASB ASC 606 for financial statement preparation.
2. Tax – For contractors not qualified for the small contractor exemption under IRC §460(e).
3. Tax – For contractors who do qualify for the small contractor exemption under IRC §460(e).

Key: C = Required to be capitalized as a job cost
E = Required to be expensed

	U.S. GAAP	Exempt contractor	Nonexempt contractor
Direct materials	C	C	C
Direct labor	C	C	C
Surety bonds	C	C	C
Indirect repairs	C	C	C
Indirect maintenance	C	C	C
Indirect utilities	C	C	C
Indirect rent	C	C	C
Indirect labor	C	C	C
Indirect materials	C	C	C
Indirect small tools	C	C	C
Indirect quality control	C	C	C
Indirect taxes other than income taxes	C	C	C
Indirect financial statement depreciation	C	E	E
Indirect tax return depreciation	E	C	C
Indirect contract administrative expenses	C	C	C
Indirect contract-related officer salaries	C	C	C
Indirect insurance (worker's compensation)	C	C	C
Indirect insurance (liability)	C	C	C
Indirect retirement plans	C	E	C
Indirect research and development	E	E	C
Indirect scrap and spoilage	E	E	C
Successful pre-contract costs	C	E	C
Indirect engineering and design	C	E	C
Indirect storage and related costs	C	E	C
Indirect transportation costs	C	C	C
Production period interest	C	C	C
Selling and advertising	E	E	E
General and administrative – not job related	E	E	E
Officer salary – not job related	E	E	E
Unsuccessful pre-contract costs	E	E	E
Research and development – not job related	E	E	E
Depreciation of idle equipment	E	E	E
Income taxes	E	E	E
Repairs not related to production equipment	E	E	E

Some important items to consider from the above schedule are as follows:

- In most instances, under all three categories, a portion of officer compensation should be capitalized as a job cost unless they have absolutely no connection to any contract performance.
- Income taxes (including those attributable to income from long-term contracts) are never capitalized as job costs.
- All insurance costs directly or indirectly to job performance should be capitalized as job costs while insurance not related to job performance should be expensed under all three methods.
- Similar to insurance, all employee benefits (including payroll taxes) directly or indirectly related to job performance should be capitalized as job costs while employee benefits not related to job performance should be expensed under all three methods.
- Depreciation of idle equipment should be expensed under all three methods. Therefore, management must consider the usage of their equipment throughout the year to determine what amounts should be capitalized as job costs and what portion should be currently expensed.
- Also, in regard to depreciation, small contractors are required to allocate financial statement depreciation (U.S. GAAP) to contracts (to the extent it does not exceed depreciation allowed for tax) while nonexempt contractors must allocate depreciation per the IRC used to complete the contractor's tax return.
- The following costs must be capitalized for nonexempt contractors but may be currently expensed (deducted) for exempt contractors:
    - Costs of administrative, service, or support functions;
    - Indirect retirement plan expenses;
    - Indirect research and development;
    - Successful pre-contract costs'
    - Engineering and design; and
    - Storage and related costs.

A. Job cost allocations

Similar to U.S. GAAP financial statement reporting purposes, the IRC (§1.460-5) requires costs incurred to be allocated to the contractor's various jobs. There are five basic rules concerning cost allocation for tax purposes:

1. **Books and records** – The contractor is required to maintain separate accounts for each contract. Direct costs are required to be charged to the jobs they apply to and indirect costs must be allocated to all jobs they benefit.
2. **Direct labor** – These costs must be allocated using a specific identification method; the particular job worked on by the employee. If the direct costs are attributable to more than one job, they must be allocated to those jobs using a reasonable method.
3. **Direct materials** – These costs must be allocated using a specific identification method to the jobs that utilized them.
4. **Indirect costs** – These costs must be allocated using a specific allocation method (whenever feasible and possible) or using some form of burden rates that result in a reasonable allocation. It should be noted that similar to U.S GAAP, indirect costs must be allocated to both jobs completed during the year as well as those that are still in progress as of the year-end.
5. **Production period interest** – As was noted earlier in Chapter 2, all contractors (including small contractors as defined by IRC §460) must capitalize production period interest and allocate these costs to all jobs benefited using a reasonable method.

The Alternative Minimum Tax and the Construction Industry

The Alternative Minimum Tax and the Construction Industry

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Recognize how the alternative minimum tax impacts the construction industry; and
- Identify ways to reduce the impact of the alternative minimum tax.

I. Introduction

Every taxable entity must be concerned about the alternative minimum tax (AMT). However, for the construction industry, the impact may be even more significant.

Virtually every type of contractor will be impacted from at least one aspect of the AMT. The two major exceptions to this rule are as follows:

1. Homebuilders (as defined by the IRC and discussed in Chapter 2) who are exempt from all aspects of the AMT; and
2. C corporations – Recent legislation has eliminated AMT considerations for most C corporations (there is still a 15 percent minimum tax for C corporations with over $1 billion in adjusted financial statement income for tax years beginning after December 31, 2022).

No alternative minimum tax adjustment is required for any residential construction contract entered into during a tax year beginning after July 4, 2025.[1]

Other exemptions from the AMT that directly impact the construction industry are:

- Bonus depreciation; and
- Section 179 taken on fixed assets.

II. Pass-through entities and sole proprietorships

The following types of entities will continue to have AMT adjustments passed through:

- S corporations – Passed through to the shareholders.
- Partnerships/LLCs – Passed through to the partners or members.
- Sole proprietorships.

The TCJA significantly increased the amount of AMT exemptions and phaseout limits beginning in 2018. These increases were made permanent with the passage of the OBBBA.

[1] IRC §56(a)(3).

These changes signify that many individual taxpayers who prior to 2018 had their AMT exemptions phased out subjecting them to the AMT will, starting in 2018, no longer be impacted by the AMT. The two most important aspects of the AMT that directly impact the construction industry are:

- The long-term contract adjustment (in most instances, the much more significant aspect); and
- The deprecation adjustment.

III. Long-term contract adjustment

Contractors are subject to an AMT adjustment if they utilize for their normal method of accounting a method other than the percentage-of-completion method for recognizing revenue from their long-term contracts in progress. The contractor is required to compare the difference between recognized taxable income under the method used for regular tax purposes and the amount that would have been recognized if the percentage-of-completion method had been utilized. In addition, IRC §460 instructs that when computing the percentage-of-completion adjustment, the contractor should utilize the cost-to-cost method whereby the numerator is costs incurred through the date of the tax year-end, and the denominator is anticipated total costs.

For every pass-through entity, (S corporations and partnerships/LLCs), this difference will have to be passed through to the shareholders/partners/members as an adjustment that will have to be recognized on the shareholder/partner/member's return.

It should be noted that this AMT adjustment can be a positive or negative adjustment when computing alternative minimum taxable income (AMTI) for the purpose of passing through the adjustment to the shareholders/partners/members for S corporations and partnership/LLC, depending on whether the method utilized by the contractor or the percentage-of-completion method produces a greater amount of taxable income.

A. Case study

Marvin Contractors, LLC (a partnership) commenced job 10 on October 1, 20X1, which was expected to be completed by May 10, 20X2 (since Marvin has a December 31 year-end, this contract is deemed to be a long-term contract as defined by IRC §460). Marvin's normal method of accounting for long-term contracts is the cash method. Job 10 is the only active job. See the table below for financial information concerning job 10.

Total contract price	$ 8,000,000
Total billings through December 31, 20X1	$ 1,400,000
Total cash collected through December 31, 20X1	$ 1,100,000
Total estimated costs for job 10	$ 6,000,000
Total costs incurred through December 31, 20X1	$ 1,200,000
Total amounts actually paid through December 31, 20X1	$ 1,000,000

What we need to determine is the amount of AMT adjustment that needs to be recognized by Jonas Huber, a member who has a 90 percent ownership in the LLC.

B. Case study solution

First, we need to determine the amount of taxable income from job 10 based on Marvin's normal method of accounting, the cash basis:

Total cash collected through December 31, 20X1	$ 1,100,000
Total amounts actually paid through December 31, 20X1	(1,000,000)
Recognized taxable income	$ 100,000

Next, we need to determine taxable income using the percentage-of-completion method:

Total costs incurred through December 31, 20X1	$1,200,000
Total estimated costs for job 10	$6,000,000
Based on the cost-to-cost method, job completion is:	20%
Total contract price	$8,000,000
Percentage complete as of December 31, 20X1	20%
Revenue to be recognized for 20X1	$1,600,000
Less: Total costs incurred through December 31, 20X1	(1,200,000)
Recognized taxable income	$ 400,000

The AMT adjustment would be calculated as follows:

Taxable income using the percentage-of-completion method	$ 400,000
Taxable income using Marvin's normal method (cash basis)	(100,000)
Total AMT adjustment	300,000
Jonas Huber's allocable portion	90%
Jonas Huber's AMT positive adjustment	$ 270,000

Jonas Huber will report the $270,000 AMT positive adjustment on Form 6251, line 2p.

Before we move on, we should reiterate that for pass-through entities (S corporations and partnerships/LLCs), AMT must always be passed through to its shareholders/partners/members. There is no small contractor exception to this rule.

IV. The depreciation adjustment

While the long-term contract adjustment is for sure the most important consideration for the contractor and AMT, the depreciation adjustment could also be significant, especially for road builders and similar types of contractors who utilize a significant amount of equipment.

Some important issues involving the contractor, AMT, and depreciation:

- It affects real and personal property placed in service after 1986.
- Similar to the long-term contract adjustment, it can result in either a positive or negative adjustment when computing AMTI for the purpose of determining the amount to pass-through to the shareholders/partners/members.
- The contractor is required to compute the amount of depreciation expense for regular tax purposes known as the general deprecation system (GDS) and the amount of depreciation if the contractor had utilized the alternative depreciation system (ADS). Using ADS generally increases the number of years over which property is depreciated, thus decreasing the annual deduction. The AMT adjustment is the difference between these two amounts. Note that the taxpayer generally must use the GDS unless they are specifically required by regulation to use the ADS or they elect to use it.
- There are two significant differences between the GDS and the ADS (both of which will generally result in less of a depreciation expense deduction in earlier years for AMT purposes but a greater amount in later years):
  - The GDS generally utilizes the 200 percent declining-balance method while the ADS generally utilizes the 150 percent declining-balance method; and
  - For property placed in service prior to 1999, ADS generally requires a longer recovery period than GDS. It should be noted that this provision is not applicable for assets placed in service after 1998; GDS and ADS use the same recovery period.

Example: Herman Contractors, Inc. (an S corporation) owns various pieces of construction equipment. During 20X1, it recognized $85,000 of depreciation expense using the GDS to figure the deduction. If instead they had used the ADS, the amount of depreciation would have been $75,000 due to the longer depreciation period. Accordingly, Herman would recognize a positive AMT adjustment. This amount would be passed through to Donald Herman, 100 percent shareholder, who would then reflect this AMT adjustment on line 2l of Form 6251.

V. Minimizing the AMT

In many instances, the most important issue facing contractors when discussing AMT, is how to minimize the impact of the effects of this potentially imposed additional tax. Since the long-term contract adjustment generally has the greatest impact that should be the main focus area of contractor concern. Probably the best way to minimize the impact of the AMT is to reduce the percentage-of-completion recognized on jobs reported as of the year-end in the work-in-progress schedule. In other words, the more a job is considered complete (based on the percentage-of-completion calculation), the more taxable income the contractor will need to recognize.

There are generally three ways the contractor can reduce the percentage-of-completion and minimize their recognition of taxable income:

- Control their subcontractor billings;
- Evaluate the usage of materials on jobs in progress; and
- Reevaluate the calculation of estimated costs to complete.

A. Subcontractor billings

Similar to the contractor, its subcontractors will attempt to front-end load their billings in order to collect as much cash as quickly as possible. However, any amounts billed by the subcontractor to the contractor are

included in the numerator (costs incurred to date) of the percentage-of-completion formula, thereby increasing the amount of taxable income recognized by the contractor.

To minimize this problem, the contractor should attempt to only approve amounts billed by the subcontractor to work actually performed through the invoice date.

Example: Shirley is a general contractor. She signs a contract on November 1, 20X1, with Roth Plumbing to have them perform work on her contract. Roth is considered a subcontractor to Shirley. The work to be performed by Roth is expected to be completed by August 31, 20X2, signifying this to be a long-term contract. The following is financial information concerning this subcontractor contract as of and for the period ending December 31, 20X1:

Total contract amount	$ 600,000
Total estimated costs	(400,000)
Total anticipated gross profit	$ 200,000
Total amount billed by Roth to Shirley as of December 31, 20X1 (signifying work performed through that date)	$ 100,000
Percentage of job completion (100,000/400,000)	25%
Gross profit Shirley would need to recognize ($200,000 × 25%)	$ 50,000

However, Shirley was able to perform a thorough analysis and was able to determine that Roth had only incurred $80,000 of costs (as he attempted to front-end load the job). Accordingly, as of December 31, 20X1, the percentage complete should have been:

$80,000/$400,000	20%
Gross profit actually recognized by Shirley ($200,000 × 20%)	$ 40,000

By performing this subcontractor analysis, Shirley was able to reduce her AMTI by $10,000.

B. Uninstalled materials

What are uninstalled materials? It exists when the contract requires the contractor to purchase equipment or material at the beginning of the contract but does not allow the contractor to install the equipment or utilize the materials on that job, and accordingly, the contractor cannot bill the owner for these particular costs.

It should be noted that this issue of uninstalled materials creates a lose-lose situation for the contractor. On the one hand, uninstalled materials create additional taxable income, but at the same time, the contractor cannot recognize these costs incurred as additional revenue for financial statement reporting purposes.

There appears to be two ways for the contractor to avoid or at least minimize this situation:

1. Reword their contract with the owner, which will allow them to bill for these costs at an earlier date; or
2. Attempt to minimize equipment and material purchases close to year-end to avoid or reduce the amount of uninstalled materials located at the job site.

C. Estimated costs to complete

When a contractor estimates its cost to complete on open jobs as of the balance sheet date, it will compute this amount following U.S. GAAP rules. However, the rules for computing estimated costs to complete for AMT purposes are substantially different.

For AMT purposes, a significant portion of the contractor's home office overhead (general and administrative expenses) must be allocated to the various projects as indirect job costs. Therefore, since these indirect job costs must be included in the numerator (costs incurred to date), they should also be included in the estimated costs to complete (denominator). Since this will cause an increase in the estimated costs to complete, this will then result in a lower percent of completion of the job as of the year-end date which will ultimately result in less of an AMT adjustment to be passed by the S corporation or partnership/LLC to its shareholders or partners/members.

Look-Back Provisions

Look-Back Provisions

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Recognize the issues involved with the look-back provisions; and
- Identify who needs to file Form 8697.

I. Introduction

Since contract revenue reported on the percentage-of-completion method is based principally on estimates, a taxpayer could theoretically defer the recognition of taxable income in one year by understating a contract's percentage of completion. Essentially, a taxpayer could push off reporting a majority of income to the final year of a contract. For contracts of a large dollar amount or a long-construction period, it could mean that the IRS would wait a long time for their money.

Accordingly, the IRS is not giving the taxpayer a free ride if their estimation ability is not right on target. Therefore, for those taxpayers who report under the percentage-of-completion method, IRC §460 requires the contractor to perform a look-back calculation to account for any over or underreporting of previously recognized income while the jobs were in progress. In other words, look-back provisions are the IRS's tool that takes the reporting option of the deferral of income recognition off the table.

It should be noted that in many instances, the look-back provisions apply to both regular tax and AMT purposes. It should also be noted that most contractors will find themselves subject to these provisions.

II. Exempt contracts

All construction-type contracts are subject to the look-back provisions with the following exceptions:

- Home construction and residential contracts (as discussed in Chapter 2);
- If the contractor qualifies for the small contractor exemption (as discussed in Chapter 2); those contracts whose duration is less than two years in length are exempt from look-back for regular tax but not for AMT purposes; and
- If the contractor is not qualified as a small contractor and accordingly not exempt from the provisions of IRC §460, all contracts are subject to the look-back provisions except those that fall under the following de minimis exception:
    - If the price of the contract does not exceed $1 million or 1 percent of average gross receipts for the past three years in which the contract was completed, that particular contract is exempt from the look-back provisions.

In addition to these three exceptions, IRC §460(b)(6) provides the contractor with a de minimis election. This election allows the contractor to exclude any contract where the cumulative taxable income generated from the individual contract is within 10 percent of the cumulative look-back income for each prior year for which the look-back is determined.

III. The look-back calculation

In simple terms, the look-back calculation requires the contractor to review prior-year(s) underreporting and/or overreporting from income and gross profit from jobs in progress across taxable years.

There are two times when the look-back calculation needs to be considered:

1. At the completion of the job (i.e., the year the job is completed); and
2. In years subsequent to the completion of the job if the taxpayer was required to adjust the total contract price or the total contract costs. **Note:** The taxpayer may elect not to have look-back method apply in de minimis cases [see IRC §460(b)(6)(A)].

A. At the completion of the job

We will now look at the first instance in more detail. Once a job is completed, the contractor is required to determine what the tax liability would have been if their estimates were fully accurate at each year-end.

Example: ***Barber Construction***

For instance, Barber Construction reported the following regarding jobs 101 and 102. Both jobs were started in 20X0 and completed in 20X1 (note: Barber's tax year-end is December 31).

As of and for the year ending December 31, 20X0:

		Contract 101	Contract 102
A	Contract price	$1,200,000	$ 1,500,000
B	Estimated total costs	(800,000)	(900,000)
C	Estimated total gross profit	400,000	600,000

D	Actual costs incurred in 20X0	360,000	364,000
E	Percent complete as of December 31, 20X0 (D/B)	45%	40%
F	20X0 gross profit (C x E)	180,000	240,000

As of and for the year ending December 31, 20X1:

G	Revised contract price	$ 1,200,000	$ 1,800,000
H	Actual total costs	(780,000)	(950,000)
I	Actual gross profit	220,000	850,000

J	Actual costs incurred in 20X1	420,000	586,000
K	Percent complete as of December 31, 20X1 (D + J/H)	100%	100%
L	20X1 gross profit (I x F)	40,000	610,000

We will now present the look-back calculation for jobs 101 and 102.

20X0 actual costs (D)	$ 360,000	$ 364,000
Actual total cost (H)	780,000	950,000
Percent complete for look-back purposes	46%	38%
Actual gross profit (I)	220,000	850,000
Look-back gross profit for 20X0	101,538	325,684
Gross profit originally reported for 20X0 (F)	180,000	240,000
(Over) understatement of gross profit	(78,462)	85,684

For job 101, Barber overstated gross profit as of December 31, 20X0, and accordingly, will be entitled to a refund.

For job 102, Barber understated gross profit as of December 31, 20X0, and accordingly, will be required to pay additional tax.

The regulations require that interest be calculated on the over- or underpayment of tax. The calculated tax is the amount of interest due to or from the IRS. It should be noted that it is not the increase or decrease in taxable income that is the contractor's responsibility under look-back but the interest associated with the increase or decrease in the tax. However, for purposes of enforcement, this interest is considered additional tax. Once the additional tax is determined, it should be reported on IRS Form 8697.

B. In years subsequent to the completion of the job

In addition to performing the above-detailed calculation in the year the job is completed, the regulations also require that the look-back be calculated if revenues are received or costs are incurred in a tax year after the job is completed.

However, §1.460-6(e) provides the taxpayer with an exception to this general rule of performing a second look-back, known as the delayed reapplication method.

Under this method the number of required additional look-backs is reduced. The contractor is allowed to accumulate settlements for up to five years or until the price or cost adjustment exceeds $1 million or 10 percent of the contract price at that time.

IV. Various methods

A. 10 percent deferral method

In Chapter 2, we discussed the 10 percent deferral method whereby the contractor is not required to recognize any taxable income from a job until at least 10 percent of the total estimated costs have been incurred. If that election is made, it also must be used when calculating look-back. For purposes of this calculation, actual/total contract costs are used to determine the 10 percent threshold. Accordingly, it should be noted that the 10 percent year may be different from the originally estimated 10 percent year.

Look-back not only applies to long-term contracts reported under the percentage-of-completion method for regular tax purposes, but it also applies to long-term contracts that must be reported under the percentage-of-completion method for AMT purposes [see Treas. Regs. §1.460-6(b)(1) and (4)].

B. Percentage-of-completion capitalized cost method

In Chapter 2, we discussed that contractors engaged in residential construction are required to use the 70-30 percentage-of-completion/capitalized cost method whereby 70 percent of the contract costs must use the percentage-of-completion method while 30 percent of the contract costs can be reported using the contractor's normal method (i.e., completed-contract, cash, or accrual method) Treas. Regs. §§1.460-4(e) and 1.460-6(b)(1) and (4) require that the 70 percent portion of the contract required to use the percentage-of-completion method is subject to the look-back provisions.

However, for all contracts entered into during tax years beginning after July 4, 2025, large contractors are no longer required to use the percentage-of-completion method or the 70/30 method. In other words, the normal method of accounting will generally be available.

C. Simplified marginal impact method

There is another method available to the contractor when computing the look-back calculations known as the simplified marginal impact method. This method provides a simplified method of calculating the hypothetical underpayment or overpayment of tax liability for each redetermination year based on an assumed marginal tax rate. Generally, it is the highest rate of tax in effect for the redetermination year. For non-closely held entities flow-through entities that are required to compute this method at the entity level, the highest corporate rate in effect is generally used.

Any taxpayer not required to use this method may elect to use it. However, for flow-through entities, this election is made at the owner level, not at the entity level.

1. Advantage

It makes calculating look-back interest simpler as compared to the normal method. Rather than refiguring each previous year's tax liability, this method allows the contractor to calculate underpayments or overpayments in a given year based on an assumed marginal rate.

2. Disadvantage

It may reduce the look-back method's benefit for the entity. This method places a cap on the amount of refunds the taxpayer can claim, but it does not limit the amount of interest they may owe on underpayments.

V. Form 8697

Many CPAs consider the whole issue of look-back and completion of Form 8697 one of the more difficult aspects associated with the construction industry.

Form 8697 is required to be filed for each tax year in which the contractor completed a long-term contract entered into after February 28, 1986, that was accounted for using the percentage-of-completion method or the percentage-of-completion-capitalized cost method. This form must also be completed for any tax year subsequent to the year of completion in which the contract price or contract costs are adjusted for one or more of the long-term contracts from a prior year. (However, see above where we discuss an exception to this particular rule).

In regard to pass-through entities (S corporations and partnerships/LLCs), that are not closely held, the rules of look-back apply at the entity level to any contract for which at least 95 percent of the gross income is from United States sources.

Note that a pass-through entity is considered closely held if at any time during the tax year for which there is income under the contract, 50 percent or more (by value) of the beneficial interest in the entity is held (directly or indirectly) by five or fewer persons.

It should also be noted that non-closely held pass-through entities are required to use the simplified marginal method. However, closely held pass-through entities, C corporations, and sole proprietorships are not required to use this method, but they can elect to use it.

If the contractor is an owner of an interest in a pass-through entity in which a long-term contract was being accounted for under the percentage-of-completion method or the percentage-of-completion capitalized-cost method, and the pass-through entity is not subject to the look-back method at the entity level, the contractor must file Form 8697 for its tax year that includes ends with or includes the end of the contractor's tax year in which the contract was completed or adjusted in a post-completion year.

We will now provide Form 8697 for review.

Form **8697**
(Rev. November 2018)
Department of the Treasury
Internal Revenue Service

Interest Computation Under the Look-Back Method for Completed Long-Term Contracts

► **Go to *www.irs.gov/Form8697* for instructions and latest information.**

OMB No. 1545-1031

Attachment Sequence No. **97**

For the filing year beginning , and ending . See instructions.

Type or Print	Name	**A** Identifying number
	Number, street, and apt., room, or suite no. If a P.O. box, see instructions.	**B** Check applicable box to show type of taxpayer: ☐ Corporation ☐ S corporation ☐ Individual ☐ Partnership ☐ Estate or trust
	City or town, state, and ZIP code	

C If you were an owner of an interest in a pass-through entity (such as a partnership or an S corporation) that holds one or more long-term contracts to which this interest computation relates, enter the name and employer identification number of the entity. Attach a schedule if there is more than one such entity.

Name of entity | **Employer identification number**

Part I Regular Method (see instructions)

		Filing Year	Redetermination Years		(c) Totals (Add columns (a) and (b).)
		Year ended mo. yr.	(a) Year ended mo. yr.	(b) Year ended mo. yr.	
1	Taxable income or loss for the prior years shown on tax return (or as previously adjusted) before net operating loss or capital loss carrybacks (other than carrybacks that must be taken into account to properly compute interest under section 460) (see instructions). If you were required to file Form 8697 for an earlier year, enter adjusted taxable income for the prior years from line 3, Form 8697, for the most recent filing year that affects the prior years . . .				
2	Adjustment to income to reflect the difference between: **(a)** the amount of income required to be allocated for post-February 1986 contracts completed or adjusted during the tax year based on the **actual** contract price and costs, and **(b)** the amount of income reported for such contracts based on **estimated** contract price and costs. See instructions and attach a schedule listing each separate contract, unless you were an owner of an interest in a pass-through entity reporting this amount from Schedule K-1 or a similar statement				
3	Adjusted taxable income for look-back purposes. Combine lines 1 and 2. If line 3 is a negative amount, see instructions				
4	Income tax liability on line 3 amount using tax rates in effect for the prior years (see instructions)				
5	Income tax liability shown on return (or as previously adjusted) for the prior years (see instructions). If you were required to file Form 8697 for an earlier year, enter the amount required to be reported on line 4, Form 8697, for the most recent filing year that affects the prior years .				
6	Increase or decrease in tax for the prior years on which interest is due (or is to be refunded). Subtract line 5 from line 4				
7	Interest due on increase, if any, shown on line 6 (see instructions)				
8	Interest to be refunded on decrease, if any, shown on line 6 (see instructions)				
9	Net amount of **interest to be refunded to you.** If line 8, column (c), exceeds line 7, column (c), enter the excess. File Form 8697 separately; **do not** attach it to your tax return (see instructions)				
10	Net amount of **interest you owe.** If line 7, column (c), exceeds line 8, column (c), enter the excess. Attach Form 8697 to your tax return. See instructions for where to include this amount on your return				

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 64598V Form **8697** (Rev. 11-2018)

Part II **Simplified Marginal Impact Method** (see instructions)

		Date of each prior year to which interest computation relates: (a) Year ended mo. yr.	(b) Year ended mo. yr.	(c) Year ended mo. yr.	(d) Totals (Add columns (a), (b), and (c).)
1	Adjustment to regular taxable income to reflect the difference between: **(a)** the amount of such income required to be allocated for post-February 1986 contracts completed or adjusted during the tax year based on **actual** contract price and costs, and **(b)** the amount of such income reported for such contracts based on **estimated** contract price and costs. See instructions and attach a schedule listing each separate contract, unless you were an owner of an interest in a pass-through entity reporting this amount from Schedule K-1 or a similar statement				
2	Increase or decrease in regular tax for prior years. Multiply line 1 in each column by the applicable regular tax rate (see instructions)				
	Note: For prior years beginning before 1987, skip lines 3 and 4 and enter on line 5 the amount from line 2.				
3	Adjustment to alternative minimum taxable income to reflect the difference between: **(a)** the amount of such income required to be allocated for post-February 1986 contracts completed or adjusted during the tax year based on **actual** contract price and costs, and **(b)** the amount of such income reported for such contracts based on **estimated** contract price and costs. See instructions and attach a schedule listing each separate contract, unless you were an owner of an interest in a pass-through entity reporting this amount from Schedule K-1 or a similar statement . . . . . **Note:** For tax years beginning after 2017, the alternative minimum tax for corporations has been repealed.				
4	Increase or decrease in alternative minimum tax (AMT) for prior years. Multiply line 3 in each column by the applicable AMT rate (see instructions)				
5	Enter the **larger** of line 2 or line 4. See instructions if either amount is negative				
	Pass-through entities: *Skip line 6 and enter on line 7 the amount from line 5.*				
6	Overpayment ceiling. For each column in which line 5 is a negative number, enter your total tax liability for the prior year, as adjusted for past applications of the look-back method and after net operating loss, capital loss, net section 1256 contracts loss, and credit carryovers and carrybacks to that year. For each column in which line 5 is a positive number, leave line 6 blank and enter on line 7 the amount from line 5				
7	Increase or decrease in tax for the prior years on which interest is due (or is to be refunded). Enter the amount from line 5 or line 6, whichever is smaller. Treat both numbers as positive when making this comparison, but enter the amount as a negative number .				
8	Interest due on increase, if any, shown on line 7 (see instructions)				
9	Interest to be refunded on decrease, if any, shown on line 7 (see instructions)				
10	Net amount of **interest to be refunded to you.** If line 9, column (d), exceeds line 8, column (d), enter the excess. File Form 8697 separately; **do not** attach it to your tax return (see instructions)				
11	Net amount of **interest you owe.** If line 8, column (d), exceeds line 9, column (d), enter the excess. Attach Form 8697 to your tax return. See instructions for where to include this amount on your return				

Signature(s) Complete this section **only** if this form is being filed separately.

Sign Here

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature | Date

Spouse's signature. If a joint return, both must sign | Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Form **8697** (Rev. 11-2018)

VI. Summary

After reviewing the requirements and calculations of the look-back provisions, the question remains, should the contractor and their outside CPA worry about the look-back provisions?

The following should be considered when making this determination:

- Performing the look-back calculations is an explicit requirement according to IRC §460, not an election.
- The CPA preparing the return who fails to perform this calculation could be subjected to preparer penalties.
- As we noted earlier, in many (if not most) instances, since contractors tend to overestimate gross profit on jobs-in-progress for financial statement reporting purposes, the look-back will result in refunds due to the taxpayer rather than additional tax due.

Tax tip:

In the third bullet point, we noted that in most situations, contractors tend to overstate gross profit while the job is still in progress. When the contractor is performing its year-end tax planning and they determine that profit fade will be recognized regarding a particular contract, the contractor should try to close this job prior to the tax year-end in order to collect their look-back refund.

Employee vs. Independent Contractor Issues

Employee vs. Independent Contractor Issues

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Recognize the issues involved in determining a worker's status as an employee or independent contractor and how this determination impacts the construction industry.

I. Introduction

The IRS is continuing to attack how entities treat certain persons who perform work as independent contractors rather than as employees. It has been reported that they have targeted the construction industry where they believe there may be substantial abuse exhibited by some contractors inappropriately granting a worker independent contractor status when the facts and circumstances indicate that the worker should be classified as an employee.

The costs to the contractor who is required by the IRS to reclassify workers from independent contractors to employee status will be substantial and could result in the demise of the entity. These costs may include:

- Additional payroll taxes (FICA, Medicare, and unemployment, in addition to applicable penalties and interest;
- Potential back overtime pay under the applicable state's wage and hour laws; and
- Additional potential retirement plan contributions.

Under §6041(a) after the OBBBA, the threshold amount for required information reporting on certain payments made in a calendar year to a payee by a payor in the course of the payor's trade or business is increased from $600 to $2,000 for payments made after December 31, 2025. For calendar years after 2026, the $2,000 threshold will be adjusted for inflation.

II. Rev. Rul. 87-41

The current guidance on the issue of independent contractor vs. employee is Rev. Rul. 87-41, which lists 20 factors and three categories of control that provides the necessary guidance whether an employer-employee relationship exists. These factors were based on the circumstances that the courts identified and relied upon when deciding whether an employment relationship existed. It should be noted that not all of the factors need to be present to determine an employer-employee relationship or a subcontractor status. These factors and categories of control are to be considered a guide to the contractor in order to allow them to assess the likelihood as to whether an individual is an employee or an independent contractor.

The three additional categories listed after these 20 factors are the result of the IRS recognizing changes in business practices (including the construction industry) since 1987 (when the initial revenue ruling was published). Therefore, they created these three categories of factors to assess the degree of control and independence between the entity and the individual. These three additional categories are to be used by the contractor in conjunction with the 20 factors that will now be listed to assess whether an employee or independent contractor arrangement exists.

A. 20 factors for consideration by the contractor

1. Instruction

An employee must comply with the instructions when, where, and how to work. The control factor is present if the contractor has the right to require compliance with its instructions.

2. Training

An employee receives ongoing training from or at the direction of the contractor. Independent contractors use their own methods and receive no training from the purchases of their services. For the construction industry, because of the very nature of the work performed by its workers, this may be considered one of the most important factors when making the employer-employee vs. independent contractor determination.

3. Integration

An employee's services are integrated into the construction operations because the services are important to the contractor This shows that the worker is subject to direction and control of the contractor and therefore will generally be classified as an employee.

4. Services rendered personally

If the services must be rendered personally, presumably the contractor is interested in the methods used to accomplish the work as well as the end results. An employee often does not have the ability to assign that work to other employees, while an independent contractor may assign work to others.

5. Hiring, supervising, and paying assistants

If a contractor hires, supervises, or pays assistants, the worker is generally categorized as an employee. An independent contractor hires, supervises, and pays assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the results.

6. Continuing relationship

A continuing relationship between the worker and the contractor indicates that an employer-employee relationship exists. The IRS has found that continuing relationships may exist when work is performed at frequently recurring intervals, even if the intervals are irregular.

7. Set hours a week

A worker who has set hours of work established by a contractor is generally an employee. An independent contractor sets his or her own hours.

8. Full time required

An employee normally works full time for a contractor. An independent contractor is free to work when and for whom they choose.

9. Work done on premises

Work performed on the premises of the contractor (job site) for whom the services are performed suggest employer control, and therefore, the worker may be an employee. Independent contractors may perform the work wherever they desire as long as the contract requirements are performed.

10. Order or sequence set

A worker must perform services in the order or sequence set by a contractor and is generally an employee. Independent contractors perform the work in whatever sequence they desire.

11. Oral or written reports

A requirement that the worker submit regular or written reports to the contractor indicates a degree of control by the entity and suggests an employer-employee relationship.

12. Payments by the hour, week, or month

Payments made by the hour, week, or month generally point to an employer-employee relationship.

13. Payment of expenses

If the contractor generally pays the worker's business and/or travel expenses, the worker is ordinarily an employee.

14. Furnishing of tools and materials

If the contractor furnishes significant tools, materials, and other equipment that would normally be supplied by an employer, the worker would generally be considered an employee.

15. Significant investment

If a worker has a significant investment in the facilities where he or she performs their services, the worker may be classified as an independent contractor.

16. Profit or loss

If the worker can make a profit or incur a loss, the worker may be an independent contractor. Employees are typically paid for their time and labor and have no liability for the contractor's expenses or liabilities.

17. Working for more than one contractor at a time

If a worker performs construction services for a number of unrelated contractors at the same time, the worker may be considered an independent contractor.

18. Making contracting services available to the general public

If a worker makes his or her contracting services available to the general public on a regular and consistent basis, the worker may be an independent contractor.

19. Right to discharge

The contractor's right to discharge a worker is a factor indicating that the worker is involved in an employer-employee relationship.

20. Right to terminate

If the worker can quit work at any time without incurring liability, the worker is generally considered an employee.

B. Categories of control factors for additional consideration by the contractor

1. Behavioral control

Includes the type of instructions the contractor gives to the worker, such as when and where to do the work and the training the contractor provides to the worker. The key consideration is whether the contractor has the right to control the details of the worker's performance or has established that right.

2. Financial control

Addresses the contractor's rights to control the business aspects of the worker's job.

3. Relationship of the parties

The nature of the relationship may be evidenced by:

- A written contract;
- The benefits provided to the employee, such as paid vacation and health coverage;
- The permanency of the position; and
- The extent to which the services performed are a key aspect of the construction work of the contractor.

C. Which factors are the most important?

One thing that is important to remember when examining these factors is that none of them are necessarily determinative. According to the IRS website:[1]

> Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no "magic" or set number of factors that "makes" the worker an employee or an independent contractor and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

D. Department of Labor final rule (January 10, 2024)

On January 10, 2024, the Department of Labor published a final rule for determining when a worker should be considered an independent contractor or an employee under the Fair Labor Standards Act. This final rule went into effect on March 11, 2024. Similar to the IRS rules, the DOL rules invoke a totality-of-circumstances determination. In other words, no one factor is determinative. Perhaps most importantly, no factor is given more weight than other factors. In previous proposed rules, the DOL examined the possibility of weighing certain factors more than others, but this concept was dropped in the final rule.

The DOL examines six factors for this determination.

1. Opportunity for profit or loss depending on managerial skill

Similar to the IRS profit or loss consideration, the DOL suggests that generally only contractors have the opportunity for profit or loss.

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[1] Internal Revenue Service (April 7, 2023). *Independent Contractor (Self-Employed) or Employee?* Retrieved from IRS website: https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee.

2. Investments by the worker and the potential employer

The more one invests in their product or service using their own capital, the more likely they are an independent contractor.

3. Degree of permanence of the work relationship

Contractors are generally hired on a per-project basis. Employees are hired on a more permanent and ongoing basis. Therefore, the more permanent the relationship is, the more likely it is an employee relationship.

4. Nature and degree of control

The more control an employer has over performance and the economic aspects of the relationship, the more likely the worker is an employee.

5. Extent to which work performed is an integral part of the potential employer's business

The more integral the work is to the employer's business, the more likely they are an employee.

6. Skill and initiative

The more specialized skill that the worker demonstrates, the more likely they are an independent contractor.

E. IRS Voluntary Classification Settlement Program

The IRS provides employers who have misclassified workers the opportunity to voluntarily come forth and correctly place them as employees with minimal back taxes.

To be eligible for the Voluntary Classification Settlement Program (VCSP), taxpayers must meet the following requirements:

- A taxpayer must have consistently treated the workers to be reclassified as independent contractors or other nonemployees, including having filed all required Forms 1099 for the workers to be reclassified;
- A taxpayer may not be under employment tax audit by the IRS; and
- A taxpayer may not be under audit concerning the classification of workers by the Department of Labor or any state agency.

By participating in the VCSP, the taxpayer agrees to treat the workers (or classes of workers) as employees in future years. The taxpayer will also receive the following benefits in exchange:

- Pay 10 percent of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year determined under the reduced rates of IRC §3509(a);
- Not be liable for any interest and penalties on the amount; and
- Not be subject to an employment tax audit with respect to the worker classification of the workers being reclassified under the VCSP for prior years.

Application for the VCSP is made using Form 8952.

Note:

If a taxpayer is under IRS audit regarding employee classification, they are not eligible for the VCSP. The IRS Classification Settlement Program (CSP) may be available to them, however.

III. Summary

Obviously, the contractor will want to classify as many workers as possible as independent contractors in order to avoid paying the following related expenses generally associated with employee status:

- Payroll taxes;
- Workers' compensation insurance;
- Health insurance; and
- Retirement plan contributions.

However, if this position was challenged by the IRS, it appears that the burden of proof will be on the contractor to prove that the worker was in fact an independent contractor and not an employee. The more factors and conditions listed above that support the contractor's position, the greater the possibility the IRS will accept their position. Accordingly, the contractor (together with their outside CPA) must be sure to thoroughly document their position.

And finally, when the contractor is bidding on a job, they may want to include a contingency for these additional costs should the IRS impose the reclassification.

FIN 48

FIN 48

Learning objective

Upon reviewing this chapter, the reader will be able to:

- Recognize the key provisions of FIN 48 and how it specifically impacts the construction industry.

I. Introduction

There is one issue contractors and CPAs must deal with involving both tax returns and financial statements prepared in accordance with U.S. GAAP. This issue deals with uncertain and aggressive positions taken on the tax return and the potential impact on the financial statements. This issue is commonly referred to as FIN 48.

The source of U.S. GAAP concerning FIN 48 is FASB ASC 740, “Income Taxes.”

In June 2006, the FASB issued FIN 48, “Accounting for Uncertainty in Income Taxes” (in conjunction with SFAS No. 109). It is now applicable to every financial statement prepared in accordance with U.S. GAAP.

The theory behind FIN 48 is that when an entity is preparing its tax returns, they may take uncertain, aggressive positions on those returns. Senior management may be advised that these positions may fall into a gray area and in the event of an examination by the IRS or any other taxing authority sometime in a future year, the uncertain/aggressive positions could be disallowed. This in turn could result in not only an additional tax assessment but the possibility of additional assessed interest and penalties.

However, historically, when the entity prepares its financial statements for the year the uncertain or aggressive positions are taken, no disclosure or accrual for potential additional tax, interest, and penalties have been made. Therefore FIN 48 instructs the entity when preparing their financial statements, they should accrue (for C corporations) and disclose (for all entities) the potential impact of a government examination of the entity’s tax return if it is management’s position that it is more likely than not (greater than 50 percent likelihood) that the uncertain or aggressive position will be disallowed by the taxing authority.

II. Application of FIN 48

It should be noted that for FIN 48 purposes, it is always assumed that every tax return will be examined by the applicable authorities, whether it is:

- Federal;
- State;
- Local; and
- Franchise.

Any tax that is based on income is subject to the provisions of FIN 48.

III. FIN 48 and the construction industry

What are some of the issues that may cause FIN 48 to have an impact on contractor-related financial statements because of uncertain or aggressive positions taken on the tax return?

- The method of revenue recognition used for long-term contracts (i.e., improper use of the completed-contract, cash, and accrual methods).
- The entity not fully being in compliance with nexus issues in those jurisdictions where they may have performed construction work that may result in the payment of additional takes in those jurisdictions. For contractors, this may be a very prevalent issue, since many contractors perform work in many different states and localities.
- Ignoring various AMT issues.
- Ignoring look-back provisions.
- When using the completed-contract method, considering a job only 94 percent complete as of the reporting date, whereas the IRC requires recognition of gross profit from the contract when it is considered 95 percent complete.

Conclusion

Conclusion

Learning objective

Upon reviewing this chapter, the reader will be able to:

- Identify the most commonly missed tax strategies for contractors.

I. Tax issues in the construction industry

A reading and understanding of the material contained in this course should make it obvious why many CPAs consider the construction industry to be the most difficult industry to stay in compliance with the Internal Revenue Code and related regulations.

Some of the issues where the CPA needs a certain level of expertise in order properly service their client and the construction industry includes:

- Taxation of long-term contracts, especially the rules and regulations of IRC §460;
- Knowledge of noncommercial types of contractors, which includes homebuilders and residential construction;
- The rules concerning cost capitalization: which costs require capitalization and which may be currently deducted;
- The alternative minimum tax (AMT) and its impact on the construction industry
- The look-back rules; and
- The rules concerning the issue of independent contractor vs. employee and how it directly impacts the construction industry.

II. Most common tax mistakes for contractors

A. Percentage-of-completion method

As discussed in detail in Chapter 2, many contracts are exempt from the requirement to use the percentage-of-completion method on their construction contracts. As we further noted, contractors generally try to avoid the percentage-of-completion method since this often results in an acceleration of recognizing taxable income over other methods. Contracts exempt from the requirement to use the percentage-of-completion method include:

- Home construction contracts (as defined).
- Residential construction contracts (as defined).
- Specifically exempt construction activities, which includes the following activities:
  - Industrial and commercial painters;
  - Engineers;
  - Architects; and
  - Construction management-type services.
- Short-term contracts.

B. 10 percent election

As noted in Chapter 2, there is a deferral opportunity for contractors required to use the percentage-of-completion method known as the 10 percent deferral method whereby no taxable income is recognized from a contract until it is considered 10 percent complete. Unfortunately, there are some CPAs who may not be aware of this provision resulting in an unnecessary acceleration of revenue.

C. Alternative minimum tax

As discussed in detail in Chapter 4, few industries are more impacted by alternative minimum tax (AMT) than the construction industry. The two most important AMT adjustments for contractors are:

1. The long-term contract adjustment; and
2. The depreciation adjustment.

Maybe the most important detail is that pass-through entities (S corporations and partnerships/LLCs) always must pass their AMT adjustments through to their shareholders and partners/members. No alternative minimum tax adjustment is required for any residential construction contract entered into in a tax year beginning after July 4, 2025.

D. Look-back calculations

As discussed in Chapter 5, many contractors are subject to the look-back provisions (if not related to their regular tax, then for AMT purposes). As was also discussed, in most situations, contractors tend to overestimate their gross profit for financial reporting purposes. Accordingly, in most situations, look-back results in refunds due to the contractor rather than additional tax due.

E. Choice of entity

As discussed in Chapter 1, historically, when a contractor was organizing as a new entity, more often than not, the outside CPA would recommend they should be taxed as a pass-through entity (either an S corporation or a partnership/LLC) due to lower personal tax rates (as compared to C corporations) and no double taxation on the contractor's earnings (which applies to C corporations). However, because of the TCJA, the outside CPA may now at least want to consider C corporation status for two reasons:

- The flat 21 percent tax rate imposed on C corporations (which may be lower than the rate imposed from the pass-through entities in certain situations); and
- The elimination of any AMT considerations.

Obviously, these considerations will need to be balanced against the benefits of pass-through entities, especially the §199A deduction.

III. Summary

The importance of obtaining a thorough knowledge of IRC §460 and other regulations dealing with taxation of the construction industry cannot be overemphasized. Accordingly, we must ask the question, what is the primary reason CPAs are involved in litigation with their construction clients?

The answer is not a surety or bank seeking recovery as the result of relying on upon financial statements audited or reviewed by the outside CPA that were subsequently determined to contain material U.S. GAAP misstatements that ultimately resulted in the surety or bank incurring significant losses. But rather, it results from legal action brought on by the client due to the improper preparation of their various tax returns and it was alleged that the outside CPA was lacking the necessary knowledge to prepare those returns in accordance with the IRC.

Discussion question:

How has this course helped better prepare you to work for or represent construction clients?