



Accounting for Construction Contracts - Construction Tax Tips

What is Taxable Income?

When you are paid for work, the income you earn is taxable. This is true whether you are an employee or a subcontractor. The income you earn from all side jobs is also taxable. It does not matter whether you:

- Are paid by cash or check,
- Get a credit on a bill,
- Receive other goods or services in exchange,
- Collect the payment later, or
- Receive a Form 1099 or W-2 (or not) showing the amount of income you earned.

Example: Joe, as an employee of ABC, Inc., installs cabinets. He also does remodeling side jobs.

In addition to his wages from ABC, Inc., Joe's income includes everything he earns from his side jobs, whether or not he receives a Form 1099.

When you work as an employee, your employer gives you a W-2 form that shows the income you have earned. When you work for yourself, you may or may not receive a Form 1099 from the people you work for; however, you are responsible for keeping track of and reporting all of your income. Now that you know what is included in income, you need to choose an accounting method.

What is an Accounting Method?

Every taxpayer reports income and expenses on their tax return according to a method of accounting. An accounting method is a set of rules used to determine when and how to report income and expenses. Basically, accounting methods are divided into two categories - the cash and accrual methods. There are several different accrual methods.

You must use an accounting method that clearly shows your income. An accounting method clearly shows your income when it treats all income and expenses the same from year to year and is appropriate for your line of work. Choosing the right method is important to your business because it will affect when you report income and deduct expenses.

How Do I Choose a Method?

There are special tax rules that control the accounting method you must use for your construction business. Generally, you choose your tax accounting method when you file your first tax return for the business.

Your choice of accounting method depends on:

1. The type of contracts you have,
2. Your contracts' completion status at the end of your tax year, and
3. Your average annual gross receipts.

Most construction businesses use two different tax accounting methods; one for their long-term contracts and one overall method for everything else. A long-term contract is any contract that is not completed in the same year it's started.

Most construction businesses use the Accrual Method for their overall method of accounting. See the [Accrual](#) section for information on the Accrual Method.

Cash Method of Accounting

One method that some construction contractors can use for both their overall method and for their long-term contracts is the cash method. However, there are significant limitations on who can and cannot use this method.

How Does the Cash Method of Accounting Work?

A contractor using the cash method of accounting reports cash receipts as income when received and deducts expenses when paid. If you pay an expense that benefits you for more than one tax year, you must spread the cost over the period you receive the benefit.

Example: You pay \$1,000 in Year 1 for a business insurance policy that is effective for one year, beginning July 1st. You can deduct \$500 in Year 1 and \$500 in Year 2.

In the cash method, income may be actually or constructively received. If you received a check from a customer in Year 1 but did not deposit or cash it until Year 2, it is still included in income

in Year 1 because that's the year you actually received it.

Constructive receipt occurs when you have unrestricted access to income you have earned.

- If a customer called you in December and told you that a payment for a job was ready, but you didn't pick it up until January, you would have constructive receipt of the income in December.
- If someone else receives the money for you, you have constructively received the money.

The key to constructive receipt is IF you could have received the money in one year but chose not to receive it until a later year, it must be included in your income in the first year as if it had been actually received in that year. You cannot postpone including it in your income until the next year.

What are the Limitations on the Use of the Cash Method?

There are two situations in which your use of the cash method of accounting can be limited. First, you are not allowed to use the cash method if your business is a corporation or a partnership with a C corporation as a partner, whose average annual gross receipts exceed \$5 million. There is no exception to this limitation.

Second, depending on what type of business you have, you may not be allowed to use the cash method if your total purchases of "merchandise" for the year are "substantial" compared to your gross income for the year.

So, what do the terms "merchandise" and "substantial" mean?

Merchandise includes any item physically incorporated in a product you transfer to your customers. In the construction industry, merchandise is commonly called materials. For example, the lumber used to frame a building is merchandise for tax purposes.

Merchandise is generally considered to be substantial when it is at least 10% - 15% of your gross income for the year. This percentage is not a hard and fast rule, but a guideline used in some court cases.

Exception to the Merchandise Limitation

An exception to the requirements to use an accrual method and to account for inventories is found in [Revenue Procedure 2001-10](#) (PDF), which permits most small businesses of \$1 million or less to use the cash method of accounting. The accounting of inventory items is simplified by allowing their cost to be deducted in the year the merchandise is paid for or sold whichever is later.

The rest of this tax tip assumes you have to use one of the accrual methods and you use a calendar tax year, from the 1st of January to the 31st of December. The rules that follow show you how to choose a method of accounting for your long-term contracts.

Accrual Methods of Accounting

If you can't use the cash method, you must choose an accrual method of accounting. In the construction industry, there are several specialized accrual methods available, each of which has its own set of rules and limitations. In general, all accrual methods attempt to match the expenses that relate to a specific contract to the income from that contract.

The rest of this tax tip concentrates on helping you choose the correct accrual method for your construction business and assumes that you use a calendar tax year, from the 1st of January to the 31st of December.

Choosing an Accrual Method

Choosing a permissible method of accounting for tax purposes involves the four steps discussed below. As your business grows and changes, you might have to use a different method of accounting. You should review the following four steps every year to ensure that you are using a permissible method of accounting for your construction contracts.

Step One - Classify all Construction Contracts as either Short-Term or Long-Term.

A long-term contract is any contract that spans a year-end. If you have a contract that you start on December 26th but do not complete until January 23rd, you have a long-term contract. Therefore, a short-term contract is any contract you start and finish within one taxable year.

Use your overall method (i.e. accrual or cash, if allowed) for your short-term contracts. You must then choose an accounting method for all your long-term contracts. The rest of these steps will lead you through the process of choosing your long-term contract accounting method.

Step Two - Classify all Long-Term Contracts as either Home Construction or General Construction Contracts.

Home Construction Contracts are contracts for work on buildings that have four or fewer residential units. Eighty percent or more of the estimated total contract costs must be for the construction, improvement, or rehabilitation of these units. If a contract is not a home construction contract, it is a general construction contract.

Example: Contracts to build single-family homes, duplexes, triplexes, or quadplexes would be home construction contracts. Contracts to build apartment buildings would not be home construction contracts.

To select an accounting method for home construction contracts, see the [Home Construction Contracts](#) section. For long-term general construction contracts, there is one more step to take to choose the correct accounting method.

Step Three - Classify Yourself as Either a Small or Large Contractor

This is a two-part step. The first part is to measure your average annual gross receipts for the last three tax years of your construction business. If the amount is \$10 million or less, you are a small contractor. If it is more than \$10 million, you are a large contractor and do not have to consider the second part of this step. Large contractors are required to account for long-term contracts using the percentage-of-completion method (PCM). Under PCM, contract income is reported annually according to the percentage of the contract completed in that year. For example, if a contract is 50% complete at the end of the taxable year, 50% of the contract income would be included in taxable income. See the [Large Contractor Methods](#) section for additional information.

If you are a small contractor, the second part of this step requires that you separate your long-term general construction contracts into two categories. The first category is those contracts that are reasonably likely to be completed within two years from the date work begins.

The second category is long-term general construction contracts that you estimate will take two years or more to complete. For these longer-duration contracts, you must use a large contractor method, even though you are a small contractor.

Example: Carl's Construction had average annual gross receipts for the last three tax years of less than \$10 million. In 2000, Carl had 20 contracts.

At the time he entered 19 of the contracts, he estimated they could be completed in less than two years from when they are started. He estimated one of the contracts would take three years to complete. Carl will use the large contractor rules for that one contract and the small contractor rules for the other 19 contracts.

Example: Use the same facts as the last example, except assume Carl's Construction had average annual gross receipts of \$12 million for the last three tax years. Since his average annual gross receipts for the last three years were over \$10 million, Carl is required to use the large contractor rules for all of his contracts. The estimated completion time of the contracts does not matter.

Are You a Small or Large Contractor?

Determine if you are either a small or large contractor by answering the following questions:

Q: Are your annual gross receipts for the last 3 years \$10 million or less?

Y: Answer the next question.

N: As a Large Contractor, you must use the Percentage of Completion Method (PCM) for your general construction contracts.

Q: Do you have any general construction contracts that you estimate will take more than 2 years to complete?

Y: Use Percentage of Completion Method (PCM) for your longer-duration general construction contracts.

N: As a Small Contractor, you should use either: Accrual, [Old Percentage of Completion Method \(Old PCM\)](#), Cost Comparison Method (CCM), or Percentage of Completion Method (PCM) for all your general construction contracts.

This table shows the methods that are available to use on your general construction contracts. Most contractors will use the Accrual Method for their overall method of accounting.

LONG-TERM CONTRACT METHODS				
TYPE OF CONTRACTOR*	ACCRUAL	OLD PCM	PCM	CCM
Small Contractor	YES	YES	YES	YES
Large Contractor	NO	NO	YES	NO

* The overall method should be accrual.

Types of Costs

Before you can understand how the different accrual methods work, it's important to know about the different types of costs your construction business will have.

The two basic categories of costs your construction business will have are job costs and general and administrative (or G&A) costs.

Job Costs are the expenses related, either directly or indirectly, to the construction job, like construction wages, materials, and allocated indirect costs. G&A Expenses are the day-to-day expenses of running the business, like office expenses and utilities. However, certain

administrative costs are sometimes treated like indirect job costs to figure the income earned on a contract.

General and Administrative Expenses

General and administrative (G&A) expenses are indirect costs of operating a construction business that cannot be traced to specific jobs. However, certain administrative costs may be treated like indirect job costs.

For example, the wage paid to the person in the office who keeps track of the costs for each job is a G&A type expense that would be treated as an indirect job cost. On the other hand, selling and advertising costs are G&A expenses that would not be treated like indirect job costs.

Generally, your G&A expenses will be deductible under the accrual rules, as explained later.

Job Costs

Job costs are divided into two groups. Direct job costs such as labor, materials, and subcontractor expenses can be traced directly to the construction project. The wage paid to a site manager is an example of a direct labor cost. Similarly, direct materials would include lumber for framing a house or concrete for the foundation of a shopping center.

Direct costs also include amounts paid to subcontractors. Subcontractors work for and are paid by the general contractor on a project. Subcontractors may also provide the raw materials for the job. Labor and materials provided by a subcontractor are generally treated as direct costs.

Indirect job costs are all the costs necessary for the performance of the contract other than direct materials, direct labor, and subcontractors. The expenses included in indirect job costs differ depending on whether you are a small or large contractor.

Allocating Indirect Costs

You have learned that indirect job costs benefit the project but are not tied as clearly to it as direct costs are. Indirect job costs often involve expenses that benefit more than one job and must be allocated among all the jobs that received benefit.

Example: Norm started three different jobs in 2000. None of the jobs were completed by the end of 2000. He spent 6 months on the first job, 4 months on the second job, and 2 months on the third job.

He had \$12,000 of indirect costs to be allocated to the three jobs. Norm would allocate the indirect costs as:

First Job

$\frac{6 \text{ mo.}}{12 \text{ mo.}} \times \$12,000 = \$6,000$ Allocated Indirect Costs

Second Job

$\frac{4 \text{ mo.}}{12 \text{ mo.}} \times \$12,000 = \$4,000$ Allocated Indirect Costs

Third Job

$\frac{2 \text{ mo.}}{12 \text{ mo.}} \times \$12,000 = \$2,000$ Allocated Indirect Costs

Indirect Job Costs for Small Contractors

- Repair & maintenance expenses for equipment & facilities
- Utilities
- Rent of equipment & facilities
- Quality control
- Taxes relating to labor, materials, supplies, equipment or facilities
- Administrative costs
- Indirect materials and supplies
- Tools & Equipment
- Depreciation
- Insurance on equipment & machinery
- Indirect labor and contract supervisory wages
- Production period interest expense

See the list of [indirect job costs for large contractors](#).

Small Contractor Methods

Accrual Method of Accounting

Income: You include an item in income in the tax year when all events have occurred that fix your right to receive the income and you can determine the amount with reasonable accuracy. Generally, this means you:

Report income:

- When it's **earned**, or

- When it's **due** from the customer, or
- When it's **received** from the customer
- Whichever is **earlier**

Income is generally earned when you have finished the work to your customer's satisfaction and due when you bill your customer. This means that sometimes you will include an item in income before you have actually received payment.

You may use this method for your long-term contracts only if your annual gross receipts do not exceed \$10 million AND the estimated completion time does not exceed 2 years.

Advance Payments

Generally, advance payments for services are included in income when you receive the payment. You may delay including an advance payment in income until the next tax year only for services you will perform by the end of the next tax year.

Expenses: G&A expenses and job costs are deducted in the tax year you incur them. An expense is incurred:

the later of:

- When the merchandise or services are received, or
- When the amount of the expense can be accurately determined

This means that sometimes you will deduct expenses before you actually pay them. However, if you pay an expense that benefits you for more than one tax year, you must spread the cost over the period you receive the benefit. You also cannot take an immediate deduction for any capital expenditures. Examples of capital expenditures are buildings, machinery, equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. Generally, capital expenditures must be deducted by means of depreciation or amortization. For more information on depreciation, please see [How to Depreciate Property](#).

Accrual Example: Cooper's Construction agreed to remodel Steve's office. Cooper uses the accrual method and estimates the job will take about 6 weeks.

He finished the job on December 8 of Year 1 and sent Steve a bill on December 15 for \$8,000. Steve paid it in full on January 22 of Year 2.

On December 1 of Year 1, Cooper received a \$4,500 invoice from the lumberyard for the materials used on the job. He paid it on January 5 of Year 2. Cooper also had \$2,000 of G&A costs for Year 1.

On the accrual method of accounting, Cooper will report the \$8,000 income from this contract in Year 1 because the income had been earned when the job was completed. He will deduct the \$4,500 of job costs and the \$2,000 of G&A costs in Year 1 because the expenses had been incurred in that year.

The one variation on the accrual method is an election to exclude retainages from income until you have an unconditional right to receive them. If you make this election, you also have to wait to deduct retainages payable until they are paid.

You cannot elect to exclude retainages if you use the PCM or CCM methods.

For the cash or accrual method of accounting, it isn't necessary to trace job costs to a particular job. However, many businesses keep track of which costs relate to which job to have more accurate data on the profitability of their jobs and to improve their bidding process. If you use the Percentage of Completion or Completed Contract Method, it is very important to keep each job's costs separate.

There are some advantages to using the Accrual Method:

- It provides better matching of income and expenses
- It gives a more accurate picture of your financial position than the cash method

If you have jobs that extend over the year-end, you may want to choose the Percentage of Completion or Completed Contract Method. They may be more advantageous to you than the accrual method.

Old Percentage of Completion Method - General Rule

The Old Percentage of Completion Method (Old PCM) is a method that only affects how your income is computed and reported on your tax return. When you use this method, all G&A and job costs are deducted using the accrual method.

With this method, you report income from long-term contracts as work progresses. A long-term contract is any contract that spans a year-end. If you have a contract that you start on December 26th but do not complete until January 23rd, you have a long-term contract. You will report some income in each year of a long-term contract.

There are several advantages to using Old PCM:

- It is the most accurate way to measure income
- It evens out the reporting of income over the life of the contract

- Losses may be recognized based on the percentage of the contract completed
- It is the method preferred by most banks and bonding companies

The main disadvantage is its complexity and the fact that it accelerates income compared to other methods.

To determine your current year's gross receipts from a long-term contract, you multiply its "completion factor" (i.e., percentage of completion) by its "total contract price" and then subtract the amount of gross receipts you previously reported for this contract. You compute your gross receipts in this way even if you bill the customer for a different amount.

There are two ways to compute your income under Old PCM, either the cost comparison method or the work comparison method. Both of these methods are explained in detail below.

Old PCM Cost Comparison Method

You compute your income under this method by dividing the deductible job costs for the year by the estimated total job costs. This percentage is multiplied by the contract price to figure out how much income to report in each year. The contract price has to include all retainages receivable, any change orders agreed upon at the time of the computation, and any reimbursements for costs incurred by the contractor.

The income to be reported on the tax return is computed this way even if the customer is billed a different amount.

Notice that even though G&A and Job Costs are deducted under the accrual method, Job Costs are used in the computation of income under the Old PCM Cost Comparison Method.

Old PCM Cost Comparison Method Example: Calvin's Construction contracted with Tom and Allison to build a warehouse for their business. Calvin estimated the construction would take about 9 months, starting on October 1, 2000. This was Calvin's only contract for the year and he uses Old PCM and a cost comparison method.

The total contract price was \$300,000 and estimated total costs for the contract were \$250,000. By December 31, 2000, Calvin had billed Tom and Allison \$100,000 and spent \$75,000 in deductible job costs. Calvin's G&A expenses for the year were \$10,000. He computes income like this:

The job costs deductible in 2000 divided by the total estimated costs for the contract equals the percentage of the contract that is completed in 2000. Multiply that percentage by the contract price to get the amount of income to report in 2000.

Costs deductible in 2000 \$75,000 = 30% Completed
 Total estimated costs \$250,000

\$300,000	Contract Price
X 30%	Percentage of Completion for 2000
\$ 90,000	Income to be reported in 2000

Calvin's net income for the year is:

\$ 90,000	Contract Income
(75,000)	Job Costs
<u>(10,000)</u>	G&A Costs
\$ 5,000	Net Income

Old PCM Work Comparison Method

You compute a contract's completion factor by comparing the work performed to date to estimated work to be performed. For each year of the contract, the completion factor must be certified by an architect or engineer or otherwise supported by appropriate documentation.

Old PCM Work Comparison Method Example:

Charlie contracted with Murphy to build a building. Charlie estimated the construction would take about 18 months, starting on July 1 of Year 1. Charlie uses Old PCM and the work comparison method.

The contract price was \$1,500,000. By December 31 of Year 1, Charlie had finished one-third of the work on the building (certified by the architect) and he had billed Murphy \$550,000 and incurred \$410,000 in job costs on the first restaurant. His G&A costs for Year 1 were \$20,000. He computes his Year 2 net income like this:

Work Performed to Date = 33.33% Completed
 Estimated Work to be Performed

Contract Price	\$1,500,000
Completed	X 33.33%
Income to be Reported in Year 1	\$ 500,000
Job Costs	(410,000)
G&A Costs	<u>(20,000)</u>

Year 1 Net Income \$ 70,000

By December 31 of Year 2, Charlie had finished the other two restaurants. In Year 2, he billed Murphy \$950,000 and incurred \$840,000 in job costs. His G&A costs were \$30,000. He computes his Year 2 net income like this:

Work Performed to Date = 100% Completed
Estimated Work to be Performed

Contract Price	\$1,500,000
Completed	X 100 %
Total Income	\$1,500,000
Income Reported in Year 1	(500,000)
Income to be Reported in Year 2	\$1,000,000
Job Costs	(840,000)
G&A Costs	(30,000)
Year 2 Net Income	\$ 130,000

The computation for the entire contract is:

	<u>Year 1</u>	<u>Year 2</u>	<u>Total</u>
Income	\$500,000	\$1,000,000	\$1,500,000
Job Costs	(410,000)	(840,000)	(1,250,000)
Contract Profit	\$90,000	\$160,000	\$250,000
G&A Costs	(20,000)	(30,000)	(50,000)
Net Income	\$70,000	\$130,000	\$200,000

Notice that the income to be reported on the tax return is different than the amount billed to the customer in each year of the contract.

Completed Contract Method

With this method, you report all the income from the contract and deduct all the related job costs in the year the project is completed and accepted by the customer.

The number of indirect costs that you must characterize as job costs will vary depending on your size. In general, a large homebuilder has to capitalize a greater number of indirect costs than a small homebuilder or small general contractor. You should consult your tax advisor regarding types of indirect costs that you must capitalize.

G&A expenses, net of any amounts included in job costs, should be deducted as explained in the Accrual Method.

Completed Contract Method Example:

Craig uses CCM. In June of Year 1, he contracted with Murphy to build a restaurant for \$500,000. The estimated total costs for the contract were \$400,000. On March 31 of Year 2, the contract was completed and Murphy accepted the building.

As of December 31 of Year 1, Craig had \$370,000 of job costs tied to the contract. From January 1 to March 31 of Year 2, he incurred another \$30,000 of job costs on the restaurant.

Craig's income and job costs from other contracts in Year 1 and Year 2 were:

	<u>Year 1</u>	<u>Year 2</u>
Income	\$750,000	\$300,000
Job Costs	\$525,000	\$225,000
G&A Costs	\$ 75,000	\$ 85,000

Under CCM, Craig must capitalize all the job costs related to the restaurant contract and wait to deduct them until the job is completed and the income is reported in Year 2. In Year 1 and Year 2 Craig will report:

	<u>Year 1</u>	<u>Year 2</u>
Gross Income	\$750,000	\$800,000
Job Costs	(525,000)	(625,000)
G&A Expenses	(75,000)	(85,000)
Net Income	\$150,000	\$90,000

The advantage of the completed contract method is that it normally achieves the maximum deferral of taxes.

The disadvantages of the completed contract method are:

- The books and records do not show clear information on operations
- Income can be bunched into a year when a lot of jobs are completed, and
- Losses on contracts are not deductible until the contracts are completed

It is important to note that the Completed Contract Method may only be used by small

contractors.

Many taxpayers will choose to use PCM as their long-term contract method for their books (so they can give their banks and bonding companies the type of financial statements they prefer) and CCM for their tax returns (so they can have the maximum deferral of taxes).

How Do You Account for Home Construction Contracts? [Read the section.](#)

How Do You Account for Large Contractor Construction Contracts? [Read the section.](#)