

# Take an Auditor's-Eye View of Your Construction Business

BY STEPHEN W. WOUCH

**W**hile contractors are in the business of construction, an IRS auditor's line of work is more like deconstruction. It's the auditor's job to review and tear apart tax returns to make sure the federal government gets every dollar of individual and business revenue it's due. With a hefty tax code as their reference, auditors are trained to examine filings to determine whether tax returns are complete and in full compliance with the law.

The U.S. tax code is very complex: more than 70,000 pages in length at the Senate Finance Committee's last count. Imagine trying to follow a blueprint with that level of detail. Then, add to it distinctly different specs for each specific build-out. This provides a glimpse into an auditor's challenge and on-the-job learning curve.

## **The Auditor's Tool Box**

To help its agents, the IRS maintains a series of Audit Technique Guides (ATGs) covering certain thorny laws and industries, including construction. Think of these guides as a *Cliff's Notes* version of



tax code portions most applicable to a respective taxpayer segment. Still, even this abbreviated version that auditors study before opening the books of a construction business is 11 chapters and more than 250 pages long.

The same variables that make construction a challenging field make accounting for construction businesses anything but ordinary. Every job has its own unique set of issues that differ from project to project, region to region and day to day. Weather, jobsite conditions,

labor issues, performance of suppliers and subcontractors, change orders and environmental factors come into play. Plus, unlike owners of retail stores or manufacturing plants, most contractors bill and are paid on an incremental basis, with no definitive point of sale. The use of the percentage-of-completion accounting method causes construction businesses to pay taxes even on income they haven't billed, much less collected.

Just as auditors are well served by brushing up before they begin a

job, construction owners, contractors and any in-house accounting or bookkeeping personnel would do well to study the IRS's Construction ATG. The introductory chapters that tell how the construction sector is structured and how contractors and subcontractors interact may seem elementary, but the subsequent content should be required reading to stay in line with the tax laws and understand issues that could cause problems.

Following are five of the main topics covered by the current edition of the Construction ATG.

#### **Accounting for Long-Term Contracts**

How to account for the revenue from long-term construction contracts has been an area of much confusion in the industry. The size of the business generally determines whether a contractor must use the percentage-of-completion method of accounting for revenues and apply the look-back rules. Companies with revenues averaging more than \$10 million in gross receipts during the prior three years are classified as large contractors and thus are generally subject to these provisions. Small contractors (with less than \$10 million in revenues) may elect other methods of accounting for revenue on their income tax returns. However, both large and small contractors may be required to use the percentage-of-completion method for alternative minimum tax (AMT) purposes.

The "large contractor" definition has not been changed since 1986. Associated Builders and Contractors' Tax Advisory Group is working

hard to change that, as well as gain exemption from AMT for all small contractors. Further, many contractors and practitioners either do not understand the look-back rules or choose to ignore them. The IRS doesn't like the look-back rules either, but a legislative change would be necessary to get rid of them.

#### **Cost Allocation and Capitalization**

The ATG also deals with how to determine what costs must be allocated and perhaps capitalized as part of the construction costs. Agents typically find that contractors may be charging direct costs to jobs, but often they neglect to include overhead costs that should be allocated to jobs as part of the costing process.

Certain small contractors may use the cash method of accounting. Still, they may not be able to deduct the cost of certain materials and supplies until they are paid for or within the tax year in which they are actually used. Depending on the type of entity and the method of accounting for unused materials and supplies, a gross receipt threshold of \$1 million, \$5 million or \$10 million may apply.

#### **Income Recognition**

The ATG addresses improperly deferred income due to delayed billings. One example is waiting until the entire job is complete—not just the specific subcontractor's portion—to recognize income. Related-party transactions are scrutinized carefully to uncover income-shifting schemes or deductions generated that are


not at arms-length. To look for red flags, agents are instructed to perform minimum-income probes to determine whether income may have been diverted to owners.

#### **Unreported Income**

The ATG tells agents to apply certain techniques when auditing a contractor. In particular, it specifies that "special attention needs to be given to the possibility of unreported income." Auditors are instructed to discuss with their managers any omitted income item in excess of \$10,000. Such findings during an audit could lead to a criminal investigation of the contractor.

#### **Income for Personal Use**

Deducting costs of items on the income tax return that are for personal use raises another red flag for auditors. A high percentage of audit changes are made to gross receipts, cost of goods sold, meals and entertainment, car and truck expenses, insurance expenses and officer compensation. The ATG provides a breakdown according to type of entity.

The Construction ATG is a tool for contractors as well as IRS agents. The same methods an auditor uses to detect errors or fraud can be used to protect construction businesses. 

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