

SMALL BUSINESS/ SELF EMPLOYED

Where Can I Go For Help?



Order free copies of all IRS forms and publications by calling **1-800-829-3676 (1-800-Tax-Form)**.

Excellent Publications for Small Businesses:

Business Resource Guide (CD-ROM), Publication 3207.

At A Glance, Publication 3698

If you have questions, contact your tax preparer or contact the IRS 24 hours a day, seven days a week at **1-800-829-4933 (1-800-Tax-4933)**.



Access the IRS Web Site for federal tax forms, publications, tax law changes, and other tax information for individuals and businesses on the Internet at www.irs.gov.

For more information specific to the construction industry, go to: www.irs.gov/smallbiz, Under "Contents" click on "Industries/Professions." Click on, "Construction."



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TAX INFORMATION FOR SMALL CONSTRUCTION BUSINESSES



INTERNAL REVENUE SERVICE

*Construction
Specialization Program*

The Internal Revenue Service has identified several issues that may cause problems for the owners of small construction businesses.

This document is intended to make you aware of these issues and to provide you with information, which will help you avoid pitfalls along the way.

These issues include:

- Accounting Methods
- Capitalization of Indirect Costs to Long-Term Contracts
- Independent Contractor or Employee Classification

Whether you have an existing business or just starting one, we want to help you understand and comply with the tax laws that affect your business.

By recognizing the significance of these issues, small construction business owners can properly file their tax returns and avoid costly problems.



Accounting Method Issues

Accounting methods are not always a contractor's choice in the construction trade. Some contractors who use the cash method of accounting may be required to use an accrual method.

What are Accounting Methods?

- ✘ An accounting method is a set of rules to determine when and how income and expenses are reported. It includes not only the overall method but also the accounting treatment of any material item. Examples of accounting methods are cash receipts and disbursements, accrual, and combinations of such methods. Whichever method is elected, it must clearly reflect income.
- ✘ If your business operates as a C corporation with gross receipts in excess of \$5 million, you generally are required to use an accrual method of accounting.
- ✘ If an inventory method is required because merchandise (or materials) is an income-producing factor in the business, generally, an accrual method must be used for purchases and sales.
- ✘ An exception to the requirements to use an accrual method and to account for inventories is found in Revenue Procedure 2002-28, which permits most small businesses with "average annual gross receipts" of \$10 million or less to use the cash method of accounting. However, a taxpayer otherwise required to use the accrual method cannot qualify for this exception. In addition, a business whose principal activity is mining, manufacturing, wholesale trade, retail trade or information

industries will generally be ineligible to use this exception. (See Rev. Proc. 2001-10). The accounting of inventory items is simplified by The Revenue Procedure allowing their cost to be deducted in the year the merchandise is sold or paid for, whichever is later. Generally the percentage of completion method is required for long-term contracts. A long-term contract is one that is still in process at the end of your taxable year. For example, if work on a contract to construct a building begins in November 2000, and ends in January 2001, and the contractor used the calendar tax year, the contract is a long-term contract.

- ✘ Home construction contracts are not subject to the percentage-of-completion method. In addition, general construction contracts are not subject to the percentage of completion method if certain completion time and gross receipts tests are satisfied. For all these exempt construction contracts, a taxpayer may use an "exempt contract" method, which includes the percentage of completion method, the exempt-contract percentage-of-completion method, the completed contract method, or any other permissible method.
- ✘ Whether a method is permissible depends on a number of factors, such as the type of business entity, business activity, level of gross receipts, and existence or absence of merchandise as an income-producing factor in the business.

Further information can be found in Accounting periods and Methods, Publication 538, Internal Revenue Code Sections 446, 448, 460, and their respective Treasury Regulations.

Indirect Cost Issues

Contractors are required to allocate indirect job costs to their long-term contracts annually unless the Code or regulations provide otherwise. Whether contractors are required to capitalize these allocable job costs, or are permitted to deduct these allocable job costs, depends on the contractor's method of accounting for long-term contracts.

- ✘ Allocable job costs include costs that are incurred because of the contractor's construction projects, such as repairs, equipment maintenance and rentals, utilities at the job site, depreciation on construction equipment, officer's compensation, and workers' compensation insurance.
- ✘ Non-allocable job costs included expenses for unsuccessful bids and proposals and for marketing, selling, and advertising expenses. These costs are exempted from the cost allocation requirement.
- ✘ In general, contractors using the percentage of completion method are required to allocate indirect job costs to their long-term contracts. Contractors using the completed contract method of accounting are required to capitalize indirect job costs allocated to long-term contracts until the contract is completed.

Why is the Capitalization of Indirect Costs an Important Issue?

Many contractors utilizing the completed contract method of accounting overstate their deductions because they are not properly allocating costs to long-term contracts. Under the completed contract method, income or loss is reported in the year in which the contract is completed. In addition to direct materials and labor costs, all indirect costs incurred for reason of a long-term contract or that directly benefit

the long-term contract, must be allocated, or capitalized to that contract. As long as that contract has not been completed and accepted, these costs must not be deducted as current period costs.

Some indirect costs may benefit both the long-term contract and other business activities. These costs will require a reasonable allocation between the other business activities and the long-term contract. Suggested methods are specific identification method or the use of ratios based on direct costs, hours, or other units of measure.

Further information is contained in Treasury Regulation 1.460 and IRC section 263A for certain contractors such as large home construction contracts. Contractors required to use the percentage of completion method for long-term contracts should refer to IRC Section 460.

Independent Contractor or Employee Classification Issues

Before you can know how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be an employee or an independent contractor.

The three factors to consider when making this determination are:

- ✘ Behavioral Control
- ✘ Financial Control
- ✘ Relationship of the Parties

Further information can be found in Employer's Supplemental Tax Guide, Publication 15-A.



Audit Technique Guides

Audit Technique Guides contain examination techniques, common and unique industry issues, business practices, industry terminology, and other information. There are several of these guides specific to construction, which may help you understand your industry. They can be found at www.irs.gov/smallbiz. Click on Industries/Professions, Click on Construction.

North American Industry Classification System (NAICS)

When preparing your tax return, you should refer to the instructions for each return type (i.e., Form 1040, Schedule C, Form 1120, 1120S, or 1065) for the proper NAICS code that most accurately describes your particular business activity. General construction codes are provided for Building, Developing, General Contracting, Heavy Construction, and Special Trade Contractors:

Building, Developing, and General Contracting

- 233110 Land Subdivision and Land Development
- 233210 Single Family General Construction Contractors

Heavy Construction

- 234100 Highway and Street Construction

Special Trade Contractors

- 235110 Plumbing, Heating, & Air Conditioning
- 235210 Painting & Wall Covering Contractors
- 235310 Electrical Contractors
- 235410 Bricklaying Construction Contractors
- 235610 Roofing, Siding, and Sheet Metal