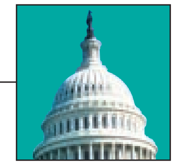

BY MICHAEL CIRANGLE

Protect Your Company with the IRS' Construction Audit Techniques Guide

As the construction industry returns to prerecession levels, CFMs should prepare for increased IRS scrutiny of their selected tax accounting methods and deductions. From reasonable compensation issues to application of accounting methods for exempt and non-exempt contracts, CFMs need an understanding of the issues that the IRS will focus on during an audit.

The IRS' Construction Audit Techniques Guide (ATG)[1] is an important resource that provides a framework for how IRS agents will examine a construction company during an audit. Compared to other industries, construction has some of the most complex, advantageous, yet often-litigated tax intricacies.

This article will explore select topics from the ATG, provide current developments surrounding those topics, and give practical solutions that CFMs can use to prevent unwanted attention from the IRS.

Accounting Methods

A company's choice and application of tax accounting methods are some of the most frequently audited items. Accounting methods determine when and how the company should recognize or defer income and capitalize or deduct expenses for tax purposes. Not only can a contractor choose from numerous accounting methods, but it can also use multiple accounting methods simultaneously, depending on the types of contracts in progress.

Recognizing the complexity of the industry, the IRS' ATG provides a detailed overview of each method of accounting available to contractors.[2] (For a deeper dive into the types of methods, read "Construction Tax Accounting Methods & Choices: An Overview" by Rich Shavell in the January/February 2016 issue.)

In addition to understanding accounting method choices, CFMs should also know how to implement those methods. One of the most common mistakes is an incorrect or unnecessary application for a change in accounting method. For example, small contractors that have historically been within the $10 million average gross receipts test but exceed that threshold in a given tax year often make this error. While exceeding this threshold does change how the company must report its income for non-exempt long-term contracts, many contractors mistakenly apply for a formal method change.

Per the ATG, the correct way to implement the change is to start accounting for any new contracts that commenced in the tax year when the company no longer meets the small contractor exception under the newly chosen long-term contract method. However, the company must continue to account for the contracts that remain in process from previous tax years under the applicable accounting method, commonly referred to as the "cut-off method."

Incorrectly filing an application for a method change will raise a red flag to the IRS. Additionally, most applications to change an accounting method will include an adjustment to taxable income, which, if positive, could be spread over four years. Because the incorrect application of the rules will likely defer income farther into the future than allowed under normal long-term contract accounting methods, the IRS could target these erroneous adjustments.

Another issue to consider is the potential tax implications associated with financial reporting decisions or other changes that could impact a contractor's accounting method.

A typical example is an update or change to financial reporting software. Although these changes could be very valuable from a financial reporting standpoint and for making management decisions, even the slightest change could require an accounting method change for tax purposes. Should the IRS question this change, it will need to know how job costs or revenue pre- and post-change are reported.

Another example is the impending revenue recognition changes from the Financial Accounting Standards Board (FASB). While CFMs will be concentrating on how to implement these changes for financial statement reporting purposes, these new standards will also significantly impact the calculation of a company's taxable income.

Historically, for large contractors, the percentage-of-completion method (PCM) for GAAP financial reporting purposes was very similar to the PCM for tax purposes – so similar, in fact, that tax advisors may not have made any adjustments for tax reporting purposes.

However, the new revenue recognition standards will significantly change this landscape. Once the new standards take effect, financial statement PCM calculations can no longer be used in preparing the company's tax returns. If they are, a method change is needed because the company is changing the way it reports income for tax purposes.

Once these new standards are rolled out, the IRS will be looking for method changes; if none are filed, the IRS will attempt to find out why.

CFMs often make major business decisions without fully understanding the potential tax implications or consulting a tax advisor. Your company's tax advisor should be alerted to any changes before they are implemented – not after – to help prepare for a potential IRS inquiry.

Key takeaway: Accounting methods for the construction industry are numerous and complex. Be sure to periodically update your tax advisor about your business and any changes that are occurring – even if you don't think they will have tax implications. That conversation could save your company thousands of dollars and a lot of headaches in the long run.

Look-Back Interest Calculations

Look-back interest calculations are one of the most difficult and time-consuming tax calculations in the tax code. As outlined in the ATG, interest on any hypothetical underpayment of tax due to changes in contract estimations over the life of contract must be paid to the IRS. Conversely, the IRS will refund the taxpayer interest on any hypothetical overpayment of tax. This calculation is required for all contractors that use the PCM.[3]

Oftentimes, the actual interest that is due or refunded is small compared to the overall operations of the company. This, coupled with the difficulty and time needed to calculate the hypothetical tax difference, may deter contractors from taking the time to perform the calculation or enlist the help of advisors to ensure the calculations are correct. Failure to file the necessary Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, will raise a red flag that your company is not following the rules and give the IRS a reason to perform an audit.

The IRS will likely prioritize the look-back calculations that require a refund to the taxpayer. If money is owed and consequently paid to the IRS, the review of those forms will likely take less priority.[4] Clearly, simply filing the form will significantly reduce risk.

Key takeaway: Look-back calculations can be costly and time-consuming. A contractor that does not want to spend the time or money to prepare and file the form exposes the company to the possibility of an IRS audit on the entire company's activities – not just the interest that would have been due to the IRS. Additionally, if the company owes and pays the interest to the IRS, it is at lower risk of audit than if it was seeking a refund.

Reasonable Compensation

Reasonable compensation is a critical issue with the IRS.[5] C corporations that have minimal (if any) taxable income with no dividends paid out, but have high compensation amounts for company officers or owners face continual challenges. Companies that intentionally reduce corporate profits with unreasonably high compensation to avoid the double taxation inherent in a C corporation are increasingly targeted by the IRS.

In fact, a recent court case, ***H.W. Johnson, Inc. v. Commissioner***, addressed this issue in favor of the taxpayer.[6] The case involved a family-held concrete contracting company run by two brothers. In 2003 and 2004, the IRS deemed the brothers' compensation of approximately $2 million and $3.7 million to be unreasonably high.

The tax court disagreed with the IRS' decision based upon the facts of the case and a five-part test, which analyzed the:

1) Role of the employee/shareholder;
2) Character and condition of the corporation;
3) Internal consistencies in establishing compensation levels;
4) Comparison of compensation levels to those of similar employees in similar business; and
5) Conflicts of interest in setting compensation levels.

While no one factor is determinative, the combination of the facts supported the brothers' compensation as deductible.

While it is beneficial to have a taxpayer-friendly court decision to use as an example in setting compensation levels, every reasonable compensation situation requires a facts-and-circumstances analysis. The IRS has stated that it will continue to pursue reasonable compensation cases despite the outcome of this case. The costs for a company to defend itself in these cases are significant, so it is imperative that CFMs pay close attention to their compensation levels to discourage IRS inquiries.

Key takeaway: Serious analysis should be performed to determine if compensation levels are appropriate for the role an individual plays within the business and comparable to employees at similar companies. Documenting this analysis will show the IRS that you have spent significant time ensuring you are following the spirit of the law. Having a history of a reasonable amount of taxable income and paying dividends should also help ward off serious IRS investigations.

Accumulated Earnings

Per the IRS, closely held C corporations are more likely to accumulate earnings and profits beyond the reasonable needs of the business in order to avoid income tax on their shareholders.[7] However, each case is unique and there may be good reason why such accumulation is necessary and has occurred.

In examining companies that it believes have excessive accumulated earnings, the IRS will look at the normal operating needs of a company, working capital needs for bonding, possible future equipment needs, and other financial indicators. Multiple court cases cited in the ATG give an idea as to how the IRS could interpret a company's accumulated earnings.

To mitigate the risks of having too much accumulated earnings, consider distributing earnings regularly as dividends or increased compensation based on merit and corporate results. However, if you decide to increase compensation, keep in mind IRS concerns regarding reasonable compensation discussed previously. These two issues are closely connected and require a reasonable strategy to be put in place. Additional strategies that can be implemented include:

- Considering an S corporation election where appropriate;
- Avoiding non-business investments that increase retained earnings;
- Preparing annual budgets and forecasts to determine if your accumulated earnings are in line with the company's operational needs;
- Obtaining and documenting evidence of your bonding needs;
- Documenting bank covenants that require you to have a certain level of liquidity; and
- Avoiding giving out shareholder loans.

Key takeaway: Document, document, document! The key to any successful defense of an IRS accumulated earnings examination is to document why you need such accumulated earnings to support your business. Tax avoidance is not an acceptable explanation.

Conclusion

While this article has explored a number of potential IRS audit topics, we've only scratched the surface. A healthy understanding of what issues are material to your company is key to minimizing tax risk and focusing its time, energy, and money where it will work best.

CFMs should regularly communicate with their tax advisors and stakeholders about which accounting methods they are utilizing, how beneficial those methods are, and how the company can improve in order to avoid a visit from the IRS. ■

Endnotes

1. Originally published in 2009, the Construction Industry ATGs are often reviewed and updated.
2. IRS Construction Industry ATG – Chapter 3: Small Construction Contractors. *www.irs.gov/businesses/small-businesses-self-employed/construction-industry-audit-technique-guide-atg-chapter-3.*
3. IRS Construction Industry ATG – Chapter 5: Look-Back Interest. *www.irs.gov/businesses/small-businesses-self-employed/construction-industry-audit-technique-guide-atg-chapter-5.*
4. This should not be taken as advice to make incorrect calculations, but merely highlight the need for compliance.
5. IRS Construction Industry ATG – Chapter 8: Other Tax Issues in Construction. *www.irs.gov/businesses/small-businesses-self-employed/construction-industry-audit-technique-guide-atg-chapter-8.*
6. H.W. Johnson, Inc. v. Commissioner, TC Memo 2016-95.
7. IRS Construction Industry ATG – Chapter 8: Other Tax Issues in Construction. *www.irs.gov/businesses/small-businesses-self-employed/construction-industry-audit-technique-guide-atg-chapter-8.*

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