



# Tax Method Changes for the Construction Industry

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## WHO ARE WE

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Eric Wallace provides tax expertise to CPA firms and businesses on the tangible property regulations, Code Sections 263(a), 263A, 460, depreciation, changes in accounting methods, and tax, accounting, auditing, and consulting for construction and real estate companies. Eric is a member of the AICPA and served on the Association of General Contractor's National Tax and Fiscal Affairs Committee.

Eric has written extensively on construction accounting, audit, tax, and advisory services topics and issues, including [Knowledge-Based Audits of Construction Contractors and Related Entities](#), available on the CCH© Accounting Research Manager. He is also the author and instructor for the CCH Tangible Property R2regulations Certificate Program.

Eric served on the Accounting Framework Task Force that wrote the AICPA Framework, issued June 2013, and served on its Financial Reporting for Private Companies Task Force (2003/2006). He was also the Chairman of the Construction Financial Management Association (CFMA) and Chairman of the Tax and Fiscal Affairs Committee 2004/2005.

## WHAT WE DO

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We create a sizeable ongoing tax deferral for qualifying construction contractors.

We create a hybrid method change for the construction industry so that long-term contracts (under 460) remain on the PCM accrual method. However, non-long term contracts such as time and materials, cost plus, service, maintenance, unit pricing, or construction management can be put on the cash method. This hybrid method change will be pre-approved by the IRS (with a consent letter) and will create an ongoing tax deferral between accounts receivable and accounts payable.

Our true value comes from contractors that are over \$26 million in annual gross receipts. Contractors under \$26 million should also be doing the hybrid method to alleviate AMT. Also, in states that allow pay if paid, we can eliminate the accounts payable to subcontractors and reduce the numerator of the PCM formula. Contractors with many different contract types benefit the most from these method changes.

Over the last 24 months, we have successfully created a hybrid method for over 100 different contractors and have never had an application denied by the IRS.



# WHAT IS A TAX METHOD CHANGE

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Definition of a Change in Accounting Method. Section 481 and the regulations under do not include a definition of “accounting method” or explain what constitutes a change in an accounting method—the terms are defined only by reference to Section 446 (General rule for methods of accounting).

Section 481 applies to a change in a taxpayer’s over-all method of accounting for gross income or deductions, such as a change from the cash method of accounting to the accrual method of accounting and any change in the “treatment of a material item.” The regulations define “material item” as “any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.”

## WHY IS THIS IMPORTANT

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Construction industry members — including owners, developers, contractors, subcontractors, and supply chain vendors — have experienced varying degrees of hardship due to the COVID-19 pandemic. The extent of the consequences is dependent upon the location of both the respective businesses and underlying projects. Direct impacts have ranged from a slowdown of available goods and labor through to suspensions and, in some instances, terminations of parties or entire projects. Construction activities remain in flux in some states and cities, depending upon whether construction is classified as an essential business.

As a result, the COVID-19 crisis has led to the need for industry members to address short-term and long-term business challenges and formulating project-by-project solutions in the face of a new global and national environment. The full breadth and scope of the changes needed to address issues arising from the pandemic are still unknown but are likely to continue.

Cash on hand is now imperative to the survival of many contractors. By changing the current method of reporting income, we help contractors defer large amounts of tax and help create more substantial cash reserves.

The CARES Act has also created an opportunity to amend previous closed tax years and apply a net operating loss to those years. This opportunity will create an overpayment situation and create a permanent tax deduction.





# QUALIFICATIONS TO APPLY THE HYBRID MODEL

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The determination process of qualified candidates is the following:

1. They must be profitable.
2. They must have a significant percentage of the business that is not in an ESOP.
3. They must have contracts that are available to move from accrual, percentage-of-completion (POC) method to cash AND those contract types have more in receivables (ARs) than payables (APs)
4. Contract types that can be moved to the cash method can include short-term contracts, T & M work, service contracts, construction management, cost plus, and unit priced contracts. We read their contract language to determine if the contracts are, in fact, these types of contracts.
5. There must be a consistent delta difference between their ARs and APs at year-end.
6. They must have contracts that are required to be reported under the accrual, POC method where the GC employs subcontractors to do the work, AND
  - The contracts with the subs have explicit “pay IF paid” (not paid WHEN paid) language.
  - The contracts are in states that recognize/honor pay if paid language between GCs and subs (NY, NC, SC, WI, and CA are states that do not recognize pay if paid).
  - They have consistent large amounts due to subcontractors are their year-end from year to year.
7. Beware of the hurdle that may exist where the contractor (GC or subcontractor) and their CPAs, are either not aware of the potential tax method change opportunities, or do not believe that such method changes will be honored by the IRS or both.



# EXAMPLES OF SUCCESSFUL METHOD CHANGES

Below are examples of tax method changes completed over the past three years and resulting tax deductions.

TYPE OF TAXPAYER	LOCATION	TYPE OF METHOD CHANGE	TAX DEDUCTION	TAX YEAR
Electrical Contractor	CA	Accrual to Cash	\$9.44MM	2016
Utility Contractor	MI	Accrual to Cash	\$16.4MM	2017
General Contractor	AZ	Pay if Paid Deferral	\$25MM	2018
HVAC Contractor	MD	Accrual to Cash	\$8MM	2017



# FOR CPAs

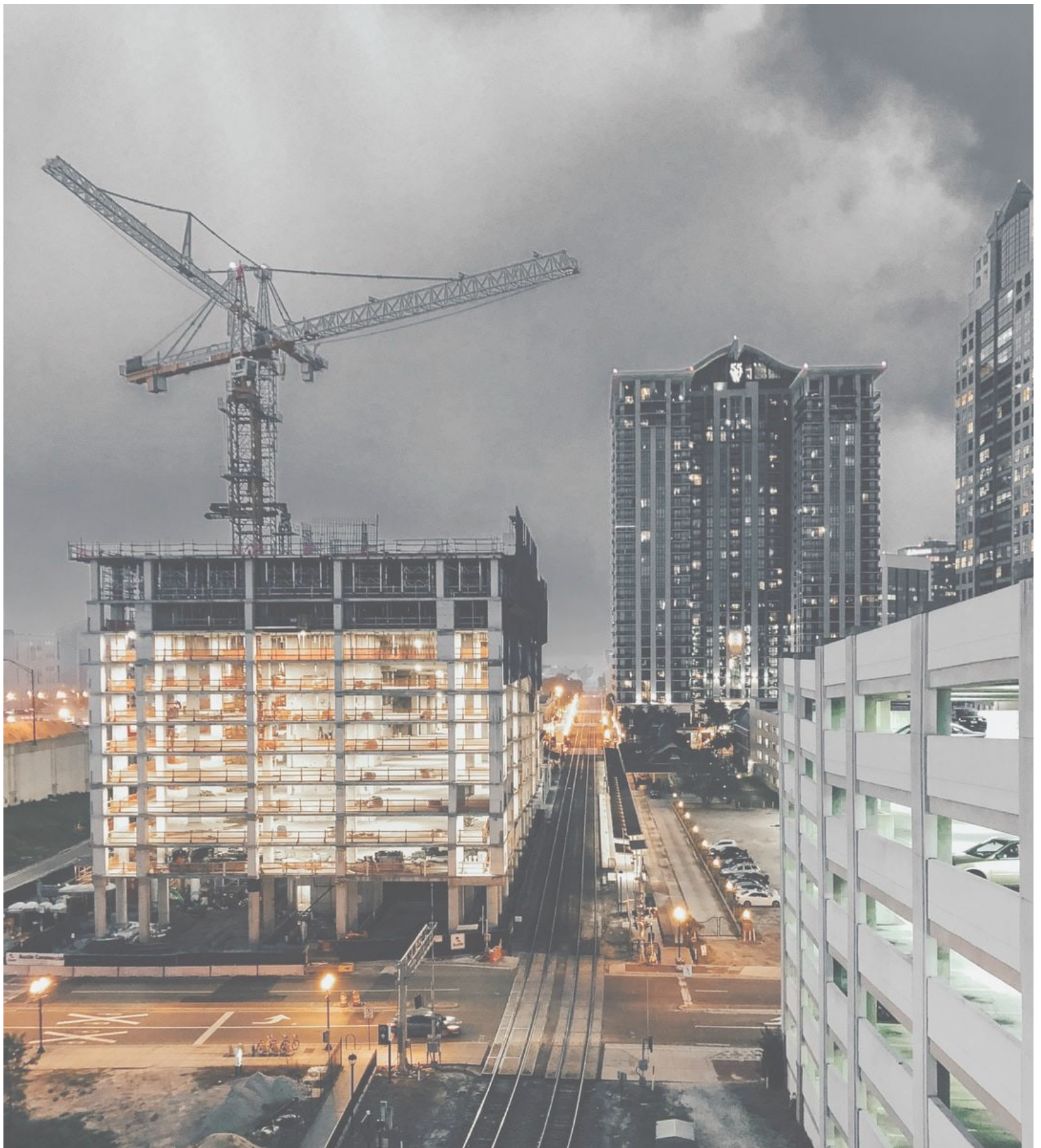
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We avoid 6011 issues in the following manner:

1. This is not a tax shelter that would require disclosure (we obtain an IRS Consent Letter).
2. A tax method change is not a section 165 loss.
3. This is not a transaction of interest for tax avoidance. The IRS lacks enough information to determine whether the transaction should be identified as a tax avoidance transaction. The IRS will have full disclosure of the underlying facts and rules on the fact pattern and underlying law to issue their consent letter.
4. We ask for the confidentiality of the Form 3115 filings and attachments but not the tax strategy as the IRS Consent Letter is shared with the tax return preparer (if a CPA firm). The IRS Consent Letter fully describes the underlying facts, laws, and new method employed.
5. We do not have contractual protection (transactions in which a taxpayer has a right to a full or partial refund of fees in the event the intended tax consequences of the transaction are not sustained (no fees upfront to be refunded) or “if the transaction’s fees are contingent upon a taxpayer’s realization of tax benefits”).
6. Our fees are contingent upon receipt of the IRS Consent Letter, not the receipt of their tax refunds.
  - ♦ Section 6707A states, “transaction specifically identified by the Secretary as a tax avoidance transaction.”
  - ♦ Note that a tax method change request is not a tax avoidance effort.
  - ♦ A tax method change approved by the IRS can never be a “transaction specifically identified by the Secretary as a tax avoidance transaction.”
  - ♦ A tax method change is also not a “transaction.”







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