Copyright © 2019 by the Construction Financial Management Association (CFMA). All rights reserved. This article first appeared in *CFMA Building Profits* (a member-only benefit) and is reprinted with permission.

BY RICH SHAVELL

The New Small Contractor Threshold:

Transition Requirements for Tax Purposes

For construction contractors, taxpayers are generally required to use the percentage-of-completion method (PCM) of accounting for long-term contracts[1] for tax reporting purposes. However, if a contractor's average annual gross receipts are below a statutory threshold, then other tax reporting methods are permissible.

This article examines the new threshold as permissible by the *Tax Cuts and Jobs Act*, which allows contractors to potentially transition to tax reporting methods, which may be more favorable, as well as the mechanics to achieve these changes.

The New Small Contractor Exemption

The requirement for using the PCM generally does not apply to a construction contract entered into by a taxpayer that estimates such contract will be completed within the two-year period beginning on the contract commencement date, and also meets the gross receipts test of IRC §448(c) for the taxable year in which such contract is entered.[2]

The Tax Cuts and Jobs Act (TCJA), signed on December 22, 2017, included one of the most significant changes affecting contractors in decades by increasing the threshold for defining small contractors. Effective January 1, 2018, the small contractor exemption increased from $10 million to $25 million.[3]

Therefore, contractors with average gross receipts of $25 million or less during the three prior years are now considered small contractors. The TCJA permits more contractors to use tax accounting methods other than the PCM, such as the completed contract method (CCM) or even the cash method, for long-term contracts.

For the typical contractor, this is generally more advantageous for cash flow purposes. These methods permit the recognition of profit and payment of the corresponding tax to mirror the timing of reporting actual job profit i.e., at the end of job when retainage and final payments are received.

This small contractor exemption applies to only those contracts meeting the two-year requirement and the receipts threshold. The contractor may have contracts that still require the PCM because the specific contracts are estimated at contract commencement to exceed two years. This is a 24 months' time frame and not two tax years.

C Corporation Faces Limit on Using Cash Method

IRC §448 limits the use of the cash (cash receipts and disbursements) method of accounting for tax reporting purposes. This limitation also uses an annual gross receipts test to determine if a taxpayer is allowed, or restricted, from using the cash method for tax return purposes.

A C corporation or partnership (with a corporate partner) meets the gross receipts test of this code section for any taxable year if the *average annual gross receipts* does not exceed $25 million for the three-taxable-year period ending with the taxable year which precedes such taxable year.[4] Therefore, if the C corporation does not exceed the $25 million threshold, the taxpayer can use the cash method of accounting on their tax return. S corporations can, in most cases, use the cash method as an overall tax accounting method regardless of gross volume.

Pre-TCJA

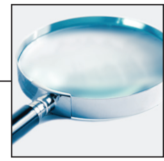
As mentioned, before the TCJA, contractors that exceeded the average annual gross receipts threshold of $10 million in their current tax year were required to use the PCM to report their long-term contracts. This was a mandatory accounting change for tax return purposes.[5]

Let's consider the mechanics and definitions for the average annual gross receipts test and then look at examples of how to handle a change.

Requirements

Gross Receipts

In addition to the construction company, one must also consider gross receipts from commonly controlled entities or joint ventures under the gross receipts test's aggregation rules.



All persons treated as a single employer under subsections (a) or (b) of IRC §52 or subsections (m) or (o) of §414 shall be treated as one person for purposes of the gross receipts test.[6] These are generally the attribution rules for pension requirements. Put simply, if you control it, then you likely have to include the related entity's receipts in your computation.

There are generally two basic requirements that impact inclusion of gross receipts from joint venture partners:[7]

1) A joint venture must allocate income from *all* trades or businesses whether or not incorporated of any venturer that has 50% or greater ownership interest.
2) A joint venture must aggregate a proportionate share of the construction-related gross receipts for any entity with which the joint venture has a 5% or more (but less than 50%) ownership interest.

So, if there is more than 50% ownership/control, include all receipts of the related party regardless of the industry from which it was derived. And if there's a "more than 5%" up to 50% interest, then only include construction receipts of the related entity (or entities).

Consent Requirements

After the TCJA, a taxpayer that previously adopted the PCM for exempt long-term construction contracts and wants to change to another permissible exempt contract method of accounting is still required to request consent to change.[8] This consent requirement is accomplished by filing IRS Form 3115 and possibly paying a fee.

This should not be confused with a contractor that moved past the $10 million threshold and was required to switch to the PCM on a mandatory basis, and now that contractor's average annual gross receipts is under the new $25 million threshold and wants to go back to the prior method. This situation is a "mandatory" change back to what was the long-term contract method before exceeding the $10 million threshold. In some cases, the contractor may have been on the PCM for so long that it does not know what the prior method was (also called the "normal method"), in which case it can still file Form 3115, and change to another method other than PCM.

These changes to long-term contracts are reported on a cut-off basis and applies only to long-term construction contracts entered into after December 31, 2017, in taxable years ending after December 31, 2017. An automatic change does not require payment of a fee for the IRS to review the requested change.

Restated: if you were previously using the PCM for long-term contracts because you were forced to change when you exceeded the prior $10 million threshold and now you meet the $25 million gross receipts test, consent is not required for a change in 2018.[9] In the future, should you exceed the gross receipts test, the IRS just requires you to start using PCM for all new contracts for the following tax year.

Cut-Off Basis vs. §481(a) Adjustment

When you switch to a permissible accounting method for long-term contracts on the cut-off basis, you only use the new accounting method for contracts started in the taxable year of the change in accounting methods.[10] Contracts started in a prior year, for which you must still recognize profits (or losses) until completion, remain on the previous method until they are complete.

For certain contractors switching from the cash method to, say, the accrual method or the PCM, the required use of the cut-off method can be confusing. The contractor should compute the status of each contract on the cash basis as the contract enters the tax year. Then, at the start of the year of change the new method would be utilized for new long-term contracts.

Adding to the confusion is that the contractor may maintain the cash method for all activities other than reporting long-term contracts. Conversely, they may switch to the overall accrual method for all activities from the cash method. Consulting with a tax advisor familiar with these issues is always a good idea. Under these scenarios, the cut-off method may not apply to the entire change and a Section 481(a) adjustment may also be needed.

For example, consider an HVAC service contractor that has no long-term contracts. The difference between what was reported as income and expenses on the prior year's tax return for service revenue and short-term contracts is compared to what the contractor would have been reported under the accrual method (the new accounting method) is called a §481(a) adjustment.

Generally, this would be the variance between accounts receivable (not yet recognized as income) and accounts payable (not yet deducted). Be advised that this example doesn't consider all items yet to be recognized or deducted. The §481(a) adjustment enables the service contractor to recapture and "catch-up" the difference between the two accounting methods, and can net to either a negative or a positive amount.

If a net negative (loss), the contractor can elect to take all of the loss in the year of the accounting method change. If a net positive adjustment, then it can spread the income equally over the following four taxable years, starting with the taxable year of the accounting method change.

For the typical contractor switching from the cash method to the accrual method as an overall method change while simultaneously also changing its long-term contract method (i.e., from cash to CCM), it may very likely have both a §481(a) adjustment as well as the required use of the cut-off method for their long-term contracts.

See scenario 7 on the last page for an example of a §481(a) adjustment combined with the cut-off method.

Alternative Minimum Tax

Contractors structured as S corporations (and other pass-through entities) with long-term contracts reporting under the small contractor exemption will face the possibility of being taxed under the Alternative Minimum Tax (AMT) rules. In the case of any long-term contract (but not home construction contracts) entered into by the taxpayer on or after March 1, 1986, the taxable income from such contract shall be determined under the PCM (as modified by §460(b)) for AMT purposes.[11]

Therefore, if you qualify as a small contractor (i.e., $25 million gross receipts test) and report your long-term contracts for tax purposes under a method other than PCM, you must report the difference in taxable income of your long-term contracts from your reportable method and PCM as an AMT adjustment item. This amount is included in a calculation with other AMT adjustment items and could impose additional tax on the taxpayer in the form of the AMT.

Restated: If you report your long-term contracts on the CCM on your tax return for regular tax purposes, then you will have to compute your contracts on the PCM to compute the AMT adjustment.

The difference in profit between the two methods will be reported on the tax return as an AMT adjustment, which can be either positive or negative depending on the year. This computation reflects the reversal of accounts that are directly correlated with the PCM calculation:

PCM to CCM

Prior Year Billed to Date	$1,945,917
Prior year Cost of Revenues to Date	(1,524,806)
Prior Year Cost in Excess	$191,376
Prior Year Billings in Excess	$(176,852)
Prior Year Gross Profit Deferred Under the CCM	$435,635
Current Year Billed to Date	$(4,473,974)
Current Year Cost of Revenue to Date	$3,570,101
Current Year Cost in Excess	$(133,631)
Current Year Billings in Excess	$482,913
Current Year Deferred GP Under the CCM	$(554,591)

Reduction in profit for regular tax purposes (CCM vs. PCM gross profit) is computed as ($118,956) and therefore the AMT adjustment is a positive $118,956. This is the variance of the $435,635 gross profit deferred from the prior year, which must be reported in the current year; as compared to the current year gross profit of $554,591 that is permitted to be deferred under the CCM.

In the previous example, the difference in taxable income from long-term contracts using both methods is $118,956. That is, the PCM produces more income than the CCM for the current year in this example, but we should recognize that the converse can also occur. The computed variance amount of $118,956 is not specifically taxed. Rather, the AMT adjustment is included in the AMT Forms on the tax return with other AMT adjustments. The final result from that calculation may produce additional tax on your tax return.[12]

Potential Scenarios

The following examples are assumed to take place during the 2018 calendar tax year, unless otherwise specified:

1) The contractor was over the pre-TCJA $10 million threshold and is now over the new $25 million threshold: Current method of accounting for long-term contracts is PCM.

Gross receipts are as follows:

2017 – $22,000,000

2016 – $28,000,000

2015 – $27,000,000

The average gross receipts is $25,666,667 for the preceding three years. The contractor exceeds the $25 million gross receipts threshold and is already using the PCM as its accounting method for long-term contracts. No changes are required or permitted.

2) Contractor meets new threshold but not old threshold: Changing methods because the new law now permits the CCM where the current method of accounting for long-term contracts is PCM. The contractor previously reported

its long-term contracts under the CCM, but was forced to report under the PCM when revenues exceeded the $10 million threshold in an earlier year.

Gross receipts are as follows:

2017 – $14,000,000

2016 – $11,000,000

2015 – $13,000,000

The average gross receipts is $12,666,667 for the preceding three years. The contractor now meets the $25 million threshold, but under pre-TCJA did not meet the old $10 million threshold and until 2018 had been reported on the PCM.

The contractor can now utilize another permissible method of accounting for the 2018 tax year, namely the CCM. The contractor does not file Form 3115 but is required to now report on the prior – normal method – which was the CCM. Reporting for 2018 is done on a cut-off basis, so the §481(a) adjustment is not required as all long-term contracts started in 2018 are reported under the CCM.

The long-term contracts started in prior years must continue to be reported under the PCM. The contractor could be susceptible to AMT for the new contracts being reported under the CCM.

3) Contractor was previously under the threshold but now exceeds threshold: A change is required. The current method of accounting is CCM.

Gross receipts are as follows:

2017 – $68,000,000

2016 – $5,000,000

2015 – $5,000,000

In this unusual scenario, the contractor landed a massive contract in 2017. For 2018, the average gross receipts for the preceding three years is $26 million, causing the contractor to cross the $25 million threshold.

In the past, the contractor met the $10 million threshold and reported under the CCM for tax purposes. The contractor must use the cut-off method and report under the PCM for any contracts entered into during the year of change (2018). No consent or Form 3115 is required to be filed and a §481(a) adjustment is not permitted.

For 2018, there is an AMT adjustment for the old jobs started in prior years and reported for regular tax purposes under the CCM. For the new jobs being reported under the PCM, there is no AMT adjustment because the jobs are being reported under the PCM for both regular tax purposes and AMT purposes.

4) Contractor in prior example drops below the statutory threshold in a later year: A change back to the CCM is permitted.

Consider the contractor in the previous example that, a few years later in 2021, sees its average annual gross receipts drop under $25 million because the large job performed in 2017 is no longer included in the computations.

In 2021, the contractor would consider the tax years 2018 through 2020 to determine whether it meets or exceeds the small contractor exemption. Assuming at that time the average annual gross receipts are under $25 million, the contractor would then go back to the CCM. The contractor would start to report under the CCM for those long-term contracts entered into during 2021, and would continue to report the jobs started in prior years under the PCM until their completion. Again, Form 3115 is not required to be filed and there is no §481(a) adjustment.

5) Contractor was under the old law threshold and remains under the new threshold: No change necessary. The current method of accounting is CCM.

Gross receipts are as follows:

2017 – $11,000,000

2016 – $9,000,000

2015 – 6,000,000

The average gross receipts for the preceding three years is $8,666,667. The contractor does not exceed the $25 million threshold nor did it previously exceed the $10 million threshold. The contractor stays on the CCM. No IRS consent is necessary and Form 3115 is not filed. As in the past, the contractor could be susceptible to AMT.

6) In an earlier year, the contractor previously requested IRS consent via Form 3115 to change to the PCM for its exempt contracts; i.e., it requested a change from CCM to PCM when it previously qualified as a small contractor. Now the contractor wants to go back to the CCM because it meets the new threshold.

Assume average annual gross receipts are now $20 million and are expected to stay under $25 million. The revenue procedure that the IRS issued in 2018 indicates that a contractor that previously requested a change in method for its exempt contracts is required to request consent to change back to CCM. The Revenue Notice is not explicit and so it appears that

such a request could require paying a fee of almost $11,000.[13] That's the current fee, which has continually increased over the last 20 years or so. The fee is intended to reimburse the IRS to review the *request* for change.

A practical concern for a contractor and its tax preparer is knowing with certainty whether the contractor previously asked for a change to the PCM method (when it qualified as a "small contractor") by filing a prior Form 3115.

Or, in the past, did the taxpayer simply change its long-term contract reporting to the PCM because the prior $10 million threshold was exceeded? Depending on the economic cycle and the nature of the contractor's prior tax accounting method, there could have been reason to file a change under Form 3115.

7) Contractor was using the cash method and wants to change its overall method to accrual, but wants to also shift to the CCM for its long-term contracts.

Assume average annual gross receipts are $20 million and are expected to stay under $25 million. In this example, the taxpayer, could either be an S corporation or a C corporation, as the law now permits C corporations to use the cash method if they meet the new $25 million threshold.

Here is a situation that could have two mechanisms for change. The long-term contracts would be changed on a cut-off basis as previously described. The change from the cash method to the accrual method (or vice versa) would result in a §481(a) adjustment for the activities other than the long-term contracts. Service operations and short-term contracts, for example, could result in a potential revenues and expenses being duplicated.

For simplicity, assume there was $40,000 in accounts receivable in excess of accounts payables and accrued expenses for the non-long-term contract activities at the beginning of the year of change. Because this is a positive §481(a) adjustment, the IRS permits this amount to be spread over four years.

The result: In 2018, the contractor switches its overall tax method to accrual and reports $10,000 of the $40,000 with the remaining $30,000 recognized over the following three years. Additionally, the long-term contracts are reported in 2018 under the cut-off method via two tax methods: CCM for new contracts and PCM for the contracts started in prior year(s).

Summary

The new law permits an increased number of contractors to take advantage of the more favorable tax reporting methods such as the cash and the completed contract methods. 2018 tax returns should be construed to determine whether an automatic change is appropriate and feasible. As always, CFMs should discuss this with their tax advisor. ■

Endnotes

1. IRC §460(a).
2. IRC §460(e)(1)(B).
3. IRC §460(e)(1)(B)(ii) referencing 448(c).
4. IRC §448(c)(1).
5. Rev. Proc. 2002-28 Section 7.02(3).
6. IRC §448(c)(2).
7. IRC §52(a) & IRC §1563(a).
8. Rev. Proc. 2018-40.
9. Ibid.
10. Ibid.
11. IRC §56(a)(3).
12. TCJA repealed the AMT for C corporations. The discussion of AMT focuses on pass-through entities.
13. Rev. Proc. 2019-1 Appendix A.

RICH SHAVELL, CPA, CVA, CCIFP, is President of Shavell & Company, P.A., a full-service CPA and consulting firm specializing in serving contractors based in south Florida. Rich joined CFMA in 1990 and has served the Association in various capacities.

A longtime *CFMA Building Profits* author, he has authored this Tax Techniques column for the past two years. Rich served as Chairman of CFMA's Tax & Legislative Affairs Committee, is a current member of CFMA's Emerging Issues Committee, and serves on the Board of CFMA's South FL Chapter.

Phone: 561-997-7242
E-Mail: info@shavell.net
Website: www.shavell.net