Construction Accounting Methods: Choosing the Right Method for Tax Savings

A Practical Guide for Construction Contractors

Construction contractors have unique opportunities to manage the timing of taxable income through the selection of tax accounting methods. Unlike many industries, contractors may qualify for several different accounting methods depending on the nature of their contracts, annual revenue levels, and project duration. In certain situations, businesses may even use different methods for different types of contracts.

Selecting the appropriate method can create significant tax deferral opportunities, improve cash flow, and better align tax obligations with the economics of the business.



UNDERSTANDING LONG-TERM CONTRACTS

Before discussing accounting methods, it is important to understand the concept of a long-term contract, as many construction-specific accounting rules apply only to these contracts.

Generally, a long-term contract is a contract for the construction, building, installation, or improvement of property that is not completed within the same tax year in which it is entered into. For example, a project that begins in November and is completed the following March is considered a long-term contract even though the project duration is only a few months.

The distinction is important because Internal Revenue Code §460 contains special accounting rules for long-term contracts, including situations where the Percentage of Completion Method (PCM) may be required.

WHY ACCOUNTING METHODS MATTER

For most contractors, the question is not whether income will ultimately be taxed, but when. Different accounting methods can accelerate or defer taxable income, impacting:

- Annual tax liability
- Cash flow available for operations and growth
- Bonding and financing considerations
- Financial statement reporting
- Estimated tax payments

Because construction projects often span multiple accounting periods, the timing differences between methods can be substantial.

CASH VS. ACCRUAL ACCOUNTING

CASH METHOD

Under the cash method, income is generally recognized when payment is received and expenses are deducted when paid. Contractors that satisfy the applicable gross receipts requirements may qualify to use this method.

Advantages to using the cash method

- Often produces the greatest tax deferral opportunities.
- Simple to administer.
- Better aligns taxable income with actual cash collected.
- Provides flexibility in managing year-end collections and payments.

CASH VS. ACCRUAL ACCOUNTING - CONT.

Potential drawbacks to using the cash method

- May not provide the most meaningful operational reporting.
- Certain lenders, sureties, or stakeholders may prefer accrual-based financial information.

ACCRUAL METHOD

Under the accrual method, income is generally recognized when the right to receive payment becomes fixed, regardless of when cash is collected. Expenses are generally deducted when the liability is incurred.

Advantages to using the accrual method

- Often provides a clearer picture of overall business performance.
- Better matches revenue and related expenses.

Potential drawbacks to using the accrual method

- Frequently accelerates taxable income.
- Can create tax obligations before cash is received.

For tax planning purposes, the accrual method is often less favorable than the cash method because revenue is recognized earlier.

COMPLETED CONTRACT METHOD (CCM)

The Completed Contract Method (CCM) allows contractors to defer both contract revenue and related expenses until the project is substantially complete. For eligible contractors and contracts, CCM is often one of the most tax-efficient methods available.

Advantages to using the CCM

- Significant tax deferral opportunities.
- Particularly advantageous for projects spanning multiple tax years.
- Simplifies taxation of contracts experiencing profitability fluctuations during construction.

For example, assume a contractor begins a project in November 2026 and finishes it in March 2027. Under CCM:

- Little or no taxable income may be recognized in 2026.
- Revenue and profit are generally reported in 2027 when the contract is completed.
- This timing difference can create meaningful cash flow benefits.

PERCENTAGE OF COMPLETION METHOD (PCM)

The Percentage of Completion Method generally recognizes income as work progresses rather than when the project is complete. Contractors exceeding the applicable gross receipts limits are commonly required to use PCM for many long-term contracts.

How it works
Revenue is recognized based on the percentage of costs incurred relative to total estimated project costs. For example:

- Total estimated project cost: $1,000,000
- Costs incurred during the year: $400,000
- Percentage complete: 40%

Approximately 40% of expected project revenue and profit is recognized for tax purposes.

Advantages to using PCM
- Income recognition closely follows project performance.
- Often aligns with financial statement reporting.

Potential drawbacks to using PCM
- Accelerates taxable income.
- Contractors may owe taxes before collecting all related cash.

RETAINAGE CONSIDERATIONS

Retainage is a common feature of construction contracts and can significantly affect tax reporting. Many owners withhold a portion of contract payments until project completion, final inspection, or warranty satisfaction.

For certain contractors using accrual accounting, retainage may not be taxable until the right to receive the funds becomes fixed and unconditional. When contractual terms require final completion and approval before payment is due, retainage may be deferred from taxable income until those conditions are met.

Planning opportunity
Proper treatment of retainage can:

- Reduce current-year taxable income.
- Better align taxation with actual cash realization.
- Improve cash flow management.

Contract language should be reviewed carefully to determine the appropriate tax treatment.

IMPACT OF GROSS RECEIPTS THRESHOLDS

One of the most important factors in determining available accounting methods is a contractor's average annual gross receipts for the preceding three tax years.

For tax years beginning in 2026, the inflation-adjusted gross receipts threshold is $32 million. Contractors below this threshold generally have greater flexibility in selecting accounting methods for qualifying long-term contracts, while contractors above the threshold may be required to use PCM for many contracts.

Why the threshold matters
Contractors below the threshold may have access to:

- Cash method accounting
- Completed Contract Method for qualifying contracts
- Simplified long-term contract methods
- Greater tax deferral opportunities

Contractors exceeding the threshold may be required to:

- Use PCM for many long-term contracts
- Accelerate taxable income recognition
- Recognize tax liabilities before related cash is fully collected

Because growth can cause a contractor to cross the threshold, businesses should regularly monitor revenue levels and evaluate the tax impact of exceeding the limit.

CAN ACCOUNTING METHODS BE CHANGED?

Yes—contractors are not necessarily locked into their current accounting methods forever. As businesses grow, change direction, or become eligible for different methods, opportunities may exist to adopt a more favorable tax approach.

However, changing accounting methods generally requires filing Form 3115, Application for Change in Accounting Method, with the IRS. The change often results in a Section 481(a) adjustment, which accounts for the cumulative difference between the old and new methods.

What is a Section 481(a) adjustment?
A Section 481(a) adjustment prevents income or deductions from being counted twice or omitted when transitioning between methods. Depending on the circumstances:

- Positive adjustments may be recognized over multiple years.
- Negative adjustments may provide an immediate tax benefit.
- Some construction-specific method changes qualify for automatic IRS consent procedures.

The tax impact can be significant, making a method-change analysis a valuable planning exercise.

KEY QUESTIONS EVERY CONTRACTOR SHOULD ASK

- Are we using the most tax-efficient accounting method available?
- Have our gross receipts changed enough to create new opportunities?
- Are retainage balances being treated properly?
- Would a change from accrual to cash create tax savings?
- Would a switch from Percentage of Completion to Completed Contract be beneficial where permitted?
- Have we evaluated whether a Form 3115 filing could generate a favorable Section 481(a) adjustment?

Choosing the Right Method for You

Construction contractors operate under a unique set of tax accounting rules, particularly with respect to long-term contracts, that can create meaningful planning opportunities. Understanding whether a project qualifies as a long-term contract, monitoring the annual gross receipts threshold, and selecting the most appropriate accounting method can significantly affect the timing of taxable income and cash flow.

Whether evaluating cash versus accrual accounting, leveraging the Completed Contract Method, managing retainage, or considering an accounting method change, proactive planning can produce substantial tax savings. Contractors should periodically revisit their accounting methods, particularly after significant growth, acquisitions, or changes in project mix, to ensure they continue using the approach that best aligns with their business objectives.

If you have questions about your accounting method, our Construction and Real Estate team is here to help. Contact us to get started today.

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