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Cash Or Accrual? Don't Let The IRS "Code 448" You

Because of an IRS crackdown on cash method contractors, you may need to switch to the overall accrual method. IRS auditors are increasingly disallowing the cash method for nearly all but the smallest businesses who carry no inventory.

Of interest to the IRS auditors is the accounting method you use, and whether that method accurately reflects your company's income. In most cases, construction contractors are included in Internal Revenue Code Section 448, which requires that the overall accrual method of accounting be used. Only this accrual method can reflect accurately if inventory is income-producing.

To determine if inventory is an income-producing factor, the IRS tests whether or not the cost of materials in your inventory is equal to, or greater than, 15% of your gross receipts. If the figure is 15% or more, the IRS can change your method of accounting from the cash to the accrual method for the years under audit.

If you are audited before switching to the accrual method, the IRS has the authority to bring into one taxable year all of the additional taxable income recognized by the audit. This may make it difficult for you to pay your taxes, and require you to scale back your operations. As a worst case example, some auditors have placed their entire adjustments into the earliest year under scrutiny. In other cases, auditors have allowed more lenient settlements.

Not all companies carrying inventory have been forced to make the switch. For example, a paving contractor's inventory consisted mostly of emulsified asphalt, which had to be installed within 5 hours after it was received from the supplier, or be discarded. This contractor was able to successfully argue that the material's unstable nature did not make it inventory. However the IRS has not accepted that ruling as a general condition for construction contractors. Instead, it has given notice that it will only leave identical cases unchallenged. Based on recent case history, the IRS has ample precedent on its side to force contractors from cash to accrual.

However, don't be hasty when deciding to make an election to change your method of accounting. There are many options available to most contractors, other than the straight accrual method. In addition, a voluntary election may allow you to recognize the income over a period of time. Talk with us to gain a full understanding of the options available.