

 Fact Sheet

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The Construction Industry and the Tax Gap

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Not reporting or under-reporting business income, including income from construction activities, contributes to the tax gap. Contractors, subcontractors, as well as individual workers need to be aware of everything that counts as income and proper accounting methods so they pay their fair share of taxes. They also need to be aware of all deductible expenses so they don't overpay their taxes.

This fact sheet is the 15th in a series to help reduce the tax gap by helping taxpayers better understand the tax code. The tax gap is the difference between the amount of taxes that should be paid in a given year and the amount actually paid voluntarily and in a timely way.

Income

Contractors, subcontractors, and workers must pay taxes on income received for all work, including side jobs and work that is paid for with cash. This includes work in exchange for credit on a bill. It also includes work that is done in exchange for goods or services in a barter exchange. You are required to report your income even if a Form 1099 or a W-2 is not issued to you.

Income and expenses are reported on tax returns based on one of two accounting methods, which include either the cash method or the accrual method. Either method must clearly reflect a consistent treatment of income and expenses from year to year.

Most construction businesses use two different tax accounting methods, one for long-term contracts and one overall method for everything else, which is often the accrual method. A [special section](#) of the IRS web site can help companies pick the best accounting method for their needs.

Accrual Accounting

The accrual method requires reporting income in the year earned and expenses in the year incurred. The purpose of an accrual method of accounting is to match income and expenses in the correct year. If you use an accrual method for reporting your expenses, you must use an accrual method for figuring your income.

Common accrual methods used in the construction industry are the "completed contract method" and the "percentage of completion method." Under the completed contract

method, all income and expenses from the contract are reported in the year the project is completed and accepted by the customer. Under the percentage of completion method, income is reported in proportion to the percentage of costs incurred to date when compared to total estimated costs for the contract.

Cash Accounting

The cash method requires reporting cash receipts as income when received and expenses when paid. Again, if you use the cash method for reporting your expenses, you must use the cash method for reporting your income. Receipt of income occurs when a contractor has unrestricted access to income, including income earned. Contractors who could have received money in one year, but chose not to receive the money until a later year, must include the money as income in the first year, as if it had been actually received in that year.

Two types of businesses are not permitted to use the cash method of accounting. These include a corporation and/or a partnership with a C corporation as a partner with average annual gross receipts exceeding \$5 million, and a business with substantial purchases of materials, generally 10 to 15 percent of its gross income.

Additional information on income and accounting methods is available in [Publication 538](#), Accounting Periods and Methods.

Expenses

Ordinary and necessary business expenses are deductible. An “ordinary” expense is one that is common and accepted in the construction business. A “necessary” expense is one that is helpful and appropriate for the construction business. An expense does not have to be indispensable to be considered necessary.

Common business expenses deductible in the year incurred include:

- Utilities
- Car and truck expenses
- Advertising
- Employee salaries
- Trade association dues
- Rent expense
- Supplies
- Continuing education
- Small tools expected to last one year or less
- Steel toe work boots
- Business licenses

Expenses for business assets that are expected to last more than a year must be capitalized and depreciated over their useful lives. Examples of assets include:

- Cement mixer
- Compressor
- Ladder
- Other heavy machinery
- Buildings and real property

Personal expenses including clothing that can be worn off the job site, fines and penalties, and the non-business use of vehicles or computers cannot be deducted.

Other expenses including certain meal and entertainment expenses may be deductible in part or only if certain conditions are met. Additional information about other expenses is available in [Publication 535](#), Business Expenses; [Publication 463](#), Travel, Entertainment, Gift and Car Expenses; [Publication 946](#), How to Depreciate Property; [Publication 334](#), Tax Guide for Small Business, and [Publication 587](#), Business Use of Your Home. And, further industry information is available in the [Construction Industry - Federal Taxation Curriculum](#).