

The North Carolina Contractor Tax & Audit Survival Guide

How to Avoid Costly Mistakes, Stay Compliant, and Be Prepared for an Audit

Introduction

Contractors in North Carolina face unique challenges when it comes to taxes, worker classification, and regulatory compliance. Even well-run businesses can run into issues simply due to how complex the rules are.

This guide is designed to help you understand where risks exist, how audits happen, and what you can do now to protect your business.

Why Contractors Get Audited

Construction businesses are frequently audited due to two primary areas:

1. Worker Classification (NCDES)

The NC Division of Employment Security actively reviews contractor relationships to determine whether subcontractors have been properly classified. Misclassification can lead to:

- Back payroll taxes
- Penalties and interest
- Required reclassification of workers

2. Sales & Use Tax (NCDOR)

The application of sales tax in construction depends on how work is classified:

- **Capital Improvements** → Often exempt with proper documentation
- **Repair, Maintenance & Installation (RMI)** → Typically taxable

Misunderstanding this distinction can result in:

- Under-collection of tax
 - Overpayment of tax
 - Audit assessments
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Common Contractor Mistakes

Many audit issues stem from the same patterns:

- Treating all workers as 1099 without proper structure
- Misclassifying projects between capital improvements and RMI
- Failing to properly collect or remit sales tax
- Inconsistent or unclear invoicing practices
- Lack of documentation to support tax treatment

What Auditors Look For

When auditors review a construction business, they typically focus on:

- How workers are paid and classified
- Contracts and agreements with subcontractors
- Job invoices and how tax is applied
- Purchase records for materials
- Consistency between reported revenue and project activity

Even small inconsistencies can raise questions that lead to deeper review.

How to Stay Compliant

1. Structure Worker Relationships Properly

- Clearly define independent contractor vs employee roles
- Maintain agreements and supporting documentation
- Ensure payment methods align with classification

2. Understand Tax Treatment of Your Work

- Identify whether work qualifies as a capital improvement or RMI
- Use proper forms (such as E-589CI when applicable)
- Apply tax consistently across projects

3. Maintain Clean, Accurate Records

- Keep books up to date
- Reconcile accounts regularly
- Ensure financial reports reflect actual activity

4. Standardize Billing Practices

- Ensure invoices reflect correct tax treatment
- Avoid inconsistent pricing or tax application
- Align billing with how work is classified

If You're Selected for Audit

An audit doesn't mean something is wrong—but how you respond matters.

What to Expect

- Request for documentation (financials, invoices, contracts)
- Review of worker classification
- Evaluation of sales tax reporting

Best Practices During an Audit

- Respond accurately and on time
- Provide organized documentation
- Avoid guessing or incomplete responses
- Work with someone who understands the process

How We Help Contractors

We work with contractors to both **prevent issues** and **support them if an audit occurs**.

Proactive Support

- Review worker classification and payroll structure
- Evaluate sales tax application on projects
- Ensure billing and financial records are aligned

Audit Preparation

- Organize documentation before issues arise
- Identify gaps or inconsistencies early
- Strengthen your position before an audit begins

Audit Representation

If you are selected for audit, we:

- Communicate directly with state agencies
 - Organize and present your documentation
 - Explain your financial structure clearly
 - Guide you through the process from start to finish
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Final Thoughts

Contractor audits in North Carolina are common—but they are manageable with the right structure and preparation.

The key is not waiting until there's a problem.

When your financials, billing, and tax handling are set up correctly from the beginning, audits become far less disruptive—and far more defensible.

Need Help Getting Set Up or Staying Compliant?

Whether you're:

- Unsure about worker classification
- Concerned about sales tax handling
- Behind on your books
- Preparing for or facing an audit

Schedule a Consultation

Build your business with confidence—knowing your financials are accurate, compliant, and structured the right way.