Chapter 3: Accounting for contractors, home builders, and developers
Chapter 6: Completed contract method

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CHAPTER 3
ACCOUNTING FOR CONTRACTORS, HOME BUILDERS, AND DEVELOPERS

CONTENTS

Introduction 3005
Example Charts of Accounts for Contractors 3007
Example Charts of Accounts for Home Builders and Developers 3008
GAAP for Construction Contractors 3008
   Revenue Recognition Methods for GAAP 3009
      Percentage-of-Completion (POC) Method 3009
   Nature of Reasonable Estimates and Inherent Hazards 3011
      Previous Reliability and Related Testing 3012
   Recognition of Contract Revenue and Expenses and Nature of Reasonable Estimates and Inherent Hazards under International Accounting Standards (IAS) 3016
Completed Contract Method and GAAP 3017
Construction Management Contracts 3018
Construction Manager at Risk 3018
Measuring Progress on Contracts under the POC Method 3019
   Input Measurements 3019
      Exhibit 3-1: Cost-to-Cost Formula 3020
   Output Measurements 3021
   International Accounting Standards on Measuring Progress on Contracts 3022
Income Determination: Revenue Elements 3022
   Basic Contract Price in General 3022
   International Accounting Standards for Revenues 3023
   Basic Contract Price: Cost-Type Contracts 3023
   Materials Furnished by the Customer 3024
Change Orders 3024
   Accounting for Unpriced Change Orders 3025
   Approval 3026
   Change Orders Scope and Price 3026
   International Standards on Change Orders 3027
Claims 3027
   International Rules on Claims 3028
   Incentives 3028
Income Determination: Cost Elements for Contractors 3028
   Materials: Treatment of Materials as a Job Cost, Rules for Inclusion 3030
   Overhead, Indirect Costs, Allocation Methods, Other Costs 3031
      Exhibit 3-2: Cost Systems Considerations 3032
Chapter 3: Accounting for Contractors, Home Builders, and Developers

Revisions of Estimates
Abandonments and Changes in Use
Selling Costs
Rental Costs
Accounting for and Reporting Investments in Construction Joint Ventures
Definitions of Construction Related Accounts
Definitions of Accounts Related to Home Builders and Land Developers
Appendix 3A: Example 1: Chart of Accounts for Contractors
Appendix 3B: Example 2: Chart of Accounts for Contractors
Appendix 3C: Home Builder, Developer, Rental, Contractor Complete Chart of Accounts
Appendix 3D: Home Builder, Developer, Rental, Contractor Abbreviated Chart of Accounts for Smaller Entities
Appendix 3E: Home Builder, Developer, Rental, Contractor Direct and Indirect Construction Costs Subsidiary Ledger
Direct Construction Costs
Indirect Construction Costs Subsidiary Ledger
Land Development Costs Subsidiary Ledger
Appendix 3F: How to Allocate Overhead
Overhead Defined
Measurement Approaches for Overhead Allocation
Labor Overhead Group
Exhibit 3-4: ABC Labor Overhead Example
The Internal Equipment Group
Exhibit 3-5: ABC Equipment Rental Rates Example
The General Overhead Group
Allocating Overhead to Multiple Divisions
Allocating Interest Expense
Budgeting Overhead
Flexible Overhead Allocations for Greater Profitability: Alternative Approach
Exhibit 3-6: XYZ Contractor/Developer Overhead Analysis
Alternative Overhead Strategies When Volumes Are Low
Appendix 3G: Overhead Considerations in General for Contractors
Direct Costs Identification
Exhibit 3-7: Comparison of Job Costs with and without Indirect Job-Cost Allocations
Indirect Costs
Exhibit 3-8: Contract Cost Types Possible Allocation Methods
Appendix 3H: Computing Income Earned under the Percentage-of-Completion Method
Example 3-13: Comparison of Alternative A and Alternative B
Discussion of Comparison of Alternatives A and B
Example 3-14: Comparison of Alternative A and Alternative B
Discussion of the Results under the Two Methods
Appendix 3I: Examples of Computation of Income Earned
Example 3-15: Cost-to-Cost Method
Example 3-16: Labor-Hours Method
Example 3-17: Construction Management (CM)
Example 3-18: Unit Price
Example 3-19: Utility Contractor and Unit Price
Example 3-20: Zero Profit
Appendix 3J: Loss Contract
  Loss Contract (Adapted from AICPA SOP 81-1)
  Alternative A Method
  Alternative B Method
Appendix 3K: Combining
  Combining (Adapted from AICPA SOP 81-1)
  Segmenting
Appendix 3L: Table of Minimum Initial Investments for Real Estate Sales, Other Than Retail Land Sales
Appendix 3M: Description of Methods of Accounting Available for Real Estate Sales Transactions
  Installment Method
  Cost Recovery Method
  Deposit Method
  Reduced-Profit Method
  Full Accrual Method: Retail Land Sales
  Percentage-of-Completion Method: Retail Land Sales
Appendix 3N: Examples of Calculations for Recognition of Profit on Sales of Real Estate, Other Than Retail Land Sales
  Example 3-21: Illustration of Effect of Land Lease, New Multifamily Residential Property
    Primary Land Lease—Land Owned by Third-Party Lessor:
      Nonqualifying
  Example 3-22: Primary Land Lease—Land Owned by Third-Party Lessor:
    Qualifying
  Example 3-23: Subordinated Land Lease—Land Owned by Seller:
    Qualifying
  Example 3-24: Subordinated Land Lease—Land Owned by Seller:
    Nonqualifying
  Example 3-25: Illustration of Profit Recognition—Sale of Property with Construction and Support Obligations by Seller
    Assumptions
    Calculations of Profit to Be Recognized
    Schedule A: Example of Profit Calculation
    Schedule B: Example of Profit Calculation
    Schedule C: Calculation of Adjusted Projected Rental Revenue
  Example 3-26: Illustration of Profit Recognition: Installment Method, with Debt Assumed by Buyer
    Assumptions
INTRODUCTION

Understanding the accounting for contractors, home builders, and real estate developers (comprising issues ranging from recognition to measurement, including debits, credits, typical accounts, usual journal entries, unique calculations, etc.) is not an easy process. Even experienced accountants find the mastery of accounting for these industries to be a process that can take several years. The FASB and IASB are jointly working on a “revenue recognition” project in an attempt to provide one, overall definition of what “revenue” is. The change this may make to accounting for contractors, home builders, and developers is yet to be determined. A discussion paper on “revenue recognition” released in 2009 offered an indication that setting a definition of “revenue” will not be an easy process for the FASB and IASB, nor will it be easy eventually for contractors, home builders, and real estate developers to implement. The following sections describe the “norm” as of 2010.

Keep in mind that the accounting issues for any industry are classified by three general accounting concepts. These concepts are not unique to the construction, home builder, and real estate development industries but are related to all accounting applications:

1. Recognition. When a particular accounting debit or credit should be recorded.
2. Measurement. In what amounts a particular accounting treatment should be recorded.
3. Disclosure and Presentation. What should be disclosed to the readers of the financial statements and in what form.

For contractors, (1) prior, current, and future period recognition is an important concept in relation to estimates of contract revenues, over- and underbillings, and contract losses; (2) measurement is important in the determination of how much and under what method criteria should be used for these revenues (including change orders and claims), costs, over- and underbillings, and contract losses to be recorded; and (3) disclosure and presentation relates to the required, optional, and preferred information about contractor assets, liabilities, equity, revenues, costs, cash flows, and anticipated future events that the users of contractor financial statements desire.

“Under-” and “overbillings” are typical terms used in the construction industry to account for the balances in a contractor’s set of books. “Underbillings” refers to the asset account that measures the amount of billings on an uncompleted contract (also known as a contract in process or contract in progress) that is measured under the percentage-of-completion method. Under U.S. GAAP, an underbilled contract has a positive balance in the asset account called “costs and estimated earnings in excess of billings on uncompleted contracts.” In an uncompleted contract that the contractor has overbilled, under U.S. GAAP, the overbilled liability account is called “billings in excess of costs and estimated earnings on uncompleted contracts.”

Example 3-1: Strong Contractors has a contract to install pipe in a factory. The total amount of the fixed-price contract is $100,000 and Strong expects to incur
$75,000 of its total costs in the performance of the contract. As of December 31, 20X9, Strong has incurred $25,000 of its estimated total contract costs and billed $50,000. Strong measures its progress for accounting purposes under the percentage-of-completion method, using costs to date compared to total estimated job costs. What would the accounting entry be on Strong’s books to record its progress under the contract as of December 31, 20X9?

Discussion: $25,000 divided by $75,000 (total costs incurred to date compared to total estimated contract costs) equals 33.33% complete, or one-third. That means that of the total $100,000 contract, Strong has earned $33,333 in revenue ($100,000 times one third). Comparing Strong’s earnings of $33,333 to what it has billed to date of $50,000 would require Strong to recognize a liability of $16,667 in the account “billings in excess of costs and estimated earnings on uncompleted contracts.” The debit to this credit entry would be to the revenue account “contract revenue,” assuming that when Strong issued its $50,000 of billing to the owner, it credited revenue and debited contract receivables for $50,000 each.

The issues outlined above are also applicable for home builders and real estate developers that are performing under a contract. For home builders or developers who are constructing speculative projects, however, (1) recognition, in general, usually occurs under the deposit method where the property sales price is recorded as revenue and the capitalized costs are recorded as the cost of the sale (there are, however, many varieties and modifications of this rule depending on the agreement between the parties, which varieties and modifications are described in this chapter); (2) measurement of what revenues and costs will be recorded also varies greatly for the development industry; and (3) disclosure for developers relate to the areas unique to it such as listing of the inventories and types and the related liabilities and contingencies.

The overall issues of recognition, measurement, and disclosure related to contractors, home builders, and developers are based upon the determination of the appropriate revenue and cost events that occur over a length of time that is meant to be measured at an interim date, such as the end of a month, quarter, or year. Accounting for these contracts and industries requires the estimation of future events, i.e., the completion of the contract revenues and costs or the sale of property in amounts that have yet to occur and applying these estimates to the current period under consideration. For example, these estimates can relate to the extent of the contract’s completion, which are continually subject to revision. The construction, home builder, and developer’s industry accountant must be able to respond to revisions with appropriate adjustments.

Normally, revenue and cost recognition occur when the earnings process is complete and the parties have exchanged consideration. Applying this practice to the construction industry would mean that contractors would not recognize any contract revenue or costs until the contract was completed and the contractor was paid. The application of this earnings process to the revenues and cost recognition of the construction industry would produce results that would distort the contractor’s earnings process. Accounting Research Bulletin No. 45 (ARB-45) (ASC 605) (Long-Term Construction-Type Contracts) (issued by the AICPA Committee on Accounting Procedure in 1955) describes the percentage-of-completion (POC) method and states that it “recognizes income as work on a
contract progresses; recognition of revenues and profits generally is related to costs incurred in providing the services required under the contract.”

**EXAMPLE CHARTS OF ACCOUNTS FOR CONTRACTORS**

A good contractor’s chart of accounts should include a complete listing of the unique and typical accounts used in the construction industry. A review of a contractor’s chart of accounts might assist the reader in a better understanding of the GAAP for contractors that are further discussed in this chapter.

The contractor accounts subject to the greatest estimation are “costs and estimated earnings in excess of billings on uncompleted contracts” (an asset account to account for underbillings on uncompleted contracts) and “billings in excess of costs and earnings on uncompleted contracts” (a liability account used to account for overbillings on uncompleted contracts and the related revenue recognition). These two accounts are not generated by the contractor’s payroll, accounts payable, or accounts receivable systems but, rather, are generated by the contractor’s comparison of earnings to date compared to the contract billings to date on each individual contract in an adjusting journal entry, with the difference posted to revenues.

These accounts are only two examples of the unique types of accounts that make up a contractor’s chart of accounts. Readers should review the examples of charts of accounts for contractors that are presented in Appendixes 3A and 3B. You may want to use these examples when setting up systems for contractors or correcting or modifying them. These examples are structured so that internal overhead calculations can be tracked. In Appendix 3A, for example, account number 506, titled “Internal Equipment Rental Expense,” is the calculation of the internal equipment costs, a debit, and is an offset to account number 700 titled “Internal Equipment Rental Income,” which is a credit.

In the second example, Appendix 3B, three overhead offset groups of accounts are used to account for (1) labor overhead, (2) internal equipment costs, and (3) general overhead.

These overhead accounts of labor overhead, internal equipment costs, and parts of the general overhead are allocated in this example to the job-cost accounting group, accounts numbered in the 5000s. Specifically, account number 5040, titled “company equipment,” is the accumulation of the costs of the contractor’s equipment costs as accumulated in accounts 6510 to 6650 and is a contra account to account number 6690, titled “applied company equipment.” Account 5070, “burden,” is the accumulation of the costs of the contractor’s labor costs as accumulated in accounts numbers 6020 to 6320 and is a contra account to account number 6470, titled “applied burden.” Account 5080, titled “overhead,” is the accumulation of some of the general overhead costs of accounts 7010 to 7670 and is the contra account to account number 7670, titled “applied overhead.” These overhead costs can be applied according to various methods. Consult Appendix 3F on how to allocate overhead. Many of these methods are outlined in Appendix 3G, in Exhibit 3-7, titled “Cost Types and Possible Allocation Methods.”
A contractor’s chart of accounts established in this manner better enables its accounting system to determine the appropriateness and accuracy of its overhead allocation methods.

**EXAMPLE CHARTS OF ACCOUNTS FOR HOME BUILDERS AND DEVELOPERS**

Example charts of accounts are also presented for large and small home builders and for developers. These charts of account contain accounts that are unique to these industries. These charts should be reviewed by the home builder’s and developer’s accountants for possible modification of their current chart or for establishing and setting up new entities. Please see Appendix 3C for a large home builder/developer chart of accounts. Also see Appendix 3D for a small home builders’ chart of abbreviated accounts and Appendix 3E for a further breakdown of accounts for direct costs, indirect costs, and developer-type costs.

**GAAP FOR CONSTRUCTION CONTRACTORS**

Generally accepted accounting principles (GAAP) for contractors go back to the issuance of ARB-45 in 1955. The current source of GAAP for the construction industry, which has not changed for many years, is as follows:

- ASC 605-35 (formerly, ARB-45, Long-Term Construction-Type Contracts, issued by the AICPA Committee on Accounting Procedure in 1955)
- ASC 605-35 (formerly, Statement of Position 81-1 (SOP 81-1), Accounting for Performance of Construction-Type and Certain Production-Type Contracts, issued by the Accounting Standards Division, American Institute of Certified Public Accountants (AICPA) July 15, 1981)
- AICPA Audit and Accounting Guide *Construction Contractors* (originally issued by the AICPA in 1981 but modified by the AICPA from time to time to include certain changes that are necessary because of the new issuance of authoritative pronouncements)
- Annual Audit Risk Alert *Construction Contractors Industry Developments* (issued annually by the AICPA to alert its members to current accounting changes and the environmental risks of the industry)

In 2009 the FASB officially released in authoritative form its new Accounting Standards Codification (ASC) (see http://asc.fasb.org). The FASB’s Codification project accumulated all of the sources of GAAP in one location and simplified the classification of accounting standards by restructuring all authoritative U.S. GAAP for nongovernmental entities into one online database under a common referencing system. The FASB has stated that its Codification is the first step in organizing U.S. accounting standards for convergence with International Financial Reporting Standards (IFRS). The Codification is the single authoritative source for U.S. GAAP for nongovernmental entities, superseding all prior non-SEC accounting and reporting standards.

The International Accounting Standards Board has issued a statement on contractors titled International Accounting Standard 11 (Revised 1993) (IAS-11) (Construction Contracts). During 2008, International Financial Reporting Inter-
Chapter 3: Accounting for Contractors, Home Builders, and Developers

The Interpretations Committee (IFRIC), the interpretative body of the IASC Foundation, issued IFRIC-15 (Agreements for the Construction of Real Estate). IFRIC-15 addresses the issue of whether a construction contract falls under the provision of IAS-11 (Construction Contracts) or IAS-18 (Revenue).

Although international standards are not necessarily applicable to U.S. entities, they provide additional insight into accounting treatment for contractors. In addition, under the effort to align standards, international standards are becoming more significant for U.S. entities.

Officially, U.S. GAAP for contractors has not been updated for some time, other than the issuances of accounting standards that are not unique to the industry; nevertheless from a practical perspective, the industry has adapted to changes in the construction industry (for example, accounting for design/build contracts). There have been significant changes, however, within the construction industry since the issuance of SOP 81-1 (ASC 605-35) more than 20 years ago, including but not limited to:

- The types of contracts that contractors are a party to, including design/build (the blending of risks typically associated with a contractor along with the agency relationships typically found in a construction management contract), partnering and joint ventures in various forms, and others.
- Business combinations, mergers, consolidations.
- Technology not limited to use in construction equipment and processes, bidding, online abilities, fund transactions, accounting systems, and others.
- The effect on revenue and cost recognition, especially change orders and claims.
- Concern about the appropriateness of change order and claim revenue recognition.
- Joint venture accounting issues (not limited to ASC 810-10 (FIN-46R) considerations).
- International work and the various accounting differences for contractors between U.S. GAAP and the international standards (International Accounting Standards for the construction industry are included in this chapter).

Revenue Recognition Methods for GAAP

Percentage-of-Completion (POC) Method

ASC 605-35 (formerly, SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts) recommends using the POC method when estimates are reasonable and dependable and certain conditions exist. The use of the percentage-of-completion method depends on the ability to make reasonably dependable estimates. For the purpose of ASC 605-35, “the ability to make reasonably dependable estimates” relates to estimates of the extent of progress toward completion, contract revenues, and contract costs. The
AICPA (the issuer of the SOP) has stated that the POC method is preferable as an accounting policy in circumstances where reasonably dependable estimates can be made and where the following conditions exist:

- Contracts executed by the parties normally include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement.
- The buyer can be expected to satisfy its, his, or her obligations under the contract.
- The contractor can be expected to perform his or her contractual obligations.

The definition of “reasonably dependable estimates” relates to all areas subject to estimation, including:

- Percent complete (i.e., progress made toward completion or a contract).
- Contract revenues (in total and amount earned to date).
- Contract costs.

ASC 605-35 states a strong presumption that contractors generally have the ability to produce estimates that are sufficiently dependable to justify the use of the POC method (PCM). Persuasive evidence to the contrary is necessary to overcome the presumption of the use of the POC method.

Small contractors with poor, informal estimating procedures that result in poorly documented estimates and marginal-quality job-costing systems may influence the conclusion about the ability to produce dependable estimates. However, the contractor’s internal procedures and systems, generally, should not influence the development of accounting principles, but rather should be dealt with as internal control and auditing concerns.

The ability to produce reasonably dependable estimates is an essential element of contracting. An entity must have the ability to update and revise estimates continually with a degree of confidence to meet GAAP (note that the recognition of loss on uncompleted contracts requires this ability).

ASC 605-35 assumes that entities with significant contracting operations have the ability to produce reasonably dependable estimates and that the POC method should be applied.

The POC method should be applied on one or more bases as outlined by ASC 605-35. According to ASC 605-35, entities with significant contracting operations generally have the ability to produce reasonably dependable estimates and that for such entities, the POC method of accounting is preferable in most circumstances. The method should be applied to individual contracts or profit centers, as appropriate, under one or more of the following accounting methods:

1. Normally, a contractor is able to estimate total contract revenue and total contract cost in single total amounts. Those amounts should normally be used as the basis for accounting for contracts under the percentage-of-completion method (PCM). (The POC determination can also be per-
formed under an acceptable criterion such as cost-to-cost or some other input or output measurement such as labor costs or labor hours.)

2. For some contracts, on which some level of profit is assured, a contractor may only be able to estimate total contract revenue and total contract costs in ranges of amounts. If, based on the information arising in estimating the ranges of amounts and all other pertinent data, the contractor can determine the amounts only in the ranges that are most likely to occur, those amounts should be used in accounting for the contract under the POC method. If the most likely range of amounts cannot be determined, the lowest probable level of profit in the range should be used in accounting for the contract until the results can be estimated more precisely. At that time, the contractor can change its accounting to the POC method described above.

3. In some contract circumstances, however, estimating the final outcome may be impractical except to assure that no loss will be incurred on a contract. In those circumstances, a contractor should use what is termed a “zero estimate of profit.” Under this method, equal amounts of revenue and costs should be recognized until results can be estimated more precisely. A contractor should use this method only if the previously described methods (single amounts or profit ranges) are clearly not appropriate. A change from a zero estimate of profit to a more precise estimate should be accounted for as a change in accounting estimate.

4. The use of the completed contract method (CCM) for a single contract for which reasonably dependable estimates cannot be made is permitted by GAAP, but the contractor must disclose such policy if utilized and the reasons for its use.

Normally a contractor discloses its revenue and cost recognition policies on every material accounting method it uses. This means that a contractor may have a revenue and cost recognition method for fixed-price contracts, a separate one for time and material contracts, and yet, a different revenue and cost recognition method for service contracts.

Industry professionals need to be sure of what the definition of what a contract “cost” is and that they understand its significance as it relates to the contractor’s revenue recognition method(s). ASC 605 refers to, and uses the word “costs” in the following phrases: “total contract cost,” “costs of revenue earned,” “costs allowable,” “estimates of costs to complete,” “costs incurred,” and “use of estimates in determining revenues, costs.” Nowhere in the accounting guidance, however, is what is considered to be a contract “cost” named. The federal tax code is specific about what is required to be a contract cost, but for U.S. GAAP purposes, there is no accounting guidance for what is required to be a contract cost. This is more fully discussed in the section titled “Income Determination: Cost Elements for Contractors” later in this chapter.

**Nature of Reasonable Estimates and Inherent Hazards**

In practice, contract revenues and associated costs are estimated using methods that range from simple to complex. The ability to produce reasonably dependable
estimates does not depend on the elaborateness of the contractor’s estimating process. A contractor’s estimating procedures should provide reasonable assurance of a continuing ability to produce reasonably dependable estimates.

The ability of a contractor to estimate anticipated contract revenues and costs covers more than merely the estimating and documentation of revenues and costs. It covers a contractor’s entire internal control system including, but not limited to, its contract administration and management control systems. It depends on all of the procedures and personnel of the contractor, and it encompasses the systems and personnel not only of the accounting department, but of all areas of the company that participate in

- Production control (project management)
- Cost control
- Administrative control
- Accountability for contracts

Previous Reliability and Related Testing

ASC 605-35 makes an important statement that contractors and their advisors can use to justify tests of the contractor’s estimating system:

Previous reliability of a contractor’s estimating process is usually an indication of continuing reliability, particularly if the present circumstances are similar to those that prevailed in the past [ASC 605-35-25-25; SOP 81-1, par. 26].

One might inquire as to the meaning of the phrase “previous reliability of a contractor’s estimating process,” and how to test this process to ensure that it is reliable, and whether it can be trusted to continue to be reliable. The reliability of the contractor’s estimating process relates to a comparison of its previously uncompleted contract estimates to the ultimate results of these contract revenues, costs, and contract gross profits. If one looks back in time and tests the contractor’s ability to estimate its revenues, costs, and gross profits in the previous year or prior years, one can reasonably determine if a contractor’s estimating process was reliable. In order to reach his or her audit opinion, the auditor can then determine whether the present circumstances are similar to those circumstances that generated the pervious ability to estimate with accuracy or reliability. Such a test can be performed by comparing the prior estimated year-end uncompleted contract elements with the final contract numbers. (Often, the term “estimated costs to complete” is misused in relation to the total picture of what determines the final contract estimate of profitability. A contract does not just have costs to complete, it often has an equal amount of revenue and profit along with the associated contract costs to complete. The proper terminology would, rather, be “estimate of final contract gross profit.” Under such a preferred term, the concepts of the match of anticipated contract revenues along with the anticipated or estimated contract costs produce an estimate of final contract profitability. This is why, in the calculation of final contract profitability, one must compare the change in revenues along with the comparison of changes in contract costs.) Consider where the previous estimated revenues, costs, and gross profits changed in the following manners:
CHAPTER 6
COMPLETED CONTRACT METHOD

CONTENTS

Introduction 6001
   Current Development 6002
   Completed Contract Method: IRS Developments 6004
   IRS Argument 6006
Number of Completed Contract Methods Available 6012
Home Builders 6013
The Mechanics of the CCM 6014
   CCM and the Cash Method 6015
Contract Commencement Date for the CCM 6017
Contract Completion under the CCM 6018
   Law Prior to January 11, 2001 6018
   Current Rules for Contract Completion under the CCM 6020
Gross Contract Price 6022
CCM Contract Costs 6023
   Interest and Job Costs Applicable to the CCM 6024
   Postcompletion Revenues or Costs 6025
Contract Disputes 6026
   Previous Law 6026
   Current Law under the 460 Regulations for Contract Disputes 6026
Look-Back Requirements for the CCM 6029
CCM and Cost-Plus-Type Contracts 6030
Court Cases and the CCM 6032
IRS Issues with the CCM 6033
AMT and the CCM 6035
   Requirement for Consistent Treatment 6037
Disclosure and Reporting Issues 6037
Appendix 6A: Compilation of Sections from the 2009 IRS Construction ATG 6038
that Address CCM Issues
   Background 6038
   Completed Contract Method (CCM) 6038
   Post Completion Expenses 6039
   Issues to Consider for Completed Contract Method Taxpayers 6039
   Long-Term Contract Adjustment for Alternative Minimum Tax 6039
   Example AMT Adjustment 6040
   Look-Back and Alternative Minimum Tax 6040
   Small Contractors Becoming Large Contractors 6040
   Example Completed Contract Method 6041
   Retainages 6041
   Determining Completion under Completed Contract Method (CCM) 6041
   Improper Use of the PCM or Completed Contract Method 6041
   Allocation of Indirect Costs 6042
6002  Construction Guide: Tax and Advisory Services

Improper Expense Recognition under the Completed Contract Method  6043
Claim Income  6043
Subcontractor Improperly Deferring Income  6043
Built-in Gains Tax  6043
Losses  6043
Severed Contracts  6044
Alternative Minimum Tax  6044

INTRODUCTION

The completed contract method (CCM) often results in the greatest tax deferral (compared to other long-term contract accounting methods and regular accounting methods that the small contractor can employ such as the straight accrual method, the cash method, or other long-term methods such as the PCM) for contractors that possess the following characteristics:

• The contractor typically has uncompleted long-term contracts open at year-end and the amount of deferred gross profit on these open jobs stays similar or increases from one year to the next and
• Alternative minimum tax (AMT) due does not significantly reduce the deferral effect of the deferred gross profit.

The CCM method may be elected by a taxpayer/contractor in its initial year or when it first has a long-term contract. The CCM and it can be used to account for a contract if

• The contractor is entitled to use a long-term contract treatment (the words “treatment” and “accounting” are used interchangeably). Since 2007 this has been a significant issue for the IRS, which on March 13, 2007, released “Industry Director Directive on the Super Completed Contract,” and the Department of Treasury, which on August 4, 2008, released Proposed Amendments of Regulations (NPRM REG-120844-07), which pertain to the home construction contract (HCC). This issuance is discussed in detail in this chapter. All contractors who use the CCM, and their advisors, should review the latest issuances in detail and assess the risk of an IRS-initiated accounting method change either as a change to its long-term contract treatment or the way the contractor applies the CCM. For example, if the IRS determines that a contractor using the CCM is not entitled to do so, this would result in a change in its long-term contract treatment. Similarly, if a contractor is treating contract completion at the subdivision level and the IRS determines that it should be at the lot level (i.e., the contract should be severed), it would result in a change in the way the contractor is to apply the CCM.

Current Development

On September 21, 2009, the IRS LMSB Division issued an “Updated Directive Issued on the Use of Completed Contract Method in Residential Construction Industry,” which identified two specific misuses of the CCM and the scenarios in which they are present.
Chapter 6: Completed Contract Method

In the first identified misuse, certain taxpayers improperly applied the CCM to residential land sales using the CCM as a long-term construction method for work on “common improvements,” including minor subcontract work on common improvements. The Directive points out that a contract for the construction of only common improvements is not a home construction contract.

The IRS’s position on this subject remains troubling to the construction world and its advisors. Using the category described above, it appears that the IRS will seek to deny long-term contract treatment to many types of contractors, including site contractors, street pavers, utility contractors, electrical contractors, and others unless they are doing work specifically on a home. Previously the IRS had stated that it would deny use of the CCM to these contractors who perform work for land developers and allow CCM treatment for those who perform work for home builders directly. The proposed regulations are exactly the opposite of the September 21, 2009, the IRS LMSB Division Directive.

In the second misuse, taxpayers postpone recognition of a completed contract to improperly defer income. The LMSB position is that the contract is complete and income and expenses are recognized under the CCM when the house is sold. Here the IRS is focuses on contractors who delay the recognition of all profit in a subdivision until all homes are sold. Very few, if any, home builders, developers, or contractors currently take this aggressive tax position.

The IRS’s Directive presents five scenarios. It also states that under the proposed regulations, three of the five scenarios that the Directive presents would be permitted:

On August 1, 2008, proposed regulations were released which would expand the types of contracts eligible for the home construction contract exemption and would amend the rules for how taxpayer-initiated changes in methods of accounting to comply with the regulations under § 460 must be implemented.

Under the proposed regulations, taxpayers in scenarios 1, 2 and 3(b) would be permitted to use the CCM. However, the proposed regulations are not effective until the rules are published in final regulations in the Federal Register and cannot be relied upon for tax years beginning prior to the date the final regulations are published. Additionally, per the proposed regulations’ preamble, the definition of a home construction contract would be expanded and, therefore, would not be a clarification of the tax law currently in effect. The preamble also states that, in conjunction with the expansion of the home construction contract definition, the IRS and Treasury expect to propose specific severance and completion rules for the completed contract method.

The IRS argues that the proposed regulations expand the definition of a “home construction contract.” That is true, but only for the use of the HCC for condos. The IRS also takes the position that the definition is expanded because the proposed regulations focus on the two-part requirement of the necessary elements to have a HCC. The first part is that it is a dwelling unit, and the second part is that one must also improve real property directly related to and located at the site of the dwelling units. Many advisors have taken the position that this definition, originally created as part of the 1986 Tax Reform Act, was meant to contain an “or” and not an “and” for these elements. Please see Chapter 11, “Home Builders and Developers,” for further discussion.
6004 Construction Guide: Tax and Advisory Services

- The contractor meets the exceptions to the requirement to use the PCM for extended-period long-term contracts under 460(e) and the regulations, as defined by 1.460-3(b); and
- The CCM is properly elected or employed in the first year the contractor is subject to open contracts at year-end.

The advantages of the CCM are
- Possible greatest deferral available to a contractor (all gross profit on open/uncompleted contracts is deferred until the year that the contract is completed).

The disadvantages of the CCM are
- The contractor is subject to the AMT calculations and adjustment for the difference between the income reported under the CCM and what would have had to have been reported under the accrual/PCM if the CCM is being applied to a non-HCC;
- The contractor could experience a backwash of gross profit reporting from the prior year(s) if all previously open contracts are completed in a particular year and there are no open jobs at year-end;
- Recognition of amount of loss for loss contracts is not available until the job is completed;
- Significant differences can result in gross profit reporting between the CCM and the PCM; these calculations require significant accounting to track;
- The CCM has resulted in greater IRS scrutiny in the past, and it now attracts even great IRS attention. The IRS prefers that if the CCM is employed, that contract completion be determined under the briefest possible time criteria, even if that level of segregation is not realistic. Also, the IRS’s attention is currently focused on the combination of the HCC industry and the use of the CCM. If the CCM can be denied to the contractor, other methods (such as those under the accrual method or the PCM) usually result in greater and earlier reporting of income; and
- The CCM is available only to small contractors (or to account for a particular exempt contract) with a three-year-average tax revenue of less than $10 million in taxable gross receipts and each individual contract is estimated to be completed within 24 months unless the contract qualifies for the HCC exception.

Completed Contract Method: IRS Developments

In 2005, the author, as co-chairman at the time of the CFMA Tax Committee, requested that the IRS’s Issues Identification and Resolution (IIR) program address HCC issues being experienced due to the lack of clear definitions and directions. Although the IIR program is stated to be a one-year process, almost four years later the issues remain unresolved. Instead of resolution, proposed regulations are causing more problems. In fact, more controversies are being
Chapter 6: Completed Contract Method

created. In the preamble to the proposed regulations issued in late 2008, the Department of the Treasury sought comments on severing and the CCM:

Under the current regulations under section 460, the appropriate severing of a home construction contract requires a facts and circumstances analysis based upon certain factors that are neither specific nor always relevant to home construction contracts. Likewise, the date a home construction contract is considered completed and accepted is determined using a facts and circumstances analysis.

The IRS and Treasury Department are aware of controversies related to the application of the existing facts and circumstances analyses for determining the appropriate severance and final completion and acceptance of home construction contracts accounted for using the completed contract method. Expanding the definition of a home construction contract as provided in these proposed regulations may heighten the significance of these issues. As a result, the IRS and Treasury Department expect to propose specific severing and completion rules for home construction contracts accounted for using the completed contract method. Taxpayers are encouraged to submit comments on the types of severing and completion rules that would result in the clear reflection of income for home construction contracts accounted for using the completed contract method. Specifically, the IRS and the Treasury Department request comments on the circumstances (if any) in which it would not be appropriate to require severing and completion of a home construction contract to be determined on a dwelling unit by dwelling unit or lot by lot basis or, when a contract is not for the sale of a dwelling unit or lot, on the basis of when the taxpayer receives payment(s) under the contract.

It appears that with the current disastrous economic times for home builders, the Department of the Treasury continues to delay the release of the final regulations. It is likely they will be finalized after the Treasury either matches the issues with the HCC exception with legislative efforts to stimulate the HCC industry or the industry and the economy recovers.

The completed contract method (CCM) has been around for decades and is in accordance with the final 460 regulations (and even previous to this was a permitted method of the 451 regulations for many years (i.e. years prior to 1986)). The problem with the use of the CCM is what the IRS termed in late 2006 as “perceived abuses” of the CCM and the CCM in combination with the HCC. The IRS called these methods the “super completed contract method” in the “Industry Director Directive on the Super Completed Contract Method” (LMSB-04-0207-012, Impacted IRM 4.51.5) it issued on March 13, 2007, and in its subsequent update, issued on September 15, 2009 (LMSB-04-0209-006, Impacted IRM 4.51.2). In these Directives, the IRS defines a “super completed contract” as a contract in which a taxpayer that is permitted to use the CCM defers completion beyond the year that the contract would be considered complete or a method where the taxpayer improperly uses the CCM under circumstances where it is not a permitted method.

On the other hand, certain taxpayers and their CPA advisors have stated that these methods are “creative CCM methods.” Contractors, subcontractors, and home builders who properly employ the normal CCM methods along with (or without) the HCC are being caught in the middle as the IRS initiates actions and deploys their team to stop these IRS-defined abuses.
Two categories of misuses of the CCM are defined by the IRS and apply to the construction, real estate development, and home building industries as follows:

1. Taxpayers are improperly treating residential land sales contracts and long-term construction contracts (including contracts for subcontract work for common improvements) as home construction contracts eligible for CCM (Scenarios 1 & 2).

2. Taxpayers are postponing recognition that a contract is considered complete to improperly defer income (and expenses) under CCM (Scenario 3, 4 & 5).

The five potential scenarios referred to by the IRS as follows, in the Updated Directive of September 2009 (although the wordings of the two Directives are similar, there are significant differences):

1. A residential land developer (taxpayer) enters into a sales/construction contract with a homebuilder to provide improved lots (lots that have been cleared, graded and utilities provided to the lot line) and a future common improvement (e.g., clubhouse, pool, road, etc.). The taxpayer sells the lots but has not yet begun construction of the common improvement. The taxpayer does not satisfy the $10,000,000 gross receipts test in Treas. Reg. § 1.460-3(b)(3). The taxpayer treats the contract as a home construction contract and defers the recognition of income and expenses from the lot sales until the common improvement has been completed.

2. The taxpayer is a subcontractor hired by the land developer to do clearing and grading and to construct roadways, sidewalks, utilities, grading, or other common improvements within a residential community. When entering into the contract, the taxpayer estimated the contract would take more than 2 years after the contract commencement date to complete. The taxpayer treats the contract as a home construction contract, thus deferring the progress payments until the entire contract is completed.

3. The taxpayer sets up two partnerships to separate land development from home construction. The builder partnership enters into a contract with the land development partnership to build all the homes in the development. The builder partnership’s price for each home constructed is determined independently. The builder partnership defers the income and expenses on homes it builds until the entire contract has been completed; that is, all of the homes in the development are built. Alternatively, the land development partnership, which does not satisfy the $10,000,000 gross receipts test in Treas. Reg. § 1.460-3(b)(3), sells the lots to the builder partnership and defers the income and expenses on all lot sales until all lots and common amenities have been completed and accepted.

4. A home builder “adopts” a “project-by-project basis” to determine when completion occurs. The homebuilder defers income and expenses from all home sales within a phase of a development until the phase (project) has been completed. The homebuilder erroneously relies on Rev. Proc.
Chapter 6: Completed Contract Method

92-29 for its project-by-project basis for determining when a contract is completed under CCM.

5. A home builder is required to provide a future common improvement to a residential development. As the homes are sold, the homebuilder takes the position that none of the homes are 95% complete because the allocable portion of the future common improvement keeps the completion factor for each home to less than 95%.

Except for scenario 2, these issues are all related to home-builder and developer issues and are more fully discussed in Chapter 11, “Home Builders and Developers.” This is a significant new development and could affect the ability of all contractors to continue to use the CCM as a successful deferral method. The one scenario that applies to contractors only is analyzed in the following section.

IRS Argument

Presented here is material excerpted from the Updated Directive of September 2009. This presentation of scenarios was the IRS’s argument as to why a subcontractor performing common improvements (in the 2007 Directive this was defined only as “site work for a land developer”) is not entitled to the HCC. Previously, for the 2007 Directive and subsequent to the 2009 release, the IRS did not attempt to deny the use of the HCC for a subcontractor site developer performing the exact same work directly for a home builder. Nor did the IRS address the common industry practice of a site developer performing the same work for an LLC wholly owned by the home builder. For those years, it appeared that the IRS said that if the work is performed for a “land developer,” the HCC exception would not apply. The IRS did not attempt to define a “land developer” or any potential exceptions to their rule if the land developer is owned 100% by a home builder; nor did the 2007 Directive consider the case of a land developer that has related-party transactions with a home builder (such as in a joint venture where two home builders form a partnership to develop land and share the developed lots).

The IRS’s position on subcontractors in its 2007 Directive changed with the release of the 2009 Directive. The troubling aspect of the IIR for HCC was that the IRS did not know what position it wanted to take on these issues, because the underlying laws, rules, and regulations did not fit its changing positions. The IRS position is now clear on this issue: no subcontractor performing only common improvements, whether it performs work directly for a home builder or not, is entitled to use the CCM for such contracts.

Presented here is the IRS’s argument along with the author’s comments:

Attachment 2 to Updated Industry Director Directive, Proforma Form 5701—
for Subcontractor Only Providing Common Improvements within a Residential Community Not Allowed CCM

Issue:

Is a taxpayer’s contract to perform only off-site improvements for a residential land developer exempt from the percentage of completion method under section 460 because it meets the definition of a home construction contract?

Facts:
The taxpayer is a subcontractor hired by a land developer to construct roadways, sidewalks, utilities, grading, or other common improvements within a residential community where single family homes are to be constructed. When entering into the contract, the taxpayer estimated the contract would take more than 2 years after the contract commencement date to complete and the taxpayer’s average annual gross receipts for the prior three years exceeds $10 million.

The taxpayer enters into a single contract for the entire development. The development is expected to be completed in X years. The taxpayer treats the long-term construction contract as a home construction contract and as a result has elected the completed contract method of accounting (“CCM”). All income and expenses are being deferred until the contract is completed.

Tax Law & Argument:

I.R.C. §460(a) generally requires the use of the percentage-of-completion method of accounting for long term contracts. See also Treas. Reg. §1.460-1(a)(1) and Treas. Reg. §1.460-3(a). I.R.C. §460(e)(1)(A) provides an exception from the general rule requiring use of the percentage-of-completion method, namely “any home construction contract.” I.R.C. §460(e)(6)(A) defines a home construction contract as follows:

460(e)(6)(A) HOME CONSTRUCTION CONTRACT.—The term “home construction contract” means any construction contract if 80 percent of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to—460(e)(6)(A)(i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and 460(e)(6)(A)(ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

For purposes of clause (i), each townhouse or rowhouse shall be treated as a separate building.

For purposes of I.R.C. §460(e)(6)(A), dwelling unit is defined at I.R.C. §168(e)(2)(A)(ii) as “a house or apartment used to provide living accommodations in a building or structure.”

As it relates to site developers, the IRS interprets the Internal Revenue Code as meaning that the work that site developers perform (which can include grading; water runoff; drainage; retention ponds; soil compaction; utility line installation for water, sewage, etc.; excavation for the home’s foundation) does not qualify for or relate to dwelling units and improvements to real property directly related to the dwelling units and the site of the dwelling units. There are two parts to the IRS argument: (1) a contractor must meet two parts of this test (construction of dwelling units and improvements to real property directly related to dwelling units) and (2) a site developer does not actually construct a dwelling unit and nor does the person or entity that it is performing the work for (i.e. the land developer). The failure of the IRS argument is clear from its definition that the work the site developer performs meets both parts of the test: (1) a site developer does in fact incur costs that are attributable to dwelling units and that (2) those improvements are related to real property directly related to the dwelling units. Nowhere in the IRC does it state that the HCC exception requires “vertical” construction as part of the first part of the two part test. Site development work is
essential to the construction of any home. One cannot build a house without the services that a site developer provides.

The Directive continues:

Treas. Reg. §1.460-3(b)(2) further defines a home construction contract:

(2) Home construction contract

(i) In general.—A long-term construction contract is a home construction contract if a taxpayer (including a subcontractor working for a general contractor) reasonably expects to attribute 80 percent or more of the estimated total allocable contract costs (including the cost of land, materials, and services), determined as of the close of the contracting year, to the construction of—

(A) Dwelling units, as defined in section 168(e)(2)(A)(ii)(I), contained in buildings containing 4 or fewer dwelling units (including buildings with 4 or fewer dwelling units that also have commercial units); and

(B) Improvements to real property directly related to, and located at the site of, the dwelling units.

(ii) Townhouses and rowhouses.—Each townhouse or rowhouse is a separate building.

(iii) Common improvements.—A taxpayer includes in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units.

I.R.C. §460(e)(6)(A) and Treas. Reg. §1.460-3(b)(2) both state that the allocable costs, for the 80% percent computation, must be for the construction of dwelling units and improvements to real property directly related to, and located at the site of such dwelling units. Since the subcontractor-taxpayer described herein has no allocable costs for the construction of dwelling units, his improvements to real property are not within the definition of a “home construction contract.” This view is further supported by Treas. Reg. §1.460-3(b)(2)(iii) which states the taxpayer will include in the cost of the dwelling units their allocable share of common improvements. This statement indicates that the taxpayer must also be providing construction of a dwelling unit. The subcontractor-taxpayer is not constructing any portion of the dwelling unit; therefore, the common improvement costs cannot be allocated to a “phantom” asset.

There are basic flaws in the IRS argument. First they argue that the work that the site developer does is not part of the construction of the dwelling unit. However, a home cannot be built on an unexcavated site or a site that is not level for the footprint of the home. So, the site developer’s work does, in fact, contribute to the construction of the home. It is not just improvement to real property. The IRS also argues that in order to qualify for the HCC exception one must do both.

This view is also supported by prior authority. Notice 89-15 (1989-1 C.B. 634) provides guidance on several issues under Section 460 in a question-and-answer format. Q&A 43 and 44 address the definition of a home construction contract and common improvements:

Q-43: What is a “home construction contract” for purposes of section 460(e)?
A-43: For purposes of section 460(e) the term “home construction contract” means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of (i) dwelling units (within the meaning of section 167(k)) contained in buildings (with each townhouse or rowhouse treated as a separate building) containing four or fewer units, and (ii) improvements to real property directly related to such dwelling units and located at the site of such dwelling units. All costs attributable to the building, construction, reconstruction, or rehabilitation under the contract of such dwelling units and improvements, and allocable to the contract, including costs of materials and land, are taken into account towards meeting the 80-percent test. For the treatment of a mixed-use building, see Q&A-41.

Q-44: For purposes of the 80-percent tests of Q&A-41 and Q&A-43, can costs that a developer expects to incur to construct, build, or install roads, sewers, and other common features not located on the sites of dwelling units (“off-site work”) be treated as attributable to dwelling units that the developer is constructing under contract?

A-44: Yes. Assume, for example, that a developer enters into a contract for the construction and sale of a house. The costs of off-site work properly allocable to this contract are treated as attributable to the construction of the house for purposes of the 80-percent test.

Carol Conjura, who worked for the IRS and who wrote Notice 89-15, which was issued in 1989, was also on the industry IIR team. Conjura stated to the IRS in person at IRS and industry IIR meetings that what the IRS states is contrary to the intended reading of Notice 89-15.

Q&A-43 specifically states that 80% of the contract costs are attributable to the “building, construction, reconstruction, or rehabilitation, of (i) dwelling units . . . and improvements to real property directly related to such dwelling units and located at the site of such dwelling units . . . “ This is a two prong test, dwelling unit and improvements to real property, not an either/or test.

The author’s response to the foregoing argument is to repeat the comments appearing above, that site work directly related to a home is just as important to the building, construction, etc. of the home as the framing of the house. Site work is also an improvement to real property. The IRS admits that the site work is an improvement to the real property; however, they argue, however, site developer work is not related to the building, construction, etc. of the home.

The 2007 Directive stated the following:

Some taxpayers may argue that the legislative history of § 460(e)(6), H.R. Conf. Rep. No. 100-1104, at 118 (1988), says that a contract is a home construction contract if 80 percent or more of the estimated total costs to be incurred are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, “or improvements to real property directly related to and located at the site of, dwelling units.” Unlike § 460(e)(6), which discusses dwelling units and improvements “directly related to such units,” a reading of the legislative history without reference to the statute might cause one to believe that the contract can be for dwelling units or improvements to real property, such as roadways. This is not an issue. In interpreting statutory language, courts look first to whether the relevant statutory language itself is plain and unambiguous. See United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241 (1989); Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842 (1984). If the statutory language is ambiguous,
Chapter 6: Completed Contract Method

courts may consider legislative history. See Robinson v. Shell Oil Co., 519 U.S. 337, 340 (1997). In the present case, however, the statute is clear, looking to the costs of dwelling units and “improvements . . . directly related to such dwelling units.”

The IRS inserted the language above in the Directive because the law firm that assisted the National Home Builders Association in lobbying for the HCC in the 1988 Act presented evidence to the IRS regarding Congress’s intent that was contrary to the IRS’s position.

As previously stated, Q&A 44 addresses the construction of common improvements, which it describes as “off-site work.” This Q&A allows the cost of common improvements to be included in the cost of the dwelling unit for purposes of the 80-percent test so long as “the developer is constructing” the related dwelling unit, and such common improvements are related to the developer’s “contract for the construction and sale of a house.” This Q&A thus supports the IRS position that a taxpayer’s construction of a dwelling unit must occur for the taxpayer to be able to allocate the common improvement expenses to “such dwelling unit.”

The above wording is a response to the current IRS position on what HCC construction work is considered to be on-site and, therefore, would qualify for the exception and, consequently, what HCC-ineligible off-site work would be. In our IRS IIR meetings during 2006, the IRS asked the industry representatives what we considered to be qualified HCC work. Specifically, the question asked whether work that was performed within the subdivision, work performed within the lot lines of the home site, or work performed within the “four walls” of the home would qualify for the HCC exception. From the Directive, and at least for most of 2007, the IRS took the position that a HCC only encompassed work performed within the “four walls” of the home. It is obvious to non-IRS construction industry experienced advisors that this IRS position will not survive the test of time, let alone the near term.

Furthermore, Treas. Reg. §1.460-3(c) provides additional support for the proposition that a contract void of any home construction activity cannot be a home construction contract. This section distinguishes a residential construction contract from a home construction contract, with the distinction being the number of dwelling units per building.

(c) Residential construction contracts.—A taxpayer may determine the income from a long-term construction contract that is a residential construction contract using either the PCM or the percentage-of-completion/capitalized-cost method (PCCM) of accounting described in §1.460-4(e). A residential construction contract is a home construction contract, as defined in paragraph (b)(2) of this section, except that the building or buildings being constructed contain more than 4 dwelling units. [Reg. §1.460-3.]

This section provides that a residential construction contract is a home construction contract, “except that the building or buildings being constructed contain more than 4 dwelling units.” (emphasis added). This section is a clear statement that a residential construction contract, like its cousin the home construction contract, must involve “building or buildings being constructed.” The above authorities consistently indicate that construction of dwelling units is required in order for the related costs to be included in the 80-percent test.

Conclusion:
The taxpayer’s contract to construct the common improvements does not qualify as a home construction contract; therefore, the taxpayer is not permitted to use the completed contract method of accounting. Per I.R.C. § 460(a), the taxpayer is required to use the percentage-of-completion method, so long as the taxpayer’s contract is not subject to any other exception under section 460.

The 2009 Directive, however, came up with a different argument:

Treas. Reg. § 1.460-3(b)(2)(i) describes which long-term construction contracts are home construction contracts. In general, 80 percent of the contract costs must be attributable to the construction of the dwelling unit and improvements to real property “directly related to, and located at the site of, the dwelling units” being constructed under the contract in Treas. Reg. § 1.460-3(b)(2)(i)(A). For purposes of meeting the 80 percent test, builders with contracts calling for the type of construction described in Treas. Reg. § 1.460-3(b)(2)(i) may, under § 1.460-3(b)(2)(iii), include the dwelling unit’s allocable share of the costs of common improvements (required by law or by the contract) in the cost of the dwelling unit being constructed under the contract. Thus, a contract providing for the construction of a house cannot fail the 80 percent test because the cost of common improvements required by the contract is over 20 percent of the contract costs.

However, a contract solely for the construction of common improvements cannot be a home construction contract for two reasons. First, the contract does not require construction activity described in Treas. Reg. § 1.460-3(b)(2)(i). Therefore, the contract will have no dwelling unit cost to which the costs of the common improvements will be added as required by Treas. Reg. § 1.460-3(b)(2)(iii). Second, common improvement costs, although added to § 1.460-3(b)(2)(i) costs, do not qualify by themselves as § 1.460-3(b)(2)(i) costs. This is because common improvements, regardless of whether they are located on a particular building lot or not, benefit more than one dwelling unit. Therefore, they are not “directly related to” any particular dwelling unit being constructed. In summary, Treas. Reg. § 1.460-3(b)(2)(iii) is a cost allocation rule for home construction contracts and does not provide an alternative means to qualify a long-term construction contract as a home construction contract.

The problem with the IRS’s argument originates in its statement, above, “This is because common improvements, regardless of whether they are located on a particular building lot or not, benefit more than one dwelling unit.” The IRS’s position suggests that they do not understand home building. Site development, site clearing, and foundation ground work done on a particular building site is considered by the IRS to be a common improvement even though such work applies to an individual home. The IRS is stating that a site developer’s contract to perform such work in a subdivision or phase does not qualify for CCM treatment. Certainly that work is directly related to a particular dwelling unit. Without such work, the home would not get a building permit, nor even—without a permit—be able to be built. A home has to start with foundation work everywhere but in the IRS world.

Please note that all of the above goes away if the 2008 proposed 460 regulations are finalized.