DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Large and Mid-Size
Business Division

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MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTOR, FIELD SPECIALISTS, LMSB
DIRECTOR, INTERNATIONAL COMPLIANCE, STRATEGY AND POLICY, LMSB
DIRECTOR, PRE-FILING AND TECHNICAL GUIDANCE, LMSB
DIRECTORS, FIELD OPERATIONS, NATURAL RESOURCES AND CONSTRUCTION

FROM: Keith M. Jones */s/ Keith M. Jones*
Director, Natural Resources and Construction

SUBJECT: Industry Director's Directive #2 Super Completed Contract Method

This memorandum is issued to update and supersede the first Industry Director's Directive on the Super Completed Contract Method (SCCM) of accounting (LMSB-04-0207-012) issued March 13, 2007. It also provides direction in examinations involving use of the SCCM in the residential construction industry. SCCM is an LMSB Tier II Issue.

The completed contract method (CCM) of accounting is a tax method used in the construction industry allowing taxpayers to defer the recognition of income and expenses until the contract is completed. The CCM may be used for only two types of contracts: (1) Home construction contracts and (2) other construction contracts that the taxpayer estimates (when entering into the contract) will be completed within 2 years of the contract commencement date, provided the taxpayer satisfies the $10,000,000 gross receipts test in Treasury Regulation § 1.460-3(b)(3).

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Issues

It frequently takes many years to complete large residential communities. Some taxpayers are improperly using the CCM to defer income from land sales, home sales and subcontract work as many as 15 or more years into the future. A sale of one of these homes by the initial purchaser could be a taxable transaction long before the land developer recognizes income from the initial sale of the lot on which the home is built.

Taxpayers' misuse of the CCM is a growing trend within the residential construction industry. The scenarios which follow illustrate these two misuses.

- 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).

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

The issue in the following scenarios is whether the taxpayers may use CCM for their contracts and, if so, when a contract is considered completed.

Scenario 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.

Scenario 2 The taxpayer is a subcontractor hired by the land developer to do clearing and grading and to construct roadways, sidewalks, utilities 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 and defers recognition of the income and expenses until the entire contract has been completed.

Scenario 3 The taxpayer establishes two partnerships which it controls. One develops the land, and the other builds homes.

(a) 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.

(b) 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.

Scenario 4 A homebuilder "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. 92-29 for its project-by-project basis for determining when a contract is completed under CCM.

Scenario 5 A homebuilder 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 percent complete because the allocable portion of the common improvement keeps the completion factor for each home to less than 95 percent.

LMSB Position

Regarding scenarios 1, 2 and 3(b), a contract for the construction of only common improvements is not a home construction contract. In appropriate circumstances, the severance rules under IRC §460 may apply.

Regarding scenarios 3(a), 4 and 5, the issue is when the contract is considered completed. The current LMSB position is that, ordinarily, as each home is sold the contract is considered completed and accepted, and income and expenses are recognized under the CCM. In addition, the project-by-project method is an improper aggregation of individual contracts, and the subject matter versus secondary items issue should be addressed.

Regarding scenario 4, when examining the project-by-project issue, examiners should make appropriate adjustments and, if appropriate, apply penalties.

Proposed Regulations

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.

Conclusion

This directive continues to be in effect for these SCCM issues identified during examinations. When examiners discover deferral issues, they should follow LMSB's position described above. Since the timeframe of the issuance of final regulations and the anticipated additional guidance regarding severance and completion is uncertain, the Industry Director, to conserve examination resources, provides guidance on examinations of taxpayers that are permitted to be on the completed contract method (i.e. Scenarios 3(a), 4, and 5). Revenue agents generally should limit examinations of this issue to contract deferrals that extend beyond two tax years after the contract is entered into. This scope limitation is intended to provide guidance as to what contracts will be examined and does not provide taxpayers a deferral of income for two years. This scope limitation does not apply to taxpayers described in Scenarios 1, 2, and 3(b) since they are not permitted to be on the completed contract method.

The improper use of CCM by a residential land developer, homebuilder or a subcontractor to a residential land developer or homebuilder should ordinarily be raised as an audit issue, which will ensure consistency and prevent widespread use of improper methods.

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Audit Techniques

During the initial stages of the examination, the examiner should determine the fact pattern of the issue and obtain the contracts between the land developer and home builder, home builder and home buyer, and any other contracts that provide contractual obligations for common improvements that are to be provided.

In the case of a taxpayer that is eligible to use CCM but is improperly postponing when a contract is considered completed, the examiner should do the following:

- Obtain a list of all contracts that were completed. For a homebuilder the list should contain all homes that have been sold to date.
- Determine whether the taxpayer treated the contracts as completed during the years being examined.
- Document when title is passed from the builder to the homeowner.

- Request any contracts which provide contractual obligations for the taxpayer to construct common improvements (i.e., with Home Owners Association, municipalities, etc.).

- Document the method of accounting used for book purposes compared to tax purposes.

- Base the examination adjustment on those homes that the taxpayer has not treated as completed under CCM.

In the case of a taxpayer that is ineligible to use CCM but is using it nevertheless, the examiner should do the following:

- Obtain a list of all such contracts that were incomplete during any portion of the years being examined.

- Obtain copies of any contracts between the taxpayer and its customers.

- Document how the taxpayer bills and receives payment (e.g., by unit, by phase, etc.)

- Determine whether there are any contingencies or restrictions placed on payments received by the taxpayer.

- Document the method of accounting used for book purposes compared to tax purposes.

- Ascertain whether a change in method of accounting is required.

Attached are these pro forma Forms 4564, Information Document Request (IDR), and 5701, Notice of Proposed Adjustment:

Attachment 1, Pro forma IDR for Subcontractor Only Providing Common Improvements within a Residential Community (Scenarios 1 and 2)

Attachment 2, Pro forma Form 5701 for Subcontractor Only Providing Common Improvements within a Residential Community Not Allowed CCM (Scenarios 1 and 2)

Attachment 3, Pro forma Form 5701 for Land Developer Deferring Sales of Improved Lots under CCM Until the Entire Development is Complete (Scenario 3(b))

Attachment 4, Pro forma IDR for Deferral of Home Sales Until 95 Percent of Costs Are Incurred When an Uncompleted Common Improvement is the Primary Factor Preventing the 95 Percent Test from Being Met (Scenario 5)

Attachment 5, Pro forma Form 5701 for Homebuilder Deferring Sales of Home and/or Lot Until 95 Percent Completion (Scenario 5)

Contact

If you have any questions, please contact the Construction Technical Advisor.

Issue Tracking

UIL Codes: 460.04-00 Exception for Certain Construction Contracts
460.04-01 Home Construction Contract Exceptions

SAIN: 707 Accounting Methods

Second Tier SAIN: 360 Completed Contract Method

Project Code: 0539

ERCS Tracking Code: 0539

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Attachments (5)

cc: Commissioner, LMSB
Deputy Commissioner, Operations, LMSB
Deputy Commissioner, International, LMSB
Director, Planning, Quality, Analysis & Support, LMSB
Director, Research & Workload Identification, LMSB
Division Counsel, LSMB
Chief, Appeals
Commissioner, SBSE
www.IRS.gov

Attachment 1

Pro Forma IDR for Subcontractor Only Providing Common Improvements within a Residential Community

Please provide the following information for each development for which you are providing construction activities:

1. Identify, by name, each separate development to which you provided construction activities during the tax year(s) under examination.
2. List the year that you began construction activities within each development and the estimated date of completion.
3. Describe, in general, all the construction activities that are to be provided by you in each development.
4. Copies of the contract, any amendments, and change orders between you and the party that hired you to provide these construction activities for each development.
5. Schedule of all direct and indirect costs incurred to date that details the allocation to each subcategory of work performed within each development (for example, street in Phase I, utilities in Phase I, golf course, club house, sidewalks Phase I, etc.).

Attachment 2

Pro Forma 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 entered into a single contract for the entire development. 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

IRC §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). IRC §460(e)(1)(A) provides an exception from the general rule requiring use of the percentage of completion method for "any home construction contract." IRC §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 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 activities referred to in paragraph (4) with respect to —
>
> (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
>
> (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 IRC §460(e)(6)(A), dwelling unit is defined at IRC §168(e)(2)(A)(ii) as "a house or apartment used to provide living accommodations in a building or structure * * *." Treas. Reg. §1.460-3(b)(2) further defines a home construction contract as follows:

(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 row houses. — 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.

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.

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 IRC §460(a), the taxpayer is required to use the percentage of completion method.

Attachment 3

Pro Forma 5701 for Land Developer Deferring Sales of Improved Lots under CCM Until the Entire Development is Complete

Issue

Are contracts between the taxpayer's Developer Partnership and Home Builder Partnership for the sale of residential lots "home construction contracts" as described in §460(e)(6) of the Code?

Facts

A consolidated group of corporations is involved in developing large master planned residential communities. In an effort to effectively manage these large developments, two partnerships are formed: a Developer Partnership (the taxpayer) and a Home Builder Partnership. The taxpayer purchases the tract of land, obtains approvals, permits, required zoning, and builds the roads and other improvements. The lots are sold to the Home Builder Partnership who eventually builds homes on the improved lots. The completed homes are then sold to unrelated third parties. The taxpayer and the Home Builder Partnership are wholly owned by members of a consolidated corporate group.

The taxpayer enters into a single contract with the Home Builder Partnership. In addition to the sale of the real estate, the taxpayer is required to provide paved roads, curbs, gutters, and utilities (up to the perimeter of the lots) to service the lots. The sale of the real estate to the Home Builder Partnership is determined on an annual "take-down" schedule in which a specific number of lots are sold to the Home Builder Partnership each year.

The taxpayer does not build houses or dwelling units in the communities. The Home Builder Partnership and its subcontractors build the dwelling units in the communities.

During the years under examination, at the time of the sale of lots to the Home Builder Partnership, the taxpayer has not completed all the lot improvements or common improvements that are required to be provided within the community. The estimated construction costs to be provided by the taxpayer exceed 10 percent of both total contract price and the contract price on a lot-by-lot basis. Therefore, the taxpayer's contracts are long-term construction contracts. The contract does not meet the *de minimis* construction activities standards defined in Treas. Reg. §1.460-1(b)(2)(ii).

For tax purposes, the taxpayer has adopted the completed contract method under the premise that the single contract with the Home Builder Partnership is a home construction contract. The taxpayer is deferring the income recognition on the sale of all the lots until the date of final completion of its obligations under the contract and acceptance by the Home Builder Partnership of the improved lots even though many of

these lots have already been sold to unrelated third parties. For financial statement purposes, the taxpayer defers the sale of the lots until the lot is sold outside of the controlled group (i.e., sold by the Home Builder Partnership to an unrelated third party).

Law and Argument

IRC §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).

IRC §460(e)(1)(A) provides an exception from the general rule requiring use of the percentage of completion method, namely "any home construction contract."

IRC §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 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 activities referred to in paragraph (4) with respect to —
>
> (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
>
> (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 IRC §460(e)(6)(A), dwelling unit is defined at IRC §168(e)(2)(A)(ii) as "a house or apartment used to provide living accommodations in a building or structure * * * ." Treas. Reg. §1.460-3(b)(2) further defines a home construction contract as follows:

> (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 row houses. — 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.

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 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 costs of common improvements (required by law or by the contract) in the costs 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 solely because the cost of common improvements required by the contract is more than 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.

Conclusion

Because the taxpayer's contract for the development and sale of lots is not a home construction contract, the taxpayer may not use the completed contract method of accounting but must use the percentage of completion method of accounting to report income and costs.

Attachment 4

Pro Forma IDR for Deferral of Home Sales Until 95 Percent of Costs are Incurred When an Uncompleted Common Improvement is the Primary Factor Preventing the 95 Percent Test from Being Met

For **each** development, project or community that has deferral of any home sales for tax purposes because 95 percent of the costs have not been incurred, provide the following information:

1) Name of development.
2) Total number of lots to be developed.
3) Year the development is expected to be completed.
4) Total number of homes built and sold by you as of the end of the tax year(s) under examination. Include the gross amount of these sales for each year and the amount deferred for tax purposes each year.
5) Total number of lots sold by you, without the construction of a home, as of the end of the tax year(s) under examination, and total dollar amount of these sales for each year and the amount deferred for tax purposes each year.
6) Description of how each of the following costs are allocated to each individual home/lot:
    a) Land cost (both direct and indirect)
    b) Building costs (both direct and indirect)
    c) Common improvements (both direct and indirect)
7) Description of each common improvement that you are contractually obligated or required by law to provide for the development.
8) Description of the document evidencing the contractual obligation or requirement of law and a description of the nature of the obligation contained in the document.
9) Identification of the person(s) to whom you are contractually obligated or required by law to provide common improvements.
10) Estimated cost of each common improvement and manner in which the estimate was made.
11) Portion of the estimated cost of common improvements allocable to each home/lot and description of the manner in which the estimated cost was allocated to each lot if not described in item 6, above.
12) The estimated date production will begin on each common improvement and estimated date of completion of each common improvement.
13) Schedule showing the following information with regard to each common improvement:
    a) Total cost of the common improvement incurred as of the beginning of the tax year under examination.
    b) Total cost of the common improvement incurred during the tax year under examination.
    c) Total estimated cost of the common improvement to be incurred after the tax year under examination.

14) Schedule showing the following information with regard to each home/lot sold during the year and home/lots still owned by you as of the end of the tax year:
    a) Total cost of each home/lot incurred as of the beginning of the tax year under examination.
    b) Total cost incurred for the direct land and building during the tax year under examination.
    - Total cost incurred for common improvements during the tax year under examination.

Attachment 5

Pro Forma 5701 for Homebuilder Deferring Sale of Home and/or Lot Until 95 Percent Completion

Issue

May a taxpayer defer the income from the sale of a constructed home because he includes the allocable costs of common improvements in the 95 percent completion computation under Treas. Reg. §1.460-1(c)(3)(A)?

Facts

The taxpayer bought a tract of land with the intent to subdivide the property and construct single family homes. The taxpayer entered into a long-term construction contract to build a particular home for a buyer. The taxpayer properly elected the completed contract method of accounting for its exempt long-term construction contracts. The taxpayer also was contractually obligated to provide common improvements within the tract of land where the homes are to be constructed. At the time of closing, when title to the home was transferred to the buyer, the taxpayer received the full contract price. However, not all common improvements had been constructed by the taxpayer at the time of closing.

An example of the cost allocation of a particular home, at the time of sale, is shown below:

Allocable contract cost incurred on the lot (underlying land)	$ 50,000
Allocable contract cost incurred on the construction of the home	300,000
Allocable contract cost incurred on common improvements	20,000
Allocable contract cost to be incurred on common improvements	30,000
Total estimated contract cost	$ 400,000

At the time the home was sold, $370,000 of the allocable contract costs had been incurred, which is 92.5 percent of the total estimated allocable cost of the contract. The taxpayer asserts that the above computation allows the taxpayer to defer income from the sale of the home until the 95 percent threshold for completion is met, per Treas. Reg. §1.460-1(c)(3)(A).

Law and Argument

IRC §460(a) generally requires the use of the percentage of completion method of accounting for long-term contracts. IRC §460(e)(1)(A) provides exceptions to the general rule requiring use of the percentage of completion method, including one applicable here, for “any home construction contract." Treas. Reg. §1.460-4(c)(1) provides permissible exempt construction contract methods such as the completed

contract method (CCM) used by this taxpayer. Treas. Reg. §1.460-4(d)(1) states that, in general, "a taxpayer using the CCM to account for a long-term contract must take into account in the contract's completion year, as defined in §1.460-1(b)(6), the gross contract price and all allocable contract costs incurred by the completion year."

Treas. Reg. §1.460-1(b)(6) defines "completion year" as "the taxable year in which a taxpayer completes a contract as described in paragraph (c)(3) of this section." Treas. Reg. §1.460-1(c)(3) defines contract completion as follows:

> (i) In general. — A taxpayer's contract is completed upon the earlier of —
>
> (A) Use of the subject matter of the contract by the customer for its intended purpose (other than for testing) and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or
>
> (B) Final completion and acceptance of the subject matter of the contract.
>
> (ii) Secondary items. — The date a contract accounted for using the CCM is completed is determined without regard to whether one or more secondary items have been used or finally completed and accepted. If any secondary items are incomplete at the end of the taxable year in which the primary subject matter of a contract is completed, the taxpayer must separate the portion of the gross contract price and the allocable contract costs attributable to the incomplete secondary item(s) from the completed contract and account for them using a permissible method of accounting. A permissible method of accounting includes a long-term contract method of accounting only if a separate contract for the secondary item(s) would be a long-term contract, as defined in paragraph (b)(1) of this section.

In other words, the contract is completed the earlier of the date when (1) the taxpayer incurs 95 percent of the costs of the subject matter and the customer uses the subject matter as intended, or (2) the taxpayer completes the subject matter and the customer accepts it. The question is whether the "subject matter" includes common improvements.

When issuing the current regulations, the Treasury Department intended that the test for contract completeness reflect the substance of the transaction and discourage the use of formalities that would unreasonably delay a contract's completion. See "Accounting for Long-Term Contracts," 66 Fed. Reg. 2219, 2220 (Jan. 11, 2001).

Accordingly, Treas. Reg. §1.460-1(c)(3)(ii) plainly states that the taxpayer must separate secondary items that are incomplete "at the end of the taxable year in which the primary subject matter of a contract is completed * * * ." Under our facts, the

"primary subject matter" of the contract is the home which the taxpayer completed. The sale closed, and title was delivered to the buyer, with the taxpayer receiving the full contract price by the end of the taxable year. The contract is for the sale and construction of a home. Any common improvements that the taxpayer is contractually obligated to provide are neither separately priced in the contract nor are they subject to a separate acceptance by the customer, which further supports the position that the construction of the home is the primary subject matter of the contract. Collectively, the common improvements benefit all the parcels in the tract of land and not just this one parcel or home. The subject matter of the contract is the construction of a home.

The final question is whether at least 95 percent of the costs "attributable to the subject matter" have been incurred by the taxpayer. Since the subject matter is the construction of the home, the taxpayer must omit the allocable costs of common improvements from this computation because they are not the primary subject matter of the contract under Treas. Reg. §1.460-1(c)(3)(ii). Consequently, the taxpayer has incurred more than 95 percent of the costs and, together with the customer's use of the house for its intended purpose, has satisfied the first test for contract completion under Treas. Reg. §1.460-1(c)(3)(i)(A). This reflects the substance of the transaction and discourages the abuse of income deferral, consistent with the intent of the Treasury Department when promulgating the regulation.

Further, the contract is complete because final completion and acceptance of the subject matter of the contract has occurred, meeting the second alternative test of Treas. Reg. §1.460-1(c)(3)(i). The full contract price paid for the home is received by the taxpayer upon the closing of the home. Also, title passes and the customer has use of the home for its intended purpose: the home can be used as a dwelling unit, which satisfies part of the first alternative test in the regulation. The use of the home is neither dependent upon nor impaired by the uncompleted common improvements (e.g., pool, clubhouse, etc.), which must be considered secondary items.

The taxpayer argues that these authorities support the position that the common improvements are part of the subject matter of the contract:

1. Example 4 of Treas. Reg. §1.460-1(j)
2. *Ball, Ball and Brosamer, Inc. v. Commissioner*, 964 F.2d 890 (9th Cir., 1992), *aff'g.* T.C. Memo. 1990-454
3. The definition of a home construction contract in Treas. Reg. §1.460-3(b)(2)(iii).

In Example 4 of Treas. Reg. § 1.460-1(j), the taxpayer agreed to construct a shopping center with an adjoining parking lot. By the end of the taxable year in issue, the customer began using the retail portion of the shopping center, but not a portion of the parking lot because it was not finished. Allocable contract costs for the unfinished portion exceeded 5 percent of "total allocable contract costs attributable to the subject matter." The parking lot is not a common improvement. The use of the retail shopping center is dependent upon the use of a parking lot by its customers. Without ample parking, the taxpayer's customer is unable to attract the capacity of business that the retail shopping center can accommodate. This example would more appropriately

parallel a home with an unfinished driveway when the customer moves in. Under a construction contract, the contractor's failure to perform its obligation would prevent the customer from using the subject matter for its intended purpose. The extension of Example 4 to common improvements that may be located blocks or even miles away is without merit.

The taxpayer also argues for the application of *Ball, Ball and Brosamer, Inc.*, where the court applied a facts and circumstances analysis under the now obsolete Treas. Reg. §1.451-3(b)(2) to conclude that minor unfinished work precluded final completion and acceptance of the contract. Prior to the issuance of the current regulations under §460, final completion and acceptance was the only test for contract completion, determined by facts and circumstances. (See the now obsolete Treas. Reg. §1.451-3(b)(2).). For contracts entered into after January 10, 2001, the new regulations define completion by providing a test that explicitly differs from that applied in *Ball, Ball, and Brosamer, Inc.* A contract is now deemed complete on the earlier of when the customer uses the subject matter of that contract and the taxpayer has incurred at least 95 percent of the total allocable costs attributable to the subject matter, or when the taxpayer has completed the subject matter and the customer has accepted it. Further, the subject matter in either test is the primary subject matter, the home. See Treas. Reg. §1.460-1(c)(3). Without agreeing with the way the court applied the final completion and acceptance test in *Ball, Ball and Brosamer, Inc*., the Treasury Department issued the new alternative test for contract completeness in order to ensure that the completion date comports with the substance of the transaction. See "Accounting for Long-Term Contracts," 66 Fed. Reg. 2219, 2220 (Jan. 11, 2001).

Finally, the taxpayer cannot rely on the definition of a home construction contract in Treas. Reg. §1.460-3(b)(2)(iii) for the inclusion of common improvements in the cost of the dwelling units for purposes of contract completion. IRC §460(e)(6)(A) defines a home construction contract:

> 460(e)(6)(A) HOME CONSTRUCTION CONTRACT. — 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 activities referred to in paragraph (4) with respect to —
>
> (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
>
> (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.

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 row houses. — 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.

Under this regulation, inclusion of common improvements in the cost of the dwelling units qualifies many homebuilding contracts as “home construction” contracts when the cost of the common improvements exceeds 20 percent of the allocable contract costs. Thus, these homebuilders may use the CCM for large, master planned communities that provide extensive common improvements such as golf courses, pools, tennis courts and schools.

Whether or not the taxpayer has a home construction contract is not at issue. The Service agrees that the taxpayer’s contract meets the definition of a home construction contract; therefore, the completed contract method is a proper method for its long-term construction contracts. The issue is when the contract is considered complete for tax reporting purposes. While the “common improvements” subparagraph in Treas. Reg. §1.460-3(b)(2) above adds to the definition of a “home construction contract,” Treas. Reg. §1.460-1(c)(3), on the other hand, excludes common improvements from the definition for “contract completion.” The latter regulation specifies that only allocable costs “attributable to the subject matter” of the contract are includible in the 95 percent computation towards contract completion, and, as previously discussed, the regulation explicitly provides that only the primary subject matter be considered in the determination of the completion date. Construction of the home is the primary subject matter of the contract, not common improvements. The common improvement

computation in determining the question of whether a home construction contract exists in Treas. Reg. §1.460-3(b)(2)(iii) does not apply when determining contract completion.

Conclusion

Under these facts, the taxpayer cannot defer the completion of the contract until the completion of a future common improvement. The contract is completed in the year in which either (1) 95 percent of the total allocable contract costs of the primary subject matter of the contract, the home, have been incurred, and the home is being used by the customer for its intended purpose, or (2) the home is completed and accepted by the customer, whichever of these two tests is met first.