CONSTRUCTION EXECUTIVE

Conflict in Court Over Income Recognition for Construction Contractors

Posted @ 6/12/2017 6:51 AM By **Barry A. Fischman and Michael D'Addio**
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The 9th Circuit Court's review of how construction contractors should recognize income had a somewhat surprising outcome. The key question being considered was: When should developers recognize income under the completed contract method? Is it when the entire project is complete, is it on percentage of completion, or is it upon the sale of each individual home sold?

Shea Homes, which used the completed contract method to account for its planned development communities, claimed that final completion and acceptance under Reg. 1.460-1(c)(3) did not occur until the last road was paved and the final bond was released. However, the Internal Revenue Service (IRS) contended that final completion took place upon the sale of each home.

In 2014, the Tax Court ruled that developers of large planned residential communities properly used the completed contract method of accounting to report their income. It also held that income recognition could be deferred until the improvements and amenities were substantially completed. Income was not required to be recognized on the sale of each individual unit. Furthermore, the fact that the improvements would not be completed in the year that a contract for the sale of home was entered into made each contract a "long-term contract."

Two years later, the 9th Circuit rejected the IRS appeal in the Shea Homes Inc. v. Commissioner case and concurred with the Tax Court.

As a result of this case, the IRS issued Action on Decision (AOD) 2017-03, AOD 2017-15 and Internal Revenue Bulletin (IRB) 1072 expressing its nonacquiescence with the Tax Court and 9th Circuit Court decisions.

EXISTING REGULATIONS AND GUIDELINES

IRC section 460 provides that accounting for long-term contracts must generally be done on the percentage of completion method. IRS sec 460(f)(1) defines a long-term contract as "any contract for the manufacture, building, installation or construction of property if such contract is not completed within the tax year in which the contract is entered into." However, certain exceptions apply to the mandatory use of the percentage of completion method, including a "home construction contract." This exception permits a taxpayer to use the completed contract method under which revenue is not recognized until the contract is completed.

A home construction contract means 80 percent or more of the estimated total contract costs

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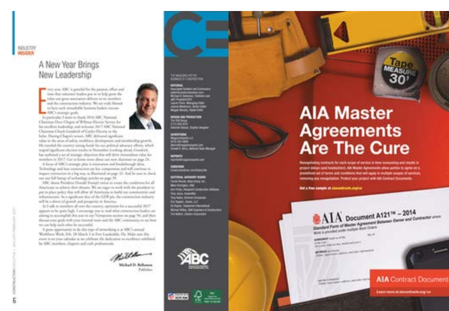

are reasonably expected to be attributable to building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvement of real property with respect to:

- dwelling units contained in buildings with four or fewer dwelling units; and
- improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

In determining a home construction contract, regulation section 1.460-3(b)(2)(iii) provides a taxpayer can include in the costs of the dwelling units the allocable share of the cost that the taxpayer reasonably expects to incur for common improvements (e.g., sewer, roads, clubhouses) that benefit the units.

There is no statutory definition of "completion" (determined on a per contract method) for the completed contract method. However, regulation section 1.460-1(f) provides that a contract is completed when it satisfies of the following tests.

- Use and 95 Percent Completion Test: upon use of the subject matter of the contract by the customer for its purpose and at least 95 percent of total allocable contract costs related to the subject matter have been incurred.
- Final Completion and Acceptance Test: upon final completion and acceptance (based on all facts and circumstances.)

The Facts of the Case
In 2004 and 2005 Shea Homes Inc. (SHS), Shea Homes Limited Partnership (SHLP) and Vistancia LLC sold homes in 114 developments that were advertised to provide the buyer with more than "bricks and sticks" of a home—emphasizing a "live well, work well, play well" lifestyle.

Costs included in the home construction businesses were land acquisition, financing, municipal and other regulatory approvals of entitlements, construction of infrastructure, construction of amenities, construction of homes, marketing, bonding, site supervision and overhead, and taxes.

SHS, SHLP and Vistancia constructed the developments in a particular sequence: grading land, initial construction of amenity and infrastructure common improvements, construction of homes, and construction and finalization of any remaining common improvements. They charged a single price for the property with no separate price for the home, lot, improvements, etc. The contract with the buyer identified the home as the subject matter of the contract. However, depending on the state in which the property was located, additional documents were required to protect the buyer.

- Arizona required buyers to acknowledge reading a copy of the developer's public report before signing the sales contract.
- California required the purchase contracts to include a form as evidence of the buyer's receipt of the public report.
- The public reports identified the developments' common areas and improvements, along with the anticipated completion dates and assurances of completion.
- The developments were covered by declarations of covenants, conditions and restrictions (CC&Rs), under which each homeowner automatically became a member of the development's homeowner association. The CC&Rs required a transfer of the improvements to the homeowner's association.

Before SHS, SHLP and Vistancia could close escrow on a home, they were required to either have completed the common improvements for the development or post a bond. This means that some property closings occurred prior to completion of homeowner improvements and amenities.

The taxpayer's position was the transfer must be considered to include rights in the improvements and ancillary benefits as part of what was to be transferred. The "contract" had to include the improvements in determining it was long term (and eligible for the completed contract method). Additionally, the 95 percent test should take into account the related common improvements (which was the method used by the taxpayer's accounting department). Consequently there was no "completion" on the closing of dwelling units until the common improvements were finished.

The IRS's position was the cost of the improvements should not be included in the tests to determine date of completion because the subject matter of the contract was the home and not the ancillary improvements. The contract between the parties mentioned only the home. The improvements were "secondary items," which are not considered under both completion tests.

Under this position, most of the homes would not be long-term contracts because they were completed in the same year in which the contract was entered. Consequently, the completed contract method should not apply to these units. Moreover, where long-term contract status did apply, the contract would be complete on the close of escrow for the sale of each home.

The IRS said that the allocable share of home improvements should be applied solely for the purpose of determining "home construction" status and not for the method of determining income recognition.

According to the Tax Court's analysis, the contracts involved more than just the homes. Under Arizona, California and Colorado state law, a contract can incorporate other documents by reference. The sales contracts referenced the public reports of the development, which referenced the obligation to complete the common improvements and amenities. The purchasers were aware of the amenities and understood that the price included the right to use them. The purchaser could have purchased a comparable home without a community for less. The use of bonds, imposed by state law to secure the requirement to finish the improvements, provides further evidence of this connection. State law takes a more expansive view of real estate to include common improvements as part of the item transferred.

Additionally, the regulations provide that the subject matter of a home construction contract can extend beyond the mere building of the dwelling unit. The improvements and amenities were an important part of the contracts and an essential element to the developer's marketing plan.

THE 9TH CIRCUIT DECISION

The IRS changed its argument a bit before the Appellate Court. It conceded that the Tax Court correctly held that the subject matter of the home construction contracts was more than just the individual house and lot purchased. It includes the common improvements of the planned community development, which are contractually obligated to be constructed. However, the developer applied the 95 percent test to determine completion by considering all of the budgeted costs for the entire community, including all of the houses. The IRS argues that the 95 percent test should be satisfied when 95 percent of the budgeted costs of the contracted-for house, lot and common amenities have been incurred—but should exclude the costs of the other houses.

The appellate court denied the IRS's appeal. The judges noted that the IRS was making an argument that had not been presented to the trial. Under significant court precedent, if there were trial court errors with respect to this matter, it was the IRS's responsibility. This was a sufficient reason for a finding in favor of the taxpayer for one of the judges in the concurring opinion.

Two of the three judges addressed this matter directly and stated that the buyers had an interest in the completion of the entire development and they were not merely certain amenities.

The IRS disagrees with the court decisions, but there was some positive movement in the IRS position during the course of the trials. In the Tax Court case, the IRS argued that the contract (for determining long-term contract status and 95 percent completion) was the particular lot and house under contract. The common improvements were only secondary to the contract and the construction of other homes should be ignored.

In the Appellate Case, the IRS conceded that the subject matter of the home construction contract of the taxpayer was more than merely the particular dwelling unit being purchased. The IRS agreed that it should include an allocable share of the common improvements. However, the IRS believes the costs of the other houses in the development should be excluded.

In the big picture, this is a generally positive case for taxpayers. However, it must be noted that both courts looked to the specifics of the case and the way that the improvements were connected to the home sales under the marketing strategy of the seller, the contractual language and state law. A different result could occur where there is not such a strong connection.

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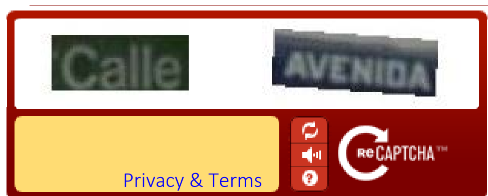

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