

LB&I Concept Unit

Knowledge Base – Corporate/Business Issues & Credits

Library Level	Number	Title
Shelf		Accounting Issues
Book	213	Long-Term Contracts
Chapter	1	Long-Term Contracts - Construction
Section		

Unit Name	Land Developers and Subcontractors - Proper Method of Accounting	
Primary UIL Code	460.04-00	Exception for Certain Construction Contracts

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General Overview

Land Developers and Subcontractors - Proper Method of Accounting

NOTE: This Practice Unit was updated to incorporate changes due to the Tax Cuts and Jobs Act for tax years beginning after 12/31/2017. This Practice Unit supersedes the 9/21/17 Unit with the same title and DCN MAT/C/71_02_01_03-02.

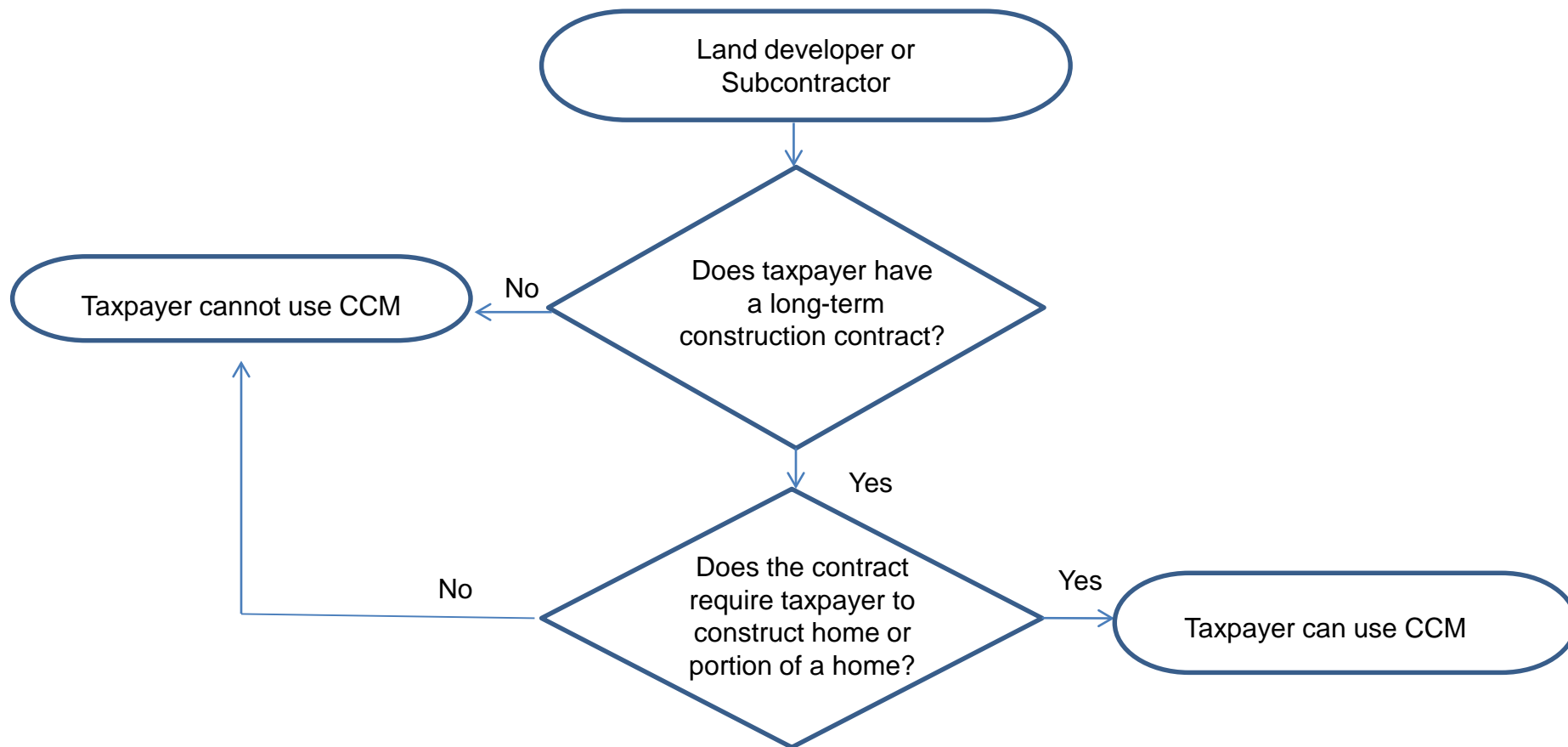
The completed contract method of accounting (CCM) is unique to the construction industry. It is generally considered the preferred method of accounting because it allows taxpayers to defer the recognition of income and expenses until the year a contract is completed. The completed contract method is a permissible method for home construction contracts and small construction contracts.

Land developers and the subcontractors they hire to construct the common improvements (e.g., water lines, utilities, roads, sewers, parks) may be taking the position that their contracts are home construction contracts even though they do not construct any homes. In general, taxpayers are required to use the percentage of completion method (PCM) for these contracts.

Diagram of Concept

Land Developers and Subcontractors - Proper Method of Accounting

Diagram of Concept*



* The diagram does not apply to small construction contracts

Detailed Explanation of the Concept

Land Developers and Subcontractors - Proper Method of Accounting

General Rule and Exceptions

Analysis	Resources
<p>The general rule is that taxpayers must compute the taxable income from long-term contracts using the PCM. See Internal Revenue Code (IRC) 460(a).</p> <p>There are two exceptions to the required use of the PCM that allow a taxpayer to elect the CCM for long-term contracts, they are:</p> <ol style="list-style-type: none">1. any home construction contract, and2. any other construction contract where the taxpayer estimates (when entering into the contract):<ul style="list-style-type: none">- completion of the contract within 2 years and- the average annual gross receipts for the 3 taxable years preceding the taxable year the taxpayer enters into the contract do not exceed \$25 million or less (\$10 million or less for tax years beginning prior to January 1, 2018). <p>If the land developer or subcontractor meets either exception, the CCM is a permissible method of accounting.</p> <p>See IRC 460(e) and Treasury Regulation (Treas. Reg.) 1.460-3(b).</p>	<ul style="list-style-type: none">▪ IRC 460(a) - <i>Requirement That Percentage of Completion Method Be Used</i>▪ IRC 460(e) - <i>Exception for Certain Construction Contracts</i>▪ Treas. Reg. 1.460-3(b) - <i>Exempt Construction Contracts</i>

Detailed Explanation of the Concept (cont'd)

Land Developers and Subcontractors - Proper Method of Accounting	
Analysis	Resources
<p>In general, taxpayers in the construction industry prefer to use the CCM because it defers the recognition of income and expenses until the year of completion. See Treas. Reg. 1.460-4(d).</p> <p>The taxpayer's contract qualifies as a home construction contract if 80% or more of the total estimated costs (as of the close of the taxable year in which the taxpayer entered into the contract) under a contract are attributable to the construction of both:</p> <ul style="list-style-type: none">▪ a dwelling unit, and▪ improvements to real property directly related to that dwelling unit. <p>Land developers, in addition to purchasing and preparing the land for residential development, typically provide common improvements that benefit more than one parcel of land (e.g. water lines, utilities, roads, sewers, parks).</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.460-4(d) - <i>Completed-contract Method</i>▪ IRC 460(e)(6)(A) - <i>Home Construction Contract</i>

Detailed Explanation of the Concept (cont'd)

Land Developers and Subcontractors - Proper Method of Accounting

Analysis

The Internal Revenue Service (IRS) has consistently taken the position that a land developer would need to construct homes, in addition to improvements, in order to meet the definition of a home construction contract:

- A land developer constructing dwelling units includes the cost of common improvements in the dwelling unit costs for the 80% test. See Notice 89-15, Question & Answer 43 and 44.
- Neither the land developer nor the subcontractor constructing common improvements have a home construction contract, since they are not also constructing a home. See 2003 IRS Non-docketed Service Advice Review (NSAR) 20006.
- “The plain intent of the statute is to provide the more favorable CCM of accounting to only taxpayers actually building homes. Hence the term home construction contract.” See Technical Advice Memorandum (TAM) 200552012.

Resources

- Notice 89-15 - Guidance is provided to IRC 460 relating to accounting for long-term contracts
- 2003 IRS NSAR 20006 - Definition of Home Construction Contracts
- TAM 200552012 - Land sale contracts are not home construction contracts

Detailed Explanation of the Concept (cont'd)

Land Developers and Subcontractors - Proper Method of Accounting

Analysis

In 2014, the Tax Court in *Howard Hughes Company, LLC v. C.I.R.* upheld the Service's position that the taxpayer, a land developer, did not have home construction contracts. The Tax Court found that the intended beneficiaries of the home contract exception were taxpayers involved with the actual construction of the homes. Even though their developmental work paves the way for and facilitates home construction, land developers were not permitted to use CCM if they were not also constructing homes. The taxpayer appealed the Tax Court's decision and the Service's position was upheld by the 5th Circuit.

In TAM 201650014, issued subsequent to the *Howard Hughes* decision, the IRS permitted a taxpayer to use the CCM for contracts that required the grading and soil compaction of an individual lot where the foundation of a home would be constructed. This TAM appears to contradict the *Howard Hughes* decision. However, the work done was on a lot-by-lot basis as opposed to common improvements that benefit more than one unit of property. The grading and soil compaction were specific to each lot based upon the structure to be built and were covered by home warranties. The TAM is based on a very narrow set of additional, specific facts and circumstances. It is important to note that TAMs cannot be relied upon by another taxpayer or cited as precedent.

Resources

- *Howard Hughes Company, LLC. V C.I.R.*- 142 T.C. 355 (2014)
- *Howard Hughes Company, LLC. V Commissioner* - 805 F.3d 175 (5th Cir. 2015)
- TAM 201650014 - Compaction of soil for the foundation of a home qualified as home construction contract

Detailed Explanation of the Concept (cont'd)

Land Developers and Subcontractors - Proper Method of Accounting	
Analysis	Resources
<p><u>Changes in Method of Accounting</u></p> <p>For tax purposes, income recognition related to long-term contracts under IRC 460 is a method of accounting. See Treas. Reg. 1.460-4(g).</p> <p>If you determine that a taxpayer is not permitted to use the CCM, you should initiate an “involuntary” (or Service-imposed) change in accounting method. You should impose the change in method of accounting with an IRC 481(a) adjustment. See Revenue Procedure (Rev. Proc.) 2002-18 Guidance for Service-imposed Change in Accounting Methods.</p> <p>Any taxpayer who wishes to change to or from the CCM must file an application for a change in accounting method (Form 3115) using the voluntary method change consent procedures in Rev. Proc. 2015-13. The regulations also state that any voluntary long-term contract change in accounting method must be made on a cut-off basis rather than using an IRC 481(a) adjustment. Accordingly, any voluntary method change under IRC 460 will be applied to contracts entered into on or after the first day of the year of change.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.460-4(g) - <i>Method of Accounting</i> ▪ IRC 481(a) - Adjustments Required By Changes in Method of Accounting General Rule ▪ Rev. Proc. 2002-18 - <i>Changes in Method of Accounting; Examinations</i> ▪ Rev. Proc. 2015-13 - <i>Changes in Accounting Periods and in Methods of Accounting</i> ▪ Form 3115 - <i>Application for Change in Accounting Method</i> ▪ Form 3115 Instructions

Index of Referenced Resources

Land Developers and Subcontractors - Proper Method of Accounting

IRC 460(a) - *Requirement That Percentage of Completion Method Be Used*

IRC 460(e) - *Exception for Certain Construction Contracts*

IRC 460(e)(6)(A) - *Home Construction Contract*

IRC 481(a) - *Adjustments Required By Changes in Method of Accounting General Rule*

Treas. Reg. 1.460-3(b) - *Exempt construction contracts*

Treas. Reg. 1.460-4(d) – *Completed-contract Method*

Treas. Reg. 1.460-4(g) - *Method of Accounting*

Notice 89-15 - *Guidance is provided to IRC 460 relating to accounting for long-term contracts*

Howard Hughes Company, LLC. V C.I.R. - 142 T.C. 355 (2014)

Howard Hughes Company, LLC. V Commissioner - 805 F.3d 175 (5th Cir. 2015)

Rev. Proc. 2002-18 - *Changes in Method of Accounting; Examinations*

Rev. Proc. 2015-13 - *Changes in Accounting Periods and in Methods of Accounting*

TAM 200552012 - *Land sale contracts are not home construction contracts*

TAM 201650014 - *Compaction of soil for the foundation of a home qualified as home construction contract*

2003 IRS NSAR 20006 - *Definition of Home Construction Contracts*

Form 3115 - *Application for Change in Accounting Method*

Form 3115 Instructions

Training and Additional Resources

Land Developers and Subcontractors - Proper Method of Accounting	
Type of Resource	Description(s)
Reference Materials	<ul style="list-style-type: none">▪ Issue Snapshot - <i>Involuntary (Service Initiated) Method Change Issues</i>▪ Audit Technique Guide for Construction

Glossary of Terms and Acronyms

Term/Acronym	Definition
C.I.R.	Commissioner of Internal Revenue Service
Common Improvement	Any real property or improvements to real property that benefit two or more properties that a developer separately holds for sale. The developer must be contractually obligated or required by law to provide the common improvement, and the developer must not recover the cost of the common improvement through depreciation. Examples of common improvements include streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools.
Completed Contract Method (CCM)	A method of accounting for long-term contracts in which all contract income and all contract costs are deferred until the year in which the contract is considered complete.
Completion Year	A contract is completed upon the earlier of (1) the customer has use of the subject matter of the contract for its intended purposes and at least 95% of the allocable contract costs have been incurred, or (2) final completion and acceptance of the subject matter of the contract.
Construction Contract	Any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to or improvements of real property.
Home Construction Contract	A long-term construction contract in which 80% or more of the total estimated allocable contract costs are for the construction of dwelling units contained in buildings with 4 or fewer dwelling units, and improvements to real property directly related to and located at the site of the dwelling units.
IDR	Information Document Request
IRC	Internal Revenue Code
Land Developer	A person or entity that prepares raw land for development. The developer may develop the land and then sell it to a builder, an investor, or another developer.
LLC	Limited Liability Company

Glossary of Terms and Acronyms (cont'd)

Term/Acronym	Definition
Long-Term Contract	A building, installation, construction, or manufacturing contract that is not completed within the taxable year in which it is entered into.
NOPA	Notice of Proposed Adjustment
NSAR	Non-docketed Service Advice Review
Percentage of Completion (PCM)	A method of accounting for long-term contracts in which the amount of gross income reportable each year is that portion of the gross contract price which represents the percentage of the entire contract completed during the year. The degree of completion is generally determined by comparing the total allocated contract costs incurred to date with the total estimated contract costs. The applicable portion of income and expenses incurred are recognized each year of the contract.
Small Construction Contract	Any non-home long-term construction contract in which the taxpayer expects (at the commencement of the contract) to complete within 2 years AND the average annual gross receipts for the prior 3 taxable years is \$25 million or less (\$10 million or less for tax years beginning prior to January 1, 2018).
TAM	Technical Advice Memorandum

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
	None at this time.	