BY RICH SHAVELL

Home Construction Contracts & the CCM: A Mandatory Audit Issue?

In a March 2007 Field Directive, the IRS instructed audit groups to more closely construe certain issues surrounding the use of the completed contract method (CCM).[1]

While the Directive has a broad scope, it addresses certain issues that negatively affect contractors, especially land developers and subcontractors who apply the CCM to home construction contracts (HCCs).

According to the Directive, construing the use of the CCM "is a mandatory audit issue which will ensure consistency and to prevent widespread use of an improper method." This means that revenue agents who audit developers and contractors must look for completed contract issues.

The Directive also states that "in the cases we have seen so far, the taxpayer's position is egregious and depending upon the materiality of the issue, penalties should be considered and applied." This appears to be a significant change in policy by the IRS, and a shift that CFMs and their tax advisors should examine closely.

Subcontractors & Land Developers

The Directive outlines IRS concerns with five scenarios. The second scenario discusses subcontractors who work for a land developer.

Before the Directive

From 1989 to about 2003, subdivision subcontracts generally qualified as HCCs. Then, around 2004, the IRS began to distinguish between subcontractors who worked for "land developers" as opposed to "homebuilders."[2]

For example, let's say a paving contractor performed identical services (paving the entrance and the streets) for Home Community 1 and Home Community 2. The *entity* that owned Home Community 1 "performed work" on the homes, which made the entity a "homebuilder" according to the IRS definitions of these terms. Because of the owner's status as a homebuilder, the paving contractor's work would qualify as an HCC, and the paver could use the CCM to defer taxable income regardless of revenue.

The entity that owned Home Community 2 did not "perform work" on the homes. The IRS distinguished this entity as a "land developer" that sold the lots, or sold off portions of the property to other companies that would eventually build and market the homes.

Because of the owner's classification as a land developer, the paving contractor could not take advantage of the benefits afforded to taxpayers working under an HCC. (For more information about these benefits and an expanded definition of an HCC, see the sidebar on page 64.)

After the Directive

In this recent Directive, the IRS has further restricted the use of HCCs, indicating that some contractors will not qualify for the CCM, even if the work is performed for a homebuilder.

In Attachment #4 to the Directive, the IRS asserts that to be considered home construction, common improvements must touch the lot of the home being constructed within the community.[3] This differs from industry understanding of Revenue Notice 89-15[4] and prior IRS practice.

In the past, taxpayers who performed common improvements received consent agreements when they changed accounting methods. For example, contractors who used the percentage-of-completion method (PCM) to account for work similar to the Home Community example would probably have requested permission to change to the CCM for their HCCs.

And, it's very likely that the IRS would have issued consent agreements in response to the requests. But now, the IRS has changed its interpretation. What advice can be given to taxpayers with these prior consent agreements? What are their audit risks now that the IRS has issued this Directive?

A Closer Look at Attachment #4

In Attachment #4, the IRS asserts that improvements not

continued on page 64

touching the lot of the home are excluded from allocable costs because the work is not performed in conjunction with an actual home (i.e., vertical construction).

The IRS concludes that if costs are not allocable, then the work cannot be part of home construction. The following are the facts presented in Attachment #4.

> *"Issue:* Whether a taxpayer's contract to perform only off-site improvements for a residential land developer is exempt from the percentage-of-completion method under §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.
>
> "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 CCM of accounting (CCM). All income and expenses are being deferred until the contract is completed."

Definition of a Home Construction Contract

Contracts defined as HCCs are not subject to the PCM requirement, the costing requirements of Reg. 1.460-5, the look-back requirements of Reg. 1.460-6, and the AMT adjustment associated with non-HCC long-term contracts. So, it makes sense that contractors want to take advantage of HCCs, and the IRS would prefer to limit the availability of the HCC classification.[5]

IRC §460(e)(4) defines a construction contract as "any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property."

IRC §460(e)(6)(A) defines an HCC as a construction contract when 80% or more of the estimated total contract costs are reasonably expected to be attributable to those activities involved in a construction contract with respect to:

1) dwelling units contained in buildings containing four or fewer dwelling units, and
2) "improvements to real property directly related to such dwelling units and located on the site of such dwelling units."

For IRC §460(e)(6)(A), a dwelling unit is defined in 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)(i) provides more clarification: "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% 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:

1) "Dwelling units, as defined in §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
2) "Improvements to real property directly related to, and located at the site of, the dwelling units.
3) "Townhouses and rowhouses. Each townhouse or rowhouse is a separate building.
4) "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."

Clearly, the HCC definition is complex. The IRS Directive focuses on several other issues, in addition to land developers and contractors who work on the site of dwelling units, but not on the home directly. Therefore, all contractors should consult with their tax advisors about IRS scrutiny of this classification.

In reviewing the law and pronouncements on the issue, the IRS cites IRC §460, the regulations under §460, and Revenue Notice 89-15. However, §460(e)(1)(A) provides an exception from the requirement to use the PCM, namely any HCC.

In Attachment #4, the IRS asserts that:

> "§460(e)(6)(A) and Treas. Reg. §1.460-3(b)(2) state that the allocable costs, for the 80% percent [allocation] 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."

The IRS also cites Q&A-43 and 44 of Revenue Notice 89-15 as a prior authority:

> *"Q-43:* What is a 'home construction contract' for purposes of §460(e)?
>
> *"A-43:* For purposes of §460(e) the term 'home construction contract' means any construction contract if 80% 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 §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 toward meeting the 80% test.
>
> *"Q-44:* For purposes of the 80% 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') to 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% test."

The Service emphasizes that, according to Q&A-43, 80% of contract costs are attributable to the "building, construction, reconstruction, or rehabilitation, of dwelling units ... and improvements to real property directly related to such dwelling units and located at the site of such dwelling units ... ."

This appears to be the crux of the IRS argument: The HCC qualification is a two-prong test, not an either/or test. Improvements to the dwelling unit ***and*** improvements to real property are required.

Until recently, the HCC classification was not interpreted as a two-prong test. Remove the two-prong requirement and the improvements located at the site of the dwellings are, once again, allocable costs with no "phantom assets."

Roadwork and other site improvements are necessary for the home to be functional. Homes need sewers, water, electricity, and streets. How can a developer sell lots without fundamental infrastructure? How can a homebuilder not allocate these items?

The IRS concludes in Attachment #4 that: "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 CCM of accounting. Per IRC §460(a), the taxpayer is required to use the PCM, so long as the taxpayer's contract is not subject to any other exception under §460."

There is no vertical construction requirement in Revenue Notice 89-15, A-44, or the regulations. Why does this prior guidance indicate that off-site work qualifies for the 80% test? Why does the HCC distinction require detailed inter-

continued on page 66

pretation to exclude fundamental construction work necessary for functional homes?

At the same time, language in Revenue Notice 89-15 clearly indicates that off-site work qualifies as home construction for the 80% test. Q-44 specifically includes "roads, sewers, and other common features not located on the sites of dwelling units ('off-site work') to be treated as attributable to dwelling units."

Industry Involvement

Since 2005, industry associations have sought clarification on HCCs:

May 2005: CFMA and ABC formally requested that the IRS consider the definition of an HCC within the Service's Industry Issue Resolution (IIR) Program. The IIR program issues guidance to resolve frequently disputed or burdensome tax issues that affect a significant number of business taxpayers.

For each issue selected for the program, a resolution team of IRS, Chief Counsel, and Treasury personnel gathers to collect information, analyze relevant facts, and recommend guidance. In August of 2005, this was one of only two issues selected for that cycle of the IIR Program.

December 2005: Industry stakeholders met with the IIR team to begin the exchange of information. At the same time, the IRS was in the midst of an audit of a land developer. Unrelated to the IIR meeting, a Technical Advice Memorandum (TAM) was issued to address IRS concerns about perceived abuses by developers.

The TAM indicated that land sale contracts were not HCCs eligible for the CCM if the land development company did not perform construction contract activities (vertical construction) with respect to dwelling units.

Early 2006: Industry stakeholders provided the IRS with fact patterns so the IIR team could better understand industry practices and common circumstances. The industry also provided technical memos.

January 2007: Contractor associations, including the original submitters of the IIR request, met with the IRS. During the meeting, they explained that IRS efforts to curb perceived abuses among land developers could negatively impact subcontractors.

Conclusion

Based on informal discussions with the IRS, it appears that the next response to the December 2005 TAM will be either a Revenue Ruling or Revenue Procedure.

The industry had hoped the IRS would move to its original perspective on common improvements and HCCs. With the issuance of this Directive, that does not seem to be the case. BP

RICH SHAVELL, CPA, CCIFP, is President of Shavell & Company, P.A., CPAs and Consultants in Boca Raton, FL.

Rich has presented comments before the IRS on proposed regulations and has testified before the House and Senate on the effect of proposed legislation on contractors.

A member of CFMA's South Florida Chapter, he is currently the Vice Chairman of the Tax & Legislative Affairs Committee and previously served as a Trustee of the ICCIFP. Rich also serves as Chair of ABC's National Tax Advisory Group.

Phone: 561-997-7242
E-Mail: rich@shavell.net
Web Site: www.shavell.net

Endnotes:

1. www.irs.gov/businesses/article/0,,id=169122,00.html
2. For an example, see 2003 IRS NSAR 20,006, 2003 WL 22171910.
3. www.irs.gov/businesses/article/0,,id=169126,00.html
4. Revenue Notice 89-15, 1989-1 C.B. 634.
5. Eric Wallace and Tanya LaCosse, "The IRS' Evolving Definition of a Home Construction Contract," *CFMA Building Profits* November/December 2004.

Copyright © 2007 by the Construction Financial Management Association. All rights reserved.
This article first appeared in ***CFMA Building Profits.*** Reprinted with permission.