Construction Industry Audit Technique Guide

This document is not an official pronouncement of the law or the position of the Service and cannot be used, cited, or relied upon as such. This guide is current through the revision date. Since changes may have occurred after the revision date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the revision date.
The taxpayer names and addresses shown in this publication are hypothetical.

Audit Technique Guide Revision Date 4/19/2021

Publication 5522 (Rev. 4-2021) Catalog Number 35393M Department of the Treasury
Internal Revenue Service publish.no.irs.gov

Table of Contents

I. Overview 10

A. Foreword 10

B. Participants in the Construction Industry 10

B.1. Contractors 10
B.2. General or Prime Contractors 10
B.3. Construction Managers 10
B.4. Commercial Contractors 11
B.5. Commercial Project Owners 11
B.6. Residential Construction Developer 11
B.7. Subcontractors 12
B.8. Highway Contractors 12
B.9. Heavy Construction Contractors 12
B.10. Architects and Engineers 13
B.11. Material Suppliers 13
B.12. Construction Lenders 13
B.13. Surety Companies 14
B.14. Multiple Roles 14

C. The Contracting Process 14

C.1. Scheduling Subcontractors 15

D. Contract Income 16

E. Types of Contracts 16

E.1. Short-Term Contracts 16
E.2. Long-Term Contracts 16
E.3. Fixed Price or Lump Sum Contracts 16
E.4. Cost-Plus Contracts 17
E.5. Time and Material Contracts 17
E.6. Unit Price Contracts 17
E.7. Change Orders 17

F. Bonding 17

G. Building Permits 18

H. Notice of Completion 19

I. Law/Authority 19

I.1. Exhibit 1-1 Federal Tax Law and Guidance 19

J. Relevant Terms 26

J.1. Exhibit 1-2 Definitions and Terminology 26

K. Resources 39

K.1. Exhibit 1-3 Construction Industry Resources 39

II. Long Term Contracts 44

A. Overview 44

B. Law/Authority related to Long-Term Contracts 45

C. Contracts Required to be Reported Using the PCM 45

D. Contracts Exempt from the PCM 46

D.1. Example of Small Construction Contract Exception: 46

E. Construction and Manufacturing Contracts 47

E.1. Long-term Contract 47
E.2. Construction Contract 47
E.3. Manufacturing Contract 47
E.4. Integral Components of Real Property 48

F. Contract Classifications 48

F.1. Hybrid Contracts 49

G. De Minimis Construction Activities 50

H. Non-Long-Term Contract Activities 50

I. Related Party Contract 51

J. Severing and Aggregating Contracts 53

III. Small Construction Contractors 55

A. Overview 55

B. Exceptions to the PCM and Look-back Interest 55

B.1. $25 Million Gross Receipts Test ($10 million for tax years beginning prior to 1-1-2018) 56
B.2. Controlled Groups Explained 57
B.3. Attribution of Gross Receipts of Less than Controlling Interest 58

C. Proper Method of Accounting for Small Construction Contractors 58

D. General Rule for Accounting Methods 59

E. Methods of Accounting 60
F. Selecting an Accounting Method 60
G. Cash Method of Accounting 60
H. Accrual Method of Accounting 62
H.1. Advance Payments – Accrual Method 62
H.2. Exception to Reporting Advance Payments in Year of Receipt – Accrual Method (For tax years beginning before 1-1-2018) 63
H.3. Exception to Reporting Advance Payments in Year of Receipt – Accrual Method (For tax years beginning after 12/31/2017) 63
H.4. Deducting Expenses under the Accrual Method of Accounting 64
H.5. Accrual Method and Retainages 64
I. Completed Contract Method (CCM) 65
I.1. Completion of a Long-Term Contract 65
I.2. Post Completion Expenses 66
I.3. Allocation of Indirect Costs 67
I.4. Issues to Consider for Completed Contract Method Taxpayers 69
I.5. Subcontracts and Completion 69
J. Exempt-contract percentage of completion method (EPCM) 70
J.1. Alternative Minimum Tax (AMT) 70
K. Small Construction Contractors Becoming Large Construction Contractors 70
IV. Large Construction Contractors 71
A. Overview 71
B. Methods of Accounting for Contracts Subject to IRC Section 460 PCM 72
C. Cost-to-Cost Method 72
C.1. Allocable Contract Costs 73
C.2. Direct Material Costs 75
C.3. Uninstalled Dedicated Materials 75
C.4. Direct Labor Costs 76
C.5. Pre-Contract Costs 76
C.6. Indirect Costs Not Generally Allocable to a Contract 77
C.7. Nondeductible Costs 77
D. Impact of Cost Allocation on the Percentage of Completion Computation 78

E. Cost-Plus Contracts and Federal Long-Term Contracts 80
F. Simplified Cost-to-Cost Method 80
G. Percentage-of-Completion 10-Percent Method 81
H. Percentage-of-Completion/Capitalized-Cost Method (PCCM) .. 82
I. Total Estimated Contract Price and Claim Income 83
J. Additional Considerations for PCM 84
K. Reversal of Income on Terminated Contract 86
V. Mid-Contract Change in Taxpayer 87
A. Overview 87
B. Constructive Completion Transactions 88
B.1. Constructive Completion Transactions – Tax Treatment by Old Taxpayer… 88
B.2. Constructive Completion Transactions - Tax Treatment by New Taxpayer… 89
B.3. Examples of Constructive Completion 89
C. Step-in-The-Shoes Transactions 91
C.1. Step-in-the-Shoes Transactions - Tax Treatment by Old Taxpayer 91
C.2. Step-in-the-Shoes Transactions - Tax Treatment by New Taxpayer 92
C.3. Examples of Step-in-the-Shoes Transactions 92
C.4. Special Rules Related to Certain Partnership and Corporate Step-in-the Shoes Transactions 93
D. Look-Back Interest Rules for Taxpayer Mid-Contract Change . 94
E. Look-back Interest – Constructive Completion Transaction 94
F. Look-back Interest – Step-in-the-Shoes Transaction 94
VI. Financial Accounting Versus Tax Accounting 95
A. Overview 95
B. Financial Accounting 95
B.1. International Accounting Standards 96
B.2. Accounting Standards Codified Topic (ASC) 606 – Revenue from Contracts with Customers 96
B.3. Balance Sheet Accounts 97
B.4. Balance Sheet Reporting 99
C. Book and Tax Differences 99

C.1. Revenue Recognition 99
C.2. Contract Related Services 100
C.3. Determining Completion for Percentage of Completion Method 100
C.4. Loss Recognition 100
C.5. Uninstalled Dedicated Materials 100
C.6. ASC 606 – Revenue from Contracts with Customers 101

D. Sample Financial Statements using Percentage of Completion Method 102

D.1. Exhibit 6-1 Balance Sheet 102
D.2. Exhibit 6-2 Statement of Income and Retained Earnings 103
D.3. Exhibit 6-3 Earnings from Contracts 104
D.4. Exhibit 6-4 Contracts Completed 104
D.5. Exhibit 6-5 Contracts in Progress 105

E. Exhibit 6-6 Tax Accounting Methods 105

VII. Homebuilders and Land Developers 108

A. Overview 108

B. Home Construction Contract Defined 108

B.1. Common Improvements 109
B.2. Mixed Use Buildings 110

C. Recent Developments 110

C.1. Important Court Decisions – Completed Contract Method 110

D. Taxation of Homebuilders 111

E. Speculative Homes (No Contract) 111

E.1. Income Recognition – Spec Homes 112
E.2. Cost Recognition – Spec Homes 112
E.3. Revenue Ruling 66-247 112
E.4. Inventory vs. Real Estate 113
E.5. Speculative Homes Becoming Long-Term Contracts 114

F. Contractors Building Homes Under Contract 114

F.1. Long-Term Methods of Accounting 114
F.2. Completed Contract Method (CCM) 115
F.3. Percentage of Completion Method (PCM) 115
F.4. Exempt Contract Percentage of Completion Method (ECPM) 115
F.5. Other Permissible Accounting Methods 115
F.6. Large Homebuilders 116
F.7. Model Homes 116

F.8. Furnishings in Model Homes 116

G. Land Developer 117

G.1. Income Recognition – Land Developer Without a Construction Contract… 117
G.2. Cost Recognition – Land Developer Without a Construction Contract 117
G.3. Allocating Costs to Each Parcel of Property 118
G.4. Common Improvements Allocable to the Cost of the Lots Developed by the Taxpayer 119
G.5. Alternative Cost Method of Accounting for Real Estate Developers – Revenue Procedure 92-29 123

VIII. Other Tax Issues in Construction 126

A. Overview 126

B. Accounting Method Issues 126

B.1. Improper Computation of the Average Annual Gross Receipts for Small Business Taxpayers under Internal Revenue Code § 460 (After 12-31-2017)……. 126
B.2. The taxpayer must aggregate all gross receipts from all trades or businesses whether or not they are under common control. For example:… 127
B.3. Improper Computation of the $5 Million Average Annual Gross Receipts under IRC § 448 (Before 1-1-2018) 127
B.4. Netting Gross Receipts for the Small Business Taxpayer Threshold .. 128
B.5. Retainages 128
B.6. Delayed Billings under Accrual Method 129
B.7. Determining Completion under Completed Contract Method (CCM) ... 129
B.8. Improper Use of the PCM or Completed Contract Method 129
B.9. Deferring Costs under Percentage of Completion Method 130
B.10. Allocation of Indirect Costs 130
B.11. Improper Inclusion of Costs in PCM Computations 131
B.12. Improper Expense Recognition under the Completed Contract Method…. 132
B.13. Homebuilder Building for Speculation 132
B.14. Common Improvements 132

C. Income Issues 133

C.1. Advance Payments 133
C.2. Improper Computation of the Contract Amount under Percentage of Completion Method (PCM) 133
C.3. Claim Income under PCM 133
C.4. Unreported Income 134
C.5. Other Compensation Income 134

C.6. Delayed Billings 135
C.7. Subcontractor Improperly Deferring Income 135
C.8. Scrap Sales 135
C.9. Built-In Gains Tax 136
C.10. Installment Sales 136
C.11. Model Homes - Gain on Sale and Leaseback Arrangements 136
C.12. Warranty Agreements 137
C.13. Capital Gain vs. Ordinary Income - Real Estate Dispositions 137

D. Expense Issues 138

D.1. Per Diem for Lodging, Meals, and Incidentals 138
D.2. IRC § 179 Deduction Limited for Sports Utility Vehicles (SUVs) 138
D.3. Personal Use of Business Assets 139
D.4. Unreasonable Compensation 139
D.5. Double Deductions 139
D.6. Cash Method Interest Expense 140
D.7. Capitalization of Pre-development Costs 140
D.8. Contributions of Land and Facilities 140
D.9. Losses 141
D.10. Abandonment Losses 141
D.11. Related-Party Transactions 142
D.12. Bad Debts and Cancellation of Debt Income 142
D.13. Warranty Reserves or Contingent Liabilities 143
D.14. Model Homes 143

E. Tax Issues 144

E.1. Accumulated Earnings Tax 144
E.2. Alternative Minimum Tax (AMT) 145
E.3. Employment Tax 146

IX. Income Probes 146

A. Overview 146

B. Understanding the Accounting System 148

B.1. The Construction Contract 148

C. Minimum Income Probes 149

C.1. Minimum Income Probes for Non-Business Returns 149
C.2. Minimum Income Probes for Individual Business Returns 150
C.3. Minimum Income Probes for Corporations, Partnerships, S Corporations and Other Business Returns 151

D. Internal Controls 152

D.1. Audit Techniques for Evaluating Internal Controls 154

E. Use of Indirect Methods 154

E.1. Introduction 154
E.2. Indirect Methods - Overview 155
E.3. Types of Indirect Methods 155
E.4. Potential Defenses to Indirect Method Computations 158

F. Miscellaneous Income Sources 158

X. Construction Joint Ventures 159

A. Overview 159

B. Types of Joint Ventures 159

C. Joint Venture Examinations 162

D. Potential Joint Venture or Partnership Issues 163

D.1. Formation Issues 163
D.2. Operation Issues 163
D.3. Liquidation or Distribution Issues 163

XI. Additional Resources 164

A. Exhibit 11-1 Construction Industry Interview Questions 164

A.1. General: 164
A.2. Other Income: 166
A.3. Management accounting 166
A.4. Employees and subcontractors: 167
A.5. Gross Receipts: 167
A.6. Cost of Goods Sold: 167

B. Exhibit 11-2 Cost Allocation Decision Making Process 168

B.1. Step 1: Is there a contract? 168
B.2. Step 2: Is the Taxpayer Exempt from PCM per IRC § 460(e)? 168
B.3. Step 3: Is the Taxpayer a Large Homebuilder? 168

C. Exhibit 11-3 Cash to Accrual 170

C.1. Exceptions That May Allow the use of the Cash Method 170

I. Overview

A. Foreword

(1) The intent of this Industry Guide is to provide guidance for examiners conducting audits in the construction industry and information for taxpayers and practitioners associated with the construction industry. The Service recommends review of this guide prior to initiating an audit. Users of this guide may need to augment these guidelines by researching specific tax issues and new tax law.

B. Participants in the Construction Industry

(1) Numerous participants in the construction industry play a distinct role in the process. Below is a discussion of the key participants.

B.1. Contractors

(1) Contractors perform construction work in accordance with the plans and specifications provided by the owner. Each state has licensing requirements.

B.2. General or Prime Contractors

(1) A general contractor's principal business is the performance of the construction work in accordance with the plans and specifications of the owner. A general contractor takes full responsibility for the completion of the project. The general contractor will normally subcontract out a substantial part of the work, while maintaining overall control through project managers and onsite supervision. The general contractor may utilize specialty subcontractors but can perform any portion of the work. Generally, contractors are licensed.

B.3. Construction Managers

(1) Generally, the construction manager does not perform construction work on projects but is an agent for the owner. The owner may engage a construction manager in lieu of or in addition to a general contractor. As an agent, the construction manager coordinates the construction project, but has no contractual relationship with the subcontractors. Generally, construction managers only provide services. Construction managers do not perform any construction work. Construction managers are not liable for defects in the construction. However, the construction manager may be liable for design defects.

B.4. Commercial Contractors

(1) Commercial contractors specialize in commercial construction projects. These projects may include the construction of a single building or any number of buildings. Commercial projects include:

- Retail projects like shopping centers, restaurants, and grocery stores;
- Rental facilities like office buildings, industrial parks, and apartments;
- Business locations like company headquarters, manufacturing plants, and distribution facilities;
- Municipal buildings like city halls, prisons, schools, and hospitals; or
- Special projects like amusement parks, racetracks, coliseums, and churches.

(2) A commercial contractor constructs nonresidential buildings, such as office buildings, warehouses, and shopping centers.

B.5. Commercial Project Owners

(1) The owner of a construction project may be an individual, corporation, partnership, or government body. The owner evaluates whether a project is feasible and will provide the future benefits desired. The owner then engages an architect or engineer to design the plans and specifications of the project. Normally, the owner secures the necessary financing for the project for both the construction period and permanent financing upon completion. The owner will retain title to the project throughout the construction phase, subject to liens from construction loans and mechanics liens. The general contractor may or may not have an ownership interest in the project. The contractor may own a percentage interest in one of the following ways:

- Owning stock in the corporation that owns the project;
- Being a partner in a development partnership; or
- Owning the property or an interest in a joint venture as an individual.

B.6. Residential Construction Developer

(1) The examination of residential developers is different than the examination of a contractor who builds in accordance with a contract for an owner. The

developer is generally the owner and the builder of the residential development. The developer acquires land, obtains approval, secures construction financing, and begins construction of the residential development in stages or phases of construction.

(2) The developer sells the initial phase, and the construction process begins on the next phase. This process requires the builder to allocate a per-unit cost to each unit sold. The developer must match the cost of each unit (on-site costs, such as direct materials and labor, and an allocated portion of off-site costs such as streets and amenities) with the sales price of each unit sold. The sales price is often based on what the market will bear under the current economic environment.

B.7. Subcontractors

(1) The largest number of taxpayers in the construction industry is a specialty subcontractor. They can range from one-man operations to nationwide, publicly traded corporations, or divisions of larger corporations. You can distinguish subcontractors from the general contractor by the limited scope of their work, which usually involves a special skill, knowledge, or ability.

(2) Subcontractors include specialists, such as plumbers, electricians, framers, and concrete workers. They generally enter into contracts with the general contractors and may provide the raw materials used in their specialty areas.

(3) The general contractor, not the owner of the property, will usually pay the subcontractors. Subcontractors may complete their work in stages, or it may be continuous.

B.8. Highway Contractors

(1) Highway and street contractors require specialized equipment and techniques. The equipment includes bulldozers, graders, dump trucks, and rollers. Examples of highway construction include city streets, freeways, country roads, highway bridges, and tunnels.

B.9. Heavy Construction Contractors

(1) Heavy construction contractors require large and complex mechanized equipment, such as cranes, bulldozers, pile drivers, dredges, and pipe-laying devices. Some examples of projects in this category include dams, large bridges, refineries, petrochemical plants, nuclear and fossil fuel power plants, pipelines, and offshore platforms.

B.10. Architects and Engineers

(1) The architect or engineer designs the plans used by the construction contractors. The plans provide the necessary detail (dimensions, materials, location of fixtures, etc.) to the contractors. When the contractor starts the project, the architect or engineer may monitor the contractor's progress and often approves progress payments to the contractors. The architect or engineer will make modifications (change orders) in the plans as needed. Change orders are written revisions to the contract, which increase or decrease the total contract price paid to the construction contractors. The change order document contains the change order number, change order date, a description of the change, and the amount of the change order. The contractors under the terms of the contract can also issue change orders.

B.11. Material Suppliers

(1) Material suppliers provide the raw materials used in the construction project. The subcontractors purchase the materials and install them in accordance with their contract. General contractors often write joint checks to subcontractors and material suppliers to ensure that all parties receive proper payment. Suppliers may deliver materials directly to the job site and are direct job costs, which the contractor would not normally inventory. In some situations, the contractor will maintain inventories of frequently used materials on their property (i.e. yard stock).

B.12. Construction Lenders

(1) The construction lender provides the necessary funds to pay contractors on a progress basis. In return for making the loan, the lender receives interest on the outstanding loan balance. Taxpayers must capitalize construction period interest costs ("soft costs") paid by the owner to lenders during the construction period. Taxpayers often take interest and other loan costs directly from the loan principal because of the institution’s interest provisions.

(2) As construction work progresses, the construction lender (bank, savings and loan, insurance company, etc.) will advance the funds based on the work performed or based on a payment schedule. The construction lender generally secures the construction loan with the land and construction in progress. When the contractor completes the construction, the owner will secure permanent long-term financing.

B.13. Surety Companies

(1) Sureties are generally insurance companies who provide bonding to contractors. Bonds provide a form of insurance to the owner. Performance bonds protect the owner if the contractor fails to complete the construction work. Performance bonds are typically a percentage of the contract amount.

(2) Bid bonds guarantee that the contractor will sign the contract after the owner awards the contract and furnishes the necessary performance and payment bonds within a specified time. Contractors must submit detailed financial data to the surety company to secure a bond.

(3) Contractors often furnish financial statements prepared in accordance with generally accepted accounting principles (GAAP) to the surety firm on a quarterly basis or more often. Supporting schedules included in these financial statements provide extensive job information, required by the surety in order that they may analyze and limit their risk. Surety companies usually require officer shareholders of the contractor to supply personal financial statements.

B.14. Multiple Roles

(1) Each of the above participants can have multiple roles in the construction process. For example, the owner could also be the general contractor (builder or developer). The general contractor in addition to providing supervision may also do specialty work. Design-build companies are growing.

(2) Construction lenders frequently hold an equity position in a development partnership to participate in the management decisions and to share in the profits. Anchor tenants, such as major department store chains participate in the development partnership in exchange for signing long-term leases. Contractors and material suppliers can obtain rights in the project by filing mechanics liens against the property.

C. The Contracting Process

(1) When the owner determines that the project is feasible and construction financing is available, he will solicit bids from general contractors and/or specialty contractors. Owners will use trade publications and newspapers to invite contractors to bid for the construction contract.

(2) The notice will provide the procedures the contractor is to follow in submitting a bid. The bidding contractor obtains a copy of the plans and specifications from the owner to prepare the formal bid. The bidding contractor solicits bids from subcontractors, estimates direct material and labor costs, and evaluates

the ultimate profit potential of the contract. The amount of the bid covers the estimated costs and profit for the construction project.

(3) The owner evaluates the submitted bids and will award the contract to the successful bidder. The contract document contains the contract amount, project start and completion dates, progress billing procedures, insurance requirements, and other pertinent information. There are standard cost manuals that a general contractor can use as a guideline in computing the bid. These guides contain a compilation of cost data for each phase of construction.

(4) It is important to realize that the cost of bidding a job can be considerable. The costs include reviewing and reproducing the job specifications and blueprints, calling in subcontractors to get bids on the work involved, developing the total cost figure for the project, and preparing a formal bid. The preparation of the bid is the first step in the cost control system. The bid becomes the budget by which the contractor measures the actual expenditures.

(5) The object of the cost control system is to provide the general contractor with information regarding actual project costs versus anticipated or budgeted costs. These cost comparisons are essential for internal control as well as for auditing purposes.

(6) You may see situations where a contractor might pursue a "break even" bid to generate enough cash flow to meet payroll, particularly in recession periods. The general contractor solicits bids from subcontractors in the various trades, the subcontractors bid for the jobs in much the same way owners do.

C.1. Scheduling Subcontractors

(1) The owner expects the general contractor to schedule the subcontractors so that the construction runs smoothly and completes the contract on time. The various specialty areas include the following:

- Site Work
- Foundation
- Framing
- Exterior
- Roofing
- Interiors
- Specialties
- Mechanical

- Electrical

(2) This list conveys some of the complexity inherent in the construction process. It reflects the necessity of scheduling the work of subcontractors and using a budget, bid costs, and actual cost variances for cost control purposes. Budgeting and scheduling are critical factors in determining the success of the contractor.

D. Contract Income

(1) Most companies use a standard construction contract. The most important information contained in the contract is the amount and how often the owner will pay the general contractor. The contract will state whether the contractor will bill monthly, at the completion of the contract, or at certain stages of the project. The billing invoices may include copies of the subcontractor bills and lien releases.

(2) The owner may have a supervisor at the site that confirms that the contractor has completed the work for which he has billed. The contract may also include provisions for retainages that the owner will usually withhold from the general contractor until the project is complete. Owners usually withhold retainages at a rate of 10 percent of the billed amount, but the percentage may decrease over the life of the project. The general contractor, in turn, will retain a portion from the amounts owed to the subcontractors.

E. Types of Contracts

E.1. Short-Term Contracts

(1) Short-term contracts are contracts started and completed within the taxpayer's taxable year. For short-term contracts, the taxpayer treats construction costs as current period costs under all methods of accounting except the cash method. Under the cash method, the taxpayer treats construction costs as current period costs for a short-term contract only if the taxpayer pays the expense during the year.

E.2. Long-Term Contracts

(1) IRC section 460(f)(1) defines long-term contracts as any contract for the manufacture, building, installation, or construction of property, if the taxpayer does not complete such contract within the taxable year the taxpayer enters into such contract.

E.3. Fixed Price or Lump Sum Contracts

(1) A fixed price or lump sum contract states that the contractor will complete the project for an agreed price, despite unforeseen costs that might exist

during the construction phase. Some fixed price contracts provide for some variations for economic price adjustments, incentives, etc. If any modifications to the original contract occur, the contractor executes change orders. These often increase or decrease the contract amount.

E.4. Cost-Plus Contracts

(1) Cost-plus contracts stipulate that the contract amount will be the cost of the construction project plus a fee. The contractor may earn the fee in various ways.

(2) The contractor generally earns a fixed fee evenly throughout the term of the contract. A percentage fee is frequently based on the amount of cost incurred. Most cost-plus contracts have a guaranteed maximum to protect the owner from cost overruns. Many cost-plus contracts allow the contractor to share in cost savings if the contractor completes the project under budgeted cost. The contract will specify which costs are included in the contract amount. Generally, the contract will include a clause that allows the owner to review or audit those costs.

E.5. Time and Material Contracts

(1) Time and material contracts are contracts that provide payments to the contractor based on direct labor hours at a fixed rate plus the cost of materials and other specified costs.

E.6. Unit Price Contracts

(1) The unit price contract method is a variation of the lump-sum (or fixed price) contract method where the contractor bids a set price per unit item. The contractor generally uses the unit price method in cases in which the owner has not determined the number of units required when the contractor bids the contract.

E.7. Change Orders

(1) The contractor or the owner can initiate change orders. A change order modifies the original contract, and either increases or decreases the contract costs and/or contract price.

F. Bonding

(1) Owners often require bonding of the general contractor. In these cases, the owner requires the general contractor to purchase a guarantee or surety

bond. The purpose of the bond is to guarantee to the owner and lender that, should the general contractor fail to finish the project, the funds will be available to hire a replacement. The surety company bases a general contractor's bonding capacity upon their financial statements and past performance. The surety company will deny the bond request if it exceeds the general contractors bonding capacity.

(2) A contractor may leave what appears to be an unusually large amount of cash in the company for increasing his or her bonding capacity. Exam should consider this when determining if accumulated earnings tax is applicable. The following types of bonds are available:

- Bid bonds provide for payment to the owner of the difference between the bid that the owner accepts and the next lowest bid if the general contractor with the accepted bid fails to enter into a contract.
- Contract bonds indemnify the owner against the failure of a general contractor to comply with the requirements of a contract.
- Performance or completion bonds guarantee completion of the project by the general contractor.
- Labor and material payment bonds guarantee to the owner that the general contractor will pay all costs of labor, material, and supplies incurred regarding the project, thus voiding mechanics' liens.
- Maintenance bonds guarantee the owner against defects in workmanship and are usually one year in duration.
- Subcontracting bonds are performance and payment bonds issued by the subcontractor to the general contractor to guarantee the subcontractor's performance and payment of obligations required under the contract.

(3) State and federal contracts usually require surety bonds. In other cases, owners may use collateral bonds in which the contractor pledges real or personal property as collateral with value equivalent to the contract price.

(4) When a contractor defaults a performance bond, it is not unusual for the insurer or bonding company to hire the defaulted contractor to complete the job, because they are familiar with the project. Most bond defaults result from financial difficulties with the project at hand, rather than from the lack of technical ability on the part of the contractor. Thus, the bonding company can act as another third-party control on the business and accounting practices of the contractor.

G. Building Permits

(1) Before construction can begin on a project the general contractor or owner must receive the necessary building permits from the appropriate

municipality. The general contractor or owner turns the specifications and blueprints of the project into the Building Department, along with an application for a permit. The issuance of a permit may take time, because the approval process is likely quite involved, especially in the case of new construction.

(2) The general contractor or owner may have to submit results of soil testing, environmental impact studies, or other information. Sometimes the municipality mandates a public hearing, if opposition to the project is known. However, in most cases, the municipality issues the permit within a few months. The cost of the permit may be the responsibility of the general contractor. The owner may pay for it, however, along with the costs of any related studies.

(3) Construction projects follow the standards of the Uniform Building Code. A Building inspector examines the project at various stages to verify that the contractor is constructing the project according to this Code.

H. Notice of Completion

(1) Once the contractor completes the building, it requests a Notice of Completion. The project must pass a final inspection. Once the project passes that inspection the municipality issues a Notice of Completion, along with a Certification of Occupancy. The local recorder records these documents at the office of the municipality. At this point the municipality appraises the property for property tax purposes. Note: The municipality makes several appraisals throughout the construction process that addresses timing or allocation issues.

I. Law/Authority

I.1. Exhibit 1-1 Federal Tax Law and Guidance

Citation	Title/Summary
IRC Section 263	Capital expenditures.
IRC Section 263A	Capitalization and inclusion in inventory costs of certain expenses.
IRC Section 446	General rule for methods of accounting.
IRC Section 460	Special rules for long-term contracts.
IRC Section 461	General rule for taxable year of deduction.
IRC Section 461(h)	Certain liabilities not incurred before economic performance.
IRC Section 1001	Determination of amount of and recognition of gain or loss.
IRC Section 1221	Capital asset
IRC Section 1237	Real property subdivided for sale.

Citation	Title/Summary
Rev. Rul. 66-247	The costs incurred by a taxpayer in the construction of a house for speculative sale (including the cost of the land) must be capitalized regardless of the taxpayer's overall method of accounting.
Rev. Rul. 69-314	Accrual basis taxpayer is not required to include in income retainages receivable until the all-events test is met under the contract.
Rev. Rul. 69-536	Real estate held for sale by a taxpayer cannot be inventoried in computing taxable income.
Rev. Rul. 70-67	Construction vs. Services: An architect who draws the plans and supervises the work of construction cannot report income from contracts extending over more than one year on the completed contract basis.
Rev. Rul. 74-104	Evaluation expenditures incurred in connection with the acquisition of existing residential property for renovation and resale are capital expenditures that must be taken into account as part of the cost of acquiring the property. However, if such expenditures do not result in the acquisitions of property, they are deductible as losses in the taxable year the corporation decides not to acquire the property.
Rev. Rul. 80-18	Construction vs. Services: A contract to provide engineering services does not qualify as a long-term contract because it does not require taxpayer to actually construct or build anything even though his services are functionally related to activities, which may be the subject of long-term contracts. Thus, such taxpayer is not entitled to use either the completed contract or percentage of completion method.
Rev. Rul. 81-277	The payment by a contractor of money to a buyer in exchange for a release of the buyer's claim against the contractor for failure to fulfill the contract for construction of a plant constitutes a return of capital rather than gross income to the buyer. The cost basis of the plant is adjusted downward to reflect the payment.
Rev. Rul. 82-134	Construction vs. Services: A taxpayer, who by contract furnishes engineering services and construction management to clients, is not entitled

Citation	Title/Summary
	to use the completed contract method of accounting. Taxpayer primarily performs services and construction supervision and is not required to actually construct anything.
Rev. Rul. 84-32	Construction vs. Services: A painting contractor who paints industrial and commercial buildings, highways and railroad bridges, and industrial plants is not entitled to use the completed contract method of accounting. Taxpayer's contract is not a long-term contract because it does not require him to construct, build, or install anything.
Rev. Rul. 86-149	Construction costs of completed homes and costs of construction in progress are capital expenditures under IRC Section 263. Taxpayers cannot inventory such costs under the LIFO inventory method.
Rev. Rul. 89-25	Houses that a homebuilder used for models and/or sales offices were not subject to an allowance for depreciation.
Rev. Rul. 92-28	IRC Section 460(e)(1) permits a taxpayer to use different methods of accounting for exempt and nonexempt contracts within the same trade or business.
Rev. Rul. 93-70	An escrow agent that performs an oversight function with respect to a construction project and makes payments on behalf of the owner and general contractor is required to file information returns (Form 1099) for payments of reportable income.
Rev. Proc. 87-56	This revenue procedure specifies class lives and recovery periods for property subject to depreciation under the general depreciation system provided in IRC Section168. This Revenue Procedure lists depreciable assets used within the construction industry in Asset Class 15, Table 2, 2ith a MACRS life of 5 years.
Rev. Proc.92-29	Provides procedure for a real estate developer to obtain the Commissioner's consent to use an alternative method (other than under IRC Section 461(h)) for determining when common improvement costs may be included in the basis of properties sold for purposes of determining gain or loss resulting from the sales.

Citation	Title/Summary
Rev. Proc. 95-27	Provides safe harbor for certain structural modifications to a building that will not be treated as a demolition under IRC Section 280B.
Rev. Proc. 2001-10	Qualifying taxpayers with average annual gross receipts of $1 million or less are excepted from an accrual method of accounting under IRC Section 446 and accounting for inventories under IRC Section 471. This revenue procedure is not applicable to tax years beginning after 12-31-2017.The 2017 Tax Cuts and Jobs Act changed the requirements for use of the cash method and accounting for inventories for small business taxpayers.
Rev. Proc. 2002-28	This procedure provides an exception from using an accrual method of account and accounting for inventories to qualifying taxpayers in certain eligible businesses with average annual gross receipts of $10 million or less. This revenue procedure is not applicable to tax years beginning after 12-31-2017.The 2017 Tax Cuts and Jobs Act changed the requirements for use of the cash method and accounting for inventories for small business taxpayers.
Rev. Proc. 2004-34	Provides procedures under which accrual basis taxpayers may defer the inclusion of advance payments received (or amounts due and payable) for services the taxpayer will perform in a subsequent year. This Revenue Procedure supersedes Revenue Procedure 71-21. For tax years beginning after 12-31-2017, the 2017 Tax Cuts and Jobs Act essentially codified Rev. Proc. 2004-34. See IRC 451(c). Notice 2018-35 provides interim guidance which allows taxpayers to rely on Rev. Proc. 2004-34 until the Service provides additional guidance.
W.C. & A.N. Miller Development Company v. Commissioner, 81 T.C. 619 (1983)	Taxpayer improperly changed to a LIFO method of accounting for its home construction costs. The individual homes, which the taxpayer sold, were real estate and did not constitute “merchandise” within the meaning of Treasury Regulation Section 1.471-1.
Homes by Ayres v. Commissioner, 795 F.2d 832 (9th Cir.	The taxpayer was not allowed to use the LIFO method of accounting for its completed homes and homes under construction because real property is

Citation	Title/Summary
1986), aff'g, T.C. Memo. 1984-475	not considered "merchandise. Tract home developers, as a matter of law, cannot maintain inventories for tax purposes.
Tollis v. Commissioner, T.C. Memo. 1993-63, aff'd, 46 F.3d 1132 (6th Cir. 1995)	Ordinary income vs. capital gain from the sale of real property. Taxpayers were in the trade or business of selling real estate and, therefore, they realized ordinary income, not capital gain, from their sales of parcels.
Carpenter v. Commissioner, T. C. Memo. 1994-289	Taxpayer is not entitled to use the cash method of accounting for expenses related to construction of houses that were unsold at the end of the taxable year, but instead must capitalize the costs of construction of such unsold houses.
Walsh v. Commissioner, T.C. Memo. 1994-293, aff'd in unpublished opinion, 76 AFT 2d 95-5771.	Ordinary income vs. capital gain from the sale of real property. Court held that the taxpayer was in the trade or business of selling real estate and that income from the sale of such property was thus ordinary.
Hustead v. Commissioner, T.C. Memo. 1994-374, aff'd without opinion, 61 F.3d 895 (3d Cir. 1995)	Expenditures (legal expenses related to challenge of zoning variance) incurred in connection with land development must be capitalized per IRC Section 263A.
Von-Lusk v. Commissioner, 104 T.C. 207 (1995)	Preliminary land development costs (obtaining building permits and variances, negotiating permit fees, property taxes etc.) were nondeductible capital expenditures per IRC Section 263A.
Pierce v. Commissioner, T.C. Memo. 1997-411	A taxpayer engaged in buying and developing land for sale to residential builders is not entitled to use the lower of cost or market method, an inventory method, because real property may not be inventoried.
Foothill Ranch Company Partnership v. Commissioner, 110 T.C. 94 (1998)	Sales Contract vs. Construction Contract: The construction of the buildings or improvements to the real property did not have to be the primary subject matter of the contract in order for a taxpayer to use the percentage of completion method. It only had to be necessary for the taxpayer to fulfill its contractual obligations.
Reichel v. Commissioner, 112 T.C. 14 (1999)	Real estate taxes paid by a real estate developer were required to be capitalized per IRC Section 263A, even though no positive steps to begin

Citation	Title/Summary
	developing the parcels had occurred, because the taxpayer acquired the parcels with the intent to develop them.
Olstein v. Commissioner, T.C. Memo. 1999-290	Lots purchased from a predecessor were capital assets because the property was not held for sale to customers in the ordinary course of the taxpayer's trade or business. Sale of these lots thus resulted in capital gain.
Hancock v. Commissioner, T.C. Memo. 1999-336	Ordinary income vs. capital gain from the sale of real property. The eight lots sold by the taxpayer in liquidation of her real estate development business were in the ordinary course of her trade or business and thus the tax losses from the sales were ordinary losses.
Tutor-Saliba Corporation v. Commissioner, 115 T.C. 1 (2000)	Disputed claims are part of contract price for percentage of completion method of accounting as soon as it is reasonably estimated that the claims would be received, not when the all-events test is met.
Hutchinson v. Commissioner, 116 T.C. 172 (2001)	Pursuant to Rev. Proc. 92-29 (alternative cost method), the taxpayer could allocate estimated clubhouse construction costs to bases in the lots sold. Under the general economic performance rule, however, taxpayer could not include estimated future-period interest expense in the bases of the lots because neither law nor debt for such common improvements.
Raymond v. Commissioner, T.C. Memo. 2001-96	Taxpayer was denied the use of the installment method of accounting on homes the taxpayer built and sold in exchange for promissory notes because such sales were considered dealer dispositions.
Koch Industries v. US, 102 AFTR 2d 2008-5219 (DC Kan 2008) Koch Industries v. US, 603 F.3d 816 (10th Cir. 2010)	The taxpayer was permitted the use of PCM for the "Pavement and Structures Warranties". The court found them to be construction contracts subject to Section 460. The Tenth Circuit reversed the tax court's decision and held that the "Pavement and Structures Warranties" were not long-term contracts and were not permitted to use PCM.
Frontier Custom Builders, Inc. v.	A custom homebuilder was required to capitalize, rather than deduct, all direct and indirect costs of

Citation	Title/Summary
Commissioner, T.C. Memo 2013-231	production per IRC § 263A. Therefore, a Service-imposed method change was proper.
Howard Hughes Company, LLC v. Commissioner, 142 T.C. 355 (2014) Howard Hughes Company, LLC v. Commissioner, 805 F.3d 175 (5th Cir. 2015)	Land developer could not use the completed contract method because they did not have home construction contracts. The Fifth Circuit, affirming the Tax Court, held that two land development companies could not use the completed contract method of accounting in computing their gains from sales of property under long-term construction contracts, finding that the contracts did not qualify as home construction contracts under section 460.
Shea Homes, Inc. v. C.I.R. - 142 T.C. No. 3 (2014) Shea Homes Inc v. Commissioner, 834 F.3rd 1061 (9th Cir. 2016) Action on Decision (AOD) 2017-03	The Tax Court ruled that when interpreting the completed contract method, the subject matter of the taxpayer's contracts include the homes as well as the common improvements in the development. The Tax Court also ruled that, based on the Shea's facts, contract completion occurred when Shea incurred 95% of the costs of the entire development. The Ninth Circuit affirmed the Tax Court's determination that the subject matter of the contracts between the buyers and the taxpayers encompassed more than the mere "bricks and sticks" of the homes. On appeal, IRS conceded that the Tax Court correctly held that the subject matter of the taxpayers' home construction contracts included more than just the house and lot purchased, but challenged how the taxpayers applied the 95% test: the taxpayers deemed their home construction contracts complete for purposes of the completed contract method when they had incurred 95% of the budgeted costs for building the entire community, including the costs of building all of the houses in the community. IRS argued that the taxpayer met the 95% test when it incurred 95% of the budgeted costs of the contracted-for house, lot and common amenities, but not the costs of the other houses.

Citation	Title/Summary
	The Service issued an action on decision stating it will not follow the Ninth Circuit Court of Appeal's opinion in *Shea Homes.*
Basic Engineering, Inc. v. C.I.R., T.C. Memo 2017-26	The taxpayer could not use the completed contract method because they could not reasonably expect to complete the contract within 2 years of the contract commencement date. The taxpayer was required to use the percentage of completion method. The court did not address whether the taxpayer's contracts were long-term manufacturing or long-term construction since both are required to be reported on the percentage of completion method.

J. Relevant Terms

J.1. Exhibit 1-2 Definitions and Terminology

Term	Definition
Advance Payments	Payments generally made to a contractor prior to the performance of services or the receipt of goods.
Advances on Contracts	A current liability account on the books of contractors where billings on contracts exceed accumulated costs.
Aggregating (or Combining)	The process of treating two or more agreements as one contract for reporting income.
Assemblage	Acquisition of contiguous properties by one owner for a specific purpose, such as the development of a housing tract.
Award	Notification given to a bidder informing him or her that the property owner accepted his or her bid.
Back Charges	Billings between parties, such as from owners to general contractors or general contractors to subcontractors, covering expenses, which, according to the contract, the party billed should have incurred.
Back Fill	Soil or other materials used to fill an excavation.

Backlog	The accumulation of unfinished jobs of a contractor, including those not started. Measured by the amount of revenue the contractor expects to receive from the unfinished jobs.
Betterment	Improvement to real property, such as the addition of a sidewalk that increases the property's value. It's not a repair, restoration, or enlargement.
Bid	A formal offer from a contractor, which specifies the price he or she will charge for completing work in accordance with project specifications and contract requirements.
Bid Bond	A bond issued on behalf of a contractor that provides for the payment of the difference between the contractor's bid and the next lowest bid if the owner accepts the contractor's bid and the contractor fails to enter into a contract or furnish such bonds as required by the contract.
Bid Rigging	Any collusive action by contractors that restricts the competitive bidding process by manipulating the bids submitted on a project or projects (such as, inflating bid proposals or predetermining the lowest bidder).
Bonding Capacity	The total dollar amount of the construction bonds (or maximum value of incomplete work) that a surety company will underwrite for a contractor.
Bonus	A premium paid to the contractor that exceeds the basic contract price as a reward for meeting various goals stated in the contract; for example, completing the project prior to the contract completion date. The contract bonus clause stipulates the provisions for bonuses and is in contrast with the penalty clause.
Bridge Loan	Short-term loan to cover the period between the termination of one loan and the beginning of another loan; for example, the period between the construction loan and the permanent loan.
Broker	A party that acts as the general contractor for a project but subcontracts all the construction work required under the contract.

Building Permit	Permission granted by the local government to construct a building or to make property improvements.
Build-to-Suit	Method of leasing whereby the lessor agrees to make tenant improvements to the lessee's specifications in return for the lessee's long-term commitment to lease the space.
Buy-Down	Technique used to facilitate the sale of property. The developer offers the buyer a below-market interest rate on a mortgage loan for an initial number of years. The developer or other seller pays the lender the difference between the below-market rate and the market rate during the buy-down period, after which the borrower pays the full interest cost.
Certificate of Occupancy	Written authorization issued by a local government stating that the structure is ready and fit for occupancy.
Certificate of Payment	Statements prepared by an architect to inform the owner of the amount due a contractor for work completed on a project.
Change Order	A modification of the provisions of a contract, such as a change in specifications or manner of performance that either the owner or the contractor may initiate.
Claim	Amount that exceeds the original contract price that the contractor seeks to collect from the owner or others due to unanticipated circumstances; for example, owner-caused delays, errors in specifications, contract terminations, and disputed change orders.
Class A Office Building	Relatively new office building in a prime location, with a high occupancy rate and highly competitive rental rates.
Class B Office Building	(1) Older office building that the owner has fully renovated to modern standards that is in a prime location with a high occupancy rate and competitive rental rates. (2) Newer building that is not in a prime location.
Closing Statement	Detailed cash accounting of a real estate transaction that an escrow officer, broker, or attorney usually prepares. Also called a settlement statement.
Cluster Development	Subdivision development in which the developer builds detached houses close

	together. It results in allowing little individual yard space.
Commercial Real Estate	Income-producing property, such as shopping centers, offices, hotels, or apartments.
Commitment	A promise to perform a certain act such as making a loan.
Commitment Fee	Fee paid for a written promise to make or insure a loan for a predetermined amount and on specified terms.
Completed Contract Method (CCM)	One of the two generally accepted accounting methods for long-term contracts under which the contractor defers all contract income and all contract costs until the year in which the contractor finally completes and the owner accepts the project.
Completion Bond	A bond, generally given to the owner and the lender, guaranteeing completion of a project and the provision of funds to complete it.
Construction Contract	Any contract for the building, construction or erection of or the installation of any integral component of, or improvements, to real property. A construction contract generally specifies the work the contractor is to perform and the terms of payment.
Construction Contractor	A person or entity that enters into an agreement to build, construct, or install improvements to real property according to the owner's specifications.
Construction in Progress	A current asset account of contractors where accumulated costs exceed billings on a contract.
Construction Loan	Mortgage loan used to finance real estate construction. It may include funds for acquiring land for the construction project and the permanent financing of the completed project.
Construction Management (CM)	The function of managing and coordinating the construction of a project including the negotiating of contracts with others to perform the construction work.
Contract Bond	A bond to indemnify the owner against the failure of a contractor to comply with the requirements of a contract.
Contract Cost Breakdown	A schedule showing the various elements and phases of work in a construction project and the cost of each.

Cost-Plus Contract	A contract, which provides for reimbursement to the contractor of the costs incurred in completing the work plus some additional amount to compensate the contractor for profit, overhead, and performance. Different types of cost-plus contracts include cost-plus-fixed-fee, cost-plus award-fee, and cost-plus-incentive fee.
Cost-Plus Award-Fee Contract	A type of cost-plus contract in which the fee consists of a fixed-fee plus an amount which varies according to the level of performance of the contractor in areas such as cost savings and timeliness.
Cost-Plus-Fixed-Fee Contract	A type of cost-plus contract in which the fee is usually a stipulated sum or a percentage of cost.
Cost-Plus-Incentive-Fee Contract	A type of cost-plus contract in which the fee is based on either cost savings or performance. It varies according to the level the contractor achieves in meeting such cost or performance criteria.
Critical Path Method (CPM)	A method of scheduling construction activities according to a sequence that allows the contractor to complete the project in the shortest time.
Delayed Billings	Billings from a contractor for work performed in previous billing period.
Design Build Contract	A single contract in which the contractor agrees to provide the design, procurement, and construction services necessary to complete a project.
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.
Development Agreement	Agreement under California law by which local governments and developers can defend their respective interests during the development period. Such agreements can protect developers against changes in public policies that can cause delay or abandonment of a development project even though the developer has spent substantial funds for development.
Development Loan	A loan for off-site improvements such as streets and utilities vs. Construction Loan.

Direct Cost	Any labor, material, job overhead, or other cost that is directly attributable to a specific construction job.
Draw	The amount of progress payments that is currently available to a contractor under a contract with a fixed payment schedule.
Dwelling Unit	A house or apartment used to provide living accommodation in a building or structure, but doesn't include a hotel, motel, or other establishment where the tenant uses more than half of the units on a transient basis
Engineering Contract	A contract for engineering services only, as opposed to the actual construction of a project.
Escalation Clause	A provision in contracts providing for the contractor to make upward adjustments in the contract price of certain items or elements of work when conditions affecting the cost change.
Estimates	These are estimated costs of a construction project. A project has three types of estimates during the evolution of the project. • A contractor generally makes conceptual estimates in the early phases of a project for the owner to consider whether the project is economically feasible. • A contractor makes detailed estimates after the owner approves the design. These require a careful tabulation of all the quantities for a project or portion of a project (quantity takeoff or quantity survey). • A contractor makes a definitive estimate after the initial approximate estimates become more defined and accurate as the contractor develops additional information. Definitive estimates forecast the final project cost with little margin for error.

Exempt-Contract-Percentage of Completion Method (EPCM)	A taxpayer may elect this method if it is exempt from the requirement to use the PCM under IRC § 460. The taxpayer must include in income a portion of the total contract price that corresponds to the percentage of the entire contract completed during the taxable year.
Factory-Built Houses	Portions of homes that are constructed off-site and assembled at the building site to reduce construction costs.
Fast Tracking (or Phased Construction)	A system of scheduling the design and construction in such a manner that both phases progress simultaneously, with an appreciable reduction in the total time to complete the project.
Final Acceptance	The owner's acceptance of the project from the contractor upon certification by an architect or engineer that the contractor has completed the project according to contract requirements. Final acceptance usually precedes the date when the owner makes the final payment. The contract will specify the procedures to determine final acceptance.
Final Inspection	The final review or inspection of a project performed by an architect, engineer, or construction manager to certify that the contract has completed the work according to the contract requirements, after which the architect or engineer issues the final certificate for payment.
Fixed-Price Contract	Agreement in which the contractor agrees to perform the required work in return for a fixed price stipulated in the contract.
Front-End Loading	A common strategy used by contractors under which it assigns higher relative values to work the contractor is to complete in the early stages of a contract than to the work to be completed in the later stages. The result is that progress billings during the early stages exceed the actual value of the work done causing the contractor's revenue from the project to be higher during the early stages. See "Unbalanced Bid."
General Contractor	A contractor who contracts with an owner to be responsible for all the construction work necessary to complete a project, even though

	the contractor may use subcontractors to perform part of the work.
Gross Contract Price	Includes all amounts (including holdbacks, retainages, and reimbursement) that entitles a contractor to by law or contract to receive, whether or not the contractor is due or paid the amounts. It also includes contingent income such as bonuses, awards, and incentive payments, such as a bonus for meeting an early completion date.
Guaranty Bond	A type of bond guaranteeing that the contractor will complete the work according to the contract and/or pay all obligations. Also known as a "surety bond." If the bond guarantees completion of the work, it is a "performance bond" or "completion bond." If it guarantees payment of obligations, it is a "payment bond."
Hard Dollar Costs	Cash outlays for land, labor, and improvements.
Historic Structure	Pre-1936 building that qualifies for special rehabilitation tax credits as a historic structure under the Tax Reform Act of 1986. See IRC section 47(c)(1)(B).
Home Construction Contract	For tax purposes, a long-term contract where the taxpayer expects 80% or more of the estimated total allocable contract costs, as of the close of the taxable year in which the contract is entered, to the construction of dwelling units and improvements to real property directly related to and located at the site of the dwelling unit. It involves a building with 4 or fewer dwelling units. See residential construction contract definition for buildings containing more than 4 dwelling units.
Improvement Bond	Bond issued by public agency to finance the construction of improvements such as highways and streets.
Indirect Costs	Generally, overhead expenses of the contractor that are not directly attributable to a particular construction project.
Invited Bid	A bid submitted by one of a selected group of contractors who have received an invitation to bid on a project, as opposed to bidding that is open to all qualified contractors.

Job Costs	Costs that a contractor can allocate to specific jobs (such as material, labor and job overhead costs).
Job Gain or Job Fade	Job gain or fade is calculated on a job-by-job basis by comparing the original estimated gross profit on a project to the current estimated gross profit. An increase indicates a gain while a decrease indicates a fade.
Joint Venture	A cooperative undertaking, by two or more parties (contractors), operated as a separate business entity combining resources and sharing risks on a construction project.
Kickbacks	Payments made without any legal obligation, usually to individuals in return for their influence in obtaining a contract.
Labor and Material Payment Bond	A type of guaranty bond, which guarantees the owner that the contractor will pay all project costs for labor, material, and supplies incurred,
Labor and Material Release	Document signed by laborers and material suppliers waiving their rights under any mechanic's lien against the developer.
Letter of Credit	A document issued by a financial institution guaranteeing the payment of its client's debts up to a stated amount for a specific period.
Lien	A legal claim filed against specific property of the owner to secure payment of amounts due to material suppliers or contractors engaged to construct the project.
Liquidated Damages	Amounts stipulated in the contract, usually as a fixed amount per day, that the owner obligates the contractor to pay as compensation for damages suffered because of the contractor's failure to complete the work within a specified time.
Loan Commitment	See "Commitment."
Loan Origination Fees	Lender's charge for services in originating a mortgage. Such fees typically are 1 to 2 percent of the amount of the loan.
Long-Term Contract	A building, installation, construction, or manufacturing contract, which the contractor does not complete within the taxable year in which the contractor enters the contact.
Look-Back Method	With respect to income from any long-term contract reported under the percentage of completion method, IRC § 460(b) requires a

	taxpayer to pay or entitles a taxpayer to receive interest on the amount of tax liability deferred or accelerated because of overestimating or underestimating total contract price or contract costs. The look-back method requires taxpayers to pay interest for any deferral of tax liability resulting from the underestimation of the total contract price or the overestimation of total contract costs. Conversely, if the taxpayer overestimates the total contract price or the taxpayer underestimates the total contract costs, IRC 460(b) entities the taxpayer to receive interest for any resulting acceleration of tax liability.
Lump Sum Contract	See “Fixed-Price Contract.”
Maintenance Bond	A bond guaranteeing the owner that, for a specified time following the completion of a project (warranty period), the contractor will rectify any defects in workmanship or materials. A performance bond normally includes a one-year maintenance bond.
Mechanic’s Lien	A lien on real property in favor of persons supplying labor or materials for a building or structure, generally for the value of the labor or materials provided. A mechanic’s lien also exists for professional services in some states. The owner cannot obtain clear title to the property until it settles the claim.
Negotiated Bid	A bid proposal from a specific contractor (selected on reputation, past performance, quality of work, expertise, or other reasons) in which the owner and contractor negotiates the terms and conditions, as opposed to the competitive bidding process under which the owner seeks the lowest bid from various qualified contractors.
Offsite Costs	Expenditures incurred for the improvement of raw land that the developer does not relate to the construction of the building (such as, curbs, gutters, sidewalks, and streets).
Off Balance Sheet Financing	Financing that does not appear on the balance sheet (such as, operating leases).
Onsite Costs	Expenditures incurred for the actual construction of a building.

Overhead Costs	May refer to either job overhead or operating overhead costs. "Job overhead costs" are direct costs of work, which the contractor can allocate to a specific job, but cannot allocate to specific items of work within that job. "Operating overhead costs" are indirect costs of operating a construction business that the contractor cannot allocate to specific jobs.
Owner	The customer of a contractor, architect, or engineer who generally owns the right to the land on which the project is being built.
Payment Bond	A bond guaranteeing payment of the contractor's obligations incurred on a project. See "Labor and Material Payment Bond."
Penalty Clause	In contrast to the bonus clause, this provision of the contract provides for a reduction of the amount payable under a contract if the contractor fails to meet specified targets or project specifications.
Percentage-of-Completion/Capitalized-Cost Method	One of the methods of accounting that a taxpayer may use only for residential long-term construction contracts. Under this method the taxpayer must determine income from long-term contacts using the PCM for the applicable percentage of the contract and its exempt contract method for the remaining percentage of the contract. For residential construction contracts described in §1.460-3(c), the applicable percentage is 70 percent, and the remaining percentage is 30 percent.
Percentage-of-Completion Method (PCM)	One of the two generally accepted accounting methods for long-term contracts in which the amount of gross income reportable in each year is that portion of the gross contract price which represents the percentage of the entire contract completed during the year.
Performance Bond	A guaranty bond executed by the contractor to protect the owner against the contractor's failure to perform according to the terms of the contract. The contractor usually combines this with a labor and material payment bond.
Phased Construction	See "Fast-Tracking."
Pre-Qualification	The approval given a contractor under circumstances where an agency or owner

	requires bidders to meet certain standards. This approval then authorizes the contractor to submit a bid on the project.
Prime Contractor	The general contractor or any major contractor who has a contract directly with the owner.
Profit Center	The unit, usually a single contract, used by a contractor to measure profit or loss for accounting purposes.
Progress Billings	Amounts billed by a contractor during the progress of work on a project. The contractor determines the amount of the billings in accordance with the terms of the contract, the amount of work completed, and the materials suitably stored. Change orders will affect the progress billings.
Progress Payments	Payments made in response to progress billings.
Progress Schedule	Usually a diagram or other pictorial prepared by the contractor and updated monthly, showing the proposed and actual starting and completion times of the various elements or phases of work included in a project.
Project Manager	An employee of the general contractor or contract manager who is responsible for all work performed on a project.
Punch List	A list prepared by the architect or owner near the completion of a project indicating items the contractor needs to complete or correct.
Quantity Take-Off (or Quantity Survey)	A detailed compilation of the quantity of each elementary work item that the project calls for. The contractor uses these in making project cost estimates.
Residential Construction Contract	A residential construction contract differs from a home construction contract in that it involves buildings with five or more dwelling units in each building (e.g., apartment buildings or condominiums).
Retainage	Specified amount usually withheld from progress billings pending satisfactory completion and final acceptance of the project.
Severing (or Segmenting)	Treating one agreement as two or more contracts for reporting income.
Specifications (or Specs)	A technical description (along with working drawings) of the materials, workmanship,

	special construction methods, and standards required under a contract.
Subcontract	A contract between a prime contractor and a separate contractor or supplier to perform a portion of the work or supply materials for which the prime contractor is responsible to the owner.
Subcontractor	A contractor who contracts with the general contractor or another prime contractor to perform a specific part of the work required on a project.
Subcontractor Bond	Performance and payment bonds executed by a subcontractor and given to the prime contractor to guarantee the subcontractor's performance and payment of obligations required under the subcontract.
Substantial Completion	The point reached in a project at which the contractor has completed all major work. The remaining costs and potential risks of the contractor are insignificant.
Surety	A person or organization, such as a bonding company who promises in writing to make good the debt or default of another in return for consideration.
Surety Bond	A legal instrument under which a surety (bonding company) agrees to answer to another party (the owner) for the debt, default, or failure of performance of a third party (the contractor).
Time and Materials Contract	A contract that generally provides for payments to the contractor based on the number of direct labor hours expended at fixed hourly rates plus the cost of materials. To cover indirect costs and profit, the contractor charges time (and sometimes material) at marked-up rates.
Turnkey Job	A project on which the contractor is responsible to deliver a completed and operational facility.
Unbalanced Bid	A bid under which the contractor disproportionately allocates the contract price to elements or phases of work on a basis other than that of cost plus overhead and profit. For example, front-end loading is the assigning of higher relative values to the work completed during the early phases of a project, or the

	assigning of higher profits to high quantity items under a unit-price contract.
Unit-of-Delivery Method	Under this method, the contactor records revenue and cost of sales as the contractor delivers units of work. This is most suitable to production-type contracts where the contractor produces many units of a product in a continuous process (for example, aircraft).
Unit-Price Contract	A type of construction contract, which divides the work (or project) into various elements and fixes a price per unit for each element. Thus, payments to the contractor are based on the number of units of work performed for each element. This type of contract is particularly suited to projects where the quantities of work may vary substantially.

K. Resources

K.1. Exhibit 1-3 Construction Industry Resources

Name	Source	Description
Associated Builders and Contractors (ABC)	http://www.abc.org/	A national trade association representing about 23,000 contractors, subcontractors, and material suppliers. This website also provides license requirements by state.
Associated General Contractors (AGC)	http://www.agc.org/	The largest and oldest construction trade association.
American Institute of Certified Public Accountants (AICPA)	http://www.aicpa.org/	The AICPA is the national professional organization for all Certified Public Accountants. It provides members with the resources, information, and leadership to enable them to provide services in the highest professional manner to benefit the public, employers, and clients.

Name	Source	Description
American Institute of Architects (AIA)	http://www.aia.org/	The AIA is the voice of the architecture profession dedicated to serving its members; advancing their value; and improving the quality of the building environment. The AIA documents are standard forms in the building industry.
American Institute of Constructors (AIC)	http://www.aicnet.org/	AIC is an organization established to help individual construction practitioners achieve the professional status they deserve.
American Subcontractors Association (ASA)	http://www.asaonline.com/	ASA is comprised of professional constructors, suppliers, and service providers representing the construction industry through advocacy, leadership, education and networking.
Blue Book of Building and Construction	http://thebluebook.com/	Provides a listing of over 1,000,000 general contractors, subcontractors, architects, engineers by regional area.
Builder Online	http://www.builderonline.com/	Comprehensive building information with numerous links.
Building Online	http://www.buildingonline.com/	Search over 100,000 building related sites. Links to builders, retailers, news, trade shows, contractor directories, home improvement tips, accounting and estimating software.
Construction Financial Management Association (CFMA)	http://www.cfma.org/	CFMA is a source of education and information on financial management to the construction industry. Over 7,000 members.
Construction Industry CPA Consultants (CICPAC)	http://www.cicpac.com/	CICPAC is a national, not-for-profit association for CPA firms providing financial and

Name	Source	Description
		consulting services to the construction industry.
Construction Management Association of America (CMAA)	http://cmaanet.org/	CMAA supports construction managers to enhance their performance and improving their business results. CMAA also provides information about the construction management practice.
Design-Build Institute of America (DBIA)	http://www.dbia.org/	To promote the use of design-build project delivery. DBIA sponsors educational programs, publishes a Manual of Practice and Design-Build Contract Documents, public outreach and private facility owners.
Mechanical Contractors Association of America (MCAA)	http://www.mcaa.org/	MCAA is an association of more than 2,200 mechanical, plumbing, and service contractors.
National Association of Homebuilders (NAHB)	http://www.nahb.org/	The NAHB is a federation of more than 800 state and local builder associations throughout the US. The mission of this association is to enhance the climate for housing and the building industry, and to promote policies that will keep housing a national priority.
Plumbing-Heating-Cooling Contractors Association (PHCC)	http://www.phccweb.org/	PHCC is a nationwide organization with approximately 3,700 members. This association is the advocate for the plumbing, heating, and cooling contractors.
Secretary of State		Search Secretary of State websites for any state to find information on company’s address, related companies and registering agent.

Name	Source	Description
Securities Exchange Commission (SEC)	http://www.sec.gov/	Provides extensive information on publicly traded companies, including the 10-K, 10-Q filings.
Taxpayer Website	Google Search	Search construction company's website for annual reports, officers, headquarters, and subsidiaries.
Constructor	Every 2 Months	Magazine published by the Associated General Contractors of America (AGC). You can download the magazine, free of charge at http://www.agc.org/
Building Design & Construction	Monthly	Focuses on design and construction of nonresidential buildings for architects, engineers, and construction managers. You can download articles free of charge from their website: http://www.bdcmag.com/
CFMA Building Profits	Six times a year	Magazine published by the Construction Financial Management Association (CFMA) The website is at http://www.cfma.org/
Journal of Construction Accounting and Taxation	Six times a year	Articles on financial and tax accounting published by RIA (Research Institute of America). The Thomson Corporation formed the RIA business unit with the merger of RIA, Computer Language Research (CLR), and Warren, Gorham, & Lamont G&L. http://riahome.com/
Engineering News- Record (ENR)	Weekly	Magazine published by McGraw Hill Construction. Ranking of contractors by type and gross income in addition to articles on companies and projects. http://www.enr.com/

Name	Source	Description
PPC (Practitioners Publishing Company) Guide to Construction Contractors	Updated annually	Three-volume guide that discusses the industry in detail. The guide covers both financial and tax aspects.
PPC (Practitioners Publishing Company) Guide to Real Estate	Updated annually	Three-volume guide that discusses the development of real estate in detail. The guide covers both financial and tax aspects.
WG&L (Warren, Gorham & Lamont) Construction Controller's Manual	Updated annually	Provides insight to the complex accounting, tax, insurance, legal, and financial issues of the construction sector.
Robert Morris Associates (RMA) Annual Statement Studies	Updated annually	Provides comparative financial data for all types of businesses organized by SIC/NAICS codes.
CFMA Construction Industry Annual Financial Survey	Updated annually	The survey contains financial data organized by type of construction, dollar volume, and geographic region.
CCH Construction Guide: Tax and Advisory Services	Updated annually	Provides in-depth tax rules pertaining to construction contractors in an "easy-to-read" format.
AICPA Construction Contractors	Regularly Updated - not necessarily annual	AICPA Audit and Accounting Guide
AICPA Audit Risk Alert on the Construction Industry	Updated annually	No authoritative practice aids. The design is to use as an engagement planning tool. The alerts are resources for checking vital audit

Name	Source	Description
		considerations that you might otherwise overlook.
ARB (Accounting Research Bulletin) No. 43 Government Contracts	June 1953	Chapter 11 prescribes generally accepted accounting principles in three areas of accounting for government contracts. Section A deals with accounting under cost-plus-fixed-fee contracts. Section B deals with aspects of government contracts and subcontracts that are subject to renegotiation. Section C involves accounting for terminated war and defense contracts.
ARB No. 45 Long- Term Construction Type Contracts	October 1955	Describes the two generally accepted methods of accounting for long-term construction-type contracts: percentage-of-completion method and the completed-contract method.
SOP (Statement of Position) 81-1 Accounting for Performance of Construction-Type and Certain Production-Type Contracts	July 15, 1981	Provides additional guidance on the application of the generally accepted accounting principles set forth in ARB No. 43 & 45. SOP 81-1 establishes a strong preference for the percentage-of-completion method.

II. Long Term Contracts

A. Overview

(1) The construction industry is both unique and complex with respect to the number of available tax methods of accounting. A taxpayer determines the proper method of accounting for a long-term construction contract based on the type and terms of each contract, along with related party considerations.

(2) Before the enactment of the Tax Reform Act of 1986, construction contractors could choose an accounting method from various alternatives with few restrictions. Contractors would recognize income and expense from construction contracts under the cash method, accrual method, completed contract method (CCM), or percentage-of-completion method (PCM). Many contractors adopted the CCM for tax purposes because they could defer taxes until the completion of the contract.

(3) Internal Revenue Code Section (IRC §) 460 (effective for contracts a taxpayer enters into after February 28, 1986) generally requires the use of the percentage-of-completion method. Additionally, IRC § 460 introduced the "Look-back Method." There is a separate Audit Technique Guide for Look-back Interest. A long-term contract method of accounting (completed contract or percentage-of-completion) is only available to taxpayers that have long-term contracts. Therefore, the taxpayer must determine whether a long-term contract exists and the classification of the contract prior to electing a proper method of accounting. This Service designed this chapter to bring out the various factors involved in making this determination.

B. Law/Authority related to Long-Term Contracts

(1) The term "long-term" tends to indicate a contract that lasts a long period of time, but the duration of the contract is irrelevant for the taxpayer to classify it as a long-term construction contract.

(2) IRC § 460(f)(1): In general, the term "long-term contract" means any contract for the manufacture, building, installation, or construction of property if the taxpayer does not complete such contract within the taxable year in which the taxpayer enters into such contract.

(3) **Example**: A calendar-year taxpayer begins a construction job on December 31 and completes the job on January 1 of the subsequent year. IRC § 460 considers this contract as a long-term contract even though the job was only two days in duration.

C. Contracts Required to be Reported Using the PCM

(1) Under IRC § 460(b)(1), taxpayers must use the PCM to report taxable income from long-term contracts. The taxpayer generally determines the degree of completion by comparing the total allocated contract costs incurred to date with the total estimated contract costs, otherwise known as the “cost-to-cost method.”

(2) The contractor may not use engineering estimates or other approaches to determine the degree of completion if the contractor is required to use the PCM under IRC § 460.

(3) If a contractor can meet one of the exceptions of IRC § 460(e), see section below, the contractor may use engineering estimates or any other recognized output methods to determine completion, if the method is reasonable. See Chapter 4, Large Construction Contractors, for additional information regarding contracts subject to IRC § 460.

D. Contracts Exempt from the PCM

(1) IRC § 460(e) provides two exceptions to the required use of the PCM and the application of look-back interest. These two exceptions only apply to long-term construction contracts. They do not apply to long-term manufacturing contracts which are outside of the scope of this audit technique guide:

- Any home construction contract. IRC § 460(e)(1)(B) requires home construction contractors not meeting the small contractor exception (item 2 below) to capitalize costs using IRC § 263A. See Chapter 7, Homebuilders and Developers, for additional information regarding home construction contracts.
- For non-home construction contracts, the small construction contract exception, as defined in IRC § 460(e)(1)(B), may apply. At the time the taxpayer enters into the contract, if it is estimated that such contract will be completed within a 2-year period beginning on the commencement date of such contract; **and** the taxpayer's average annual taxable gross receipts for the 3 taxable years preceding the year in which such contract was entered into did not exceed $25 million ($10 million for tax years beginning before1-1-2018). See Chapter 3, Small Construction Contractors, for additional information regarding these types of contracts.

D.1. Example of Small Construction Contract Exception:

(1) A contractor enters into two long-term contracts during the taxable year. Neither of which are home construction contracts. The average annual taxable gross receipts for the prior 3 taxable years is $24,000,000.

(2) The taxpayer expects to complete Job 1 within 18 months. Job 1 is exempt from the PCM and look-back requirements of IRC § 460. The taxpayer may account for the contract under the taxpayer’s exempt method of accounting for long-term contracts (e.g. completed contract, accrual).

(3) The taxpayer expects to complete Job 2 within 30 months. The taxpayer must account for Job 2 using the PCM and IRC § 460(b)(1)(B) requires the taxpayer to use the look-back method upon the completion of the job. Even though the taxpayer’s average annual taxable gross receipts for the

prior 3 years are less than $25,000,000, the taxpayer estimates it will not complete the contract within the 2-year period.

(4) In this example, two methods of accounting for long-term contracts are proper. The example above is for tax years beginning after 12-31-2017. For tax years beginning prior to 1-1-2018, the average annual gross receipts for the prior 3 years must be $10 million or less.

E. Construction and Manufacturing Contracts

(1) IRC § 460 makes a distinction between the two categories of long-term contracts; a construction contract and certain manufacturing contracts. A construction contract pertains to real property. A manufacturing contract pertains to personal property. The Service wrote this guide primarily for use with construction contracts as opposed to manufacturing contracts. Treasury Regulation Section (Treas. Reg. §) 1.460-1(b)(1) further distinguishes a long-term construction contract from a long-term manufacturing contract.

E.1. Long-term Contract

(1) A long-term contract generally is any contract for the manufacture, building, installation, or construction of property if the taxpayer does not complete the contract within the contracting year, as defined in Treas. Reg. § 1.460-1(b)(5). However, a contract for the manufacture of property is a long-term contract only if it also satisfies either the unique-item or 12-month requirements described in Treas. Reg. § 1.460-2. A contract for the manufacture of personal property is a manufacturing contract. In contrast, a contract for the building, installation, or construction of real property is a construction contract. See Treas. Reg. § 1.460-1(b)(1).

E.2. Construction Contract

(1) For purposes of this subsection, the term "construction contract" means any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property. See IRC § 460(e)(4).

E.3. Manufacturing Contract

(1) IRC § 460(f)(2) provides a special rule for manufacturing contracts. A taxpayer shall not treat a contract for the manufacture of property as a long-term contract unless such contract involves the manufacture of:

- Any unique item of a type which the taxpayer does not normally include in its finished goods inventory; or

- Any item which normally requires more than 12 calendar months to complete (without regard to the period of the contract).

E.4. Integral Components of Real Property

(1) A contract is a long-term contract if the taxpayer does not complete the contract in the year it enters into the contract and it involves the building, construction, reconstruction, or rehabilitation of real property; the installation of an integral component to real property; or the improvement of real property. These are collectively referred to as construction contracts. Treas. Reg. § 1.460-3(a).

(2) Real property means land, buildings, and inherently permanent structures, as defined in section Treas. Reg. § 1.263A-8(c)(3), such as roadways, dams, and bridges. Real property does not include vessels, offshore drilling platforms, or natural products of land that the taxpayer has not severed.

(3) An integral component to real property includes property not produced at the site of the real property but the taxpayer intends to be permanently affixed it to the real property, such as elevators and central heating and cooling systems.

(4) **Example:** A contract to install an elevator in a building is a construction contract because a building is real property, but a contract to install an elevator in a ship is not a construction contract because a ship is not real property.

F. Contract Classifications

(1) Taxpayers must classify contracts on a contract-by-contract basis and categorize them into one of the following classifications:

- Long-term construction contract;
- Long-term manufacturing contract; or
- Non-long-term contract.

(2) Treas. Reg. § 1.460-1(b)(2)(i) clarifies that a contract's classification should be based on the performance required of the taxpayer under the contract regardless of whether the taxpayer classifies the contract as a sales contract or a construction contract. It’s not relevant that the taxpayer delivers title in the property constructed under the contract to the customer.

(3) Treas. Reg. § 1.460-1(b)(2) provides that (i) In general. A contract is a contract for the manufacture, building, installation, or construction of property if the manufacture, building, installation, or construction of property is necessary for the taxpayer to fulfill its contractual obligations and if the

taxpayer has not completed the manufacture, building, installation, or construction of that property when the parties enter into the contract.

(4) If a taxpayer must manufacture or construct an item to fulfill his obligation under the contract, it is not relevant that the contract does not require the taxpayer to deliver that item to the customer. Whether the customer has title to, control over, or bears the risk of loss from the property manufactured or constructed by the taxpayer also are not relevant. Furthermore, how the parties characterize their agreement (e.g., as a contract for the sale of property) is not relevant.

(5) **Example:** A developer, whose taxable year ends December 31, owns 5,000 acres of undeveloped land. To obtain permission from the local county government to improve this land, the taxpayer must construct a service road on this land to benefit all 5,000 acres. In Year 1, the developer enters into a contract to sell a 1,000-acre parcel of undeveloped land to a residential developer, for its fair market value. In this “sales” contract, the developer agrees to construct a service road running through the land that it is selling to the residential developer. The taxpayer estimates the complete construction of the service road to be in Year 3. The “sales” contract is a construction contract because the construction of an item (the service road) is necessary for the developer to fulfill its contractual obligations. The taxpayer must consider de minimis construction activities in classification of the contract if the taxpayer enters into it after January 10, 2001. This ATG discusses de minimis construction activities in more detail later in this chapter.

F.1. Hybrid Contracts

(1) A hybrid contract is a single long-term contract that requires a taxpayer to perform both manufacturing and construction activities.

(2) Treas. Reg. § 1.460-1(f)(2) provides that, in general, a taxpayer must classify a long-term contract that requires a taxpayer to perform both manufacturing and construction activities (hybrid contract) as two contracts; a manufacturing contract and a construction contract.

(3) Treas. Reg. § 1.460-1(f)(2) permits a taxpayer to elect, on a contract-by-contract basis, to do one of the following:

- Treat the entire contract as a long-term construction contract if at least 95% of the estimated total allocable contract costs are reasonably allocable to construction activities; or
- Treat the entire contract as a long-term manufacturing contract subject to the percentage-of-completion method of accounting. Note that there is no 95% rule with regards to an election to treat

the contract as a long-term manufacturing contract subject to the PCM as there is with the election to treat a hybrid contract as a construction contract.

G. De Minimis Construction Activities

(1) A contract with de minimis construction activities is not a construction contract under IRC § 460 if the contract includes the provision of land by the taxpayer and the estimated total contract costs attributable to the construction activities are less than 10% of the contract's total contract price.

(2) For purposes of the 10% test, the taxpayer does not include the cost of the land provided to the customer in the allocable contract costs. See Treas. Reg. § 1.460-1(b)(2)(ii).

(3) This 10% threshold provides a "bright-line" test. Prior to enactment of the regulation, Notice 89-15 provided that a contract was a construction contract if the construction activity required by the contract was necessary for the taxpayer to fulfill its contractual obligations.

(4) Example:

- A developer, whose taxable year ends December 31, owns 5,000 acres of undeveloped land with a cost basis of $5,000,000. To obtain permission from a local county government to improve this land, the developer must construct a service road on this land to benefit all 5,000 acres.
- The developer enters into a contract to sell a 1,000-acre parcel of undeveloped land to a residential developer for $10,000,000. In the sales contract, there is a provision that commits the taxpayer to construct the portion of the service road that benefits the acreage sold, as required by the local county government. The taxpayer estimates the portion of the cost of the service road attributable to the 1.000-acre parcel to be $10,000. The taxpayer does not complete the service road until the subsequent year
- Because the estimated total allocable contract costs attributable to the construction activities is $10,000, which is less than 10% of the total contract price of $10,000,000, the IRC does not consider the contract to be a construction contract and does not require the taxpayer to account for the contract under a long-term contract method.

H. Non-Long-Term Contract Activities

(1) Long-term contract methods of accounting apply only to the gross receipts and costs attributable to long-term contract activities. Treas. Reg. § 1.460-1(d)(2) defines non-long-term contract activities.

(2) Non-long-term contract activity means the performance of an activity other than manufacturing, building, installation, or construction, such as the provision of architectural, design, engineering, and construction management services, and the development or implementation of computer software.

(3) In addition, performance under a guaranty, warranty, or maintenance agreement is not a long-term contract activity and is never incidental to or necessary for the manufacture or construction of property under a long-term contract.

(4) Several revenue rulings have held that contracts for services cannot use a long-term method of accounting:

- A contract extending more than one year does not entitle an architect to report income on the CCM when the work is personal service. Revenue Ruling 70-67, 1970-1 C.B. 117.
- Engineering services and construction management, unrelated to the construction contractor, cannot use either the CCM or PCM because the contract does not require the taxpayer to construct or build anything, even though the services are functionally related. Revenue Ruling 82-134, 1982-2 C.B. 88 and Rev. Ruling. 80-18, 1980-1 C.B. 103.
- A painting contractor cannot use the CCM because he provides only painting services. Revenue Ruling 84-32, 1984-1 C.B. 129.

(5) A taxpayer must generally take gross receipts and costs attributable to non-long-term contract activities, as defined in paragraph (d)(2) of Treas. Reg. § 1.460-1, into account using a permissible method of accounting other than a long-term contract method. See IRC § 446 (c) and Treas. Reg. § 1.446-1(c).

(6) However, if the performance of a non-long-term contract activity is incident to or necessary for the manufacture, building, installation, or construction of the subject matter of one or more of the taxpayer's long-term contracts, the taxpayer must allocate the gross receipts and costs attributable to that activity to the long-term contract. Treas. Reg. § 1.460-1(d) requires allocation of the contract's gross receipts and costs among the activities.

I. Related Party Contract

(1) Treas. Reg. § 1.460-1(g) extends the reporting of the PCM to related parties that may not generally be required to report their income on the PCM. A taxpayer who performs an activity that would normally be considered a non-long-term contract activity (e.g., architectural services) must report income on the percentage-of-completion method if it is incidental to or necessary to a related party's long-term contract.

(2) This type of activity may include, for example, the performance of engineering and design services, and the production of components and subassemblies that the taxpayer reasonably expects to use in the production of the subject matter of the related party's contract.

(3) **Example:** A customer hires a general contractor to design and construct a building. The IRC considers the design portion of the contract as a non-long-term contract activity. However, it is incidental to the construction of the building because the general contractor could not build it without the design, so the general contractor accounts for the entire contract under a long-term contract method of accounting.

(4) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate, Treas. Reg. § 1.460-1(b)(4) defines a related party as a person whose relationship to a taxpayer as described in IRC §§ 707(b) or 267(b) that includes:

- A partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership;
- Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests;
- Members of a family, including only brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants;
- An individual and a corporation, in which such individual owns more than 50 percent in value of the outstanding stock, directly or indirectly, by or for such individual;
- Two corporations which are members of the same controlled group;
- A grantor and a fiduciary of any trust;
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a beneficiary of such trust;
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a corporation, in which such fiduciary owns more than 50 percent in value of the outstanding stock, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and such person controls directly or indirectly or (if such

person is an individual) controlled by members of the family of such individual;

- A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership;
- An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or
- An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

(5) **Example:** An architectural firm enters into a contract with a customer to design an office building. Since the contract is for the performance of services it is not a long-term construction contract. However, if the architect's related construction company enters into a contract with the same customer to build the "designed" building and IRC § 460 requires the construction company to account for the long-term construction contract under the PCM, the architect must account for the design services under PCM because the services are incidental to the related construction company's contract.

J. Severing and Aggregating Contracts

(1) IRC § 460(f)(3) permits and may require contractors to sever or aggregate contracts. Severance treats one agreement as two or more contracts. Aggregation treats two or more agreements as one contract. Whether a taxpayer should sever an agreement or aggregate two or more agreements, depends on the following factors (with certain exceptions) as provided in Treas. Reg. § 1.460-1(e):

- Pricing: To sever an agreement into two or more contracts, independent pricing of items in an agreement is necessary.
- Separate delivery or acceptance: A taxpayer may not sever an agreement into two or more contracts unless it provides for separate delivery or separate acceptance of items that are the subject matter of the agreement. The separate delivery or separate acceptance of items by itself does not necessarily require a taxpayer to sever an agreement.
- Reasonable business person: A taxpayer may not aggregate two or more agreements to perform manufacturing or construction activities into one contract unless a reasonable business person would not have entered into one of the agreements for the terms agreed upon without also entering into the other agreement(s).

(2) Exceptions under Treas. Reg. § 1.460-1(e)(3) provide that (i) A taxpayer may not sever a long-term contract that would be subject to the PCM without obtaining the Commissioner's prior written consent.

(3) However, a taxpayer that does not report a contract under PCM (for example, CCM, accrual, or cash), must sever any agreement that increases the number of units to be supplied to the customer, such as through the exercise of an option or the acceptance of a change order, if the agreement provides for separate delivery or separate acceptance of the additional units.

(4) Example 1:

- This situation illustrates the concept of severance. On January 1, Year 1, a construction contractor enters into an agreement to build two office buildings in different areas of a large city. The agreement provides that the construction contractor will complete and the customer will accept two office buildings in Year 2 and Year 3 respectively. The customer will pay the contractor $1 million and $1.5 million for the two office buildings respectively.
- The agreement will provide a reasonable profit from the construction of each building. Unless the IRC requires the contractor to use the PCM to account for the contract, the IRC requires the contractor to sever this contract because the buildings are independently priced, and the agreement provides for separate delivery and acceptance of the buildings. As each building will generate a reasonable profit, a reasonable businessperson would have entered into separate agreements for the terms agreed upon for each building.

(5) Example 2:

- This situation illustrates the concept of aggregation. In Year 1 a contractor enters into two separate contracts as the result of a single negotiation to construct two identical special use buildings (i.e. nuclear plant).
- Because the contractor has never constructed this type of building before, the contractor anticipates that it will incur substantially higher costs to construct the first building.
- If the taxpayer treats the agreements as separate contracts, the first contract probably will produce a substantial loss while the second contract probably will produce substantial profit.
- Based upon these facts, the IRC requires the taxpayer to aggregate the contracts because the buildings are interdependently priced, and a reasonable businessperson would not have entered the first agreement without also entering the second.

(6) Example 3:

- This situation illustrates the concept of contract options. The taxpayer reports its home construction contracts using the CCM. A contractor enters into a contract with a developer to construct 10 homes in Year 1 on land owned by the developer. The contract provides an option in which the contractor is to build an additional 10 homes. In Year 2, the developer exercises the option and the developer builds additional homes. The taxpayer would sever the option from the original contract.

III. Small Construction Contractors

A. Overview

(1) Internal Revenue Code (IRC) § 460 requires the use of the percentage of completion method (PCM) of accounting for long-term construction contracts and to compute look-back interest. There are two exceptions to the required use of the PCM and to the application of "look-back" interest rules: home construction contracts and small construction contracts.

(2) This chapter will provide an overview of the methods of accounting that are available to small construction contractors such as cash, accrual, completed contract method (CCM), and exempt percentage of completion (EPCM).

(3) Specific accounting methods for large construction contracts (i.e. contracts that do not meet one of the two exceptions of IRC § 460) and home construction contracts are discussed in chapters 4 and 7, respectively.

(4) Small construction contractors have more flexibility in electing from several methods of accounting for its long-term contracts. The contractor determines the method on a contract-by-contract basis.

B. Exceptions to the PCM and Look-back Interest

(1) IRC § 460(e) provides two exceptions for long-term construction contracts for the required use of the PCM and application of the look-back interest rules:

(1) The home construction contract, and

(2) The small construction contract exception (the contract must meet both requirements):

- The contract, at the time it is entered into, is expected to be completed within 2 years, **and**
- The contractor's average annual gross receipts, for the three prior taxable years in which the contractor entered into the contract, do

not exceed $25 million ($10 million for tax years beginning prior to 1-1-2018).

(2) Example:

- The taxpayer's average annual gross receipts are less than $25,000,000 for the three prior taxable years. The taxpayer enters into two different jobs that are not home construction contracts.
- The taxpayer's estimated completion date for Job 1 is 18 months. The taxpayer would account for Job 1 under its exempt method of accounting for long-term contracts (e.g. accrual, CCM, or EPCM). The taxpayer meets both the average annual gross receipts and the 2-year completion requirements.
- The taxpayer's estimated completion date for Job 2 is 3 years. The taxpayer must account for Job 2 using the PCM as required by IRC § 460. The taxpayer meets the average annual gross receipts test but does not meet the 2-year completion requirement.

(3) IRC § 460(e)(1) only exempts the small construction contractor from the required use of PCM, the application of look-back interest, and the allocation of certain costs. The small construction contractor must allocate production period interest to contracts.

B.1. $25 Million Gross Receipts Test ($10 million for tax years beginning prior to 1-1-2018)

(1) For the gross receipts test, the taxpayer takes into consideration income from all trades or businesses, whether or not incorporated, that are under common control of the taxpayer. Small construction contractors may not consider this aggregation rule and report its long-term contracts on an exempt method of accounting when they are required to use the PCM.

(2) Each return of a related group of tax returns may appear to qualify for the small construction contractor's exception. However, once the gross receipts of all related entities are aggregated, the exception may not apply. IRC § 460(e)(2)(A) applies the gross receipts test of IRC 448(c) for all taxpayers.

(3) The gross receipts test looks to the three prior taxable years. This enables the contractor to know if they must begin reporting new contracts on the PCM at the beginning of the tax year.

(4) If a taxpayer has been in existence for less than the three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence.

(5) The taxpayer must annualize the gross receipts for any taxable year that is less than 12 months. The taxpayer annualizes its gross receipts by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(6) Gross receipts do not include returns and allowances made during such year.

(7) The type of income included in the gross receipts test is different for tax years beginning prior to 1-1-2018. For those earlier years, gross receipts excludes items not derived in the ordinary course of a trade or business such as: interest, dividends, rents, royalties, annuities, and receipts from the sale or exchange of capital assets. For tax years beginning after 12-31-2017, gross receipts include those income items.

B.2. Controlled Groups Explained

(1) Five or fewer persons holding a substantial ownership in two or more corporations is a controlled group. These groups include “brother-sister” controlled groups, parent-subsidiary groups, combined groups, and insurance companies. Members of a controlled group are subject to related party transaction rules such as income or deduction matching and loss deferrals on sales between members.

(2) Example 1:

- This example illustrates the concept of a controlled group. The Building Corporation has four unrelated shareholders each owning 25% of the stock. The same four shareholders also own 25% each of the Bridge Corporation. The Building and Bridge corporations are a controlled group.

(3) Example 2:

- This example illustrates the concept of aggregation of gross receipts for a controlled group. Mr. A is the sole shareholder of two corporations.
- Corporation A operates a roof installation business. Corporation B operates a grocery store.
- The average annual gross receipts include the gross receipts from both businesses. It is important to note that all gross receipts from both businesses are included and not just the construction-related gross receipts.

B.3. Attribution of Gross Receipts of Less than Controlling Interest

(1) A contractor that has less than 50% ownership, but more than 5% ownership must aggregate a proportionate share of the construction-related receipts in determining average annual gross receipts.

(2) Per IRC § 448 (c)(2), all persons treated as a single employer under subsection (a) or (b) of IRC § 52 or subsection (m) or (o) of IRC § 414 shall be treated as one person.

(3) A taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person that has a five percent or greater interest in the taxpayer. In addition, a taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person in which the taxpayer has a five percent or greater interest.

(4) For this purpose, a taxpayer must determine ownership interests as of the first day of the taxpayer's contracting year and must include indirect interests in any corporation, partnership, estate, trust, or sole proprietorship according to principles like the constructive ownership rules under IRC §§ 1563(e), (f)(2), and (f)(3)(A).

(5) Example:

- This example illustrates the concept of the $25 million test for attribution of gross receipts. Bob owns 100% of the Building Corporation. The Building Corporation has $24 million average annual gross receipts for the three prior taxable years. Bob also owns 10% of the Construction Corporation. The Construction Corporation has $30 million average annual gross receipts for the three prior taxable years. The aggregate average annual gross receipts for the three prior taxable years for the Building Corporation is $27 million ($24 million + $3 million ($30 million x 10%)). Therefore, the Building Corporation must account for its long-term construction contracts under the PCM.

C. Proper Method of Accounting for Small Construction Contractors

(1) It is important to note that within the construction industry, a contractor will normally have a minimum of at least two methods of accounting. It will have an overall method of accounting such as cash, accrual, or hybrid and one or more methods for its long-term construction contracts such as completed contract, percentage of completion, and percentage of completion capitalized cost method. The contractor determines the method of accounting for its long-term construction contracts on a contract-by-contract basis.

(2) Revenue Ruling 92-28 permits a taxpayer to use different methods of accounting for exempt and nonexempt contracts within the same trade or business.

(3) Example:

- This example illustrates the concept where one contractor uses several methods of accounting. A small construction contractor uses the accrual method of accounting as its overall method to account for short-term contracts and the income and expenses not related to long-term contracts. The contractor uses the completed contract method for its exempt contracts and the PCM for the contracts that are not exempt (i.e. contracts the taxpayer does not expect to complete within 2 years). All three methods of accounting are proper.

D. General Rule for Accounting Methods

(1) IRC § 446 provides general rules for the methods of accounting that are available to the taxpayer. The general rule under IRC § 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. If a taxpayer uses a permissible tax method which is different from a method used for book purposes, this requirement is considered met as long as the taxpayer maintains reconciling entries from book to tax.

(2) The Service will change the taxpayer's method of accounting if the taxpayer has not regularly used a method of accounting or the method of accounting does not clearly reflect income. See IRC § 446 (b).

(3) In addition, permissible methods under IRC § 446(c) provide that subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting:

- IRC § 446 (c) (1): The cash receipts and disbursements method;
- IRC § 446 (c) (2): An accrual method;
- IRC § 446 (c) (3): Any other method permitted by this chapter; or
- IRC § 446 (c) (4): Any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

(4) IRC § 446 allows the cash method of accounting and the accrual method of accounting. The other methods that IRC § 446(c)(3) references for construction contracts are namely the completed contract method and the PCM.

E. Methods of Accounting

(1) A taxpayer potentially could be reporting long-term contracts under several methods of accounting because the taxpayer determines the method of accounting for its long-term contracts on a contract-by-contract basis. The choice of a proper method of accounting for long-term contracts is complex. The methods available to a contractor to account for the income and expenses of a long-term contract are as follows:

- Cash
- Accrual
- Hybrid
- Accrual with Deferred Retainages
- Completed Contract Method (CCM)
- Exempt-Contract Percentage of Completion Method (EPCM)
- Percentage of Completion Method (PCM) or Cost-to-Cost as required by IRC § 460
- Percentage of Completion Simplified Cost Method
- Percentage of Completion 10% Method
- Percentage of Completion Capitalized Cost Method (PCCM)

(2) See Chapter 4, Large Construction Contractors, for more information regarding the PCM methods listed in items 7 thru 10 above.

F. Selecting an Accounting Method

(1) If a contractor is exempt from the PCM under IRC § 460, the contractor adopts its exempt method of accounting for its long-term contracts on the initial income tax return, or in the first tax year there are long-term contracts.

(2) A taxpayer adopts a permissible method of accounting by using it on the first return that reflects the overall method or the material item. A taxpayer adopts an impermissible method of accounting by using it on two or more consecutively filed returns. See Rev. Rul. 90-38 and Rev. Rul. 72-491. The taxpayer must use the same method of accounting for all similar long-term contracts once they adopt a method of accounting. A change is generally not permitted without obtaining prior permission from the Commissioner.

G. Cash Method of Accounting

(1) Generally, the cash method of accounting is an acceptable method for construction contractors. However, there are limitations on the use of the cash method:

- IRC § 448 prohibits the use of the cash method by C corporations and partnerships with a C corporation partner whose average annual gross receipts for the three prior taxable years exceeds $25 million ($5 million for tax years beginning prior to 1-1-2018). IRC § 448 also prohibits use of the cash method by all tax shelters.
- An S Corporation, filing a Form 1120-S, is not subject to the gross receipts limitation of IRC § 448. However, an S Corporation must use the PCM for its non-exempt long-term contracts when the average annual gross receipts for the three prior taxable years exceeds $25 million ($10 million for tax years beginning prior to 1-1-2018).
- A taxpayer who must account for inventory under IRC § 471 must use the accrual method of accounting per Treas. Reg. § 1.446-(1)(c)(2)(i). For tax years beginning prior to 1-1-2018, a taxpayer could use the cash method of accounting if they elected one of the two safe harbors provided by Rev. Proc. 2001-10 and Rev. Proc. 2002-28. See Exhibit 11-3 for more information on the safe harbors and the use of the cash method. For tax years beginning after 12-31-2017, a taxpayer can use the cash method and is not required to account for inventories if they are a small business taxpayer that meets the gross receipts test of IRC § 448.

(2) Treasury Regulation § 1.446-1(c)(1)(i) requires the taxpayer to report income when actually or constructively received and to deduct expenses when paid. For income that has been earned, the taxpayer has constructive receipt when they have unrestricted access to the income.

(3) As a rule, Treas. Reg. § 1.461-1(a)(1) provides that a cash basis taxpayer shall deduct expenses in the year of payment. It further provides that where an expenditure results in the creation of an asset having a useful life extending "substantially" beyond the close of the taxable year such an expenditure may not be deductible or may be deductible only in part for the taxable year in which made.

(4) In *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980), the appellate court adopted the "one-year rule" on a cash basis taxpayer distinguishing between currently deductible expenses and capital expenditures having a useful life extending "substantially beyond" the taxable year. The court allowed a full deduction for prepaid rent in the year of payment and did not require the taxpayer to deduct it on a prorated basis.

(5) Example:

- This example illustrates the concept of constructive receipt. A general contractor contacted a subcontractor and offered payment for a job recently completed in December of Year 1. The subcontractor did not pick up the check until January of Year 2. The subcontractor reports

the income in Year 1 because the subcontractor has constructive receipt of the income.

H. Accrual Method of Accounting

(1) For book purposes, the contractor generally includes revenue in gross income when it is billable under the contract. However, for tax purposes the taxpayer reports income upon the first event fixing the taxpayer's right to receive income under IRC § 451. All events that fix the right to receive income occur at the earliest of the following:

- The required performance occurs (i.e., taxpayer earned the income);
- The payment is due to the taxpayer; or
- The taxpayer actually or constructively receives the payment.

(2) See Rev. Rul. 2003-10; Rev. Rul. 84-31; Rev. Rul. 83-106; Rev. Rul. 81-176; Rev. Rul. 80-308; Rev. Rul. 79-292; and Rev. Rul. 79-195.

(3) In *Boise-Cascade Corporation v. United States Court of Claims*, 530 F.2d 1367, cert denied, 429 US 867, (1976), the Court of Claims permitted the accrual of income based on the work performed and not upon billing entitlement.

(4) For tax years beginning after 12-31-2017, if the taxpayer recognizes the income for financial accounting purposes, the taxpayer, generally, must recognize the income for tax purposes. See IRC § 451(b).

H.1. Advance Payments – Accrual Method

(1) Advance payments or front-loading billings are common in the construction industry. The taxpayer may require a down payment before the work begins to cover the cost of the materials needed at the job site. The taxpayer must recognize the down payment in income. This principle requires an accrual basis taxpayer to include advance payments received from construction contracts in gross income in the taxable year in which the taxpayer received or constructively received rather than when earned later under accrual accounting principles. See Treas. Reg. §§ 1.451-1(a) and 1.451-2(a).

(2) Advance payments have traditionally been included in gross income in the year of receipt. Rev. Rul. 60-85, 1960-1 D.B. 181 states that Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income regardless of whether the period for prorating is definite or indefinite unless the Internal Revenue Code specifically provides a different treatment.

H.2. Exception to Reporting Advance Payments in Year of Receipt – Accrual Method (For tax years beginning before 1-1-2018)

(1) The Service recognizes a limited exception that allows an accrual basis taxpayer to defer including all or part of advance payments in gross income until the year after the year the taxpayer receives payment. See Rev. Proc. 2004-34, 2004 C.B. 991 which modified and superseded Rev. Proc. 71-21.

(2) Rev. Proc. 2004-34 does not restrict a taxpayer's ability to use the methods provided in Treas. Reg. § 1.451-5. Treas. Reg. § 1.451-5 generally allows accrual method taxpayers to defer the advance payments for goods until the taxable year in which they are properly accruable under the taxpayer's method of accounting for federal income tax purposes if that method is no later than when the advance payments are recognized in revenues under the taxpayer's method of accounting for financial reporting purposes.

(3) Rev. Proc. 2004-34, like its predecessor Rev. Proc. 71-21, allows a one-year deferral for advance payments of services. However, Rev. Proc. 2004-34 expanded the scope of Rev. Proc. 71-21 to include advance payment for certain non-services and combinations of services and non-services. Additionally, Rev. Proc. 2004-34 expanded the scope of Rev. Proc. 71-21 to include advance payments received in connection with an agreement or series of agreements with a term or terms extending beyond the end of the next succeeding taxable year.

(4) The taxpayer must also defer the advance payment until a subsequent year for financial purposes. See Section 4.01(2) of Rev. Proc. 2004-34.

H.3. Exception to Reporting Advance Payments in Year of Receipt – Accrual Method (For tax years beginning after 12/31/2017)

(1) As part of the Tax Cuts and Jobs Act (TCJA), IRC § 451(c) was added to the Internal Revenue Code codifying the one-year deferral method under Rev. Proc. 2004-34, 2004-1 C.B. 991, as the only treatment for advance payments.

(2) On April 30, 2018 the IRS issued Notice 2018-35 to provide interim guidance for advance payments. In October 2018, the IRS and Treasury released proposed regulations REG-104872-18 proposing to remove the two-year deferral method available under Treas. Reg. § 1.451-5. Treas. Reg. § 1.451-5 method was a more generous two-year deferral method, but only applied to the sale of goods.

(3) On July 11, 2019, the IRS and Treasury released final regulations. The final regulations adopted the proposed regulations with no modifications removing Treas. Reg. § 1.451-5 as a result of the changes made to IRC § 451 under the TCJA.

(4) The preamble to the final regulations notes that its removal of Treas. Reg. § 1.451-5 "ensures that the new deferral rules of section 451(c) apply uniformly and consistently to all taxpayers and simplifies tax administration."

(5) Taxpayers presently using Treas. Reg. § 1.451-5 to defer advance payments are advised to take corrective action to change their method of accounting to a different method for taxable years ending on or after July 15, 2019.

H.4. Deducting Expenses under the Accrual Method of Accounting

(1) Under the accrual method of accounting, expenses are deductible when all events have occurred that establish the fact of the liability, the taxpayer can determine the amount with reasonable accuracy, and economic performance has occurred. See Treas. Reg. § 1.446-1(c)(1)(ii)(A).

(2) In general, economic performance occurs when vendors/suppliers provide services or property to the taxpayer. See Treas. Reg. § 1.461-4(d)(2).

H.5. Accrual Method and Retainages

(1) A contractor includes retainages withheld in income when the right to receive becomes fixed and determinable. Generally, the customer withholds retainages from a contractor to ensure that the contractor satisfactorily completes its contractual obligations. Generally, if the contractual terms state the customer will pay the contractor the retainages withheld when completion and final acceptance occurs, the contractor does not have a fixed right to the retainages until that event occurs.

(2) Revenue Ruling 69-314 allows an accrual-basis taxpayer to elect to defer the retainages withheld until they are billable under the terms of the contract, which is normally when the contractor has the right to receive the retention. If the contractor defers retainages receivable, they must also defer retainages payable.

(3) In turn, retainage the contractor withholds on subcontractors is not deductible until “all-events” have occurred to fix the liability and the taxpayer can determine the amount with reasonable accuracy. Therefore, even though economic performance has occurred (i.e. the subcontractor has completed a portion of the work) all events with respect to the

retainage have not occurred to establish the liability if the contract requires full acceptance and completion.

(4) If the taxpayer is not currently deferring the retainages and wants to elect this provision under Rev. Rul. 69-314, it is a change of accounting method requires the Commissioner's permission.

(5) Example:

- This example illustrates the concept of retainages payable. A contractor hires a subcontractor to perform a portion of the project for a total of $1,500,000. The contract states that the contractor will retain 10% of the contract payment until full acceptance and completion of the job. The subcontractor completes one-third of the job and bills the contractor for $500,000.
- The contractor withholds 10% and pays the subcontractor $450,000. The contractor can only deduct $450,000 because all events that establish the fact of the liability regarding the $50,000 have not occurred. If the subcontractor fails to complete the job or completes the job unsatisfactorily the contractor does not have to pay the $50,000.

I. Completed Contract Method (CCM)

(1) Taxpayers may elect the CCM to account for its exempt contracts. The taxpayer defers all contract income and contract related expenses (both direct and indirect) until the year of completion. Because of this tax deferral, this is generally the method preferred by most taxpayers.

(2) The taxpayer cannot deduct any allocable contract costs that are not used and remain on hand when the contract is complete.

I.1. Completion of a Long-Term Contract

(1) The taxable year of completion occurs the earlier of:

- when the taxpayer incurs at least 95% of the total allocable contract costs attributable to the subject matter of the contract and the customer uses the subject matter of the contract for its intended purpose (other than for testing) or
- completion and final acceptance of the subject matter of the contract. Completion and final acceptance are based on the facts and circumstances.

(2) Example 1:

- This example illustrates the concept of completion using the customer-use rule. In Year 1, a calendar year-end taxpayer enters

into a contract to construct a building for a customer. In November of Year 2, the contractor completes the construction of the building and the customer uses the building for its intended purpose.

- In December of Year 2, the customer notifies the taxpayer of some minor deficiencies. The taxpayer agrees to correct them in January of Year 3. Reasonable estimates of the costs to correct these deficiencies will be less than 5% of the total allocable contract costs.
- The contract is complete in Year 2 because the customer used the building for its intended purpose and the taxpayer incurred at least 95% of the total allocable contract costs. The taxpayer would then use a permissible method of accounting for deducting the post completion costs incurred in Year 3.

(3) Example 2:

- This example illustrates the concept of completion using the customer-use rule. In Year 1, a calendar year-end taxpayer agrees to construct a shopping center that includes an adjoining parking lot. By October of Year 2, the taxpayer has finished constructing the retail portion of the shopping center. At the end of Year 2, the taxpayer has graded the entire parking lot but has paved only one-fourth of it because of inclement weather. In December of Year 2, the customer opens the retail portion of the shopping center and the paved portion of the parking lot to the general public.
- The contractor reasonably estimates that the cost of paving the remaining three-fourths of the parking lot when weather permits will exceed 5% of the total allocable contract costs. The contract is not considered complete in Year 2 because the taxpayer has not incurred at least 95% of the total allocable contract costs.

I.2. Post Completion Expenses

(1) Any costs incurred after a contract is completed are deductible under the taxpayer's permissible method of accounting such as the accrual method.

(2) The completed contract method (CCM) requires the taxpayer to include all income in the gross contract price in the completion year and account for any costs incurred after the completion year in the normal manner for such expenses. See Treas. Reg. § 1.460-4(d)(2).

(3) Example:

- This example illustrates the concept of post completion expenses on the CCM. As of Dec 31, Year 1, a long-term contract is 97% complete and the customer uses the property for its intended purpose. The taxpayer must include in income 100% of the total contract price in Year 1 and can deduct all contract costs that the taxpayer has incurred to date. The remaining contract costs (approximately 3% of total contract costs) incurred during Year 2 are deductible in Year 2.

I.3. Allocation of Indirect Costs

(1) Under CCM, allocable contract costs are deferred until the year of completion. The taxpayer may prematurely deduct costs because of its failure to allocate all direct and indirect costs. The taxpayer has the option to allocate all direct and indirect costs per Treas. Reg. § 1.263A-1(e) or as provided in Treas. Reg. § 1.460-5(d).

(2) Treas. Reg. § 1.460-5(d) lists the various indirect costs that are allocable to the contract:

- Repair of equipment or facilities;
- Maintenance of equipment or facilities;
- Utilities, such as heat, light, and power, allocable to equipment or facilities;
- Rent of equipment or facilities;
- Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under IRC § 105(d) as it existed prior to its repeal in 1983), shift differential pay, payroll taxes, and contributions to a supplemental unemployment benefits plan;
- Indirect materials and supplies;
- Non-capitalized tools and equipment;
- Quality control and inspection;
- Taxes otherwise allowable as a deduction under IRC § 164, other than state, local, and foreign income taxes, to the extent attributable to labor, materials, supplies, equipment, or facilities;
- Depreciation, amortization, and cost-recovery allowances reported for the taxable year for financial purposes on equipment and

facilities to the extent allowable as deductions under chapter 1 of the IRC;

- Cost depletion;
- Administrative costs other than the cost of selling or any return on capital;
- Compensation paid to officers other than for incidental or occasional services;
- Insurance, such as liability insurance on machinery and equipment; and
- Interest incurred during the production period.

(3) Treas. Reg. § 1.460-5(d)(2)(ii) also provides the indirect costs that are not allocable:

- Marketing and selling expenses, including bidding expenses;
- Advertising expenses;
- Other distribution expenses;
- General and administrative expenses attributable to the performance of services that benefit all the taxpayer's activities such as payroll expenses, legal and accounting expenses;
- Research and experimental expenses as described in IRC § 174 and the regulations;
- Losses under IRC § 165 and the regulations;
- Percentage of depletion in excess of cost depletion;
- Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on nonworking days, and an asset used in construction is considered to be idle when it is neither in route to nor located at a job-site), and depreciation, amortization and cost recovery allowances under chapter 1 of the IRC in excess of depreciation, amortization, and cost recovery allowances reported by the taxpayer in the taxpayer's financial reports;
- Income taxes attributable to income received from long-term contracts;
- Contributions paid to or under a stock bonus, pension, profit-sharing, or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under IRC § 401(a), and other employee benefit expenses paid or accrued on

behalf of labor, to the extent the contributions or expenses are otherwise allowable as deductions under chapter 1 of the IRC. Other employee benefit expenses include (but are not limited to): workers' compensation; amounts deductible or for whose payment reduction in earnings and profits is allowed under IRC § 404A and the regulations there under; payments pursuant to a wage continuation plan under IRC § 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, and membership dues;

- Cost attributable to strikes, rework labor, scrap and spoilage; and
- Compensation paid to officers attributable to the performance of services that benefit all the taxpayer's activities.

I.4. Issues to Consider for Completed Contract Method Taxpayers

(1) For contracts that are still in-process and over 95% complete at year-end – does the customer have use of the property for its intended purposes?

(2) Did the taxpayer allocate all direct and indirect costs to its long-term contracts?

(3) Alternative Minimum Tax on non-home construction contracts - discussed later in this chapter.

I.5. Subcontracts and Completion

(1) Treas. Reg. § 1.460-1(c)(3)(iii) clarifies that a subcontractor's customer is the general contractor. Thus, the subject matter of the subcontract is the relevant subject matter in determining the subcontractor's contract completion.

(2) Example:

- In Year 1, a customer hires a general contractor to construct an office building. The estimated completion date is in Year 3. The general contractor in turn hires a subcontractor to pour the concrete foundation. The subcontractor pours the concrete foundation and the general contractor accepts the work in Year 2.

The subcontractor's contract is complete in Year 2.

J. Exempt-contract percentage of completion method (EPCM)

(1) A taxpayer who is exempt from the requirement to use the PCM may elect an exempt PCM (EPCM). The taxpayer can determine completion by using any method of cost comparisons such as the following:

- Any method of cost comparison such as direct labor costs incurred to date to total estimated labor costs, or
- Comparing the work performed on the contract with the estimated total work.

(2) The taxpayer must use the method consistently and it must clearly reflect income. See Treas. Reg. § 1.460-4(c)(2).

(3) Example:

- This example illustrates the concept of EPCM. The contract requires the taxpayer to install 50 miles of utility lines. The entire 50 miles is on comparable terrain meaning no area along the 50 miles will require additional costs to install the utility lines. The taxpayer elects to determine completion based on units (e.g., miles). At the end of Year 1, 10 miles have been completed. The contract is 20% complete and clearly reflects income. However, if certain areas along the 50 miles involved rugged terrain, involving much higher construction costs than the other areas, the use of miles to determine completion would most likely not be a clear reflection of income.

J.1. Alternative Minimum Tax (AMT)

(1) Taxpayers that are exempt from the requirement to use PCM for its long-term contracts for regular tax purposes are required to use PCM for alternative minimum tax for its non-home construction contracts. See IRC § 56(a)(3). The taxpayer must also compute look-back interest for AMT purposes.

(2) For tax years beginning after 12-31-2017, corporations are exempt from AMT.

K. Small Construction Contractors Becoming Large Construction Contractors

(1) Small construction contractors who are exempt from the IRC § 460 PCM reporting requirements due to the average annual gross receipts for the three prior taxable years being less than $25 million become large

contractors when the average annual gross receipts for the three prior taxable years exceed $25 million.

(2) During this converting year, the taxpayer continues to account for any contracts started in a previous year using its exempt method (e.g., completed contract method). The taxpayer must use PCM for any new contracts started during the year. This is not a change in accounting method; the taxpayer now has non-exempt contracts. If the average annual taxable gross receipts for the three prior taxable years goes below $25 million in a subsequent year, the taxpayer will compute any new contracts started in that year under its “exempt” contract method.

(3) Example:

- The contractor has been in business for many years and properly elected the completed contract method for reporting its exempt long-term construction contracts. In Year 10, the average annual gross receipts for the three prior taxable years exceeds $25 million for the first time. In Year 12, the average annual gross receipts dropped back below $25 million:

JOB	**Year 10** **AAGR> $25 million**	**Year 11** **AAGR> $25 million**	**Year 12** **AAGR<$25 million**
Job 1 - In Process at the end of Year 9	CCM	CCM until job completion	
Job 2 - Started in Year 10	PCM	PCM	PCM until job completion
Job 3 - Started in Year 11		PCM	PCM until job completion
Job 4 - Started in Year 12			CCM

IV. Large Construction Contractors

A. Overview

(1) This chapter discusses the tax rules of long-term contracts and the requirement to use the percentage of completion method (PCM). The Service considers construction taxpayers with long-term contracts as large construction contractors. There are two types of contracts that are exempt from the PCM which are discussed separately in Chapter 3 and Chapter 7 involving small construction contracts and home construction contracts.

(2) Large construction contractors must use the PCM to report income from long-term contracts. They do not have the flexibility of selecting among several methods as the small construction contractors.

B. Methods of Accounting for Contracts Subject to IRC Section 460 PCM

(1) IRC § 460 requires large construction contractors to account for long-term contracts using the PCM and upon completion of the contract requires large construction contractors to pay or receive interest computed under the look-back method. (See the Audit Technique Guide on Look-back Interest). The amount of revenue reported each year under the contract using the PCM is determined by multiplying the total estimated contract price times the completion factor less any gross receipts reported in the prior tax years of the contract. IRC § 460 provides two methods of determining the completion factor. They are the “cost-to-cost method” and the “simplified cost-to-cost method.”

C. Cost-to-Cost Method

(1) IRC § 460(b)(1)(A) generally requires that the taxpayer compute the PCM utilizing the cost-to-cost method. Treas. Reg. § 1.460-4(b) provides guidance, in 4 steps, on how to compute income using the PCM:

(1) Compute the “Completion Factor” which is the ratio of:

Cumulative contract costs incurred through the end of the taxable year
÷
Total estimated costs the taxpayer expects to incur under the contract

- Example: At the end of Year 1, the taxpayer has incurred $500,000 of costs on a long-term contract that the taxpayer expects to incur $1,000,000 in total costs. The completion factor is 50% (500,000/1,000,000).

(2) Compute the “Cumulative gross receipts” which is the sum of:
Completion factor multiplied by total estimated contract price

- Example: Expanding on the same example in Step 1, the taxpayer expects to receive $1,200,000 under the contract from the customer. For Year 1, the cumulative gross receipts are $600,000 (50% x $1,200,000).

(3) Compute the “Current-year gross receipts” which is the difference of:
Cumulative gross receipt less the prior year’s cumulative gross receipts

- Example: Expanding on same example in Steps 1 & 2, at the end of Year 2 the taxpayer has incurred a cumulative total of $800,000 of the contract costs. The total estimated costs of the contract and the total estimated contract price remain unchanged at $1,000,000 and $1,200,000, respectively. The completion factor for year 2 is 80% (800,000/1,000,000). The cumulative gross receipts for Year 2 are $960,000 (1,200,000 x 80%). The current year gross receipts for Year 2 are $360,000 (960,000 – 600,000).

(4) Compute "Taxable Income" for the year which is the difference of: **Current year gross receipts less contract costs incurred during the year**

- Example: Expanding on the same example in Steps 1 through 3, the taxable income for the contract for Year 1 is $100,000 (600,000 – 500,000). The taxable income for Year 2 is $60,000 (360,000 – 300,000).

C.1. Allocable Contract Costs

(1) Under the PCM, a taxpayer recognizes income as it incurs costs. Treas. Reg. § 1.460-5(b), which has a direct link to IRC § 263A costs, provides the allocable contract costs that a taxpayer uses to determine the cost-to-cost method.

(2) In general, a taxpayer must allocate costs to each long-term contract subject to the PCM in the same manner it capitalizes direct and indirect costs to property produced by a taxpayer under Treas. Reg. § 1.263A-1(e) through (h). Thus, a taxpayer must allocate to each long-term contract subject to the PCM all direct costs and certain indirect costs properly allocable to the long-term contract (i.e., all costs that directly benefit or which the taxpayer incurs because of the performance of the long-term contract). However, the taxpayer can make an election to allocate contract costs using the simplified cost-to-cost method, discussed later in this chapter. As in IRC § 263A, the PCM does not permit the use of the practical capacity concept. See Treas. Reg. § 1.263A-2(a)(4).

(3) Direct costs listed under Treas. Reg. § 1.263A-1(e)(2) include:

- Direct material costs
- Direct labor costs

(4) Indirect costs listed under Treas. Reg. § 1.263A-1(e)(3) include:

- Indirect labor costs
- Officers' compensation
- Pension and other related costs

- Employee benefit expenses
- Indirect material costs
- Purchasing costs
- Handling costs
- Storage costs
- Cost recovery
- Depletion
- Rent
- Taxes
- Insurance
- Utilities
- Repairs and maintenance
- Engineering and design costs
- Spoilage
- Tools and equipment
- Quality control
- Bidding costs
- Licensing and franchise costs
- Interest
- Capitalized service costs

(5) Subject to PCM, direct material and labor costs, properly allocable to the long-term contract are all costs that directly benefit the contract, or the taxpayer incurs through the contract's performance. See Treas. Reg. § 1.460-5(b)(1).

(6) Similarly, indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit the contract, or the taxpayer incurs because of the performance of production or resale activities. See Treas. Reg. § 1.263A-1(e)(3)(i).

(7) Some indirect costs, on the other hand, may benefit both the long-term contract and other business activities of the taxpayer and the taxpayer may not be able to always specifically identify to a particular long-term contract. This allocation may be a specific "facts-and-circumstances" method, including the specific identification (or tracing) method, burden rate method (i.e., ratios based on direct costs, direct labor, etc.), standard cost method, a "simplified method" provided in Treas. Reg. § 1.263A-2(b)

and Treas. Reg. § 1.263A-3(d) or any other reasonable method (as defined under Treas. Reg. § 1.263A-1(f)(4)). See Treas. Reg. § 1.263A-1(f) and Treas. Reg. § 1.263A-1(g)(3).

C.2. Direct Material Costs

(1) Direct material costs include the costs of those materials that become an integral part of specific property produced and those materials that the taxpayer consumes in the ordinary course of production that can identify or associate with particular units or groups of units of property produced. See Treas. Reg. § 1.263A-1(e)(2)(i)(A). Taxpayers must allocate direct material costs to a long-term contract when "dedicated" to the contract. Thus, a taxpayer dedicates direct materials by associating them with a specific contract, including by purchase order, entry on books and records, or shipping instructions. See Treas. Reg. § 1.460-5(b)(2)(i). Therefore, uninstalled dedicated materials that a taxpayer dedicates to a contract become an allocable job cost.

C.3. Uninstalled Dedicated Materials

(1) A taxpayer should include the cost of uninstalled dedicated materials in the PCM computation. For tax purposes, when a taxpayer incurs the purchase of uninstalled dedicated materials, the taxpayer should consider costs as allocable contract costs for PCM. For financial reporting purposes, however, the taxpayer does not treat these same costs as allocable costs until the taxpayer installs or uses the materials, resulting in a timing difference in income recognition between book and tax.

(2) For the PCM, "incurred" has the same meaning that it has under the accrual method of accounting. See Treas. Reg. § 1.460-1(b)(8). As it applies to uninstalled but dedicated materials, a taxpayer has incurred a liability in the taxable year in which all events have occurred to establish the fact of the liability, the taxpayer can determine the amount of the liability with reasonable accuracy and economic performance has occurred.

- Establish the fact of the liability: Here, the taxpayer has ordered and received the materials, thus owing the supplier.
- Determine the amount with reasonable accuracy: Here, the taxpayer can determine the cost of the materials from the purchase order which the taxpayer submitted to the supplier.
- Economic performance has occurred, which is the earlier of when the supplier provides the property to the taxpayer or when the taxpayer pays the liability: Here, the supplier has delivered the

materials to the taxpayer or its job site. See Treas. Reg. § 1.461-1(a)(2) and Treas. Reg. § 1.461–4(d)(2)(ii).

(3) For tax purposes, uninstalled dedicated materials are considered allocable contract costs for PCM when the liability for their purchase is incurred. For financial reporting purposes, however, these same costs are not treated as allocable costs until the materials have been installed or used, resulting in a timing difference in income recognition between book and tax.

(4) **Example:** A taxpayer purchases shingles for a large multi-unit apartment building which the supplier delivers directly to the construction job site. It may be several months before the taxpayer installs the shingles on the roof of the building. For tax purposes, the taxpayer includes the cost of the uninstalled shingles in the completion factor of the PCM even though for financial purposes the taxpayer does not include the cost of the shingles until installed on the property.

C.4. Direct Labor Costs

(1) Direct labor costs include the costs of labor that the taxpayer can identify or associate with the long-term contract. For this purpose, labor encompasses full-time and part-time employees, as well as contract employees and independent contractors. Direct labor costs include all elements of compensation other than employee benefit costs described in Treas. Reg. § 1.263A-1(e)(3)(ii)(D). Elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under IRC § 105(d) as it existed prior to its repeal in 1983), shift differential pay, payroll taxes, and payments to a supplemental unemployment benefit plan. See Treas. Reg. § 1.263A-1(e)(2)(i)(B).

C.5. Pre-Contract Costs

(1) If a taxpayer reasonably expects to enter into a long-term contract in a future taxable year, the taxpayer must capitalize all costs incurred prior to entering into the contract that will be allocable to that contract (e.g., bidding and proposal costs). See Treas. Reg. § 1.460-4(b)(5)(iv).

(2) Bidding expenses are those costs incurred by a contractor in the solicitation of a long-term contract. The taxpayer must defer all bidding costs paid or incurred in the solicitation of a contract until the customer awards the contract. If the customer awards the contract to the taxpayer, the bidding costs become part of the indirect costs allocated to the subject matter of the contract. If the customer does not award the contract to the taxpayer, the bidding costs are deductible in the taxable year that the contract is awarded to another party, or in the taxable year that the

taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be re-bid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. See Treas. Reg. § 1.263A-1(e)(3)(ii)(T).

C.6. Indirect Costs Not Generally Allocable to a Contract

(1) Subject to the exception in IRC § 460(c)(2) (costs identified under cost-plus and certain federal contracts), costs not allocable to the contract are independent research and development expenses, expenses for unsuccessful bids and proposals, and marketing, selling, and advertising expenses. See IRC § 460(c)(4).

(2) Treas. Reg. § 1.263A-1(e)(3)(iii) provides a list of additional indirect costs not allocable to the long-term contract under Treas. Reg. § 1.460-5(b). These indirect costs include "deductible service costs," which generally include costs incurred because of the taxpayer's overall management or policy guidance functions, such costs from the board of directors, chief executive, financial, accounting, and legal officers. See Treas. Reg. § 1.263A-1(e)(3)(iii)(K) and Treas. Reg. § 1.263A-1(e)(4)(ii)(B) and Treas. Reg. § 1.263A-1(e)(4)(iv)(A).

(3) Even though a taxpayer classifies service cost as "general and administrative," it is allocable to the long-term contract if it directly benefits the contract or the taxpayer incurs the service cost because of the taxpayer's performance of the production or resale activities. Examples are costs from data processing, personnel operations, security services, and legal services. See Treas. Reg. § 1.263A-1(e)(4)(i)(A) and Treas. Reg. § 1.263A-1(e)(4)(i)(B) and Treas. Reg. § 1.263A-1(e)(4)(i)(e)(4)(ii)-(iii).

(4) Performance under a guaranty, warranty, or maintenance agreement is a non-long-term contract activity that is never incident to or necessary for the manufacture or construction of property under a long-term contract. See Treas. Reg. § 1.460-1(d)(2). Warranty costs are never allocable contract costs. In *Koch Industries, Inc. v. U.S.*, 603 F.3d 816 (10th Cir. 2010) the taxpayer's agreements were "warranties" within the meaning of Treas. Reg. § 1.460-1(d)(2), defining non-long-term contract activity, and thus the taxpayer could not use the PCM.

C.7. Nondeductible Costs

(1) Costs that would normally be allocable to a contract but are nondeductible by the IRC are not allocable contract costs. A common example would be the nondeductible portion of meals per IRC § 274. The taxpayer must

remove the amount incurred as well as the total estimated amount of the nondeductible cost from the percentage of completion computation.

(2) Treas. Reg. § 1.460-5(f) provides special rules applicable to costs allocated under this section. It states that a taxpayer may not allocate any otherwise allocable contract cost to a long-term contract if any section of the IRC disallows a deduction for that type of payment or expenditure (e.g., an illegal bribe described in IRC § 162(c)).

D. Impact of Cost Allocation on the Percentage of Completion Computation

(1) Unlike the PCM, a taxpayer using the completed contract method must defer the deduction of all allocable contract costs until the taxpayer completes the contract. See Treas. Reg. § 1.460-4(d)(1). Under the PCM, however, the taxpayer deducts the allocable contract costs in the year incurred. If an allocable contract cost is excluded from the completion factor it may or may not have a material effect on the gross receipts reported in each taxable year of the contract. Therefore, it is important to know what costs the taxpayer included in the completion factor.

(2) The scenarios below point out the effect that the exclusion of an allocable indirect cost could have on the gross receipts reported by a taxpayer using the PCM:

- At the end of Year 1, the taxpayer's estimated completion is 20% determined as follows:

  $100,000 Total Allocable Contract Costs Incurred To Date
  Divided By
  $500,000 Total Estimated Costs Allocable Contract Costs

(3) Scenario 1:

- The taxpayer included an indirect allocable contract cost in the total estimated allocable contract costs in the denominator. The taxpayer erroneously did not include the cost, which was incurred during the taxable year, in the numerator. The taxpayer deducted this incurred cost on the tax return. The amount is still deductible as an expense; however, the taxpayer should also add it to the numerator and, as such, impacts the amount of gross receipts reported by the taxpayer on this contract.

  $100,000 + $10,000
  Divided By
  $500,000
  Equals
  22% Complete

(4) Scenario 2:

- The taxpayer improperly excluded an indirect allocable contract cost, which the taxpayer does not incur pro-rata over the life of the contract (e.g., architect fee and building permits which the taxpayer incurs early in the contract), from both the numerator and denominator of the PCM computation. The amount incurred during the tax year is the same as the total estimated cost of this expense – the taxpayer will not incur any additional amount of this indirect cost on this contract. Again, as mentioned in scenario 1, the deductibility of this expense is proper, the only impact is the gross receipts amount reported by the taxpayer under this contract.

  $100,000 + $10,000
  Divided By
  $500,000 + $10,000
  Equals
  21.57% Complete

- Under PCM, the reference to the regulations under IRC § 263A applies only to what costs to allocate and how. Allocable contract costs under PCM, however, are still deductible in the year incurred when computing taxable income. See Treas. Reg. § 1.460-4(b)(2)(iv) and (h); Example 2, Treas. Reg. § 1.460-5(b)(1).

(5) Scenario 3:

- An indirect allocable contract cost which the taxpayer incurs pro-rata over the life of the contract (e.g., indirect labor and officer's salary that the taxpayer incurs throughout the duration of the contract), and improperly excluded from both the numerator and denominator of the PCM computation. The taxpayer must include the cost incurred during the taxable year in the numerator and the total estimated cost in the denominator, which the taxpayer must determine.

  $100,000 + $10,000
  Divided By
  $500,000 + $50,000
  Equals
  20% Complete

- As Scenario 3 indicates, theoretically, if a taxpayer does not include a pro-rata cost in the numerator and denominator of the percentage of completion computation it may not have a material impact on the gross receipts reported by the taxpayer. Thus, the exclusion of a common, everyday indirect cost from the PCM computation will probably have no effect on the income recognition of the contract.

E. Cost-Plus Contracts and Federal Long-Term Contracts

(1) Cost-plus fee contracts are common in the construction industry. With this type of contract, the owner agrees to pay the contractor a fee in addition to the costs the contractor incurs to complete the project. It may be a fixed fee or based on a percentage of the costs. This type of contract shifts much of the risk to the owner; however, the owner can reduce the risk by establishing a Guaranteed Maximum Price (GMP). The GMP establishes a maximum cost that the owner will pay and may contain a clause for the owner and contractor to share in any savings if the contractor completes the project at less than the maximum price. In cost-plus contracts, the contract will detail which costs the owner will reimburse the contractor. For percentage of completion purposes, if the contract does not normally allocate any of these "contract costs" to the long-term contract, IRC § 460(c)(2) requires the taxpayer to allocate those costs. See also Treas. Reg. § 1.460-5(b)(2)(iv):

(2) Treas. Reg. § 1.460-5(b)(2)(iv) provides that costs identified under cost-plus long-term contracts and federal long-term contracts, to the extent not otherwise allocated to the contract under this paragraph (b), a taxpayer must allocate any identified costs to a cost-plus long-term contract or federal long-term contract (as defined in IRC § 460(d)). Identified cost means any cost, including a charge representing the time-value of money, identified by the taxpayer or related person as being attributable to the taxpayer's cost-plus long-term contract or federal long-term contract under the terms of the contract itself or under federal, state, or local law or regulation.

(3) Example:

- A cost-plus contract lists some marketing expenses, which IRC § 460(c)(4) does not normally consider an allocable contract cost. However, IRC § 460(c)(2) requires the taxpayer to allocate these costs to the long-term contract.

F. Simplified Cost-to-Cost Method

(1) IRC § 460(b)(1)(A) generally requires the cost-to-cost method to determine completion. However, IRC § 460(b)(3)(A) provides an elective simplified cost-to-cost method for determining the degree of contract completion for taxpayers using the PCM. Under the simplified cost-to-cost method, a taxpayer uses only the following costs in determining the percentage-of-completion:

- Direct material costs;
- Direct labor costs; and

- Depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the long-term contract.

(2) A taxpayer must allocate subcontracted costs which represent either direct material or direct labor costs. See Treas. Reg. § 1.460-5(c)(1).

(3) Treas. Reg. § 1.460-5(c) provides for the use of the simplified cost-to-cost method for contracts subject to the PCM. In general, instead of using the cost-allocation method prescribed in Treas. Reg. § 1.460-5(b), a taxpayer may elect to use the simplified cost-to-cost method, authorized under IRC § 460(b)(3)(A), to allocate costs to a long-term contract subject to the PCM.

(4) Under the simplified cost-to-cost method, a taxpayer determines a contract's completion factor based upon only direct material costs; direct labor costs; and depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to manufacture or construct the subject matter of the contract. For this purpose, the simplified cost-to-cost method considers the costs associated with any manufacturing or construction activities performed by a subcontractor as either direct material or direct labor costs, as appropriate, and therefore the taxpayer must allocate such costs to the contract under the simplified cost-to-cost method.

(5) An electing taxpayer must use the simplified cost-to-cost method to apply the look-back method under Treas. Reg. § 1.460-6 and to determine alternative minimum taxable income under Treas. Reg. § 1.460-4(f). A taxpayer using the simplified cost-to-cost method must also utilize the costs described above in determining both the costs allocated to the contract and incurred before the close of the taxable year, and the estimated total contract cost.

G. Percentage-of-Completion 10-Percent Method

(1) Under IRC § 460(b)(5) and Treas. Reg. § 1.460-4(b)(6), the taxpayer may elect to defer recognition of revenue under PCM until it incurs 10% of the total estimated allocable contract costs. Accordingly, the taxpayer considers costs incurred before the 10% year as pre-contracting year costs and thus are not deductible until the 10% year. This method of accounting is an election and applies to all long-term contracts the taxpayer enters into during, and all taxable years after, the electing year. Once elected, the taxpayer must obtain the Commissioner's consent to change to another method. This election is unavailable if the taxpayer elected to use the simplified method for allocation of costs under IRC § 460(b)(3)(A) or is exempt under IRC § 460(e).

(2) Example:

- A contractor, C, whose taxable year ends December 31 determines the income from long-term contracts using the 10 Percent Method. For

each of the taxable years, C computes income from the contracts as follows:

10 Percent Method

	Year 1	Year 2	Year 3
Cumulative Incurred Costs to Date	$40,000	$300,000	$600,000
Total Estimated Costs	$600,000	$600,000	$600,000
Percentage Complete	6.67%	50.00%	100.00%
Total Contract Price	$1,000,000	$1,000,000	$1,000,000
Gross Revenue Reported	0	$500,000	$500,000
Expenses Deducted	0	$300,000	$300,000

H. Percentage-of-Completion/Capitalized-Cost Method (PCCM)

(1) A taxpayer may determine the income from a long-term construction contract that is a residential construction contract using either the PCM or the PCCM. The PCCM allows the residential construction contractor to report 70 percent of the contract under PCM (as required by IRC § 460) and report the remaining 30 percent under an exempt method (e.g., completed contract method). A residential construction contract differs from a home construction contract in that a home construction contract involves buildings with four or fewer dwelling units; whereas, a residential construction contract involves buildings with more than four dwelling units (e.g., apartment buildings or condominiums with five or more units in each building). See IRC § 460(e)(5).

(2) Treas. Reg. § 1.460-3(b)(2)(I)(A) turns to IRC § 168(e)(2)(A)(ii)(I) for the definition of "dwelling unit," which defines "dwelling unit" as a house or apartment used to provide living accommodations in a building or structure but does not include a unit in a hotel, motel, or other establishment where a tenant uses more than one-half of the units on a transient basis.

(3) In issuing the former regulation to the predecessor of IRC § 168(e)(2)(A)(ii)(I), the Regulations Policy Committee deleted a proposed reference that a dwelling unit must be self-contained with facilities generally found in a principal place of residence such as a kitchen. Deleting this reference indicates the intent to expand the scope of "dwelling unit" to include other living accommodations such as nursing homes, retirement homes, prisons, and college dormitories.

(4) Because nursing homes, retirement homes, prisons, and dormitories provide "living accommodations in a building or structure," they are dwelling

units for purposes of a residential construction contract under the PCCM only if the same tenant uses no more than one-half of the units for less than 30 days. For example, a prison is not a dwelling unit if it is a holding cell in a courthouse or a police station. The final regulations explain the PCCM.

(5) Treas. Reg. § 1.460-4(e) provides for the percentage of completion capitalized cost method. Under the PCCM, a taxpayer must determine the income from a long-term contract using the PCM for the applicable percentage of the contract and its exempt contract method, as defined in paragraph (c) of this section, for the remaining percentage of the contract. For residential construction contracts described in Treas. Reg. § 1.460-3(c), the applicable percentage is 70 percent, and the remaining percentage is 30 percent. For qualified ship contracts described in Treas. Reg. § 1.460-2(d), the applicable percentage is 40 percent, and the remaining percentage is 60 percent.

(6) Even though IRC § 460 allows residential construction contracts to use the 70/30-hybrid method for reporting income for regular tax, the taxpayer must report the entire contract under PCM for alternative minimum tax purposes. See Treas. Reg. § 1.460-4(f).

I. Total Estimated Contract Price and Claim Income

(1) The total estimated contract price is the amount the contractor reasonably expects to receive from the owner under the long-term contract. Total estimated contract price includes: the original contract price, “retainages,” “holdbacks,” and approved contract change orders. In addition, contractors must include, in the estimated contract price, contingent compensation such as awards, incentive payments, unapproved contract change orders, and amounts relating to claims when there is a reasonable expectation the contractor will receive these amounts. See Exhibit 1-2 for definitions of award, bonus, change order, claims, holdback, and retainage.

(2) Treas. Reg. § 1.460-4(b)(4) provides that the total contract price means the amount that a taxpayer reasonably expects to receive under a long-term contract, including holdbacks, retainages, and cost reimbursements. See Treas. Reg. § 1.460-6(c)(1) (ii) and (2)(vi) for application of the lookback method because of changes in total contract price.

(3) Treas. Reg. § 1.460-4(b)(4)(i)(B) provides that contingent compensation is any amount related to a contingent right under a contract, such as a bonus, award, incentive payment, and amount in dispute. A taxpayer includes contingent compensation in the total contract price as soon as it can reasonably predict that the taxpayer will earn the amount, even if the amount has not met the all events test. For example, if a bonus is payable to a taxpayer for meeting an early completion date, the bonus is includible in total contract price at the time and to the extent that the taxpayer can reasonably predict the achievement of the corresponding objective.

(4) The portion of the contract price that is in dispute is includible in the total contract price at the time and to the extent that the taxpayer can reasonably predict that the taxpayer will resolve the dispute in the taxpayer's favor, regardless of when the taxpayer actually receives payment or when the taxpayer resolves the dispute. See Treas. Reg. § 1.460-4(b)(4)(i)(B); *Tutor-Saliba Corp. v. Commissioner*, 115 T.C. 1 (2000).

(5) For the purposes of paragraph (b)(4)(i)(B), a taxpayer can reasonably predict that it will earn an amount of contingent income not later than when the taxpayer includes that amount in income for financial reporting purposes under GAAP. If a taxpayer has not included an amount of contingent compensation in total contract price under paragraph (b)(4)(i) by the taxable year following the completion year, the taxpayer must account for that amount of contingent compensation using a permissible method of accounting. If the taxpayer determines in a taxable year after the completion year that it will not earn an amount included in total contract price, the taxpayer should deduct that amount in the year of the determination.

(6) Total contract price does not include compensation that the taxpayer might earn under any other agreement that the taxpayer expects to obtain from the same customer (e.g., exercised option or follow-on contract) if the taxpayer does not aggregate that other agreement under Treas. Reg. § 1.460-1(e).

(7) Example 1:

- This situation illustrates the concept of contingent compensation. A contractor reports $10 million of disputed income as income on its financial statements prepared in accordance with GAAP. Treas. Reg. § 1.460-4(b)(4)(i)(B) provides that the contractor is to include this amount in the total contract price for tax purposes.

(8) Example 2:

- This situation illustrates the concept of bonuses. A contract specifies that the contractor will receive a bonus for meeting an early completion date. At the end of Year 1, the contractor is ahead of schedule and anticipates meeting the early completion date; therefore, the taxpayer should include the bonus in the total contract price for Year 1.

J. Additional Considerations for PCM

(1) The examiner needs to analyze each component of the PCM computation to ensure the taxpayer reports the proper gross income amount each year under the contract.

- Total Allocable Contract Costs Incurred to Date

- Total Estimated Total Allocable Contract Costs
- Total Estimated Contract Price

(2) Obtain a detailed accounting of all the costs included in the numerator and denominator. The examiner should consider the factors shown below in determining the numerator for the total allocable contract costs incurred to date and the denominator for the total estimated allocable contract costs.

- Verify that the taxpayer included direct and indirect allocable contract costs under Treas. Reg. § 1.460-5(b) in both the numerator and the denominator as the taxpayer incurs the cost. See Treas. Reg. § 1.460-4(b).
- For example, the denominator includes the total estimated allocable cost of equipment rental. However, it must also include equipment rental in the numerator of the PCM computation as the taxpayer incurs the cost. If the taxpayer does not include these costs in the numerator, the taxpayer has understated the completion of the contract and results in the understatement of gross income for the taxable year.
- However, if the taxpayer has not included an allocable contract cost in either the numerator or the denominator, consider the potential impact as previously discussed earlier in this chapter under "Impact of Cost Allocation on the Percentage of Completion Computation".
- Year-end bonuses paid to employees may not be allocable to the PCM computation of in-process jobs if the taxpayer pays them based on the profitability of the completed jobs. However, if the taxpayer reasonably expects to pay bonuses in a subsequent year on the jobs currently in-process, the taxpayer would include the bonuses in the denominator as a total estimated cost of the contract.
- Verify that the taxpayer did not include warranty expenses in the PCM computation. See Treas. Reg. § 1.460-1(d)(2) and Treas. Reg. § 1.263A-1(e)(3)(iii)(H).
- A taxpayer may not allocate any otherwise allocable contract cost to a long-term contract if any section of the IRC disallows a deduction for that cost or expenditure (e.g., an illegal bribe described in IRC § 162(c), nondeductible portion or meals and entertainment per IRC § 274). See Treas. Reg. § 1.460-5(f)(1).

(3) Obtain a detailed accounting of all the costs included in the total estimated contract price. The taxpayer should consider the factors shown below in determining the total estimated contract price:

- The taxpayer should include retainages, holdbacks, and cost reimbursements in the total estimated contract price because the taxpayer reasonably expects to receive these amounts under the long-term contract. See Treas. Reg. § 1.460-4(b)(4)(i)(A).

- The taxpayer should include contingent compensation such as a bonus, award, incentive payment, and amount in dispute, in total contract price as soon as the taxpayer can reasonably predict that the taxpayer will earn the amount, even if the amount has not met the all events test. Additionally, if the taxpayer includes the contingent amount in income for financial reporting per GAAP, the taxpayer must also include the amount in the total contract price. See Treas. Reg. § 1.460-4(b)(4)(i)(B).

K. Reversal of Income on Terminated Contract

(1) If a taxpayer or its customer terminates a long-term contract (under PCM) before completion and, as a result, the taxpayer retains ownership of the property, the taxpayer must reverse the transaction in the taxable year of termination. The taxpayer reports a loss (or gain) equal to the cumulative allocable contract costs reported under the contract in all prior taxable years less the cumulative gross receipts reported under the contract in all prior taxable years.

(2) As a result of reversing the transaction, a taxpayer will have an adjusted basis in the retained property equal to the cumulative allocable contract costs reported under the contract. If the taxpayer received and retains any consideration or compensation from the customer, however, the taxpayer must reduce the adjusted basis in the retained property (but not below zero) by the fair market value of that consideration or compensation. To the extent that the amount of the consideration or compensation described in the preceding sentence exceeds the adjusted basis in the retained property, the taxpayer must include the excess in gross income for the taxable year of termination. The look-back method does not apply to a terminated contract.

(3) Example:

- A contractor-taxpayer buys a parcel of land in Year 1 and enters into a contract to construct an office building on that parcel of land and reports on this contract under the PCM as follows:

	Year 1
Cumulative Gross Receipts	$2,000,000
Cumulative Allocable Contract Costs	$1,500,000
Gross Profit on Contract	$500,000

- At the beginning of Year 2, the customer defaults on the contract due to bankruptcy. The unfinished office building remains with the contractor.

- In Year 2, the contractor will report a loss of $500,000 in relation to this terminated contract computed by deducting the prior taxable year's reported cumulative gross receipts of $2 million from the prior taxable year's reported cumulative allocable contract costs of $1.5 million.
- As of termination, provided there were no additional expenses incurred on this office building in Year 2 and the contractor does not receive or retain consideration or compensation from the customer, the contractor will have an adjusted basis of $1.5 million equivalent to the cumulative allocable contract costs reported under the contract in all prior taxable years.
- However, if the contractor had billed and received proceeds of $1.8 million from the customer, none of which are due back to the customer, the contractor will report $300,000 in gross income in Year 2 (year of termination) because the $1.8 million compensation exceeds the adjusted basis of $1.5 million. The adjusted basis of the property would be zero.

V. Mid-Contract Change in Taxpayer

A. Overview

(1) A mid-contract change in taxpayer occurs when there is a transaction (e.g. sale, transfer, exchange, merger, acquisition) in which another taxpayer becomes responsible for accounting for a long-term contract prior to the contract's completion. This chapter describes the general tax rules regarding these transactions.

(2) The original taxpayer that entered into the long-term contract is the "old taxpayer". The taxpayer that subsequently becomes responsible for completing the contract is the "new taxpayer". The date of the transaction is the event (e.g. sale, transfer, exchange, merger, acquisition) that transfers the responsibility of accounting for the long-term contract from the old taxpayer to the new taxpayer.

(3) The new taxpayer will treat the contract as the same contract as the old taxpayer if the terms of the contract are not substantially changed. It does not matter if the customer of the contract agrees to release the old taxpayer from its contractual obligations.

(4) Treasury Regulation (Treas. Reg.) § 1.460-4(k) categorizes the transaction, which transfers the accounting responsibility from the old taxpayer to the new taxpayer, as either a "step-in-the-shoes transaction" or a "constructive-completion transaction".

(5) The determination of whether the old and new taxpayer has a constructive-completion transaction or a step-in-the-shoes transaction depends upon the

underlying transaction which transferred the accounting obligation of the long-term contract to the new taxpayer. The constructive-completion and step-in-the shoes transactions provide different tax treatment for the old and new taxpayer; therefore, it is critical to categorize the transaction correctly.

B. Constructive Completion Transactions

(1) A constructive completion transaction basically treats the contract as two contracts. A constructive completion transaction treats the old taxpayer as completing the contract on the date the transaction occurs and treats the new taxpayer as starting a new contract on that date.

(2) Constructive completion transactions include all transactions that the regulations do not specifically identify as step-in-the-shoes transactions, discussed later in the chapter. In general, the constructive completion rules apply to taxable transactions which include:

- IRC § 1001 transactions,
- deemed asset sales under IRC § 338, and
- IRC § 1060 transactions.

B.1. Constructive Completion Transactions – Tax Treatment by Old Taxpayer

(1) The regulations treat the old taxpayer as completing the contract on the date of the transaction. The old taxpayer includes the following in the total contract price (or gross contract price in the case of a CCM contract):

- any amounts realized from the transaction that are allocable to the contract,
- any amounts the old taxpayer received under the contract, and
- any amounts the old taxpayer expects to receive under the contract.

(2) The old taxpayer reduces the total contract price by:

- any amounts paid by the old taxpayer to the new taxpayer and
- any transaction costs paid by the old taxpayer that are allocable to the contract.

(3) The mid-contract change transaction does not affect the allocable contract costs incurred per Treas. Reg. § 1.460-4(b)(5). Costs are allocable to the contract as incurred both before and after the transaction.

(4) See Treas. Reg. § 1.460-4(k)(2)(ii) for additional contract allocation rules related to IRC §§ 338 and 1060 transactions.

B.2. Constructive Completion Transactions - Tax Treatment by New Taxpayer

(1) The regulations treat the new taxpayer as entering into a new contract on the date of the transaction. The new taxpayer must determine if the contract is a long-term contract under IRC § 460. For example, if the new taxpayer expects to complete the contract before the taxable year ends, the contract would not be a long-term contract thus the taxpayer would not be able to use a long-term contract method of accounting (i.e. percentage of completion (PCM) or completed contract (CCM)).

(2) If the contract is a long-term contract for the new taxpayer, the taxpayer will account for it using their appropriate long-term method. The new taxpayer includes the following in the total contract price:

- any amounts the new taxpayer expects to receive from the customer under the contract and
- any amounts received from the old taxpayer that are allocable to the contract.

(3) The new taxpayer reduces the total contract price by:

- any amounts paid by the new taxpayer because of the transaction that are allocable to the contract and
- any transaction costs paid by the new taxpayer that are allocable to the contract.

(4) The mid-contract change transaction does not affect the allocable contract costs incurred per Treas. Reg. § 1.460-4(b)(5). Costs are allocable to the contract as incurred both before and after the transaction.

(5) See Treas. Reg. § 1.460-4(k)(2)(iii) for additional contract allocation rules related to IRC §§ 338 and 1060 transactions.

B.3. Examples of Constructive Completion

(1) Treas. Reg. § 1.460-4(k)(5) provides Example 1 illustrating a constructive completion transaction using PCM method by both the old and new taxpayer:

(2) Example 1. Constructive completion—PCM. (i) Facts. In Year 1, X enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $200,000. In Year 2, X incurs additional costs of $400,000 before selling the contract as part of a taxable sale of its business in Year 2 to Y, an unrelated party. At the time of sale, X has received $650,000 in progress payments under the contract. The consideration allocable to the contract under section 1060 is $150,000. Pursuant to the sale, the new taxpayer Y

immediately assumes X's contract obligations and rights. Y is required to account for the contract using the PCM. In Year 2, Y incurs additional allocable contract costs of $50,000. Y correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract.

- (ii) Old taxpayer. For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000x$1,000,000)) and costs of $200,000, for a profit of $50,000. X is treated as completing the contract in Year 2 because it sold the contract. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and the total allocable contract costs are $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)). Thus, in Year 2, X reports receipts of $550,000 (total contract price minus receipts already reported ($800,000 − $250,000)) and costs incurred in year 2 of $400,000, for a profit of $150,000.
- (iii) New taxpayer. Y is treated as entering into a new contract in Year 2. The total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 − $650,000 − $150,000)). The estimated total allocable contract costs at the end of Year 2 are $125,000 (the allocable contract costs that Y reasonably expects to incur to complete the contract ($50,000 + $75,000)). In Year 2, Y reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) x $200,000] and costs of $50,000 (the costs incurred after the purchase), for a profit of $30,000. For Year 3, Y reports receipts of $120,000 (total contract price minus receipts already reported ($200,000 − $80,000)) and costs of $75,000, for a profit of $45,000.

(3) Treas. Reg. § 1.460-4(k)(5) provides Example 2 illustrating constructive completion using the CCM by both the old and new taxpayer:

(4) Example 2. Constructive completion—CCM. (i) Facts. The facts are the same as in Example 1, except that X and Y properly account for the contract under the CCM.

- (ii) Old taxpayer. X does not report any income or costs from the contract in Year 1. In Year 2, the contract is deemed complete for X, and X reports its gross contract price of $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and its total allocable contract costs of $600,000 (the sum of the costs incurred in Year 1 and

Year 2 ($200,000 + $400,000)) in that year, for a profit of $200,000.

- (iii) New taxpayer. Y is treated as entering into a new contract in Year 2. Under the CCM, Y reports no gross receipts or costs in Year 2. Y reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 − $650,000 − $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that Y incurred to complete the contract ($50,000 + $75,000)) in Year 3, the completion year, for a profit of $75,000.

C. Step-in-The-Shoes Transactions

(1) A step-in-the-shoes transaction treats the new taxpayer as if they were always the contract owner. The new taxpayer will "step-in-the-shoes" of the old taxpayer with respect to the contract. The step-in-the-shoes transaction rules apply to specific transactions that are generally non-taxable transactions. Examples of the more common step-in-the-shoes transactions include:

- IRC § 351 transactions (transfers to corporation in exchange for stock by one or more individuals which results in transferor(s) having control of the corporation,
- transfers (e.g., sales) of S corporation stock,
- conversion to or from S Corporation,
- members joining or leaving a consolidated group, and
- transfers of partnership interest.

(2) See Treas. Reg. § 1.460-4(k)(3)(i) for a complete list of step-in-the-shoes transactions.

C.1. Step-in-the-Shoes Transactions - Tax Treatment by Old Taxpayer

(1) The old taxpayer's obligation to account for the contract ends on the date of the transaction. As a result, if the taxpayer uses PCM to account for the contract, the old taxpayer recognizes income based on the cumulative contract costs incurred as of the date of the transaction. If the taxpayer uses CCM to account for the contract, the old taxpayer does not recognize any income or expenses related to the contract.

C.2. Step-in-the-Shoes Transactions - Tax Treatment by New Taxpayer

(1) Beginning on the date of the transaction, the new taxpayer must account for the long-term contract using the same method of accounting used by the old taxpayer whether that method is a proper method for the new taxpayer. For example, if the old taxpayer accounts for a contract using CCM because of the small contractor exception (i.e. average annual gross receipts for the prior 3 years does not exceed $25 million/$10 million for tax years beginning prior to 1-1-2018), the new taxpayer continues to account for that contract using CCM even though CCM is not a proper method for the new taxpayer since they are a large contractor (i.e. average annual gross receipts for prior 3 years exceeds $25 million/$10 million for tax years beginning prior to 1-1-2018).

(2) If the old taxpayer used PCM, the new taxpayer must use PCM and must include the cumulative contract costs incurred by the old and new taxpayer to determine contract completion. If the old taxpayer used CCM, upon completion, the new taxpayer recognizes all income and expenses incurred since the inception of the contract of the old taxpayer.

(3) Generally, the old and the new taxpayer do not adjust the contract price for any payments between the old and the new taxpayer with respect to the contract. The regulations provide for adjustments to the contract price for certain reorganizations and transfers. See Treas. Reg. § 1.460-4(k)(3)(iv)(B).

(4) The mid-contract change transaction does not affect the allocable contract costs incurred per Treas. Reg. § 1.460-4(b)(5). Costs are allocable to the contract as incurred both before and after the transaction.

C.3. Examples of Step-in-the-Shoes Transactions

(1) Treas. Reg. § 1.460-4(k)(5) Example 3 illustrates a step-in-the-shoes transaction using the PCM method by both the old and new taxpayer:

(2) Example 3. Step-in-the-shoes—PCM. (i) Facts. The facts are the same as in Example 1, except that X transfers the contract (including the uncompleted property) to Y in exchange for stock of Y in a transaction that qualifies as a statutory merger described in section 368(a)(1)(A) and does not result in gain or loss to X under section 361(a).

- (ii) Old taxpayer. For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000x$1,000,000)) and costs of $200,000, for a profit of $50,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i) of this section, X is not treated as completing the contract in Year 2. In

Year 2, X reports receipts of $500,000 (the completion factor multiplied by the total contract price and minus the Year 1 gross receipts [($600,000/$800,000x$1,000,000)−$250,000]) and costs of $400,000, for a profit of $100,000.

- (iii) New taxpayer. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Total contract price is the sum of any amounts that X and Y have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and Y. Thus, the estimated total allocable contract costs at the end of Year 2 are $725,000 (the cumulative allocable contract costs of X and the estimated total allocable contract costs of Y ($200,000 + $400,000 + $50,000 + $75,000)). In Year 2, Y reports receipts of $146,552 (the completion factor multiplied by the total contract price minus receipts reported by the old taxpayer ([($650,000/$725,000) x $1,000,000] − $750,000) and costs of $50,000, for a profit of $96,552. For Year 3, Y reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000−$896,552)) and costs of $75,000, for a profit of $28,448.

(3) Treas. Reg. § 1.460-4(k)(5) provides Example 4 illustrating step-in-the-shoes transactions using the CCM by both the old and new taxpayer:

(4) Example 4. Step-in-the-shoes—CCM. (i) Facts. The facts are the same as in Example 3, except that X properly accounts for the contract under the CCM.

- (ii) Old taxpayer. X reports no income or costs from the contract in Years 1, 2 or 3.
- (iii) New taxpayer. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same method of accounting used by X prior to the transaction. Thus, in Year 3, the completion year, Y reports receipts of $1,000,000 and total contract costs of $725,000, for a profit of $275,000.

C.4. Special Rules Related to Certain Partnership and Corporate Step-in-the Shoes Transactions

(1) In certain situations, the old taxpayer will adjust its basis in the stock or partnership interest because of the transaction. Generally, payments between the old and new taxpayer with regard to the contract do not adjust the contract price for step-in-the shoes transactions. However, with certain corporate transactions, the taxpayer will adjust the contract price. See

Treas. Reg. § 1.460-4(k)(3)(iv) for additional information.

D. Look-Back Interest Rules for Taxpayer Mid-Contract Change

(1) Taxpayers required to account for long-term contracts using the PCM or percentage of completion capitalized cost method (PCCM) must compute look-back interest in the year of contract completion. For a more detailed understanding of look-back interest refer to Examination and Closing Procedures Form 8697, Look-Back Interest Guide.

(2) The look-back calculation, which applies to completed long-term contracts, compares the percentage of gross profit that the taxpayer recognized in prior years to the **actual** gross profit percentage that the taxpayer should have reported. The calculation determines whether the gross profit for that particular job was over or under reported in prior years based on job cost **estimates** at the time of the tax reporting.

(3) The taxpayer will either owe look-back interest on the hypothetical understatement of tax in prior years or receive a refund of look-back interest on the hypothetical overstatement of taxes in prior years.

(4) For mid-contract changes in taxpayer, the old taxpayer and new taxpayer each have reported a portion of the contract. Thus, the question become who is responsible for computing look-back interest when the new taxpayer completes the job. The look-back interest rules are different depending on whether the transaction is a constructive completion or step-in-the-shoes transaction.

E. Look-back Interest – Constructive Completion Transaction

(1) As discussed earlier, in constructive completion transactions, the old taxpayer "completes" the contract on the date of the transaction. The old taxpayer applies look-back interest with respect to the pre-transaction years upon the date of the transaction. If the new taxpayer uses PCM or PCCM to account for the contract, the new taxpayer applies look-back interest to the post-transaction years upon completion of the contract. See Treas. Reg. § 1.460-6(g)(2).

F. Look-back Interest – Step-in-the-Shoes Transaction

(1) As discussed earlier, in step-in-the-shoes transactions, the regulations treat the new taxpayer as the owner of the contract since its inception. The new taxpayer computes look-back interest for both the pre-transaction and post-transaction years on the date the taxpayer completes the contract. The new taxpayer is liable for paying look-back interest and entitled to receive a refund. The old taxpayer does not compute look-back interest on the

transaction date and is only secondarily liable for payment of any interest with respect to the pre-transaction years. See Treas. Reg. § 1.460-6(g)(2).

VI. Financial Accounting Versus Tax Accounting

A. Overview

(1) The accounting methods available in the construction industry are unique to this industry. Understanding both the financial accounting and tax accounting requirements is important, so the proper book-to-tax adjustments can be made.

B. Financial Accounting

(1) The primary sources for generally accepted accounting principles (GAAP) for accounting for construction contracts are Accounting Research Bulletin (ARB) No. 45, Long-Term, Construction-Type Contracts and Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Under (GAAP) there are two methods of recognizing revenues on construction contracts.

(2) ARB 45, which was issued in 1955, describes the two generally accepted methods of accounting for long-term construction type contracts; the percentage of completion method and the completed contract method. Because of the complexities and uncertainties in accounting for contracts, SOP 81-1 was issued in 1981 to provide additional guidance on the application of generally accepted accounting principles (GAAP).

(3) Under SOP 81-1, the two methods are not alternatives from which a contractor is free to choose. SOP 81-1 establishes a strong preference for the percentage of completion method on the presumption that contractors have the ability to make estimates that are sufficiently dependable.

(4) Therefore, the financial statements (whether audited, reviewed, or complied) that are prepared for bonding, banking, or other reporting purposes are almost exclusively prepared using the percentage of completion accounting method. However, in some circumstances, where the taxpayer is sure that a loss will not be incurred on the contract and the estimation of the final outcome may be impractical, the percentage of completion method will use a zero-profit method (i.e. equal amount of revenue and cost are recognized until the results can be more precisely estimated).

(5) The completed contract method may be used for financial purposes in circumstances in which the financial position would not vary materially from the percentage of completion method (i.e. this would primarily occur with short-term contracts). Additionally, the completed contract method may be

used in circumstances in which the contractor cannot make reasonable estimates.

(6) However, as discussed in the chapter on Small Contractors and Large Contractors, many more accounting method choices are available to the contractor for tax purposes, depending on the length of the contract, the type of construction involved, and the average annual gross receipts of the taxpayer.

B.1. International Accounting Standards

(1) Similar to SOP 81-1, which is a United States standard, International Accounting Standard (IAS) 11 provides guidance for the accounting of the revenues and costs of construction contracts. Under IAS 11, the percentage of completion method should be used when the outcome of a construction contract can be reasonably estimated. In circumstances in which the outcome cannot be reasonably estimated, no profit should be recognized. The taxpayer should only recognize contract revenue to the extent the taxpayer has incurred contract costs. International Financial Reporting Standards (IFRS) 15, *Revenue from Contracts with Customers,* replaces IAS 11 for annual reporting periods beginning on or after 1-1-2018.

B.2. Accounting Standards Codified Topic (ASC) 606 – Revenue from Contracts with Customers

(1) The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) jointly issued ASC 606 on May 28, 2014 which is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual reporting periods beginning after Dec. 15, 2017. For all other entities, the effective for annual reporting periods beginning after Dec. 15, 2018. However, there are provisions which allow taxpayers to apply ASC 606 earlier. ASC 606 is expected to supersede all prior GAAP guidance on this topic.

(2) The core principle of ASC 606 is that an entity recognizes income it expects to be entitled to when it transfers the goods and services. The following steps provide guidance to the taxpayer in recognizing income:

- Step 1: Identify the contract with the customer
- Step 2: Identify the performance obligations in the contract
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price

- Step 5: Recognize revenue when or as the entity satisfies a performance obligation

B.3. Balance Sheet Accounts

(1) When accounting for contracts using the percentage of completion method (PCM), costs determine the revenue and not the contract's earned or billed income recognition. Determining completion by costs (Total Costs Incurred divided by Total Estimated Costs) is a computation not made through the day-to-day book recording procedures. For instance, there is not a general ledger account for total estimated contract costs.

(2) To account for the difference between percentage of completion method and billings, two balance sheet accounts are created:

- Costs and Estimated Earnings in Excess of Billings (Asset)
- Billings in Excess of Costs and Estimated Earnings (Liability)

(3) Example:

- This situation illustrates the concept of journal entries for a construction contract using the percentage of completion method. A contractor enters into a long-term construction contract, which will not be completed by the end of the tax year. The total estimated contract price is $3,000,000, the total estimated contract costs are $2,000,000 and the contract is to be completed in Year 2. The total costs incurred on this contract during Year 1 are $1,000,000. The contractor billed the customer $1,200,000 during Year 1.
- During the tax year journal entries to record the transactions of this contract would be recorded as shown below. (Note: the two entries below are a summary of the numerous transactions that would have been recorded as the costs and billings were incurred.

Journal Entries Using Percentage of Completion Method

Journal Entries	Debit	Credit
Costs Incurred	$1,000,000	
Accounts Payable		$1,000,000
Accounts Receivable	$1,200,000	
Costs and Estimated Earnings in Excess of Billings		$1,200,000

- At year-end, the contractor would determine the income to be included under the percentage of completion method as follows:

Year-End Percentage of Completion Method

$$\frac{\text{Total Costs Incurred } (\$1{,}000{,}000)}{\text{Total Estimated Costs } (\$2{,}000{,}000)} \times \text{Estimated Contract Price } (\$3{,}000{,}000) = \text{PCM Income } (\$1{,}500{,}000)$$

- The entry necessary to bring the books and financial statements in accordance with the percentage of completion method would be as follows:

Adjusting Journal Entry for Percentage of Completion Method

Journal Entries	Debit	Credit
Costs and Estimated Earnings in Excess of Billings	$1,500,000	
Income		$1,500,000

- At year-end the Costs and Estimated Earnings in Excess of Billings account has a debit balance of $300,000 and is represent as an asset on the balance sheet.
- Basically, these two balance sheet accounts represent the difference between the accrual method and the percentage-of-completion method for reporting income on a long-term contract. Under either method, the costs related to the long-term contract are deducted as incurred. Therefore, generally no difference exists between the two methods for costs.

Accrual vs. Percentage of Completion Methods

Accrual vs. Percentage of Completion Methods	Amount
Income Billings per Accrual Method	$1,200,000
Income per Percentage of Completion Method	$1,500,000
Costs and Earnings in Excess of Billings	$300,000

B.4. Balance Sheet Reporting

(1) A basic reporting principle prevents assets and liabilities from being netted or offset against each other. Thus, both accounts (Costs and Estimated Earnings in Excess of Billings and Billings in Excess of Costs and Estimated Earnings) should be present on the balance sheet. The following procedures are performed at year-end:

- For each contract in progress at year-end, the total cost incurred to date plus the estimated earnings (on percentage of completion method) is reduced by the total amount of bills rendered to arrive at a net balance. The net balance, for each contract, will be a debit if the total costs and estimated earnings exceed the billings and a credit if the billings exceed the costs and estimated earnings.
- All contracts that have a debit balance are added together with the total shown as an asset on the balance sheet.
- All contracts that have a credit balance are added together with the total shown as a liability on the balance sheet.

(2) See the Contracts In-Process Schedule at the end of the chapter for an illustration of the procedures above.

C. Book and Tax Differences

(1) Schedule M-1 and M-3 adjustments result from both timing differences and permanent differences between financial and tax accounting. The following items point out some of the differences in financial and tax accounting that is unique to the construction industry. The examiner should reconcile the differences through Schedule M-1 and M-3 adjustments.

C.1. Revenue Recognition

(1) As discussed above, Statement of Position 81-1 (SOP 81-1) virtually requires construction companies to report income on the percentage of completion method. Generally, the bonding company or a lending bank will require the taxpayer to submit audited (possibly reviewed) financial statements, which will be reported on the percentage of completion method. For tax accounting, the contractor may use a different method, such as completed contract method, percentage of completion method, or capitalized cost method.

C.2. Contract Related Services

(2) SOP 81-1 paragraph 12 provides a listing of contracts that are covered by this statement. Included in that listing are engineers, architects, and construction management taxpayers. Therefore, for financial purposes these contracts would be accounted for under the percentage of completion method. However, for tax purposes, they generally cannot use a long-term contract method (e.g., completed contract or percentage of completion). Revenue Ruling 70-67, Revenue Ruling 80-18, Revenue Ruling 82-134, Revenue Ruling 84-32.

C.3. Determining Completion for Percentage of Completion Method

(3) SOP 81-1 paragraph 44 provides many methods to measure the extent of progress towards completion. They include the cost-to-cost method, variations of the cost-to-cost method, efforts expended method, the units-of-delivery method, and the units-of-work-performed method. For tax purposes, IRC § 460 generally requires the cost-to-cost method. However, the taxpayer may also elect the percentage of completion 10% method in which none of the contract revenue or costs is included in taxable income until the contract is 10% complete. The contractor may also elect the simplified cost-to-cost method to determine contract completion.

C.4. Loss Recognition

(4) SOP 81-1 paragraph 85 requires the contractor to report the total loss on a contract as soon as it is evident that a loss will occur. “When the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract should be made. Provisions for losses should be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method.” However, for tax purposes, the loss is not recognized until the job is completed, if on the completed contract method, and as incurred, if on the percentage of completion method.

C.5. Uninstalled Dedicated Materials

(5) For tax purposes, the taxpayer must include uninstalled dedicated materials as an allocable contract costs for PCM when they incur the liability for those materials, thus increasing the completion percentage. For financial reporting purposes, the taxpayer does not treat them as allocable costs until the materials have been installed or used, resulting in a timing difference in income recognition between book and tax. See Treas. Reg. §

1.460-5(b)(2)(i).

C.6. ASC 606 – Revenue from Contracts with Customers

(6) As discussed earlier in this chapter, when taxpayers implement ASC 606, they need to consider the income tax implications of the new accounting guidance because they may need to record revenue for financial reporting purposes from contracts with customers at a different time than they record taxable income.

D. Sample Financial Statements using Percentage of Completion Method

(1) The exhibits below illustrate the financial statements when reporting construction contracts on the percentage of completion method. They also include items to consider when reviewing these statements.

D.1. Exhibit 6-1 Balance Sheet

Exhibit 6-1
Balance Sheet
December 31, XXXX

Assets	
Current Assets	
Cash	9,000
Contract Receivables	335,000
Costs & Estimated Earnings in Excess of Billings [1]	28,711
	372,711
Property & Equipment	
Furniture, Fixtures, & Equipment	6,000
Accumulated Depreciation	-1,500
	4,500
Other Assets	
Deposits	750
Total Assets	377,961
Liabilities and Stockholder's Equity	
Accounts Payable	121,000
Accrued Liabilities	17,000
Deferred Income Taxes	36,000
Billings in Excess of Costs and Estimated Earnings [1]	5,666
	179,666
Common Stock	1,000
Retained Earnings	197,295
	377,961

[1] These accounts should reconcile to the Exhibit 5 - Contracts in Progress

D.2. Exhibit 6-2 Statement of Income and Retained Earnings

Exhibit 6-2
Statement of Income and Retained Earnings
December 31, XXXX

Contract Revenue Earned [1]	1,439,159
Costs of Revenue Earned [1]	1,174,000
Gross Profit	265,159
General & Administrative Expenses	199,000
Income Before Income Taxes	66,159
Income Taxes	
Current	12,000
Deferred	4,000
Net Income [2]	50,159
Beginning Retained Earnings	147,136
Ending Retained Earnings	197,295

[1] From Exhibit 3 - Earnings from Contracts

[2] Should reconcile to Schedule M-1/M-3 Book Income

D.3. Exhibit 6-3 Earnings from Contracts

Exhibit 6-3
Earnings from Contracts
Year Ended December 31, XXXX

	Revenues Earned	Cost of Revenues	Gross Profit (Loss)
Contracts Completed During the year[1]	502,000	361,000	141,000
Contracts in progress at year end[2]	937,159	813,000	124,159
	1,439,159	1,174,000	265,159

[1] From Exhibit 4 - Contracts Completed– represents the amounts of revenue earned and costs incurred during the XXXX tax year.

[2] From Exhibit 5 - Contracts in Progress – represents the amounts of revenue earned and costs incurred during the XXXX tax year.

D.4. Exhibit 6-4 Contracts Completed

Exhibit 6-4
Contracts Completed
Year Ended December 31, XXXX

		Contract Totals [1]			Before Jan. 1, XXXX			Year Ended December 31, XXXX		
Project Number	Construction Project	Revenues Earned	Cost of Revenues	Gross Profit (Loss)	Revenues Earned	Cost of Revenues	Gross Profit (Loss)	Revenues Earned	Cost of Revenues	Gross Profit (Loss)
121	John's Store	312,000	248,000	64,000	193,000	172,000	21,000	119,000	76,000	43,000
122	Ron's Club	267,000	197,000	70,000	178,000	144,000	34,000	89,000	53,000	36,000
127	Parking Lot	403,000	312,000	91,000	250,000	199,000	51,000	153,000	113,000	40,000
128	Hospital [2]	35,000	38,000	-3,000	--	--	--	35,000	38,000	-3,000
130	Office Bldg	106,000	81,000	25,000	--	--	--	106,000	81,000	25,000
		1,123,000	876,000	247,000	621,000	515,000	106,000	502,000	361,000	141,000

[1] Contract Totals for Revenues Earned, Cost of Revenues and Gross Profit (Loss) would be used for the tax return if on the Completed Contract Method.

[2] Any jobs resulting in a loss should require further examination – claim income not yet recognized?

D.5. Exhibit 6-5 Contracts in Progress

Exhibit 6-5 - Contracts In Progress

	Total Estimated Contract		From Inception to Dec. 31, XXXX					Before Jan. 1 XXXX			As of Dec. 31, XXXX		For Year Ended Dec. 31, XXXX			
Project Number	Revenues	Estimated Gross Profit (Loss)	Revenues Earned	Cost of Revenues	Gross Profit (Loss)	Billed to Date	Estimated Cost to Complete	Revenues Earned	Cost of Revenues	Gross Profit (Loss)	Costs & Est. Earnings in Excess of Billings	Billings in Excess of Costs & Est. Earnings	Revenues Earned	Cost of Revenues	Gross Profit (Loss)	Percent Complete
119	1,275,000	210,000	1,228,310	1,026,000	202,310	1,225,000	39,000	1,049,000	880,000	169,000	3,310	---	179,310	146,000	33,310	96.34%
120 [1]	211,000	-10,000	107,887	113,000	-5,113	106,000	108,000	---	---	---	1,887	---	211,000	221,000	-10,000	51.13%
123	53,000	15,000	43,237	31,000	12,237	46,000	7,000	---	---	---	---	2,763	43,237	31,000	12,237	81.58%
124	258,000	50,000	129,000	104,000	25,000	117,000	104,000	---	---	---	12,000	---	129,000	104,000	25,000	50.00%
125	218,000	40,000	79,607	65,000	14,607	74,000	113,000	---	---	---	5,607	---	79,607	65,000	14,607	36.52%
126	85,000	13,000	47,222	40,000	7,222	43,000	32,000	---	---	---	4,222	---	47,222	40,000	7,222	55.56%
129	220,000	42,000	181,685	147,000	34,685	180,000	31,000	---	---	---	1,685		181,685	147,000	34,685	82.58%
131 [2]	160,000	38,000	28,852	22,000	6,852	30,000	100,000	---	---	---	---	1,148	28,852	22,000	6,852	18.03%
133 [3]	152,000	1,000	37,245	37,000	245	39,000	114,000	---	---	---	---	1,755	37,245	37,000	245	24.50%
	2,632,000	399,000	1,883,045	1,585,000	298,045	1,860,000	648,000	1,049,000	880,000	169,000	28,711	5,666	937,159	813,000	124,159	

[1] Job #120 has a total estimated loss of ($10,00). The total estimated loss has been recognized for financial purposes. However, the job is only 51.13% complete. There should be a book/tax adjustment on the Schedule M-1/M-3.
[2] Where is job #132? It is not listed on this schedule nor the completed contract schedule – Exhibit 4.
[3] Job #133 has a low estimated gross profit compared to the other jobs.

E. Exhibit 6-6 Tax Accounting Methods

Type	**Available Accounting Methods for Long-Term Construction Contactors Required to Use Percentage of Completion Method under Internal Revenue Code (IRC) § 460**
Percentage of Completion Method (PCM)	IRC § 460(b)(1)(A) and Treasury Regulation (Treas. Reg.) § 1.460-4(b) generally require that taxpayers use the "cost-to-cost" method to compute PCM which is: • Cumulative Gross Receipts = (Total cumulative allocable contract costs incurred to end of taxable year / Total estimated allocable contract costs) x Total contract price • Current Year Gross Receipts = Cumulative gross receipts less cumulative gross receipts from immediately preceding taxable year

	• Current Year Taxable Income = Current year gross receipts less allocable contract costs incurred during current year Upon contract completion, IRC § 460(b)(1)(B) requires interest computed under the “look-back” method.
Simplified Cost-to-Cost Method	IRC § 460(b)(3)(A) and Treas. Reg. § 1.460-5(c) provide an elective simplified procedure for determining the contract completion factor for taxpayers using PCM. Taxpayers only use three costs in determining the percentage of completion: 1. Direct material costs 2. Direct labor costs 3. Depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the long-term contract.
Percentage of Completion - 10% Method	IRC § 460(b)(5) - The taxpayer may elect to defer recognition of revenue under PCM until it incurs and allocates 10% of the estimated total contract costs. This election is unavailable if the taxpayer elected the simplified cost-to-cost method mentioned above.
Percentage of Completion/ Capitalized Cost Method (PCCM)	A taxpayer may determine the income from a long-term construction contract that is a residential construction contract using either the PCM or the PCCM. Under the PCCM, the taxpayer must report 70% of the contract under PCM (as required by IRC § 460) and the remaining 30% under a permissible exempt method (e.g., Completed Contract, exempt PCM, etc.). See Treas. Reg. § 1.460-3(c) and Treas. Reg. § 1.460-4 (e). A residential construction contract differs from a home construction contract in that a home construction contract involves buildings with four or fewer dwelling units, whereas a residential construction contract involves buildings with more than four dwelling units.
Cash Method	The general rule requires the taxpayer to report income when received (or constructively received) and deduct expenses when paid. The cash method is available for taxpayers that IRC § 448 does not prohibit from using or taxpayers required to maintain inventories under IRC 471. The 2017 Tax Cuts and Jobs Act, effective for tax years after 12/31/2017, changed the requirements for use of the cash method for small business taxpayers. A small

	business taxpayer is a taxpayer that has average annual gross receipts of $25 million or less for the 3 prior tax years and is not a tax shelter (as defined in section 448(d)(3)).
Accrual Method	For the recognition of income all events must occur to fix the right to receive income and the amount of income must be determinable with reasonable accuracy. The general rule is that taxpayers report income when due, earned, or received, whichever comes first. For tax years beginning after 12-31-2017, the taxpayer does not treat the all events test, with respect to any item of gross income, as met any later than when the taxpayer takes such item into account as revenue in an applicable financial statement. Under an accrual method of accounting, expenses are deductible when all events have occurred that establish the fact of the liability, the amount can be determined with reasonable accuracy, and not earlier than when economic performance has occurred.
Accrual with Deferred Retainages Method	Revenue Ruling (Rev. Rul.) 69-314 allowed an accrual-basis taxpayer to elect to defer the inclusion in income of retainages withheld by the customer until final acceptance by the customer occurred as specified in the contract.
Completed Contract Method (CCM)	The general rule is that the taxpayer defers all income and expenses (both direct and indirect) related to a contract until the job is complete. Because of this deferral, this method is generally the one preferred by taxpayers who are exempt from using the PCM.
Exempt-Contract Percentage-of-Completion Method (EPCM)	A taxpayer who is exempt from the requirement to use the PCM under IRC § 460 (using the cost-to-cost method) may elect an alternative method of cost comparison known as ECPM. The taxpayer must include in income the portion of the total contract price that corresponds to the percentage of the entire contract completed during the taxable year. However, the taxpayer may determine the completion by using any method of cost comparisons, such as direct labor costs incurred to date to estimated total labor costs, or by comparing work performed with estimated total work to perform (e.g., units of production). See Treas. Reg. § 1.460-4(c)(2).

VII. Homebuilders and Land Developers

A. Overview

(1) This chapter combines homebuilders and land developers since they are closely related. Some large homebuilders purchase large tracts of real estate, subdivide, improve the land, and construct homes. However, there are land developers that do not construct homes; they only subdivide and improve the land prior to selling the property to the party that will eventually construct a home.

(2) A home construction contract is one of the two exceptions from the required use of the percentage of completion method (PCM). The other exception is the small contractor's exception which is discussed in Chapter 3, Small Construction Contractors. Therefore, it is important to determine whether the contract meets the definition of a home construction contract to know if the taxpayer's method of accounting is permissible.

(3) Contracts that meet the definition of a home construction contract are exempt from the following:

- The requirement to use PCM;
- The application of the look-back interest provisions; and
- The requirement to use PCM for alternative minimum tax purposes.

(4) Internal Revenue Code (IRC) § 460(c)(3) requires the capitalization of construction period interest, on exempt contracts.

(5) IRC § 460(e)(1)(A) exempts any home construction contract. It is not based on the length of the contract nor the gross receipts of the taxpayer as is the case with the small contractor exception.

(6) A construction contract that meets the requirement of a home construction contract is exempt from the percentage of completion method of accounting for both regular income tax and alternative minimum tax. Speculative home builders and land developers that are not under a long-term contract are not permitted to use a long-term contract method of accounting. Rev. Proc. 92-29 allows a developer an alternative cost allocation of common improvements to even out the gross profit of each lot produced over the life of the project.

B. Home Construction Contract Defined

(1) A home construction contract is any construction contract where 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 construction of:

- Dwelling units contained in buildings containing 4 or fewer dwelling units, **and**
- Improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

(2) Treasury Regulation (Treas. Reg.) § 1.460-3(b)(2)(I)(A) refers to IRC § 168(e)(2)(A)(ii)(I) for the definition of a "dwelling unit," defining it as a house or apartment used to provide living accommodations in a building or structure. If there are more than four dwelling units (e.g. apartments, condominiums) in a building the contract is a residential construction contract. Residential construction contracts do not include motels or hotels or a place where more than half of the units are used on a transient basis.

(3) For tax purposes, each townhouse and rowhouse is a separate building and a contract to construct them thus would meet the definition of a home construction contract. Condominiums are different and a contract for such only meets the definition of a home construction contract if there are 4 dwelling units or fewer in the building.

(4) The distinction between a home construction contract and a residential construction contract is important because the IRC requires a taxpayer to use the PCM and apply look-back interest upon completion to residential construction contracts. Taxpayers may elect to use percentage of completion capitalized cost method (PCCM) for its residential contracts. See Chapter 4, Large Construction Contractors, for more information regarding PCCM.

(5) A subcontractor constructing a portion of the dwelling unit meets the definition of a home construction contract if it otherwise qualifies. See Treas. Reg. § 1.460-3(b)(2).

B.1. Common Improvements

(1) For purposes of the home construction contract 80% test, 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. The taxpayer must be contractually obligated, or required by law, to construct the common improvements within the tract or tracts of land that contain the dwelling units. If the taxpayer is not constructing any portion of the dwelling unit, the common improvement cost is not a dwelling unit cost and the contract thus does not qualify as a home construction contract. See *Howard Hughes Co., LLC v. C.I.R,* 142 T.C. 355 (2014): "…The regulations make clear that taxpayers may include the allocable share of these common improvement costs in the cost of the dwelling units…but we agree with respondent that the taxpayer must at some point incur some construction cost with respect to the dwelling unit to include these costs in

the dwelling unit cost. We do not believe that IRC § §1.460-3(b)(2)(i) and (iii), Income Tax Regs., allows a taxpayer with zero direct construction costs with respect to dwelling units to simply add common improvement costs for the purpose of the 80% test."

B.2. Mixed Use Buildings

(1) If a contract involves the construction of both commercial units and dwelling units within the same building, a taxpayer must allocate the costs among the commercial units and dwelling units using a reasonable method or combination of reasonable methods, such as specific identification, square footage, or fair market value. The IRC requires the taxpayer to use the PCM for the commercial units if they do not meet the small contractor exception.

C. Recent Developments

C.1. Important Court Decisions – Completed Contract Method

- In *Howard Hughes Co., LLC v. C.I.R.,* 142 T.C. 355 (2014), the Tax Court ruled that the developer could not use the completed contract method (CCM) because they did not have home construction contracts as defined under IRC § 460(e). The Tax Court held that a contract can qualify as a home construction contract only if the taxpayer builds, constructs, reconstructs, rehabilitates, or installs integral components to dwelling units. Howard Hughes was a land developer who sold lots to homebuilders but did not actually construct any part of the home; the Court determined the taxpayer was therefore improperly using the CCM. The appellate court in the Fifth Circuit upheld the Tax Court's decision in *Howard Hughes Company, LLC v. Commissioner,* 805 F.3d 175 (5th Cir. 2015).
- After the Howard Hughes decision, the Service issued Technical Advice Memorandum (TAM) 201650014 which on first reading, appears to contradict the Howard Hughes cases. The taxpayer's work included both rough grading and fine grading. The type of structure, that the taxpayer's customer was to build on the lot, determined the specific grading and compaction of the pad area of each lot. The taxpayer's work was also covered by home warranties.
- In the TAM, the Service held that the taxpayer's grading and soil compaction were construction of a portion of the dwelling unit and therefore the contract was considered a home construction contract and the taxpayer was permitted to use the CCM. The

Service based its conclusion on the tax law addressing whether the cost of the land preparation can be included in the basis of the building used in a trade or business or held for the production of income, and therefore depreciable. The Service also pointed out that rough grading of the lot or clearing trees would not qualify as the construction of a dwelling unit. The TAM is based on specific facts and cannot be cited or used as a precedent.

- In ***Shea Homes, Inc. v. Comm**., 142 T.C. 60 (2014), *aff'd* 843 F.3d (9th Cir. 2016), the Tax Court ruled that when interpreting the completed contract method, the subject matter of the taxpayer's contracts include the homes as well as the common improvements in the development. The Tax Court also ruled that, based on the facts, when the taxpayer incurs 95% of the costs of the entire development the contract is complete.
- The Service issued an Action on Decision (AOD) 2017-03 stating it would not follow the Shea Homes opinion. For the 95% completion test, examiners should verify that the taxpayer only included the direct and indirect costs of each home and any common improvement costs that are allocable to that home.

D. Taxation of Homebuilders

(1) To avoid confusion in the tax accounting rules, for both income and expenses, this guide will separately discuss each of the following types of construction or development:

- Speculative homes without a contract
- Contractors building homes with a contract
- Land developers not constructing homes

E. Speculative Homes (No Contract)

(1) Homebuilders will purchase lots from a developer of a subdivision to build houses. The homebuilder may build some of the homes as speculative (spec) homes. Taxpayers build spec homes with the intent of finding a buyer after the construction of the home. The homebuilder does not have a contract to build the home. In the industry, the homebuilder refers to spec homes on hand at year-end as inventory of unsold houses or work in progress. These speculative houses do not meet the definition of inventory in the Code. The IRC defines inventory as tangible personal property. Speculative houses are capital assets as defined in IRC § 263. The builder owns the real property (land) and the house inherently attached to the land. Courts have consistently held that the taxpayer must account for developed real property under a capitalization method. See *W.C. & A.N. Miller*

Development Co. v. Commissioner 81 T.C. 619 (1983); *Homes by Ayres v. Commissioner,* T.C. Memo. 1984-475, *aff'd* 795 F.2d 832 (9th Cir. 1986), and *Frontier Custom Builders Inc. v. Commissioner*, T.C. Memo 2013-231. See also Revenue Ruling 86-149, 1986-2 C.B. 67; Revenue Ruling 66-247, 1966-2 C.B. 198.

E.1. Income Recognition – Spec Homes

(1) A long-term contract method of accounting (i.e. PCM, CCM) cannot be used for spec homes because there is no contract. Speculative homebuilders report their income from the sale of a speculative house at the time of settlement or closing under IRC § 1001.

E.2. Cost Recognition – Spec Homes

(2) Regardless of the taxpayer's overall method of accounting, according to the principles in IRC §§ 263(a) and 263A, a taxpayer should capitalize the direct and indirect costs incurred in the construction of a house for speculative sale (including the cost of the land, direct materials and direct labor). For tax years beginning after 12-31-2017, IRC § 263A does not apply to a small business taxpayer. A small business taxpayer is a taxpayer that (a) has average annual gross receipts of $25 million or less for the 3 prior tax years and (b) is not a tax shelter (as defined in IRC § 448(d)(3)).

(3) Under IRC § 263(a)(1) and Treas. Reg. § 1.263(a)-1, costs incurred in the construction of homes and other permanent improvements to real property are not currently deductible. Instead the cost of unsold homes and construction in progress is a capital expenditure that becomes part of the basis of the real estate, which in turn, the taxpayer can recover either through a depreciation allowance if the taxpayer uses the property in a trade or business (rented), or as an offset against the price received in the sale or disposition of such property.

(4) Treas. Reg. § 1.263(a)-2 sets forth examples of capital expenditures, including the cost of acquisition, construction, or erection of buildings having a useful life substantially beyond the tax year.

E.3. Revenue Ruling 66-247

(1) The taxpayer must capitalize costs incurred in the construction of a house for speculative sale regardless of the taxpayer's overall method of accounting. The taxpayer will apply those costs against the amount realized upon the sale of the house for purposes of determining gain or loss in computing taxable income.

(2) Carpenter v. Commissioner, T.C. Memo 1994-289

- A building contractor could not use the cash method of accounting for expenses related to construction of houses that were unsold at the end of the tax year because he was a producer of the property. The taxpayer capitalizes the construction costs related to the unsold houses under IRC § 263A.

E.4. Inventory vs. Real Estate

(1) In the construction industry, it is common for a contractor to use "inventory" terminology for unsold homes or work in process. However, unsold homes or work-in-progress is never considered inventory. Both real estate and inventory are assets, but this distinction is important because under several accepted inventory methods, a departure from the actual cost could take place (that is, lower of cost or market). Generally Accepted Accounting Principles (GAAP) requires the taxpayer to write down real estate to its market value. See Financial Accounting Standards Board (FASB) Statement No. 144 – Accounting for the Impairment or Disposal of Long-Lived Assets. However, for tax purposes, a write-down in value is not permissible; therefore, there should be a book to tax adjustment reported on Schedule M-1 or M-3.

(2) *Atlantic Coast Realty Co. v. Commissioner*, 11 B.T.A. 416 (1928), and Revenue Ruling 69-536, 1969-2 C.B. 109 hold that the taxpayer cannot write down real estate, held for sale as "inventory" and work in process, to market value using a lower of cost or market valuation.

(3) *Homes by Ayres v. Commissioner*, T.C. Memo 1984-475, aff'd. 795 F.2d 832 (9th Cir. 1986) - Taxpayers engaged in the construction and sale of large-scale tract housing developments could not use the last-in-first-out (LIFO) method to account for the property. The court held that real estate is not inventory and the taxpayer cannot use an inventory method to account for the property.

(4) *W.C. & A.N. Miller Development Co. v. Commissioner*, 81 T.C. 619 (1983) - The taxpayer was a developer of real estate. The taxpayer acquired and constructed single-family, detached homes. The taxpayer applied a LIFO method to account for its completed homes. At the time of settlement with the purchaser of the home, the taxpayer treated all costs related to each home as cost of sales. The court held that the individual homes or lots which the taxpayer sells are real estate and do not constitute "merchandise" within the meaning of Treas. Reg. § 1.471-1. Thus, the court did not permit the taxpayer to use LIFO.

(5) Revenue Ruling 86-149, 1986-2 C.B. 67 involves a real estate developer who filed a Form 970 to apply for the LIFO method of accounting for its "inventory" of completed homes and homes in progress. The construction

costs of completed homes and costs of construction in progress are capital expenditures under IRC § 263. A taxpayer engaged in the business of developing real estate must capitalize its costs in accordance with IRC § 263.

E.5. Speculative Homes Becoming Long-Term Contracts

(1) A contractor may begin building a speculative home and enter into a sales agreement with a customer prior to completion. If the taxpayer expects the contract to be completed beyond the year the contract is entered into, the taxpayer has a long-term construction contract and would then account for the contract under its exempt long-term method of accounting. See Treas. Reg. § 1.460-4(c)(1).

F. Contractors Building Homes Under Contract

(1) As previously mentioned, any home construction contract is exempt from the requirement to use the percentage of completion method per IRC § 460(e)(1)(A). Therefore, the contractor may elect a permissible exempt contract method that includes percentage of completion, exempt percentage of completion, completed contract, or any other permissible method under IRC § 446. See Treas. Reg. § 1.460-4(c)(1). The contractor must use the elected method to account for all its long-term contracts that are exempt from the requirements of IRC § 460(a). Even though exempt construction contracts are not subject to PCM, production period interest is subject to the cost allocation rules under IRC § 460(c)(3). See Treas. Reg. § 1.460-1(a)(2)(i).

F.1. Long-Term Methods of Accounting

(1) If a contractor elects a long-term method of accounting for an exempt construction contract (e.g., completed contract method, percentage of completion method, or exempt contract percentage of completion method) it is not relevant who has title to the land. Within the definition of a contract for the construction of property, Treas. Reg. § 1.460-1(b)(2) states, "Whether the customer has title to, control over, or bears the risk of loss from, the property manufactured or constructed by the taxpayer also is not relevant." Treas. Reg. § 1.460-4 describes the tax recognition of the contract income and expenses attributable to long-term methods of accounting.

F.2. Completed Contract Method (CCM)

(1) The taxpayer includes the gross contract price and all allocable contract costs incurred in taxable income in the year of completion under the completed contract method per Treas. Reg. § 1.460-4(d).

F.3. Percentage of Completion Method (PCM)

(1) The taxpayer can elect to use the PCM cost-to-cost method, required for non-exempt contracts, as its exempt method of accounting. A taxpayer generally must include in income the portion of the total contract price that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year. The taxpayer determines completion by comparing allocable contract costs incurred with estimated total allocable contract costs. Thus, the taxpayer includes in gross income a portion of the contract price as the taxpayer incurs allocable contract costs. See Treas. Reg. § 1.460-4(b). See Chapter 4, Large Construction Contractors, for detailed information on the PCM cost-to-cost.

F.4. Exempt Contract Percentage of Completion Method (ECPM)

(1) The taxpayer may elect an exempt PCM. The taxpayer may use any method of cost comparison to determine contract completion such as: direct labor costs incurred to estimated total direct labor costs or by comparing the work performed on the contract with the estimated total work the taxpayer will perform. See Treas. Reg. § 1.460-4(c)(2). However, the taxpayer must use consistently to clearly reflect income.

F.5. Other Permissible Accounting Methods

(1) Title to the property is relevant if the taxpayer elects any permissible method, per IRC § 446, other than a long-term method of accounting, because the taxpayer must look to other IRC sections for the appropriate rules for income and expense recognition.

(2) If the contractor builds the home on land it owns and does not elect a long-term accounting method, the contractor must capitalize all costs incurred in the construction of the home per IRC § 263. See Revenue Ruling 86-149, 1986-2 C.B. 67. These costs are capital expenditures that become a part of the real estate cost that, in turn, are recovered as an offset against the price received upon the disposition of the property. See IRC § 1001.

(3) Conversely, a contractor that builds a home on land the customer owns deducts the costs following the overall cash or accrual method, whichever

method the taxpayer uses.

F.6. Large Homebuilders

(1) A large homebuilder is one failing to meet either of the exceptions for small construction contracts of IRC § 460(e)(1)(B). Therefore, a large homebuilder meets one of the following criteria:

- A taxpayer whose average annual gross receipts, for three preceding years, exceeds $25,000,000 ($10 million for tax years beginning prior to 1-1-2018) or
- Contracts that the taxpayer expects the completion to exceed a 2-year period beginning on the contract commencement date.

(2) The only distinction between a large homebuilder and a small homebuilder is that a large homebuilder must capitalize the allocable contract costs according to IRC § 263A.

F.7. Model Homes

(1) Taxpayers may buy several lots in a subdivision and build one or more styles of homes to use as a model home. The model homes may contain a portion of the home as a sales office. The taxpayer will eventually sell the model home at the end of the development. Revenue Ruling (Rev. Rul.) 89-25, 1989-1 C.B. 79, states that model homes and sales offices are not subject to an allowance for depreciation since they are property for sale in the ordinary course of business.

F.8. Furnishings in Model Homes

(1) Unlike Rev. Rul. 89-25 and *Duval Motor Co. v. Commissioner*, 264 F.2d 548, 551-52 (5th Cir. 1959), furnishings placed in model homes usually do not separately constitute an income-producing activity of a homebuilder, and do not promote the sale of similar furnishings. The model home furniture is not inventory but is used to assist the homebuilder to promote the sale of homes.

(2) IRC § 168 provides the applicable depreciation method, applicable recovery period, and the applicable convention for determining the depreciation deduction provided by IRC § 167(a) for tangible property.

(3) Revenue Procedure (Rev. Proc.) 87-56 classifies Office Furniture, Fixtures, and Equipment with a 7-year class life. This asset category includes “furniture and fixtures that are not a structural component of a building...". IRC § 168(e)(3)(C)(ii) also establishes a 7-year class life for any property which does not have a class life. Therefore, the taxpayer

should depreciate the furnishings placed within a model home over a 7-year class life.

G. Land Developer

(1) In the industry, the developer is generally the owner of the development. The developer acquires the raw land, obtains approval for development, secures the financing, and begins to clear the land, install roads, utilities, etc. The land developer may also build the homes in the development, sell the lots to a builder that will build the homes, or a combination of both.

(2) The remaining portion of this section pertains to the land developer that improves and sells the lots without having a long-term construction contract under IRC § 460.

G.1. Income Recognition – Land Developer Without a Construction Contract

(1) Since land developers are involved in the production of property without contracts, they generally report their income from the sale of a parcel of property at the time of settlement or closing per IRC § 1001.

G.2. Cost Recognition – Land Developer Without a Construction Contract

(1) The land developer must capitalize all direct costs incurred in the development of real estate (including the original cost of the land, direct materials and direct labor) according to IRC § 263(a). Additionally, IRC § 263A applies to land developers whose average annual gross receipts, for the prior three years, exceeds $25 million for tax years beginning after 12-31-2017. For tax years beginning prior to 12-31-2017, IRC § 263A applied to all developers of real property; there was no gross receipts threshold.

(2) The uniform capitalization rules of IRC § 263A(a)(1) mandate the taxpayer to capitalize certain costs to the real property being produced. These costs include pre-production costs (real estate taxes, zoning costs, design fees, etc.), production costs, and post-production costs.

(3) *Von-Lusk v Commissioner*, 104 T.C. 207 (1995) held that predevelopment costs were capitalized under IRC § 263A because the taxpayer was involved in the "production" of property.

(4) *Reichel v. Commissioner,* 112 T.C. 14 (1999) held that real estate taxes paid by a real estate developer were required to be capitalized under IRC § 263A, even though no positive steps to begin developing the parcels had occurred, because the taxpayer acquired the parcels with the intent to develop them.

(5) *Hustead v. Commissioner,* T.C. Memo. 1994-374, aff'd without opinion, 61 F.3d 895 (3d Cir. 1995) held that expenditures (legal expenses related to challenge of zoning variance) incurred in connection with land development must be capitalized under IRC § 263A.

(6) The land developer must determine the accumulated production expenditures with respect to each unit of property per Treas. Reg. § 1.263A-11. The taxpayer treats each unit of property, as defined in Treas. Reg. § 1.263A-10, as a separate costing unit to which all-direct and indirect costs described in IRC § 263A(a) are required to be capitalized.

G.3. Allocating Costs to Each Parcel of Property

(1) Generally Accepted Accounting Principles (GAAP) establishes a hierarchy of cost allocation methods based on the Statement of Financial Accounting Standards (SFAS) 67, Paragraph 11. These methods (in order) are:

- Specific identification method
- Relative value methods (appraised value, relative assessed value for real estate taxes)
- Other allocation methods (square footage)

(2) If the lots have the same general characteristics and size, the taxpayer may allocate the costs evenly to each lot. If the lots have similar characteristics but different sizes, the taxpayer may allocate the costs based on the square footage of each lot. If lots have different characteristics, the taxpayer may allocate the costs based on relative sales value. Whatever method the taxpayer uses, it must use it consistently and be reasonable.

(3) In *Homes by Ayres v. Commissioner*, 795 F.2d 832 (9th Cir. 1986), the court addressed job-costing methods. Taxpayers accounted for their construction costs by accumulating costs for each phase of a subdivision. Taxpayers would accumulate all direct and indirect costs for the year and then allocate them according to one of three methods to determine the cost of the houses sold in each phase (relative sales value method, average cost method, and square footage method). All three of these methods comport with generally accepted accounting principles and the IRS admits that they accurately reflect income.

(4) Normally each lot is a separate cost center, but when the taxpayer accumulates job costs for a subdivision in phases, the taxpayer may use a cost pool to allocate costs. The taxpayer may allocate costs according to standard cost accounting principles. Examples of methods used to determine the cost basis of the lots sold in each phase are:

- One technique for allocating the pool of capitalized costs is the "relative sales value method." This method determines cost of lots sold by multiplying total capitalized costs (already incurred plus estimated costs of completion) by the ratio of the selling prices of the lots sold to the estimated selling prices of all the lots in the phase.
- Another technique for cost allocation, "average cost method," calls for multiplying total capitalized costs by the ratio of the total number of lots sold to the aggregate number of lots to be sold in a phase.
- Finally, the "square footage method" allocates costs by multiplying total capitalized costs by the ratio of the aggregate square footage of lots to the aggregate square footage of all lots to be sold in the phase.

G.4. Common Improvements Allocable to the Cost of the Lots Developed by the Taxpayer

(1) Common improvements benefit two or more properties that the taxpayer sells. Examples of common improvements include streets, sidewalks, parks, etc. The taxpayer must be contractually obligated or required by law to provide the common improvement and the cost of the common improvement must not be properly recoverable through depreciation by the taxpayer. The taxpayer will allocate the costs of the common improvements to the benefitted lots if the taxpayer does not sell the improvement separately or operate the improvement in a trade or business.

(2) Whether the common improvements (such as a golf course or clubhouse) are allocable to the cost of the lots the taxpayer is developing is a factual determination that the developer needs to make on the merits of each situation. Upon review of the following applicable court cases, two reoccurring facts seem to be relevant:

- The basic purpose of constructing the common improvement is to induce the sale of the lots; and
- The taxpayer does not retain "too much ownership or control" of the common improvement.

(3) In the following court cases, the taxpayer could not allocate the common costs to the basis of the lots sold:

- *Charlevoix Country Club, Inc. v. Commissioner*, 105 F. Supp. 2d 756 (W.D. Mich. 2000).
  The taxpayer constructed a golf course, country club, and residential lots. The taxpayer owns both the golf course and

country club. The taxpayer sells golf club memberships both to lot owners and to the public at large. The membership permits the purchaser to use the golf course and country club but does not give them any ownership rights. The taxpayer could not allocate the costs of the golf course and country club to the lots because the taxpayer “retains complete control “of the golf course and country club. The court distinguished this case from *Norwest* (see further down) as follows: “Here, the court assumes, for purposes of deciding this motion, that CCC constructed the golf course and country club for the sole purpose of improving the salability of the residential lots contained within the development. However, even assuming the existence of such a purpose, the stipulated fact remains that CCC has not transferred any ownership interest whatsoever in the golf course or country club; instead, it has sold to others merely a right to use these properties.”

- *Colony Inc. v. Commissioner*, 26 T.C. 30 (1956), *rev’d. in part on other grounds*, 357 U.S. 28 (1958).
  The court held that the taxpayer could not add the costs of a water and sewage system, fully owned and controlled by the taxpayer, to the cost of the lots sold, even when its subsequent operation by the taxpayer was not profitable.
- The court reached a similar conclusion in *Sabinske v. United States*, 62-1 U.S.T.C. Paragraph 9210 (N.D. Tex. 1962).
- *Noell v. Commissioner*, 66 T.C. 718 (1976).
  The subdividers could not add the costs of building airport runways and taxiways, adjacent to the lots, to the basis of the lots because the taxpayer retained full ownership and control. A critical question is whether the Petitioner intended to hold the facilities to realize a return on his capital from business operations, to recover his capital from a future sale, or some combination of the two. The other question is whether he so encumbered his property with rights running to the property owners regardless of who retained nominal title that he in substance disposed of these facilities, intending to recover his capital, and derive a return of his investment through the sale of lots.

(4) In the following court cases, the taxpayer could allocate the common costs to the basis of the lots sold:

- *Norwest Corp & Subsidiaries,* 111 T.C. 105 (1998).
  The taxpayer wanted to allocate the cost of constructing an Atrium to enhance the sale of surrounding office buildings. The taxpayer was allowed to allocate the cost of common improvements to the basis of lots held for sale when the basic purpose of constructing

the common improvement is to induce the sales of the lots, and the taxpayer did not retain too much ownership and control of the common improvement. The lots held for sale were deemed to include the allocable share of the cost of the common improvement. The rationale of the developer line of cases is that, when the basic purpose of property is the enhancement of other properties to induce their sale and such property does not have, in substance, an independent existence, total cost recovery for such property should be dependent on sale of the benefited properties.

- *Hutchinson v. Commissioner,* 116 T.C. 172 (2001).
  The court permitted a developer of a residential subdivision to allocate the estimated construction costs relating to common improvements in the basis of the lots sold pursuant to Rev. Proc. 92-29. 1992-1 C.B. 748. The common improvements included the construction of a golf course, clubhouse, swimming pool, and tennis courts.

- When the taxpayer began the development, he entered into a contract with a nonprofit membership corporation whose members would purchase memberships in the golf club. The taxpayer would transfer the golf course and clubhouse to the nonprofit membership corporation when a certain number of memberships were sold or December 31, 2001 whichever was earlier. After completion of the golf course in 1996, the developer managed and operated it until April 1999 because the required number of memberships had not been sold. However, during these transition years the nonprofit membership corporation was responsible for decisions and costs of any further improvements made to the golf course and clubhouse. The court held that the developer did not possess the benefits and burdens of ownership during the transition period and thus it could allocate the estimated construction costs to the bases of the residential lots sold under the alternative cost method of Rev. Proc. 92-29.

- Revenue Ruling 68-478, 1968-2 C.B. 330.
  The developer of a subdivision and golf course conveyed part of the land and improvements, including the golf course, lake, dam, and related recreational facilities to a non-profit country club. The taxpayer did not retain any ownership in the property transferred.

- *Country Club Estates, Inc. v. Commissioner,* 22 T.C. 1283 (1954).
  The developer of a residential subdivision donated land to a nonprofit country club to build a golf course thereon. The developer treated the cost of the land donated as part of the cost of the lots sold.

- *Collins v. Commissioner,* 31 T.C. 238 (1959).
  The developer of a subdivision conveyed to the owners of the lots an equitable interest in a sewage disposal system. The court held that the taxpayer did not retain full ownership and control of the sewage system and that they parted with material property rights. The court held that if a person engaged in the business of developing and exploiting a real estate subdivision constructs a facility for the basic purpose of inducing people to buy lots, the cost of such construction is properly a part of the cost basis of the lots. This is so even though the sub-divider retains tenuous rights without practical value to the facility constructed such as contingent reversion. If the sub-divider retains 'full ownership and control' of the facility and does not part with the property or facility constructed for benefit of the subdivision lots, then the cost of such facility is not properly a part of the cost basis of the lots.

- *Willow Terrace Development Co. v. Commissioner,* 345 F.2d 933 (5th Cir. 1965).
  The court allowed a developer of a subdivision to allocate the cost of water and sewer systems to the basis of lots sold. The developer dedicated the water and sewer systems to the benefit of the homeowners under the FHA trust deed; the rights retained by the taxpayer had at that time little if any saleable value. Some relevant factors to consider in determining the proper tax treatment of the costs of such facilities are:
  1) whether they were essential to the sale of the lots or houses,
  2) whether the purpose or intent of the sub-divider in constructing them was to sell lots or to make an independent investment in activity ancillary to the sale of lots or houses,
  3) whether and the extent to which the sub-divider dedicates the facilities to the homeowners,
  4) what rights and of what value the sub-divider retains, and the likelihood of recovery of costs through subsequent sale.

(5) *Montclair Development Company v. Commissioner,* TC Memo 1966-200. The court allowed a developer of a subdivision to allocate costs of sewer and water systems. The developer transferred the system to a trustee for the benefit of homeowners in compliance with requirements of the FHA.

G.5. Alternative Cost Method of Accounting for Real Estate Developers – Revenue Procedure 92-29

(1) For common improvements that are allocable to the lots, the taxpayer allocates the costs to the lots as it incurs the costs per IRC § 461. Rev. Proc. 92-29, 1992-1 C.B. 748 provides an "alternative cost method". A developer may allocate estimated costs of the common improvements that have not yet been incurred, to the basis of lots sold.

(2) Developers must obtain permission from the Service to use the alternative cost method on a development-by-development basis. Common improvements must have the following qualities:

- Be real property or real property improvement that benefits two or more properties separately held for sale;
- The developer must be contractually obligated or required by law to provide the improvement; and
- The improvement must not be depreciable by the developer

(3) An agreement to provide improvements in exchange for a building permit is a common improvement. See *Herzog Building Corp. v. Commissioner*, 44 T.C. 694 (1965).

(4) A statement in a buyer's HUD report that the developer will provide improvements does not qualify as a contractual obligation. See Rev. Rul. 76-247, 1976-1 C.B. 217.

(5) An oral promise to a buyer to provide improvements does not qualify as a contractual obligation. See *Bryce's Mountain Resort, Inc. v. Commissioner*, T.C. Memo. 1985-293 (1985).

(6) Common improvements vary depending on the type of development. Some examples of common improvements include:

- Streets
- Sidewalks
- Sewer lines
- Playgrounds
- Clubhouses
- Tennis Courts
- Swimming Pools

(7) For any taxable year, the allocable cost of common improvements is equal to the amount of common improvement costs incurred under IRC § 461(h) plus the amount of common improvement costs the developer reasonably anticipates it will incur during the 10 succeeding taxable years regardless

of the estimated completion date of the project. See Rev. Proc. 92-29, 2.02(1). This is known as a **"10-taxable year horizon". It is important to note that Rev. Proc. 92-29 requires a private letter ruling (PLR) any time a developer wants to deviate from the "10-taxable year horizon" for determining estimated cost of common improvements. See Rev. Proc. 92-29, 6.02.**

(8) A developer may include in the basis of properties sold the allocable share of the estimated cost of common improvements without regard to whether the taxpayer has incurred the costs per IRC § 461(h). There is an important limitation, however. As of the end of any taxable year, the total amount of common improvement costs included in the basis of the properties sold may not exceed the amount of common improvement costs that the taxpayer has incurred under IRC § 461(h). If this limitation prevents a developer from including the entire allocable share of the estimated cost of common improvements in the basis of the properties sold, the taxpayer can deduct those costs in subsequent taxable year(s) to the extent that additional common improvement costs have been incurred under IRC § 461(h). See Rev. Proc. 92-29, 4.01.

(9) Taxpayers must comply with certain requirements to use the Alternative Cost Method.

- File a request with the appropriate Rev. Proc. 92-29 coordinator and attach a copy to its return, in accordance with section 6.01 of Rev. Proc. 92-29 on or before the due date of the return for the taxable year in which the taxpayer sells the first lot. The request to use the Alternative Cost Method must include:
    1. Developer's identifying information
    2. Description of the project
    3. Schedule showing the lots covered by the request and the costs to acquire such lots
    4. Schedule showing the required common improvements and information concerning the estimated cost of such improvements, the cost allocable to each lot, and the estimated date of completion of the improvements
- Sign a restricted consent extending the statute of limitations on assessment with respect to the use of the alternative cost method. The restricted consent procedures require:
- Developer must extend the statute of limitations for each year the developer uses the alternative cost method
- Developer must extend the statute of limitations period to one year beyond the expected completion date of the project
- Form 872: Individuals, partners, shareholders and Corporations use this form to extend the statute. Non-TEFRA partnerships,

Bipartisan Budget Act of 2015 (BBA) elect out partnerships and S Corporations also use Form 872 to extend the statute under the Investor Level Statute Control (ILSC) procedures.

- Form 872-P: TEFRA partnerships use this form to extend the statute. The Tax Matters Partner (TMP) signs the form. If there is no qualified TMP, Form 872 is used to extend the partner level statutes.
- Form 872-M: BBA partnerships use this form to extend the statute of limitations for making adjustments to a partnership return subject to the centralized partnership audit regime. It is signed by the partnership representative and an IRS representative.
- Form 921-I: Trusts use this form to extend the statute. Each beneficiary must sign one.
- Form 921-A: This form is obsolete and no longer applicable.
- File an annual statement with the appropriate Rev. Proc. 92-29 coordinator and attach copy to its federal tax return in accordance with section 8.02 of Rev. Proc. 92-29. The annual statement must include:
    1. Developer's identifying information
    2. Expiration date of the extended statute of limitations
    3. Description of the project
    4. Schedule showing an updated estimated cost of common improvements, the manner of allocating the costs among lots, the lots sold as of the end of the previous taxable year, the costs incurred under IRC § 461(h), and the costs included in the basis of lots sold.

(10) For each tax year in which the developer uses the alternative cost method it must extend the statute of limitations to one year beyond the extended due date of the return for which it expects to complete the project. Thus, the developer would extend the statute of limitations for the first tax year to one year beyond the due date of the return for the tenth year, assuming the developer expects to complete the project in ten years.

(11) Rev. Proc. 92-29 does not permit a developer that fails to substantially comply with the provisions to use the alternative cost method and therefore may not include common improvement costs that it has not incurred under IRC § 461(h) in the basis of properties for purposes of determining gain or loss from such properties.

(12) Rev. Proc. 92-29, Section 10 provides that if the first year in which the taxpayer uses the alternative cost method improperly is no longer open for assessment of a deficiency of tax, the Commissioner may change the taxpayer's method of accounting in a later year and impose an adjustment under IRC § 481(a). This allows the IRS to make a cumulative adjustment

or correction for all barred years in the earliest open year.

VIII. Other Tax Issues in Construction

A. Overview

(1) The construction industry is so broad and extensive that many issues found in other industries will also appear in construction cases. There are, however, some issues that are closely identified with the construction industry. This chapter provides an awareness of these construction issues but is not intended to be an all-inclusive list.

(2) Many issues are common to all industries. However, some issues are specific to the construction industry, due to the nature of the business and the special accounting methods available. Additional facts and tax research will be necessary to develop the issues in this chapter.

B. Accounting Method Issues

B.1. Improper Computation of the Average Annual Gross Receipts for Small Business Taxpayers under Internal Revenue Code § 460 (After 12-31-2017)

(1) For tax years beginning after 12-31-2017 the average annual gross receipts test for small business taxpayers increased from $10 million to $25 million. (See Chapter 3)

(2) The type of income included in the gross receipts test is different for tax years beginning prior to 1-1-2018. For those earlier years, gross receipts excluded items not derived in the ordinary course of a trade or business such as: interest, dividends, rents, royalties, annuities, and receipts from the sale or exchange of capital assets. For tax years beginning after 12-31-2017, gross receipts include those income items.

(3) Taxpayers that fail to aggregate the gross receipts of all the related companies for this computation could be improperly electing an exempt long-term method of accounting when IRC § 460 requires the percentage of completion method (PCM). IRC §§ 448(c) and 52(a), (b) requires the aggregation of the gross receipts from:

- All trades or businesses whether or not incorporated under common control,
- All members of any controlled group of corporations for which the taxpayer is a member, and

- Any predecessor of the taxpayer or of the entities in the prior two groups. IRC § 460(e)(2).

B.2. The taxpayer must aggregate all gross receipts from all trades or businesses whether or not they are under common control. For example:

- Parent – Subsidiary group when more than 50% ownership by one entity
- Brother – Sister group when 5 or fewer owners own more than 50%
- If the taxpayer has a 5% to 50% ownership, the taxpayer includes its proportionate share of the construction gross receipts according to percentage of ownership. Attribution rules apply to indirect or direct ownership.

(1) Please see Chapter 3 for examples of the aggregation of gross receipts rules for the above controlled groups.

B.3. Improper Computation of the $5 Million Average Annual Gross Receipts under IRC § 448 (Before 1-1-2018)

(1) This section only applies to tax years beginning prior to 1-1-2018. For tax years beginning after 12-31-2017 see the section above for IRC § 460.

(2) IRC § 448 (a) prohibits the use of the cash method by a C corporation, a partnership with a C corporation as a partner, or a tax shelter. IRC § 448(b)(3) and (c) allows C corporations and partnerships, with a corporate partner, to use the cash method of accounting, if the average annual gross receipts of the entity does not exceed $5 million.

(3) Partnerships, sole proprietorship, and S corporations are not subject to the IRC § 448 limitations. Therefore, they may continue to use the cash method as their exempt method of accounting for long-term construction contracts until their average annual gross receipts for the prior three years exceeds $10 million.

(4) The determination of gross receipts under IRC § 448 includes all gross receipts, while the determination of gross receipts under IRC § 460 includes only trade or business receipts. For example, gross receipts determined under IRC § 448 includes dividend income, interest income, rental income, etc., where IRC § 460 does not include these items of income. See Treas. Reg. § 1.448-1T(f)(2)(iv)(A) and Treas. Reg. § 1.460-3(b)(3)(i).

(5) As with IRC § 460, the aggregation rules under IRC § 448 applies to all entities under common control.

B.4. Netting Gross Receipts for the Small Business Taxpayer Threshold

(1) If a taxpayer offsets gross receipts with expenses other than returns and allowances the net amount reported as gross receipts on the tax return will be understated. Accordingly, this netting may improperly reflect average annual gross receipts below thresholds for small business taxpayers.

B.5. Retainages

(1) Retainages receivable are specified amounts a contractor's customer withholds from progress billings pending satisfactory completion and final acceptance of the project. The contractor, in turn, will also withhold a specified amount on the subcontractors which is known as retainages payable.

(2) Recognizing retainages receivable in taxable income depends on the method of accounting used by the taxpayer:

- Cash: Income when received or upon constructive receipt.
- Accrual: Income when received, due, or earned, whichever comes first. The taxpayer earns the retainages as they perform the work. However, the taxpayer may elect to exclude the retainages until billable per Revenue Ruling 69-314 1969-1 C.B. 139, 1969.
- Completed Contract: Income when the taxpayer completes the contract.
- Percentage of Completion: Included in the total estimated contract price as the job progresses.

(3) Similarly, recognizing retainages payable as an expense depends on the method of accounting used by the taxpayer:

- Cash: the taxpayer reports the expense when it pays the retainage.
- Accrual: deductible when the taxpayer has met the all events test per IRC § 461. However, if the taxpayer has elected to defer the retainages receivable per Revenue Ruling 69-314, the taxpayer must also defer the retainages payable until paid.
- Completed Contract: the taxpayer reports the expense upon contract completion.

- Percentage of Completion: the taxpayer reports the expense when it is deductible per IRC § 461 and includes the amount in the numerator.

B.6. Delayed Billings under Accrual Method

(1) Under the accrual method, the taxpayer may not delay billings or structure the billing entitlement in the contract to defer reporting of gross receipts.

(2) In *Boise-Cascade Corp. v. United States,* 530 F.2d 1367 (Ct. Claims 1976), cert. denied, 429 U.S. 867 (1976), the court determined that the taxpayer must accrue income based upon the work performed rather than upon billing entitlement.

B.7. Determining Completion under Completed Contract Method (CCM)

(1) Taxpayers using the CCM may not delay completing the contract in order to defer the reporting of the gross profit. Treas. Reg. § 1.460-1(c)(3) provides a "bright-line" test in determining completion and it is the earlier of the following:

- The taxpayer has incurred 95% of contract costs and the customer has the intended use of the subject matter of the contract; or
- Final completion and acceptance.

(2) Reviewing the year-end work-in-progress schedule would reveal the percent complete on each job. Any job that is 95% or more complete requires further investigation to determine if the contract meets the completion requirements above. See Treas. Reg. § 1.460-1(c)(3).

B.8. Improper Use of the PCM or Completed Contract Method

(1) In the construction industry, many taxpayers provide construction management, engineering, and architectural professional services that are an essential part of the construction process. However, these contracts do not meet the definition of a long-term construction contract involving the building, construction, reconstruction or rehabilitation of real property.

(2) In contrast, the general contractor and subcontractors are responsible for the actual construction and are usually working under the direction or advice of the construction manager, engineer, or architect. Because construction management, engineering, and architects provide services that do not meet the definition of a construction long-term contract, they cannot report their income under any long-term contract method such as

the completed contract or percentage of completion methods. They can only report income under the cash or accrual method.

(3) See IRC § 460(e)(4), Treas. Reg. § 1.460-1(d)(2), Revenue Ruling 70-67, 1970-1 C.B. 117, 1970, Revenue Ruling 80-18, 1980-1 C.B. 103, Revenue Ruling 84-32, 1984-1 C.B. 129, 1984, and General Counsel Memo (GCM) 39803 for additional guidance.

B.9. Deferring Costs under Percentage of Completion Method

(1) Costs incurred under IRC § 461 and under the cost-to-cost percentage of completion method required by IRC § 460 determine the completion rate of the job. If the taxpayer fails to record costs incurred near year-end, the percentage of completion would be understated which in turn understates the income.

(2) The taxpayer may not include uninstalled materials as a cost incurred in the numerator in the percentage of completion method. For generally accepted accounting principles (GAAP), this is appropriate. However, for tax purposes, the taxpayer must include uninstalled direct materials when dedicated to the contract. A taxpayer dedicates direct materials by associating them with a contract such as by purchase order, entry on books and records, or shipping instructions. See Treas. Reg. § 1.460-1(b)(8) and Treas. Reg. § 1.460-5(b)(2)(i).

B.10. Allocation of Indirect Costs

(1) Taxpayers must allocate the appropriate indirect costs to jobs. The following four separate code sections and regulations address the allocation of indirect costs:

- IRC § 460(c)(1) through (c)(5) applies to long-term contracts that do not meet the home construction contract or small contract exception per IRC § 460(e)(1). Treas. Reg. § 1.460-5(b) provides a direct link to IRC § 263A for the appropriate indirect costs to include in the percentage of completion method.
- IRC § 460(b)(3) allows taxpayers that fall under IRC § 460 above to elect the simplified production method. See also Treas. Reg. § 1.460-5(c).
- IRC § 263A applies to large home construction contracts. A large home construction contractor is one who does not meet one of the small contractor rules under IRC § 460(e)(1)(B). If the average annual gross receipts for the 3 prior years exceeds $25 million ($10 million for tax years beginning prior to 1-1-2018) **or** the

taxpayer does not expect to complete the contract within 2 years, the taxpayer has a large home construction contract.

1. Speculative homebuilders and land developers, constructing without a long-term contract, must also allocate costs under IRC § 263A as “producers of property”. Effective for tax years beginning after 12-31-2017, IRC § 263A does not require small business taxpayers (defined below) to capitalize costs.
2. ***Small business taxpayer.*** A small business taxpayer is a taxpayer that (a) has average annual gross receipts of $25 million or less for the 3 prior tax years, and (b) is not a tax shelter as defined in IRC § 448(d)(3).

- Treas. Reg. § 1.460-5(d) applies to small contractors both residential and commercial using the completed contract method.

(2) Failure to allocate all appropriate indirect costs may increase or decrease the income reported by the taxpayer using the PCM and will create a larger adjustment for completed-contract method users, speculative homebuilders, and land developers because these costs are not deductible until a later year upon completion of the long-term contract or when the house or lot is sold.

B.11. Improper Inclusion of Costs in PCM Computations

(1) The cost-to-cost method, required by IRC § 460, determines the completion percentage of a contract which in turn determines the amount of income the taxpayer must report.

(2) The completion percentage is determined based on cumulative allocable contract costs divided by the estimated allocable contract costs.

(3) Treas. Reg. § 1.460-4(b) provides that under the percentage of completion method taxpayers recognize income based on the following formula:

Cumulative Allocable Contract Costs / Estimated Total Allocable Contract Costs	X	Total Contract Price	=	Cumulative Gross Receipts	Less: Gross Receipts Reported in Prior Year	=	Current Year Gross Receipts

(4) If the taxpayer improperly includes estimates that are overstated, nondeductible costs, or allowances for contingencies in the total estimated costs figure (denominator) the percentage of completion will be understated. Accordingly, if the percentage completed is understated, income will also be understated. If the taxpayer fails to include estimated

costs as they are incurred in the numerator the percentage of completion and income will also be understated.

B.12. Improper Expense Recognition under the Completed Contract Method

(1) Expense recognition will be accelerated if the taxpayer improperly allocates costs from contracts that are still in progress to completed contracts. An unusually low gross profit on a job may be an indication of improper job allocation.

B.13. Homebuilder Building for Speculation

(1) The taxpayer must capitalize all costs, direct and indirect, per IRC § 263 and IRC § 263A. If the taxpayer is building an asset it owns the costs become part of the basis in the property. The taxpayer will deduct the costs when it sells the property.

(2) *Carpenter v. Commissioner*, T.C. Memo. 1994-289. A taxpayer must capitalize costs of building a house on speculation under IRC § 263A.

(3) Effective for tax years beginning after 12/31/2017, IRC § 263A does not require a small business taxpayer to capitalize costs. See IRC § 263A(i).

(4) A small business taxpayer is a taxpayer that (a) has average annual gross receipts of $25 million or less for the 3 prior tax years under the gross receipts test of IRC § 448(c), and (b) is not a tax shelter as defined in IRC § 448(d)(3).

B.14. Common Improvements

(1) Common improvements are any real property or improvements to real property that benefit two or more properties, that the developer holds separately for sale, such as roads, sidewalks, sewer lines, playgrounds, and pools.

(2) Taxpayers should not deduct common improvement costs. In general, the taxpayer should add the cost of common improvements to the basis of the benefited properties when the taxpayer incurs the costs within the meaning of IRC § 461(h).

(3) Also, if a taxpayer elects the alternative cost method under Revenue Procedure 92-29, 1992-1 C.B. 748, 1992, it may be deducting estimated costs of common improvements without complying with Rev. Proc. 92-29. See Chapter 7, Homebuilders and Land Developers for more information regarding Rev. Proc. 92-29.

C. Income Issues

C.1. Advance Payments

(1) Front-load billing is common in the construction industry. Many contractors want a percentage of their fee paid in advance before they perform any work to buy the materials necessary to perform the job. Under both the cash and accrual methods using the all events test, the taxpayer reports advance payments in income when received. However, accrual basis taxpayers may defer the advance payments to the subsequent tax year if they meet the qualifying requirements per Rev. Proc. 2004-34, 2004-22 I.R.B. 991, 2004-1 C.B. 991, 2004. See IRC § 451(c).

(2) Note: On December 22, 2017, IRC § 451(c) was amended by section 13221 of the Tax Cuts and Jobs Act, Public Law No. 115-97 (131 Stat. 2054) (the Act), to provide that a taxpayer using an accrual method of accounting (accrual method taxpayer) with an applicable financial statement (AFS) may use the deferral method of accounting provided in IRC § 451(c) for advance payments.

(3) On September 9, 2019, the § 1.451-8 proposed treasury regulations were published. These proposed regulations describe and clarify the statutory requirements of IRC § 451(c). The proposed regulations also provide a deferral method of accounting for taxpayers that do not have an AFS.

C.2. Improper Computation of the Contract Amount under Percentage of Completion Method (PCM)

(1) Once the taxpayer has calculated the percentage of completion of a long-term contract, the taxpayer applies it to the total contract price to determine the taxable income. The contract price includes change orders, retainages, expected bonuses, and claim revenue.

(2) If the taxpayer does not include any of these items as part of the contract price, the amount of income reported will be understated. The regulations also specify that, if the taxpayer includes any contingent amount in income for financial statement purposes, the taxpayer must also include it for tax purposes. See Treas. Reg. § 1.460-4(b)(4)(B).

C.3. Claim Income under PCM

(1) Claim income are amounts that exceed the original contract price that the contractor seeks to collect from the owner such as disputed change orders, costs associated with owner delays, errors in specification, and contract termination.

(2) Under the percentage of completion method, the taxpayer must include any amount they reasonably expect to receive in the contract price. This amount is reported in income as the job progresses. Examiners should inspect final progress billing requests, legal files, correspondence, complaints filed with the court, and Schedule M-1 or M-3 for potential issues involving claim income.

(3) For other methods of accounting, the taxpayer reports income from disputes as follows:

- Cash: when the taxpayer receives the amount or has constructive receipt.
- Accrual: when the dispute has been settled.
- Completed Contract: depends on the facts of each dispute:
  - Taxpayer assured of a profit or loss: See Treas. Reg. § 1.460-4(d)(4)(ii).
  - Taxpayer unable to determine a profit or loss: See Treas. Reg. § 1.460-4(d)(4)(iii).

C.4. Unreported Income

(1) Smaller contractors not faced with bonding or similar requirements for financial statements and performance verification, might only report income for a portion of their work. For example, the contractor may erroneously report only the income reflected on the Forms 1099. Some contractors may be willing to work for 20% to 25% less on the condition that the customer does not issue a Form 1099 or for the customer to pay in cash. This has an adverse effect on the industry and voluntary tax compliance in general.

(2) With the proliferation of check-cashing schemes, payment with a check is an insufficient control to validate income using bank deposit records. The examiner should look to some central element of the specialty contractor's business and compare it to another source such as an indirect method to confirm that the reporting of gross income is substantially correct. With a smaller contractor, the examiner can also look at the owner's return, life-style, assets or county records information to gain a reasonable assurance as to the economic reality of reported income.

C.5. Other Compensation Income

(1) A contractor may receive an interest in a project for his or her services rather than making an initial investment of capital. Inspecting the contractor's partnership returns will frequently reveal an interest in a construction project. The examiner should conduct a review of electronic

databases for public records such as Accurint. The contract between the owner and the general contractor will often specify what the general contractor is to receive in lieu of cash payment. See IRC § 83, Property transferred in connection with performance of services.

C.6. Delayed Billings

(1) Depending on the method of accounting, the contractor may improperly delay billings or the recording of receivables in order to defer the reporting of gross receipts. The examiner should consider selecting a sample of jobs and inspect the job folders to review the contract billing terms, progress-billing applications sent to the owner, and owner payment documents retained by the contractor to test income.

(2) Other Omission of Income Issues

- Failure to report interest income earned on funds such as retainages, deposits, and funds transferred from other escrow accounts.
- Failure to report income from remote construction projects.
- Failure to report income earned from claims subsequently settled by court decisions or arbitration.

C.7. Subcontractor Improperly Deferring Income

(1) Subcontractors hired early in a project such as land clearing, installation of cables or wiring, and laying concrete slabs may improperly defer the recognition of income under the completed contract method, because "final completion and acceptance" does not occur until the total job is complete. However, Treas. Reg. § 1.460-1(c)(3)(iii) states that final completion and acceptance of a contract, with respect to a subcontractor, occurs when the subcontractor completes its work and the party with whom the subcontractor contracted accepts the work. This is usually the general contractor.

C.8. Scrap Sales

(2) The nature of the materials used in plumbing, heating, and air-conditioning, may lead to the issue of scrap sales. For example, copper piping and tubing cut for jobs may leave small pieces that the taxpayer cannot use. The taxpayer may sell the scrap to metal dealers. Also, the taxpayer may inventory excess job materials for a future job, return to the vendor for credit, or applied to another in-process job.

C.9. Built-In Gains Tax

(1) When a C corporation converts to an S corporation, taxpayers using the completed contract method may be subject to a built-in gains tax. The taxpayer computes the value of the contracts in progress as of the day of conversion under the percentage-of-completion method which would be subject to the built-in gains tax. The amount of income that the taxpayer would have earned under PCM while a C corporation, but not reported until the following year, is unrealized income at the time of conversion. See *Reliable Steel Fabricators, Inc. v. Commissioner*, T.C. Memo. 1995-293.

C.10. Installment Sales

(1) IRC § 453 provides that dealer dispositions do not qualify for the installment sale calculation of income. Homebuilders and land developers, therefore, cannot use the installment method of accounting. IRC § 1237 does provide a limited exception in which it deems a disposition of real property subdivided for sale is not held primarily for sale in the ordinary course of trade or business. However, the taxpayer cannot have made substantial improvements to the property and must have held the property for a period of 5 years. See *Raymond v. Commissioner*, T.C. Memo. 2001-96.

C.11. Model Homes - Gain on Sale and Leaseback Arrangements

(1) Homebuilders sometimes sell a model home and then lease it back for use in their sales activities. For example, the homebuilder sells the model home(s) to an unrelated party for the lower of cost or 80% of the fair market value. The homebuilder reports a loss on this sale. The homebuilder then leases the property back from the unrelated party at 10% of the purchase price. The homebuilder retains the right to determine both the time of sale of the model home and the terms of the price and buyer.

(2) The homebuilder applies the proceeds from the sale to repay a loan from an unrelated party and a contractual bonus. Any remaining amount is kept by the homebuilder. Title passes to the buyer of the home, but the homebuilder retains many significant rights of ownership.

(3) The essence of the transaction is that of a loan. The title to the unrelated party merely acts as security. Thus, the loss on the “sale” and the lease expenses would not be deductible. See *Frank Lyon Co v. United States*, 435 U.S. 561 (1978); and *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939).

C.12. Warranty Agreements

(1) A warranty agreement is a non-long-term contract activity that is never incident to or necessary for the manufacture of property under a long-term contract. See Treas. Reg. § 1.460-1(d)(2). The taxpayer cannot use PCM to report income from a warranty agreement.

(2) In *Koch Industries, Inc. v. U.S.*, 603 F.3d 816 (10th Cir. 2010), reversed and remanded *Koch Industries, Inc. & Subs. v. U.S.*, 564 F.Supp. 2d 1276, the court of appeals held that (1) warranty agreements between taxpayer and state were not long-term contracts for purposes of tax code provision allowing taxable income from a long-term contract to be determined under the percentage-of-completion method of accounting, and (2) agreements were "warranties" within meaning of the tax regulation defining non-long-term contract activity, and thus the taxpayer was not entitled to use the PCM of accounting for long-term contracts to report $62 million in income it received from state pursuant to the agreements.

C.13. Capital Gain vs. Ordinary Income - Real Estate Dispositions

(1) The issue is whether the taxpayer is a dealer (i.e. in the trade or business of acquiring and selling property) or an investor (i.e., taxpayer who sells property only occasionally). Any gain or loss as a dealer is ordinary but any gain or loss as an investor is capital.

(2) IRC § 1221(a) defines a capital asset as property that a taxpayer holds (whether or not it is connected with his trade or business) but it does not include property that a taxpayer holds primarily for sale to customers in the ordinary course of business.

(3) The intent of the taxpayer holding or buying the property determines whether the taxpayer is a dealer or an investor. Historically, the courts have addressed seven factors in making this determination. (See *United States v. Winthrop,* 417 F.2d 905, 910 (5th Cir.1969).

- The nature and purpose of the acquisition of the property and the duration of ownership.
- The extent and nature of the taxpayer's efforts to sell the property.
- The number, extent, continuity, and substantiality of the sales. (Note: this is the biggest single factor).
- The extent of subdividing, developing, and advertising to increase sales.
- The use of a business office for the sale of the property.

- The character and degree of supervision or control exercised by the taxpayer over any representative selling the property.
- The time and effort the taxpayer habitually devoted to the sales.

(4) Developing the relevant facts is key to making a proper determination.

D. Expense Issues

D.1. Per Diem for Lodging, Meals, and Incidentals

(1) Entertainment and entertainment related meals are non-deductible after 12/31/2017 unless an exception in 274(e) applies. Non-entertainment related meals may be subject to the 50% limitation under IRC § 274(n).

(2) Taxpayers may choose to use a per diem for lodging and meal expenses while an employee is traveling instead of accounting for actual expenses. Revenue Procedure 2011-47 provides rules for using a per diem rate to substantiate the lodging, meal and incidental expenses that a payor reimburses. See Section 6.

(3) If a taxpayer pays a per diem allowance for lodging, meal and incidentals that is less than the federal per diem rate for the locality, the taxpayer has two choices:

- Treat an amount equal to the federal M&IE rate for the day as an expense for food and beverage OR
- Treat an amount equal to 40% of the allowance paid as an expense for food and beverage.

(4) Taxpayers may pay employees out-of-town expenses on a per diem basis without an amount applied to meals and deducting the total as a "lodging only expense." Rev. Proc. 2011-47, 2011-42 I.R.B. 520, 2011 does not provide rules for this. Taxpayers must follow this revenue procedure if they wish to use the per diem method for substantiation.

D.2. IRC § 179 Deduction Limited for Sports Utility Vehicles (SUVs)

(1) Taxpayers in the construction industry commonly use SUVS. IRC §179 permits taxpayers to elect to expense certain depreciable assets rather than charge them to an asset account. IRC §179(B)(5)(A) limits the amount of the deduction to $25,000.

D.3. Personal Use of Business Assets

(1) Contractors in closely held businesses may not deduct expenses for improvements to a personal residence. The taxpayer may deduct these expenses through cost of sales, along with other contract costs. If the taxpayer is a C corporation, a potential dividend issue exists if the taxpayer incurs costs to improve a shareholder's residence and the expenses are not deductible. For an S corporation or a partnership, these expenses would be a distribution to the specific shareholder or partner.

(2) An employment tax issue is possible if the improvements are to an employee's residence. A homebuilder may offer to build homes for their employees at a discount. The taxpayer may not include discount in the employees' wages as a fringe benefit. IRC § 132(a)(2) states that gross income shall not include any fringe benefit that is a "qualified employee discount" with respect to qualified property or services. IRC § 132(c)(4) specifically states that real property is not qualified property and requires the taxpayer to include the discounted amount in the employee's wages. See also Treas. Reg. § 1.132-3(a)(2)(ii).

(3) When conducting an examination of a contractor, it is crucial to fully understand the contractor's billing and job cost records. Sampling invoices for deliveries to the contractor's residence or excess building supplies charged to a job are examples of auditing techniques.

D.4. Unreasonable Compensation

(1) Officer and owner compensation fluctuate frequently and significantly. The taxpayer may make an argument that it paid higher than usual present year compensation because of low compensation in earlier years. This argument may be valid if the taxpayer used the income in earlier years to build capital.

(2) However, if the business is well established and the taxpayer is reducing profits of a high-volume year through high compensation, the examiner should consider raising the unreasonable compensation issue. Industry averages are also available through websites such as http://www.bizstats.com. This issue depends on the facts and circumstances of each case.

D.5. Double Deductions

(1) Double deductions can inadvertently occur when the contractor uses a single-entry bookkeeping system. Some job costs may be both capitalized and expensed in the current period. Since the single-entry bookkeeping system will allow duplications to occur, the examiner should consider using

in-depth investigative techniques.

D.6. Cash Method Interest Expense

(1) Interest expense on a construction loan is not deductible until a contractor on the cash method of accounting pays it. A construction loan differs from a conventional loan in that a construction loan usually does not require interim payments. The taxpayer may even finance the loan origination fees; these expenses are not deductible until the taxpayer makes payment. The examiner should review the loan documents to determine the terms for making principal and interest payments and verifying that the taxpayer made the payments during the year. See *Heyman v. Commissioner*, 70 T.C. 482 (1978), *aff'd*, 652 F.2d 598 (6th Cir. 1980).

D.7. Capitalization of Pre-development Costs

(1) A developer may purchase a parcel of property for future development. Generally, pre-development costs are not currently deductible; the taxpayer must capitalize them. The following court decisions support this position:

- *Reichel v. Commissioner*, 112 T.C. 14 (1999): The court required a real estate developer who purchased properties for development to capitalize related real estate taxes as indirect production expenses.
- *Hustead v. Commissioner*, T.C. Memo 1994-374: The court required a developer to capitalize costs incurred to challenge the zoning of property.
- *Von-Lusk v. Commissioner*, 104 T.C. 207 (1995): IRC § 263A requires a taxpayer to capitalize property taxes and preliminary costs associated with the contemplated construction.

(2) Effective for tax years beginning after 12-31-2017, IRC § 263A does not require small business taxpayers to capitalize costs. See IRC § 263A(i). A small business taxpayer is a taxpayer that (a) has average annual gross receipts of $25 million or less for the 3 prior tax years under the gross receipts test of IRC § 448(c), and (b) is not a tax shelter as defined in IRC § 448(d)(3).

D.8. Contributions of Land and Facilities

(1) Land developers and building contractors often donate land, buildings, or other assets to charitable or civic organizations and state or local governments. These assets usually have appreciated in value, due to the

passage of time and/or the development activity by the builder. The examiner should scrutinize charitable contribution deductions involving the fair market value of the donated property. Examiners should consider the intent of the builder who is donating the land or facility. A common practice is for state or local government agencies that have control of zoning and building permits to require the developer or builder to set aside and donate land and facilities for schools, parks, police and fire stations, government offices, medical facilities, community centers, water and sewer plants, roads, and maintenance buildings.

(2) If the taxpayer donated the asset due to a requirement of a government agency or promised the facility as an improvement in selling efforts to customers, then the requisite donating intent for a contribution deduction is missing. Without this intent, the non-deductible donation is a part of the cost of developing lots.

(3) When addressing this issue, examiners should inspect the builder's correspondence and legal files; zoning and permit documents; minutes of government agency meetings; corporate minutes of the builder; newspaper articles; and the builder's sales literature.

(4) Examiners should also be aware that developers or builders often only allocate development costs to the properties that will generate sales revenue. Thus, the donated property may only have the cost of raw land charged to it. The allocation of costs usually takes place in the early stages of development and the taxpayer usually makes donations of property in the latter stages of development. Lastly, examiners should ensure that taxpayers have not double recovered costs.

D.9. Losses

(1) Taxpayers may not recognize the total loss on a contract that is still in progress. Financial reporting (GAAP) requires the contractor to recognize the full amount of any anticipated loss in the current period, regardless of the degree of completion. However, for tax purposes, the loss is not deductible until the job is complete for taxpayers using the completed contract method. The loss incurred to date (not the total loss) is deductible for taxpayers using the PCM.

D.10. Abandonment Losses

(1) If a taxpayer abandons an asset, the loss is generally deductible to the extent of the taxpayer's adjusted basis in the abandoned property. To support an abandonment loss, the taxpayer must establish intent to abandon the asset and must make some affirmative act of abandonment.

The loss is deductible in the year the taxpayer sustains the abandonment with regard to non-depreciable property.

(2) In general, abandonment losses occur with specification homebuilders, real estate developers, and related-party entities more frequently than with other types of contractors. Abandonment losses may result from lack of financing, lack of bonding, disapproval of zoning changes, cost overruns, or possible tax avoidance involving related parties.

(3) In *Chevy Chase Land Company v. Commissioner*, 72 T.C. 481 (1979), the taxpayer was unsuccessful in getting property rezoned. The court permitted the taxpayer an abandonment loss for all the costs that the taxpayer incurred for the rezoning except for the cost of a topographical map because it has a continuing value; the taxpayer can use it for the new project on the property.

D.11. Related-Party Transactions

(1) A contractor or subcontractor may not deduct expenses for building or improving his or her personal residence or that of a friend or relative. The taxpayer may not allocate or report the expenses to another job. Potential issues include disallowance of personal expenses or dividend issues if a corporation is involved. The difference between the FMV and the actual sales price to the shareholder would be subject to constructive dividend rules.

(2) Allocation of indirect costs not charged to the taxpayer or relative would also result in a nondeductible loss under IRC § 267.

(3) The Tax Court held that the lot and improvements, the home built on the lot, constituted a constructive dividend transferred from the corporation to taxpayers/shareholders. The corporation would recognize a taxable gain on the transaction. *R.V.J Cezar Corp, et al*, (2010) T.C. Memo 2010-173.

D.12. Bad Debts and Cancellation of Debt Income

(1) The examiner should review a bad-debt issue when related party transactions are involved. If a party has a legitimate bad debt, the other related party should have cancellation or forgiveness–of-debt income. Bad debts are deductible under IRC § 166 and cancellation of debt is income pursuant to IRC § 108. Bankruptcy or insolvency may impact the recognition of forgiveness of debt income. A noncorporate taxpayer may elect to exclude from gross income, income from the cancellation of qualified real property business indebtedness. There are special rules and conditions for this tax provision to apply. See IRC § 108(a)(1)(D). In addition, the taxpayer may need to reduce net operating losses if

bankruptcy limits the recognition of forgiveness-of-debt income. Bad debts require an inquiry into the following questions:

- Is it a debt or equity investment?
- Whose debt is it and are there any related parties?
- Is it a business or non-business debt?
- Has the taxpayer only made adjusting journal entries to establish the loan receivable or has the cash been paid to the borrower?
- Has the taxpayer charged and reported interest on the debt?
- Do documents exist that support the transactions?

D.13. Warranty Reserves or Contingent Liabilities

(1) An accrual basis taxpayer may not deduct estimated warranty costs from a reserve account established to reflect a liability for future services:

- Treas. Reg. § 1.446-1(c)(1)(ii): Under the accrual method, the taxpayer incurs a liability in the taxable year in which all the events have occurred that establish the fact of the liability, the taxpayer can determine the amount with reasonable accuracy, and economic performance has occurred with respect to the liability.
- IRC § 461(h)(1): In determining whether the taxpayer incurred a liability, the all events test is not met any earlier than when economic performance occurs. Economic performance occurs when the taxpayer provides the service or property.

(2) Because economic performance has not occurred with respect to estimated warranty costs and contingent liabilities, the costs are not deductible. The examiner should be aware that these costs are reportable under GAAP and therefore requires the taxpayer to make corresponding Schedule M-1 or M-3 adjustments.

D.14. Model Homes

(1) Taxpayers in the business of building and selling residential houses often use certain houses as models or sales offices to assist in its sales activity.

(2) Revenue Ruling 75-538,1975-2 C.B. 34 provides that a vehicle is not property used in the business thus subject to depreciation if the taxpayer merely uses it for demonstration purposes or temporarily withdraws it from stock-in-trade.

(3) Revenue Ruling 89-25, 1989-1 C.B. 79 recognizes that taxpayers use model homes or sales offices for a small fraction of their expected useful lives and the taxpayer ultimately expects to sell them. Although the taxpayer may be reluctant or unwilling to sell the models or sales office while it uses it, they remain property held primarily for sale to customers and the taxpayer may not depreciate.

E. Tax Issues

E.1. Accumulated Earnings Tax

(1) Closely held C corporations are more likely to accumulate earnings and profits beyond the reasonable needs of the business to avoid income taxes on its shareholders than are large C corporations. Each accumulated earnings case is unique. Reasonable needs that an examiner should consider, in any accumulated earnings case, are whether the need for sufficient net liquid assets to pay reasonably anticipated, normal operating costs through one business cycle and sufficient net liquid assets to pay reasonably anticipated, extraordinary expenses and capital improvement financing.

(2) In addition, the following represents a non-exclusive list of specific items that an examiner should consider for construction contractors:

- Working Capital necessary for Bonding Purposes: The general rule of thumb is that working capital needs to be at least 10% of "backlog" for bonding purposes. A taxpayer’s specific situation may result in a different percentage based on the bonding company’s requirements. Thus, an examiner should determine this percentage on a case-by-case basis. "Backlog" work program is the sum of contracts in process less the billings from those contracts plus contracts not started.
- Equipment Needs: Contractors who have high equipment needs will generally have a need to replace the equipment on a periodic basis.

(3) This guide includes the following information to assist an examiner during an examination of a construction company in determining whether an accumulated earnings tax issue exists. An examiner must consider that, unlike most entities, a construction company normally needs to retain earnings and profits to have adequate bonding capacity. Relevant court cases involving the accumulated earning tax and construction contractors are:

- *Ready Paving and Construction Co. v. Commissioner*, 61 T.C. 826 (1974): A paving contractor had permitted its earnings to accumulate beyond the reasonable needs of its business. The

court used a "modified" Bardahl formula with the case hinging on what items were and were not to be included in determining working capital.

- *Thompson Engineering Co. v. Commissioner*, 751 F.2d 191 (6th Cir. 1985), *rev'g* 80 T.C. 672 (1983): A construction subcontractor was not liable for the accumulated earnings tax. The IRS determined the taxpayer's reasonable business needs by applying the "Bardahl" formula. The court agreed with the taxpayer that the Bardahl formula has "little or no value when applied to a mechanical contracting business that lacks a routine operating cycle." The bonding capacity, and not the Bardahl formula, is the major consideration in determining the taxpayer's business needs. The taxpayer appealed the case and the court reversed.
- *Peterson Bros. Steel Erection Co. v. Commissioner*, T.C. Memo. 1988-381, 55 T.C.M. (CCH) 1605 (1988): The taxpayer, involved in the steel erection of high-rise buildings, was not liable for the accumulated earnings tax. The petitioner's ability to obtain a bond on a job when required is of primary importance and is clearly a reasonable need of the business. The fact that the jobs rarely required the petitioner to provide a performance bond is immaterial since it had to provide a bond if required.

E.2. Alternative Minimum Tax (AMT)

(1) For tax years beginning after 12-31-2017, the 2017 Tax Cuts and Jobs Act repealed AMT for corporations and deleted IRC § 55(e), exemption for small corporations (see item 2, below). As such, IRC § 56(a)(3), treatment of certain long-term contacts, an adjustment in computing alternative minimum taxable income under IRC § 56, no longer applies to corporations. For non-corporate taxpayers, IRC § 56 remains in effect for computing AMT in accordance with IRC § 55.

(2) Taxpayers not required to use PCM for regular tax purposes under IRC § 460, may owe AMT. Taxpayers on the cash, accrual or completed contract methods must compute AMT income on the PCM. IRC § 56(a)(3) provides that taxpayers must use PCM for long-term contracts for AMT purposes, unless exempt. Exceptions to the required use of PCM for AMT:

- Homebuilders: IRC § 56(a)(3) provides an exemption for home construction contracts.
- Small Corporations: IRC § 55(e) provides an exemption for small corporations. Small corporations are C corporations with average annual gross receipts of $7,500,000 or less ($5,000,000 for the first 3 taxable years of the corporation).

(3) Bonding and lending companies require many construction companies to prepare certified financial statements. Construction companies must prepare financial statements on the percentage of completion method. (Statement of Position 81-1) Thus, the taxpayer can easily determine the difference between the percentage-of-completion method and the tax-return method for alternative minimum tax purposes.

E.3. Employment Tax

(1) The use of subcontractors is common within the construction industry. Many taxpayers treat employees as subcontractors to avoid paying employment taxes. The agent may need to seek guidance from an employment tax specialist when confronted with potential employment tax issues. Back-up withholding can apply to subcontractors. The bargain sale of a house to an employee involving a discounted sales price could produce employment tax liability.

IX. Income Probes

A. Overview

(1) The accounting methods discussed in previous chapters control contractor income recognition. Although contractors earn most of their income from building projects including new construction and remodeling, there are other potential sources of income related to construction. These include the following:

- 1. Sales of construction equipment
- 2. Consulting fees
- 3. Forgiveness of debt income
- 4. Constructive dividends
- 5. Scrap sales
- 6. Interest income earned on retainages or deposits
- 7. Income from court settlements

(2) Sales may be generated in a variety of ways, including word-of-mouth, web sites, newspapers, magazines, trade shows, showrooms, or model homes. Typically, a contractor will execute a contract detailing the total job costs and project specifications, as well as the method of payment. The contract may include provisions for retainages, which the general contractor keeps until the project is complete. While the construction contract is an invaluable source of information as to the income from the job, it is also useful in

determining the materials consumed, completion dates, job costs, gross profit, and change orders that could result in additional income from the job.

(3) One of the most difficult tasks examiners face is setting the scope of the income probes. The examiner must base this determination upon the risk assessment that it completes during the pre-planning and initial phases of the examination. The initial interview is critical in establishing what type of construction is involved and how the contractor accounts for income, expenses, work in process, and the duties and responsibilities of key personnel. Without an understanding of the business operations, method of accounting, internal controls, and the involvement of the key personnel, the examiner will not be able to properly set the scope of the examination. Internal Revenue Manual (IRM) Section 4.10.3.3 offers guidance in the preparation and documentation of effective interviews. The evaluation of internal controls is discussed in IRM 4.10.3.5.

(4) There are several resources available to the examiner when the taxpayer's business is construction related. A potential resource is the IRS website (www.irs.gov) which discusses various construction issues. Because many construction businesses are sole proprietors, the examiner may find issues on both individual and business returns. An understanding of the industry is vital for examiners to complete a quality examination.

(5) The examiner should always apply the following auditing techniques when auditing a contractor:

- Pay special attention to the possibility of unreported income.
- Interview the taxpayer and ask them to explain the operation of the business.
- Review internal controls.
- Review construction contracts to determine how the customer pays the taxpayer.
- Perform necessary income probes and consider other sources of income common to contractors.

(6) If the results of these reviews indicate the probability of unreported income, the examiner should consider indirect methods of determining income.

(7) No magic formula exists to use in examining contractors' income tax returns. The examiner must use good judgment as well as innovative techniques when faced with either inadequate or non-existent books or records. Appeals and courts have sustained estimated income when other resources and evidence support increases in net worth or living expenses.

B. Understanding the Accounting System

(1) General Techniques

- The initial interview is the best time to determine how the accounting system works and what types of internal controls are in place. Gaining an understanding of the business is critical because a contractor could have multiple businesses operating within the same entity. An example of this would be an electrical contractor who also operates a retail sales outlet. In this case, the taxpayer could record sales on the cash basis for the service business, accrual for the retail business, and percentage of completion for the contractor business. Establishing the type of construction involved, the method of accounting for income and expenses, work in process, and the duties and responsibilities of key personnel are all areas the examiner should cover in the interview. See Exhibit 11-1 for sample interview questions specific to a construction company.

B.1. The Construction Contract

(1) The construction contract is the keystone for understanding how the taxpayer should determine income. The contract will specify how much and when the customer will pay the contractor. This information will have an impact on the income and profit recognized by the taxpayer on the contract. The contract may also provide information about retainage provisions, incentives, awards, penalties, and change orders. Contracts will also specify whether the terms are "cost plus" or based on a bid.

(2) Part of the income probe will be determining if reported income is reasonable with respect to cost of goods sold. The examiner can also use industry standards from websites such as http://www.bizstats.com as a benchmark to determine if the reported gross profit is reasonable.

(3) The contract could also be a starting point for comparing materials as specified per the contract to materials charged to the job. This might indicate the taxpayer may have diverted materials for other use or to small jobs that have no contract thus not recording sales. Comparing the "budgeted cost" to the "actual cost" in situations where jobs reflect losses or nominal net profits is a good audit technique when reviewing contracts. Some municipalities have computerized building permit records that the examiner can compare with actual contracts or job costs. Examiners may use the following examples to test income from the contracts:

- Compare the board feet of lumber delivered to the square footage of the building. Guides are available that provide this information. The examiner should investigate large variances.

- Compare the cubic feet of concrete purchases to the size of the slab included in the contract.
- Compare the square footage of the roof area to the bundles of shingles purchased and delivered to the job site.
- Compare the number of major appliances, HVAC units, etc., to the size of the building.
- Compare the contractor's gross profit to the industry standards.
- Courthouse research could show properties transferred but not accounted for in the contracts.

C. Minimum Income Probes

(1) IRM 4.10.4.3 discusses the requirement for examiners to consider gross income during the examination of all income tax returns. Examiners should make certain minimum income probes are completed regardless of the type of return filed by the taxpayer.

C.1. Minimum Income Probes for Non-Business Returns

(1) The minimum probes for income outlined in IRM 4.10.4.3.2 include questioning the taxpayer or representative regarding possible sources of income, other than those reported:

- 1. Taxable sources
- 2. Non-taxable sources
- 3. Bartering activities

(2) The examiner should summarize the responses to these questions concerning possible sources of unreported income and referenced in the workpapers that document the interview questions. The examiner should also analyze internal information, such as the Currency and Banking Retrieval System (CBRS), used to track cash transactions over $10,000, and Information Returns Processing (IRP), to ensure the taxpayer listed all business or investment activities on the return. Consideration of possible bartering income is also part of the minimum income probes. Based upon the analysis of income, the examiner may use external sources (third parties) to corroborate the information received or to establish an understatement of income. Under IRC Section 7602(c), the examiner may not initiate third party contacts before giving advance notice to the taxpayer that it may make such contacts as part of the examination. See IRM 4.10.4.5.2(4) for a discussion of the procedures to initiate third party contacts.

C.2. Minimum Income Probes for Individual Business Returns

(1) IRM Section 4.10.4.3.3 expands the minimum income probes to include an analysis to determine if reported income is sufficient to support the taxpayer's financial activities. There could be unreported income, overstated expenses, a simple math error, or a combination of these items that could indicate the taxpayer did not have sufficient funds to support their financial activities. Several audit procedures should be utilized:

- **Financial Status Analysis** - Prepare a financial status analysis to estimate whether reported income is sufficient to support the taxpayer's financial activities.
- **Interview** – Conduct an interview with the taxpayer (or representative) to gain an understanding of the taxpayer's financial history, identify sources of nontaxable funds, and establish the amount of currency the taxpayer has on hand. Consider possible bartering income as part of the minimum income probes.
- **Tour of Business** - Tour the business sites and review the taxpayer's website to gain familiarity with the taxpayer's operations and internal controls and identify potential sources of unreported income.
- **Internal Control** - Evaluate the internal controls to determine the reliability of the books and records (including electronic books and records), identify high risk issues, and determine the depth of the examination of income. See the discussion following this section about the evaluation of internal controls.
- **Reconciliation of Income** - Reconcile the income reported on the tax return to the taxpayer's books and records. Reconcile the Information Return Processing (IRP) document, in the file, to ensure the tax return reflects all business and/or investment activities.
- **Testing Gross Receipts** – Test the gross receipts by tying the original source documents to the books.
- **Bank Analysis** – Prepare an analysis of the taxpayer's personal and business bank and financial accounts (including investment accounts) to evaluate the accuracy of gross receipts reported on the tax return.
- **Business Ratios** – Prepare an analysis of business ratios to evaluate the reasonableness of the taxpayer's business operations and identify issues needing a more thorough examination.

- **E-Commerce and/or Internet Use** – Determine if there is internet use and e-commerce income.

C.3. Minimum Income Probes for Corporations, Partnerships, S Corporations and Other Business Returns

(1) According to IRM 4.10.4.3.4, the examination of gross income on a business return for corporations or other business entities should include the following steps at a minimum:

- **Balance Sheet Analysis** – Prepare an analysis of the balance sheet and tax return information to assist in the identification of issues to examine.
- **Reconciliation** - Reconcile Schedules M-1 and M2 and the trial balance to the return. See IRM 4.10.3.6.1 and IRM 4.10.3.6.2 for a complete discussion.
- **Shareholder and Partners** - Evaluate copies significant shareholders or partners (greater than 20% direct or indirect ownership) tax returns for examination potential, proper treatment of related transactions, or possible diverted funds.
- **Interview** – Interview the taxpayer. See Exhibit 11-1 Construction Industry Interview Questions.
- **Tour of Business** – Conduct a tour of the physical business site controlled by the taxpayer. The purpose of a tour is to gain familiarity with the taxpayer's business operations and internal controls, identify potential sources of unreported income, and confirm the existence of assets.
- **Internal Controls** – Evaluate the internal controls.
- **Testing Gross Receipts** – Test the gross receipts by tying the original source documents to the books.
- **Ratio Analysis** – Examiners can use the taxpayer's books and records and ratios to evaluate the accuracy and reasonableness of the reported income. A horizontal analysis identifies changes over time and may result in the identification of LUQ items not readily identified from a review of a single tax return. The examiner should compare the tax return under audit to the prior and subsequent year returns and document conclusions in the case file for all business returns.
- A **vertical analysis** identifies differences between the taxpayer's business and industry standards for a given year and is an indicator of the reasonableness of gross business receipts and net

profit reported on the tax return. One source of industry standards is located at http://www.bizstats.com. A vertical analysis may not be appropriate for every case.

- **E-Commerce and/or Internet Use** – Determine if there is internet use and e-commerce income . Refer to IRM 4.10.4.3.7.1 for information on e-commerce income issues.

(2) The depth of the bank record inspection will depend on the internal controls, the analysis of the primary shareholder/partner's returns, and the judgment of the examiner. At this point, the examiner should have a solid basis for determining if there is potential for unreported income and if the books and records are reliable. When dealing with construction returns, the method of accounting is always important, because of the impact on income recognition. This could result in an adjustment to income.

D. Internal Controls

(1) IRM 4.10.3.5 discusses the evaluation of internal controls. The IRM requires examiners to evaluate the existence and effectiveness of internal controls for all types of business returns. Even in the small business environment, where the owner-managers control the entire operation, it is essential to evaluate internal controls to determine the appropriate audit techniques to use. Examiners should consider the type of business, the records, and the owner's financial status as part of the evaluation of internal controls.

(2) What exactly are internal controls in a small business environment? When would the examiner consider the internal controls inadequate to the degree of requiring an indirect method? Does the lack of good internal controls mandate the use of an indirect method? Conversely, do good internal controls automatically negate the use of an indirect method?

(3) The answer to these questions is for the most part a judgment call by the examiner. It would be rare for a sole proprietor to have limited access to the cash resources of the business. While there could be a record keeping system that incorporates a certain level of checks and balances, the credibility reverts to the owner's willingness to adhere to the established procedures.

(4) In the absence of legal requirements for contractors, such as bonding or government contracts, for the most part a sole proprietorship with no employees has very weak or nonexistent internal controls. This conclusion would normally require strong consideration of an indirect method during the examination. The exception would be a result of extenuating circumstances justifying a decision not to pursue an indirect method.

(5) The next level would be "weak" internal controls. This might occur where the owner has occasional or limited access to the cash resources of the

business. An example might be a larger Schedule C with an in-house accountant. The staff prepares most of the banking transactions. The owner, however, has the opportunity on occasion to skim cash sales and circumvent the control procedures that are in place.

(6) In similar situations, examiners will need to consider the following factors when deciding whether to pursue an indirect method:

- Type of business involves extensive cash transactions;
- The ease of skimming cash such as a large number of unidentifiable customers versus a small number of traceable customers;
- Established gross profit ratios indicating that the business is operating well below the normal gross profit ratios may indicate skimming practices are present;
- The taxpayer's standard of living is a higher standard of living than the amount of income reported would support may indicate potential skimming;
- Cash expenditures not reflected in the taxpayer's records that are identified by a courthouse records check; or
- A high percentage of cash expenditures for business or personal expenses and some or all are not reflected in the taxpayer's records.

(7) The other end of the scale is a business with strong internal controls, such as: an elaborate double entry record keeping system; periodic in-house audits; annual certified financial audits; an outside accountant who provides monthly write-up services; non-related owners with equal involvement in the business operations; or limited cash transactions with easily traceable customers. Under these circumstances, the general rule would be not to pursue an indirect method, and the exception would be where extenuating circumstances dictate otherwise. The key steps to evaluating internal controls are:

- Understanding the control environment,
- Understanding the accounting system, and
- Understanding the control procedures.

(8) First, the control environment makes up the many factors that affect the policies and procedures of the business. The examiner must understand how the business operates. Interviewing the taxpayer and/or the representative and touring the business are integral steps. Second, gaining knowledge of the accounting system provides information about many of the day-to-day business operations. Finally, the control procedures are the methods established to assure that the business operates as intended. The separation of duties is the primary control procedure because it will reduce the opportunity for any one person to both perpetrate and conceal errors or

irregularities. The greater the number of employees, and the more complex the business, the more likely some formal control procedures will exist.

(9) In conclusion, evaluating the internal controls of a business and documenting those findings in the workpapers is a mandatory item on every business return examination. The workpapers should include a statement regarding the accessibility to cash by the owner/manager, the quality of internal controls overall, and the effect the internal control environment had on the verification of income.

D.1. Audit Techniques for Evaluating Internal Controls

(1) The examiner should test the internal control system for compliance with the procedures as described in IRM 4.10.3.5.5.3. Observe a transaction through the entire accounting process. Look for consistency in recording similar transactions. At this point, the examiner will be able to determine the scope and depth of the examination. If the books and records are reliable, the examination can include direct testing of transactions, such as tracing specific items to receipts. However, if the examiner determines that the books and records are not reliable, the examination should include indirect analyses. Because the examination of the books and records will reveal the likelihood of material errors, or that transactions were valid, determining reliability through internal control analysis is a key step.

E. Use of Indirect Methods

E.1. Introduction

(1) Smaller contractors, not faced with bonding or similar requirements for financial statements and performance verification, may improperly report income for only a portion of their work. For example, they might limit income to the amount reported on Forms 1099. Some contractors have been willing to work for 20% to 25% less on the condition that the customer does not issue a Form 1099. This has an adverse effect on the industry as well as on the government.

(2) With the proliferation of check cashing schemes, payment with a check is an insufficient control to validate income via bank deposit records. The auditor should look to some central element of the specialty contractor's business and measure that factor to confirm the reporting of gross income by an indirect method. With a small contractor, the auditor can also look at the owner's return, county record information, and lifestyle/assets to gain a reasonable assurance as to the economic reality of reported income. As always, the verification of income requires the examiner’s judgment to determine if they should expand the examination to include the use of

indirect methods.

E.2. Indirect Methods - Overview

(1) At some stage of all business return examinations, examiners must consider the use of an indirect method. Equally important is the proper work paper documentation of the decision to pursue (or not to pursue) an indirect method of income reconstruction. With the passage of the Revenue Recognition Act of 1998, the examiner must document the likelihood of unreported income before proceeding with an indirect method. IRC Section 7602(e) provides that the Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income.

(2) When the records are incomplete, or there are other indications that the books and records are not reliable, the examiner may estimate income using other methods such as analyzing building permits, commissions paid to the sales staff, or applying gross profit percentages to jobs. The examiner makes the decision to use other estimates of income or to expand the scope of the income probes after evaluating the results of the initial income probes. The examiner must document the decision in the workpapers and update as they receive information. The examiner should consider the use of an indirect method of reconstructing income when:

- A review of the taxpayer's prior and subsequent year returns show a significant increase in net worth. In the case of a corporation or partnership, the determination is on the shareholder's or the partner's returns.
- Gross profit percentages change significantly from year to year or are unusually high/low for that business.
- The taxpayer's business and personal expenses exceed the reported income per the return and attempts to reconcile material imbalances have failed.
- The taxpayer's bank accounts have unexplained items of deposit.
- The taxpayer does not make regular deposits of income but uses cash instead.

E.3. Types of Indirect Methods

(1) The code and regulations do not define or specifically authorize the use of indirect methods. The authority to challenge a taxpayer's income determination is under IRC Section 446(b). If the taxpayer has regularly

used no method of accounting or if the method used does not clearly reflect income, the Secretary shall compute taxable income under such method as in the opinion of the Secretary does clearly reflect income. IRM sections 4.10.4.6.3 through 8 outline the application of the various indirect methods. These include the following:

- Bank Deposits and Cash Expenditures Method (IRM Section 4.10.4.6.4);
- Source and Application of Funds Method (IRM Section 4.10.4.6.3);
- Net Worth Method (IRM Section 4.10.4.6.7);
- Markup Method (IRM Section 4.10.4.6.5);
- Unit and Volume Method (IRM Section 4.10.4.6.6); and

(2) In addition to a discussion of the relevant case law and the indirect method computation, the IRM discusses each method in detail. In theory, each method applied properly should yield the same result. However, there are situations that indicate the use of a specific method may be more appropriate. For example, the IRM recommends the Bank Deposits and Cash Expenditures Method in the following situations:

- The taxpayer's books and records are unreliable, unavailable, withheld, or incomplete.
- The taxpayer makes periodic deposits of funds into bank account(s) which appear to be generated from an income-producing activity.
- The taxpayer pays most business expenses by check.
- The taxpayer previously used bank account deposits to determine and report taxable income.

(3) The IRM recommends the Source and Applications of Funds Method in the following situations:

- If the review of a taxpayer's return indicates that the taxpayer's deductions and other expenditures appear out of proportion to the income reported.
- The taxpayer's cash does not all flow from a bank account which can be analyzed for its source and subsequent disposition.
- The taxpayer makes it a common business practice to convert receipts into cash for the purpose of paying claimed business expenditures.

(4) The IRM recommends The Net Worth Method in the following situations:

- Two or more years are under examination.
- Numerous changes to assets and liabilities are made during the period.
- No books and records are maintained.
- The books and records are inadequate or not available.
- The books and records are withheld by the taxpayer.

(5) The IRM recommends the Markup Method in the following situations:

- When the inventories are a principal income producing factor and the taxpayer has nonexistent or unreliable records.
- Where a taxpayer's cost of goods sold or merchandise purchased is from a limited number of sources, and these sources can be ascertained with reasonable certainty, and there is a reasonable degree of consistency as to sales prices.

(6) The IRM recommends the Unit and Volume Method in the following situation:

- The examiner can determine the number of units handled by the taxpayer, and knows the price or profit charged per unit.
- The business has only a few types of products which it sells or there is little variation in the types of products which it sells or there is little variation in the types of services performed, and the charges made by the taxpayer (sales price) for merchandise or services are relatively the same throughout the tax period.

(7) Clearly, the examiner's judgment is a crucial factor in determining the best method to pursue when the examination indicates the use of an indirect method. Except for the unit and volume method, any of these methods would apply to construction returns. Construction activity results in the production of tangible personal property so the examiner may be able to determine the cost of the materials. Most materials used in construction are not exotic, so pricing is generally not a barrier to determining job costs.

(8) For example, the materials needed for a home builder who constructs an average 2,000 square foot home may require13,127 board-feet of framing lumber; 3,100 square feet of roofing material; 3,061 square feet of insulation; 15 windows; 12 interior doors; and 2,085 square feet of flooring material. The average material usage would give the examiner a benchmark to use for determining income based on costs. (National Association of Home Builders, http://www.nahb.org.)

(9) As policy, when an indirect method results in an understatement of income over $10,000, it is mandatory for the examiner to discuss the case with the

group manager. The purpose of the discussion is to consider expanding the scope of the examination and to evaluate any elements of fraud. The examiner should always consider fraud potential when unreported income is an issue. The taxpayer's explanations or lack thereof may help distinguish between civil and criminal fraud. It is important to document the case file for the responses to interview questions, reliability of books and records, or any other indications of fraud.

E.4. Potential Defenses to Indirect Method Computations

(1) If the use of a formal indirect method results in the identification of an understatement of taxable income, the examiner must ensure that it applied the method correctly to eliminate any potential defense the taxpayer may use to discredit the results.

(2) Defenses can be grouped into three categories:

- Showing the computation is inaccurate or flawed,
- Showing the unexplained difference is due to a nontaxable source, or
- Showing the unexplained difference is from expenditures of available cash accumulated in prior years.

F. Miscellaneous Income Sources

(1) Income may also arise from other sources. Some of the more common sources are:

- A contractor may have interest income from escrow accounts, retainage accounts, or deposits. Reconciling the IRP transcripts may reveal unreported interest income.
- The taxpayer could omit the income from a remote construction project. Generally, the taxpayer will account for expenses, so a careful understanding of the books and records is crucial.
- It is not unusual for a contractor to be involved in some litigation over complicated construction contracts. The taxpayer may not report the income from claims that it subsequently settles by court decisions or arbitration.

X. Construction Joint Ventures

A. Overview

(1) A joint venture is a cooperative undertaking, by two or more parties (contractors), operated as a separate business entity for the purpose of combining resources and sharing risks on a construction project. Construction companies may choose to extend and expand their capital, bonding capacity, or expertise by joining together with other competent contractors to perform work that is challenging either in terms of size or type. Some construction companies may have restricted access to international or domestic markets. By forming joint ventures, construction companies can often overcome these market limitations or restrictions. Although this form of business has advantages and disadvantages, joint ventures are often necessary for the construction company's survival and growth in a highly competitive industry.

(2) In addition to the other construction industry tax issues, joint ventures by the nature of the entity produce separate issues that examiners need to consider in an examination.

B. Types of Joint Ventures

(1) Internal Revenue Code (IRC) §§ 761(a) and 7701(a)(2) generally considers construction projects structured as joint ventures to be classified as partnerships. Joint ventures are generally formed for one specific purpose such as a job, a contract, or a project with the intent of operating for a limited duration.

(2) A joint venture may rise to the level of being an entity separate from its owners which will result in a partnership. The guidance found in the regulations indicate a joint venture is a partnership if there is an agreement to share profits. The final determination if a joint venture is a partnership is based on an understanding of all relevant facts and circumstances.

(3) IRC § 761(a) and IRC § 7701(a)(2) provide that the term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which it carries on any business, financial operation, or venture, and which is not, within the meaning of this title, a trust or estate or a corporation. The term “partner” as defined in IRC § 7701(a)(2) includes a member in such a syndicate, group, pool, joint venture, or organization.

(4) The Treasury and IRS have published regulations for classifying business arrangements for federal tax purposes. These regulations became effective on January 1, 1997. Treasury Regulation (Treas. Reg.) § 301.7701-1 prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for

federal tax purposes is a matter of federal tax law and does not depend on whether local law recognizes the organization as an entity.

(5) When classifying a business arrangement, you must first determine if there is an entity separate from its owners for federal tax purposes. Certain joint undertakings (such as a joint venture) may create a separate entity for federal tax purposes if the participants: (1) carry on a trade, business, financial operation, or venture, and (2) divide the profits from the activity. Nonetheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. Treas. Reg. § 301.7701-1 provides examples of a separate entity versus non-separate entity.

(6) For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that the co-owners maintain, keep in repair, and rent or lease does not constitute a separate entity for federal tax purposes. For example, if an individual owner or tenants in common, of farm property, lease it to a farmer for cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

(7) Treas. Reg. §§ 301.7701-2, 301.7701-3, and 301.7701-4 determine the classification of organizations that the IRC recognizes as separate entities unless another provision of the IRC calls for special treatment of the organization.

(8) Treas. Reg. § 301.7701-2 defines a business entity as any entity recognized for federal tax purposes (including an entity with a single owner that Treas. Reg. § 301.7701-3 may disregard as an entity separate from its owner) that Treas. Reg. § 301.7701-4 does not properly classify as a trust or otherwise subject to special treatment under the Internal Revenue Code. For federal tax purposes, the regulations classify a business entity with two or more members as either a corporation or a partnership. It classifies a business entity with only one owner as a corporation if it is a disregarded entity and it treats its activities in the same manner as a sole proprietorship, branch, or division of the owner.

(9) Treas. Reg. § 301.7701-3 states that a business entity that Treas. Reg. § 301.7701-2(b) does not classify as a corporation can elect its classification for federal tax purposes. An eligible entity with at least two members can elect to classify itself as an association (and thus a corporation) or as a partnership. An eligible entity with a single owner can elect to classify itself as an association (and thus a corporation) or as a disregarded entity separate from its owner. Paragraph (b) of Treas. Reg. § 301.7701-3

provides a default classification for eligible entities. Therefore, an election is only necessary when the entity chooses to classify itself as other than the default classification.

(10)For entities formed after January 1, 1997, the default classification of entities per Treas. Reg. § 301.7701-3 is as follows:

1. Domestic eligible entity:
   - classified as a partnership if it has two or more members; or
   - disregarded as an entity separate from its owner if it has a single owner
2. Foreign eligible entity:
   - classified as a partnership if it has two or more members and at least one member does not have limited liability;
   - an association if all members have limited liability; or
   - disregarded as an entity separate from its owner if it has a single owner that does not have limited liability

(11)For entities formed prior to January 1, 1997, the eligible entity generally maintains the classification it claimed under the classification regulations in effect prior to January 1, 1997. An eligible entity may elect to classify itself other than as provided in the default rules or to change its classification by filing a Form 8832, Entity Classification Election, with the appropriate service center. See Treas. Reg. § 301.7701-3.

(12)For financial statement purposes, each member of the joint venture accounts for an investment in a joint venture under the cost method, the equity method, as a pro rata share, or consolidates the entity with the investor's financial statements. For financial accounting purposes, the accounting method used to account for the construction company's investment in a joint venture is based on the ownership percentage and the degree of control the construction company has over the venture. Inspection of the taxpayer's consolidated financial statements can provide the examiner with an extended view of the construction company's investment in joint ventures because the taxpayer often consolidates both incorporated projects and joint ventures. In addition, taxpayers frequently disclose financial information of unconsolidated joint ventures in the notes to the financial statements.

(13)The Internal Revenue Code generally requires, joint ventures classified as partnerships to file separate income tax returns using Form 1065. Individual partners or investors recognize a distributive share of partnership items reported on Schedule K-1 from the construction joint venture on their income tax returns. Partnerships can be formed as general partnerships or limited partnerships and must include at least two partners. A general partnership is an association where all partners have unlimited liability. A

limited partnership is an association in which one or more general partners have unlimited liability and one or more limited partners have limited liability.

C. Joint Venture Examinations

(1) If you are examining a construction company that is involved in joint ventures, you should be aware of unique issues regarding the formation, operation, and liquidation of joint ventures. The examiner needs to consider the gross receipts of each joint venture in the rules of attribution in determining each member's eligibility to meet the small contractor's exception under IRC § 460(e)(1). See an earlier chapter of the Audit Technique Guide for additional information regarding the rules of attribution. Each member of a joint venture brings individual resources to a joint venture and the joint venture compensates the members in various ways. The examiner should view each party independently. Such a review often raises questions and potential issues:

- What are the assets, capital, services, and other resources contributed by each party?
- What was the value and basis of the property contributed?
- Did a partner contribute appreciated property to the venture?
- Was the contributed property encumbered?
- What are the profit, loss and capital sharing ratios?
- Does the partnership have allocations that differ from the partners profit or loss percentages?
- Have there been any changes in the ownership structure?
- Have there been any distributions or partial liquidations from the joint venture?
- What type of property did the joint venture distribute and to whom?
- How has the joint venture compensated the construction company (cash, increase in capital interest, etc.) for its construction work?
- How does the construction company allocate its overhead or indirect expenses to joint venture projects?
- Are there any related transactions (compensation payments, leases, loans, etc.) between the joint venture and the members of the joint venture?
- What method of accounting does the joint venture use?
- What effects do long-term contracts have on the allocation of income to incoming/outgoing partners?

- Has the joint venture properly capitalized construction period interest?

D. Potential Joint Venture or Partnership Issues

(1) Examiners who conduct examinations of joint ventures must deal with the common issues found in other construction entity examinations. The IRC explicitly states that a partnership may include a joint venture; however not all joint ventures are partnerships. Examiners must determine the type of entity that they are auditing in order to use the appropriate tax code.

(2) One can often divide these issues into three broad categories involving formation, operation, and liquidation or distribution issues. Below is a brief summary of each issue:

D.1. Formation Issues

(1) Failure to file partnership returns. See IRC § 6698.

(2) Capitalization or amortization of organization and syndication fees. See IRC § 709.

(3) Contribution of construction services by the construction company in exchange for a capital interest in the partnership. See Treas. Reg. § 1.721-1(b)(1).

(4) Contribution of construction services (by the construction company) in exchange for a profits interest in the partnership when a predictable income stream exists. See Rev. Proc. 93-27 (1993-27 C.B. 343).

(5) Deemed cash distributions on the assumption of a partner's liability on property contributed. See IRC § 752(b).

D.2. Operation Issues

(1) Does the partnership have allocations that differ from the partners profit or loss percentages? Cancellation of indebtedness income (COD income) upon bankruptcy or insolvency. See IRC § 61(a)(12), Treas. Reg. § 1.61-12 and IRC § 108.

(2) Withholding tax on distributive share of partnership taxable income to a foreign partner. See IRC § 1446.

D.3. Liquidation or Distribution Issues

(1) Distributions of cash in excess of basis in the partnership interest. See IRC §§ 731, 734, 741, 751, and 752.

(2) Interest expense deductions in connection with debt financed distributions. See IRC § 163(h).

(3) Disguised sales. See IRC § 707(a)(2)(B).

XI. Additional Resources

A. Exhibit 11-1 Construction Industry Interview Questions

These questions are intended to be a starting point for generic questions that would be applicable to the examination of a construction company. As with any examination, the questions should be tailored to the specific taxpayer under examination.

A.1. General:

(1) How many years have you been in the construction industry?

(2) What type of construction do you perform?

- Single Family Homes
- Multi-family (condominiums)
- Commercial Buildings
- Highway
- Other

(3) Where do you perform construction jobs? (Geographically)

- Local Area
- Statewide
- Nationwide
- International

(4) What type of Customers do you enter contracts with?

- Private
- City
- State
- Federal

(5) How do you get customers?

- Bid -Who makes the bids?
- Negotiated?

- What percent of jobs are bid vs. negotiated?

(6) What type of contracts do you enter?

- Fixed/lump sum contracts
- Cost +Plus Fee
- Time and material
- Other

(7) What is average length of a job? (<1 yr., 1-2 yr., more than 2 years)

(8) What licenses do you hold? (i.e. general contractor, architect, etc.)

(9) Do you have bonding? If yes, who provides the bonding?

(10) Are you required to issue certified financial statements? Reviewed Financial Statements? How often?

(11) What method of accounting do you use for tax? (Taxpayer can have several different methods depending on the type of contract)

- Percentage of Completion (PCM) - How is degree of completion determined?
- Cost-to-Cost, Engineer Estimates, Units in Place, Other?
- Completed Contract - When is a job determined to be complete?
- Accrual - How and when are customers billed during job?
- Cash - (can only be used in limited situations)

(12) What method of accounting do you use for book/financial statements?

(13) How do you determine the price to charge for a job?

- What costs (direct, overhead, etc.) are included in that figure?
- Do you have a worksheet or form that you use to arrive at that figure?
- What type of budget reports are kept and how often are they prepared?

(14) What overhead method is used to determine allocation of indirect costs to contracts? (i.e. specific identification (tracing), standard costs, burden ratios such as ratios based on direct labor hours or dollars, machine hours, etc.)

(15) (Note: Use the following questions to determine if and how much officers' salary should be charged to jobs)

- How are officers' salaries determined? (Salary/hourly/year-end bonuses) Get detail description of each officer's job (i.e. who negotiates contracts, who bids, go to job site, work on job site, etc.)

- Are officers provided corporate vehicles? Get detailed business use (i.e. going to job sites regularly)

A.2. Other Income:

1) Do you provide construction management services?
    - Architect, engineering services?
    - Remodeling?
    - Subsequent Work?
    - Warranty Work?
    - Rental Income?
2) Any legal proceedings against you or you against others?
3) Do you make provisions for losses?
4) Do you accrue for estimated warranty expenses?
5) Any estimated losses or expenses accounted for?

A.3. Management accounting

1) How do you number jobs?
2) Do change orders keep the same job # or assigned a new job #?
3) Do you maintain a budgeting system? (monthly, quarterly, yearly)
4) Describe your job cost system.
    - Explain all costs charged to jobs.
    - Are officers' salaries applied to jobs?
    - Interest expense on construction loans applied to jobs.
    - Indirect costs applied to jobs.
5) Do you obtain financing for jobs or does the customer?
6) Retainages:
    - How much is withheld by customers and when do you received them?
    - When are they included in income for tax? Book?
    - How much do you withhold on your subcontractors?

- When do you repay them? How do you account for them?

A.4. Employees and subcontractors:

1) How many employees do you have and what type of positions within the company?
    - Officers?
    - Office staff?
    - Supervisors?
    - Field workers?
    - Others?
2) What type of subcontractors do you use?
3) How are subcontractors/vendors selected?
4) Do you enter into contracts with subcontractors?
5) How are subcontractor fees determined? (negotiated, hourly, etc.)
6) Who is responsible for the issuance of 1099s to subcontractors?
7) How do you distinguish between employees and subcontractors?

A.5. Gross Receipts:

1) How is income received?
    - Percentage up-front?
    - Draws? How often and how determined?
    - At end of contract?
    - Retainages?

A.6. Cost of Goods Sold:

1) What materials are purchased for each job?
2) Who orders materials? Who approves the order?
3) Materials shipped to you or directly to job site?
4) Do subcontractors provide their own material, or do you purchase for them?

5) Do you have a warehouse/shed to keep materials?

6) What is done with extra materials from a job?

7) Inventory?

B. Exhibit 11-2 Cost Allocation Decision Making Process

Part A: Cost Allocation Decision Making Process

B.1. Step 1: Is there a contract?

A. Yes - Go to **Step 2**.
B. No - Cost allocation per IRC § 263(a) and § 263A (Speculative Home Builder or Land Developer)

B.2. Step 2: Is the Taxpayer Exempt from PCM per IRC § 460(e)?

A. Yes - If the taxpayer is a home contractor the taxpayer is exempt from the required use of PCM. Go to **Step 3**.
B. Yes - If the taxpayer is a small contractor (taxpayer expects to complete contracts within 2 years **and** the average annual gross receipts for the prior 3 years is less than $25 million. Note:10 million for tax years beginning prior to 1-1-2018) the taxpayer is exempt from the required use of PCM. Go to **Step 3**.
C. No - the taxpayer is not exempt from PCM. Cost allocation per IRC § 460(c) and Treas. Reg. § 1.460-5(b). Taxpayer may elect Simplified Cost-to-Cost Method per IRC § 460(b)(3)(A).

B.3. Step 3: Is the Taxpayer a Large Homebuilder?

A. Yes - contracts are for more than 2 years **or** the taxpayer’s average annual gross receipts for the prior 3 years is more than $25 million ($10 million for tax years beginning prior to 1-1-2018). Cost allocation per IRC § 263A.
B. No – taxpayer expects to complete contracts within 2 years **and** the taxpayer’s average annual gross receipts for the prior 3 years is less than $25 million (/$10 million for tax years beginning prior to 1-1-2018). Cost allocation per Treas. Reg. § 1.460-5(d) for Completed Contract Method or Treas. Reg. § 1.460-5(b) for Percentage of Completion Method.

Part B Production Period Interest is Allocable Under All the Above Under IRC § 460(c)(3) and § 263A(f) Cost Allocation by Type of Cost by Accounting Method

Item	Type of Cost	PCM[1]	SCM[2]	CCM	UCC[4]
1	Direct Materials	Yes	Yes	Yes	Yes
2	Direct Labor	Yes	Yes	Yes	Yes
3	Repairs	Yes	No	Yes	Yes
4	Maintenance	Yes	No	Yes	Yes
5	Utilities	Yes	No	Yes	Yes
6	Rent	Yes	No	Yes	Yes
7	Certain Indirect Labor	Yes	No	Yes	Yes
8	Materials and Supplies	Yes	No	Yes	Yes
9	Small Tools and Equipment	Yes	No	Yes	Yes
10	QC & Inspection	Yes	No	Yes	Yes
11	Taxes (Other than Income Taxes)	Yes	No	Yes	Yes
12	Financial Statement Depreciation	No	No	Yes	No
13	Tax Return Depreciation	Yes	Yes	No	Yes
14	Cost Depletion	Yes	No	Yes	Yes
15	Percentage Depletion in Excess of Cost	Yes	No	No	Yes
16	Contract General and Administrative Expense	Yes	No	Yes	Yes
17	Non-Contract G&A Expense	Yes	No	No	Yes
18	Administrative Support Departments	Yes	No	No	Yes
19	Contract Related Officer Salaries	Yes	No	Yes	Yes
20	Non-Contract Related Officer Salaries	Yes	No	No	Yes
21	Insurance (Including Bonds)	Yes	No	Yes	Yes
22	Pension, Profit Sharing. Except for Past Service Costs	Yes	No	No	Yes
23	Past Service Costs	Yes	No	No	Yes
24	Direct Research and Development	Yes	No	No	Yes
25	Rework, Scrap, and Spoilage	Yes	No	No	Yes
26	Successful Bidding Expense	Yes	No	No	Yes
27	Engineering and Design	Yes	No	No	Yes
28	Transportation Costs	Yes	No	Yes	Yes
29	Storage, Handling, Purchasing and Related Costs	Yes	No	No	Yes
30	Production Period Interest	Yes	No	Yes	Yes
31	Additional Costs under Cost Plus or Governmental Contracts	Yes	No	No	Yes
32	Marketing, Selling, Advertising, and Distribution	No	No	No	No
33	R & D Not Related to Contracts	No	No	No	No
34	Losses, Obsolescence, Decline in Value	No	No	No	No
35	Income Taxes	No	No	No	No
36	Costs Attributable to Strikes	No	No	No	No
37	Repairs Not Associated with Production Equipment	Yes	Yes	Yes	Yes

Notes
[1] Required by IRC §§ 460 and 460(c) and Treas. Reg. § 1.460-5(b)
[2] Allowed by IRC §§ 460(b)(3)(A) and Treas. Reg. § 1.460-5(c)
[3] Allowed by Treas. Reg. § 1.460-5(d)
[4] IRC § 263A (Large Homebuilders, Speculation Homes, and Land Developers)

C. Exhibit 11-3 Cash to Accrual

Cash to Accrual Issue When Merchandise is an Income Producing Factor – Applicable to tax years beginning before 1-1-2018

(1) Treasury Regulation § 1.446-1(c)(2)(i) requires the use of an accrual method of accounting if IRC § 471 requires the taxpayer to account for inventories. Treasury Regulation §1.471-1 requires an accounting of inventory in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

(2) In prior years, the IRS won many cases supporting the change from cash to accrual when merchandise was considered an income-producing factor. After much litigation in this area, a safe harbor provided by Revenue Procedure (Rev. Proc.) 2001-10 and Rev. Proc. 2002-28 allows the use of the cash method accounting to taxpayers who would otherwise have been required to use the accrual method of accounting.

C.1. Exceptions That May Allow the use of the Cash Method

(1) Revenue Procedure 2001-10

The Service issued Rev. Proc. 2001-10 on January 8, 2001 and permits eligible small businesses with average gross receipts equal to or less than $1 million to use the cash method when IRC § 471 would otherwise require an accrual method because of inventory.

The Commissioner provided administrative relief from the requirements of IRC §471 and Treas. Reg. § 1.446-1(c) (2) (i) to certain small taxpayers. This Rev. Proc. allows qualifying taxpayers (including those that provide goods and services to their customers) with average annual gross receipts of $1 million or less to use the cash method.

However, contractors that qualify under this Rev. Proc. must treat certain property as non-incidental materials and supplies as defined under Treas. Reg. § 1.162-3. The taxpayer cannot deduct these expenses until the year the taxpayer pays for them or the year in which the taxpayer uses or consumes the materials and supplies in its business.

Even though the cash method is an acceptable method, the contractor is still required to account for inventories. This exhibit discusses non-incidental material and supplies later in the exhibit.

(2) Revenue Procedure 2002-28

The Service also issued Rev. Proc. 2002-28 that allows qualifying small business taxpayers with average annual gross receipts of $10 million or less to use the cash method of accounting. Qualifying Taxpayer under Rev. Proc. 2002-28

The average annual gross receipts for the 3 prior years must be $10,000,000 or less and the taxpayer's principal business activity must be a North American Industry Classification System (NAICS) code other than one of the ineligible NAICS codes listed in Rev Proc. 2002-28:

- Mining: NAICS 211 and 212
- Manufacturing: NAICS 31 through 33
- Wholesale Trade: NAICS 42
- Retail Trade: NAICS 44 and 45
- Information Industries: NAICS 5111 and 5122

Rev. Proc. 2002-28 does not override IRC § 448 that prohibits C corporations or partnerships with a C corporate partner with average annual gross receipts greater than $5 million from using the cash method of accounting.

Rev. Proc. also does not override IRC § 460 requiring taxpayers to account for long-term construction contracts, such as contracts expected to require more than 2 years that are not home construction contracts, using the percentage of completion method.
An additional qualifying factor is that the taxpayer cannot have previously changed from the cash method to the accrual method after becoming ineligible under Rev. Proc. 2002-28.

Once a qualifying small business taxpayer exceeds the annual 3-year average of $10 million gross receipts threshold, they cannot go back to the cash method when annual gross receipts fall back under $10 million

(3) Qualifying Small Business Taxpayer under Rev. Proc. 2002-28 Section 4.01 (1)
A qualifying small business taxpayer may use the cash method as described in this Rev. Proc. for all its trades or businesses if the taxpayer satisfies any one of the following three tests:

- The taxpayer reasonably determines that its principal business activity (as defined in Section 5.04) is described in a North American Industry Classification Systems ("NAICS")
- The taxpayer reasonably determines that its principal business activity is the provision of services, including the provision of property incident to those services.
- The taxpayer reasonably determines that its principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or and specifications and did not previously change (and was not previously required to have changed) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method under this Rev. Proc

(4) Gross Receipts Tests under Rev. Proc. 2001-10 and Rev. Proc. 2002-28

As with IRC § 460, the gross receipts test uses the average annual taxable gross receipts for the prior three taxable years. However, the definition of gross receipts under Rev. Proc. 2001-10 and Rev. Proc. 2002-28 is different from IRC § 460.

Gross receipts under Rev. Proc. 2001-10 and Rev. Proc. 2002-28 include total sales (net of returns and allowances) and, all amounts received from services, interest, dividends, and rents. Whereas, gross receipts under IRC § 460 does not include returns and allowances, interest, dividends and rents.

(5) Inventory under Rev. Proc. 2002-28

IRC § 471 provides three options for taxpayers required to account for inventories:

- A taxpayer can use overall cash method and account for inventories under IRC § 471;
- Can use overall cash method and account for inventory the same as materials and supplies that are not incidental under Treas. Reg. § 1.162-3; or
- A taxpayer can use an overall accrual method and account for inventory as materials and supplies that are not incidental under Treas. Reg. § 1.162-3 and thus not deductible until used or consumed in business.

If the taxpayer chooses to treat materials under Treas. Reg. § 1.162-3, they are not subject to IRC § 263A.

(6) Non-Incidental Material and Supplies under Rev. Proc. 2002-28

An inventory item is any item that is either purchased for resale to customers or used as a raw material in producing finished goods. Inventory items that are treated as non-incidental material and supplies under Rev. Proc. 2002-28 are deductible in either the tax year the taxpayer pays for or consumes the non-incidental material and supplies, whichever is later. Treasury Regulation § 1.162-3 provides guidance on the timing of deductions for Inventory items treated as non-incidental materials and supplies.

Example:

Rev Proc 2002-28; Section 6; Example 15: Taxpayer is a roofing contractor that is eligible to use the cash method under this Rev. Proc. Taxpayer chooses to use the cash method and to account for inventory items as non-incidental materials and supplies under Treas. Reg. §1.162-3.

Taxpayer enters into a contract with a homeowner in December 2001, Year 1, to replace the homeowner's roof. Taxpayer purchases roofing shingles from a local supplier and has them delivered to the homeowner's residence. Taxpayer pays the supplier $5,000 for the shingles upon their delivery later that month. Taxpayer replaces the homeowner's roof in December 2001, Year 1, and gives the homeowner a bill for $15,000 at that time. Taxpayer receives a check from the homeowner in January 2002, Year 2.

The shingles are non-incidental materials and supplies. The cost of the shingles is deductible in the year Taxpayer uses and consumes the shingles or actually pays for the shingles whichever is later.

In this case, Taxpayer both pays for the shingles and uses the shingles (by providing the shingles to the customer in connection with the performance of roofing services) in 2001, Year 1. Thus, Taxpayer deducts the $5,000 cost of the shingles on its 2001, Year 1, federal income tax return. Taxpayer includes the $15,000 in income in 2002, Year 2, when it receives the check from the homeowner.

Example:

Revenue Procedure. 2002-28; Section 6; Example 16: Same as in Example 15, except that Taxpayer does not replace the roof until January 2002, Year 2, and is not paid until March 2002, Year 2. Because the shingles are not used until 2002, Year 2, the cost of the shingles can only be deducted on Taxpayer's 2002, Year 2, federal income tax return notwithstanding that Taxpayer paid for the shingles in

2001, Year 1. Thus, on its 2002, Year 2, return, Taxpayer must report $15,000 of income and $5,000 of deductions.

(7) Contractors Building Property to Sell on Land They Own and Rev. Proc. 2002-28

A contractor who meets the requirements of Rev. Proc. 2001-10 or Rev. Proc. 2002-28 is permitted to use the cash method of accounting. However, these revenue procedures do not apply to a contractor to the extent it enhances the value of land it owns by building structures it intends to sell. Such contractors are not permitted to immediately deduct the costs of this construction. The taxpayer must capitalize these costs and they become real property as the taxpayer completes. The taxpayer will eventually offset these costs against the sales price of the land and its improvements.

Internal Revenue Code § 263(a) (1) and Treas. Reg. § 1.263(a)-1 prohibits deductions for any amount that a taxpayer pays for new buildings or for permanent improvements or betterments that increase the property's value. Treasury Regulation § 1.263(a)-2 sets forth examples of capital expenditures, including the cost of acquisition, construction, or erection of buildings. Consequently, the taxpayer-contractor must capitalize expenses connected with real property construction on its own land, including construction of property that it intends to sell.

The purpose of Rev. Proc. 2001-10 and Rev. Proc. 2002-28 is to provide qualifying small taxpayers an exception to the required accrual method under IRC § 446 when IRC § 471 requires the taxpayer to account for inventory. However, a taxpayer-contractor building on his own land for the purpose of selling the property constructed is producing or constructing a real property asset that it cannot inventory. See *W.C. and A.N. Miller Development Company v. Commissioner* 81 T.C. 619 (1983); *Pierce v. Commissioner*, T.C. Memo. 1997-411 (1997); and Rev. Rul. 86-149, 1986-2 C.B. 67.

Revenue Procedure 2002-28, section 4.02, and Rev. Proc. 2001-10, section 4, provide inventory options that do not apply to expenses related to construction of taxpayer-owned real property. If the taxpayer has expenses related to inventory items that are not required to be capitalized and are not related to construction of taxpayer-owned real property, it can choose from the applicable inventory options.

The taxpayer can still use the overall cash method of accounting so long as it meets the definitions of a qualifying small taxpayer. Under the cash method of accounting, the taxpayer can deduct business

expenses that are not required to be capitalized, when it pays them, sells the expense items, or uses the items for the customer regardless of when they are accrued. Similarly, the taxpayer would recognize income upon receipt, subject to applicable special rules such as IRC § 1001, regardless of when the taxpayer accrues the income.

Example:

Rev Proc 2002-28; Section 6; Example 17 illustrates when a taxpayer-contractor must capitalize building costs that occur on its own land and are attributable to property that it holds for sale, rather than deducting or inventorying them. The taxpayer is eligible to use the cash method as described in this Rev. Proc. The taxpayer is a speculative builder of houses that are built on land it owns. In 2001, Year 2, the taxpayer builds a house using various items such as lumber, piping, and metal fixtures that it had paid for in 2000, Year 1. In 2002, Year 3, the taxpayer sells the house to a buyer. Because the house is real property held for sale by the taxpayer, the house and the material used to build the house are not inventory items under this Rev. Proc. Thus, the taxpayer may not account for the items used to build the house as non-incidental materials and supplies under Treas. Reg. § 1.162-3. Rather, the taxpayer must capitalize the costs of the lumber, piping, metal fixtures and other goods used by the taxpayer to build the house under IRC § 263. Upon the sale of the house in 2002, Year 3, the costs capitalized by the taxpayer will be offset against the house sales price to determine the taxpayer's gain or loss from the sale.

Example:

Guidance on the timing of deductions for inventory items treated as non-incidental materials and supplies is provided under Rev. Proc. 2002-28; Section 6; Example 18 which emphasizes the importance of determining the ownership of the property that the taxpayer builds.

Same as in Example 17, except that (1) Taxpayer builds houses on land its customers own, and (2) the houses are built in three months with payment due at completion. Because Taxpayer does not own the house, the lumber, piping, metal fixtures and other goods used by the taxpayer in the provision of construction services are inventory items, not real property held for sale. Taxpayer elects to treat the goods used to build the house as non-incidental materials and supplies under Treas. Reg. § 1.162-3. Taxpayer must deduct the cost of the lumber, piping, metal fixtures and other non-incidental materials and supplies that are used by it to build the house in 2001, Year 2, (the year those items were used by the taxpayer to build the house) notwithstanding that Taxpayer had paid for the items in 2000, Year 1. Taxpayer will

report income it receives from its customer as the income is actually or constructively received.