TAX COURT CLARIFIES COMPLETED CONTRACT ACCOUNTING METHOD

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As Yogi Berra once famously said, "It ain't over 'til it's over." This is often paramount in the construction industry when taxable income must be realized upon the completion of work.

In a recent case involving builders of a planned residential community, the taxpayers contended that "completion and acceptance" under the regulations didn't occur until the last road was paved and the final bond was released. The IRS did not agree, arguing that the test was met after the sale of each home. The U.S. Tax Court ruled in favor of the builders. (*Shea Homes, Inc. and Subsidiaries, 142 TC No. 3*)

TAX LAW BACKGROUND

A contract is deemed to be long-term if the manufacture, building, installation, or construction of property is not completed in the tax year when the contract is signed. Your firm generally is required to account for long-term contracts using the percentage-of-completion method, realizing income over time (see right-hand box).

Under the rules for long-term contracts, completion occurs on the earlier of:

1. The time when the subject matter is used by the customer for its intended purpose and you have incurred at least 95 percent of the total allocable contract costs, or

2. When there is final completion and acceptance.

With the completed contract method, you don't report income until you finish a contract, although you receive payments in years before then. The date of completion is determined without regard to whether any secondary items have been used or finally completed and accepted.

The completed contract method may be used instead of the percentage-of-completion method in two situations:

1. Home construction contracts, and

2. Other real property construction contracts if you:

- Estimate that the contracts will be completed within two years of the start date, and
- Meet a $10 million gross receipts test.

FACTS OF THE RECENT CASE

Several related limited partnerships -- including Shea Homes Limited Partnership, J F Shea Limited Partnership and Vistancia -- worked together in developing large, planned residential communities in Colorado, California and Arizona. They developed the land and built homes and common improvements, including amenities. For the years at issue, the businesses used the completed contract method to report income from the sale of homes.

Under the businesses interpretation of the completed contract rules, contracts were completed when they met the use and 95 percent test. The partnerships contended that final completion and acceptance did not occur until the last road is paved and the final performance bond required by state and municipal law was released.

The IRS, on the other hand, maintained that the subject matter of the contracts consisted only of the houses and the lots they were built on and that common improvements in the development were secondary items that did not affect completion of the contract.

According to the agency, the contract for each home met the final completion and acceptance test upon the close of escrow for the sale of each home. The IRS also contended that these contracts, which were entered into and closed within the same tax year, were not long-term contracts.

TAX COURT RULING

The Tax Court sided with the businesses, ruling that they could report income and losses using their interpretation of the accounting method. The court also held that the subject of the

A TALE OF TWO METHODS

Here's a brief comparison of the two accounting methods for long-term contracts by construction firms:

1. Percentage-of-completion method: With this method, you record revenue, profits and expenses as they occur. Also, you must recognize income each year during the project as a percentage of the completed contract. The main advantage is that you don't have to wait until the project is complete to receive compensation.

2. Completed contract method: Because the firm doesn't pay tax on any income until the project is complete, this method results in a deferred tax liability. However, any tax breaks are also delayed until completion. This deferral of tax payment and corresponding tax benefits can have a positive or negative impact on working capital. Consider all the implications before deciding to use this method.

contracts was the home and the larger development, including amenities and other common improvements.

The court reasoned that the primary subject of the contracts included the house, the lot, improvements to the lot, and common improvements to the development. Because these amenities were crucial to the sales effort, obtaining government approval for the development and affecting buyers' purchasing decisions, they were an essential element of the home sales contracts.

The court also noted that the companies expended a great deal of capital early in the projects. Land acquisition costs alone were a large percentage of the total development cost. Before the first home was even built the developers incurred many up-front costs for grading the land, installing sewer, water, gas, electric, and other utilities, and constructing roads, in addition to entitlement and bond costs. Because these were long-term projects – and given the nature of the home construction industry -- costs were difficult to predict. The businesses could not accurately determine their profit until the development was nearly completed.

The exception for builders under the long-term contract rules reflects a deliberate choice by Congress that home construction contracts should be afforded generous tax deferral under the completed contract method. This is a clear reflection of Congressional intent, the court said.

Finally, the Tax Court agreed with the companies that homebuyers were "consciously purchasing more than the bricks and sticks of the home." They were purchasing a lifestyle and understood that the price they paid included amenities.

Bottom line: It may be wise to reevaluate your company's long-term development contracts. Your firm may benefit from using the completed contract method allowing for the maximum deferral of taxes. However, that can result in having substantial income bunched in one year if multiple jobs are completed in that year, triggering a higher tax rate. Consult with your tax advisor for the best approach your firm should take.

The regulations define a home construction contract as one where 80 percent or more of the estimated total contract costs is reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of dwelling units contained in buildings containing four or fewer dwelling units, and to improvements to real property directly related to the dwelling units. ©2014

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