

## Market Segment Specialization Program



# Construction Industry

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# CONSTRUCTION INDUSTRY

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## **Chapter 1**

### **INTRODUCTION TO THE CONSTRUCTION INDUSTRY**

#### **INTENDED AUDIENCE**

This Market Segment Specialization Program Guide is intended to be used by examiners conducting audits in the construction industry and as information for taxpayers and practitioners associated with the construction industry. Review of this guide is recommended prior to initiating an audit. Examiners should augment these guidelines by researching specific tax issues and new tax law.

#### **THE CONSTRUCTION INDUSTRY AS A MARKET SEGMENT**

The construction industry represents a large segment of the total economy. Over a million companies ranging in size and speciality make the construction industry one of the largest of all industries. Businesses in the construction industry interact with businesses in related industries that supply materials, equipment, financing, and bonding to the construction contractor. Each business is dependent on one another for their survival.

In 1992, over 2.4 million returns with construction income were filed in the United States reporting gross receipts of \$661.2 billion. Individual Forms 1040 Schedule C, represented 1.9 million or 79 percent of total construction industry filings and \$96.6 billion (14.6 percent) of the total reported gross construction receipts. Corporate filings were 417,250 or 17.4 percent of total construction filings and were responsible for over \$534 billion (87.7 percent) of the reported gross receipts.

#### **PARTICIPANTS IN THE CONSTRUCTION INDUSTRY**

There are numerous participants that take part in the construction process. Each participant plays a distinct role in the process. The key participants will be discussed briefly in this introduction.

##### **Contractors**

Contractors perform the construction work in accordance with the plans and specifications provided by the owner. In general, contractors are required to be licensed by state law under separate classifications (plumbing, electrical, general building, etc.).

## **General/Prime Contractors**

A general building 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. Generally the general contractor subcontracts out a substantial part of the work, while maintaining overall control through project managers and onsite supervision. The general contractor can be any size and any form of entity, that is, sole proprietorship, partnership, or corporation. The general contractor may utilize specialty subcontractors or can perform any portion of the work. Generally contractors must be licensed. If the contractor is a corporation or partnership, an officer or partner must be licensed.

## **Construction Managers**

Generally, the construction manager does not perform construction work on projects, but is an agent for the owner. The construction manager may be engaged 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.

## **Commercial Contractors**

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: Shopping centers, restaurants, grocery stores, etc.
- \* Rental Facilities: Office Building, Industrial Parks, Apartments, etc.
- \* Business Locations: Company Headquarters, Manufacturing Plants, Insurance Companies, etc.
- \* Municipal Buildings: City Halls, Prisons, Schools, Hospitals, etc.
- \* Special Projects: Amusement Parks, Race Tracks, Coliseums, Churches, etc.

A distinction is made between the residential and commercial contractor. A residential contractor specializes in single family homes, duplexes, etc. The residential contractor usually builds for resale to one or more individual homeowners. A commercial contractor constructs nonresidential buildings such as office buildings, warehouses,



shopping centers, and so forth.

### **Commercial Project Owners**

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 many not have an ownership interest in the project.

The contractor may own a percentage interest in one of the following ways:

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

### **Residential Construction Developer**

The examination of residential developers is different than the examination of a contractor who builds in accordance with a contract between himself or herself and an owner. The developer is generally the owner of the residential development as well as the builder. The developer acquires land, obtains approval, secures construction financing, and begins construction of the residential development in stages or phases of construction. The initial phase is sold and the construction process begins on the next phase. This process requires that the builder allocate a per-unit cost to each unit sold. 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) must be matched 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. During periods of low interest rates residential construction usually booms, while high interest rates cause the market to recede.

### **Subcontractors**

The largest number of taxpayers in the Construction Industry are specialty subcontractors. They can range from one-man operations to nationwide, publicly traded corporations, or divisions of larger corporations. Over 80 percent of the

construction returns filed are Schedule C returns. Subcontractors are distinguished from the general contractor by the limited scope of their work which usually involves a special skill, knowledge, or ability.

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. The general contractor, not the owner of the property, will usually pay the subcontractors. Materials purchased by the subcontractors are generally delivered directly to the job site. The subcontractors' work may be completed in stages or it may be continuous.

### **Highway Contractors**

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.

### **Heavy Construction Contractors**

Heavy construction contractors require large and complex mechanized equipment, such as cranes, bulldozers, pile drivers, dredges, and pipelaying 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. Most industrial plants are classified in this category because of the complexity of the work. The largest engineering and construction firms are included in the heavy construction classification.

### **Architect/Engineers**

The architect or engineer designs the plans to be used by the construction contractors. The plans provide the necessary detail (dimensions, materials to be used, location of fixtures, etc.) to the contractors. When the project is started the architect/engineer may monitor the contractor's progress and often approve progress payments to the contractors. The architect/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. Change orders can also be issued by the contractors under the terms of the contract.

## **Material Suppliers**

Material suppliers provide the raw materials used in the construction project. Material supplies are purchased by the subcontractors and installed by them in accordance with their contract. General contractors often write joint checks to subcontractors and material suppliers to ensure that all parties have been properly paid. Materials are generally delivered directly to the job site and are direct job costs, which are not normally inventoried by the contractor. In some situations the contractor will maintain inventories of miscellaneous yard stock frequently used.

## **Construction Lenders**

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. Construction period interest (referred to as "soft costs") paid to lenders must be capitalized by the owner during the construction period. Interest and other loan costs are often, taken directly from the loan principal as a result of the institutions interest provisions. 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 loan is generally secured by the land and construction in progress. When construction is completed, the owner will secure permanent long-term financing.

## **Surety Companies**

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. Bid bonds guarantee that the contractor will sign the contract after it is awarded and furnish the necessary performance and payment bonds within a specified time. Contractors must submit detailed financial data to the surety company to secure a bond. Financial statements prepared in accordance with generally accepted accounting principles (GAAP) are often furnished to the surety 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. Personal financial statements are often required to be supplied from officer shareholders.

## **Multiple Roles**

Each of the above participants can and often do have multiple roles in the construction process. For example, the owner could also be the general contractor (builder/developer). The general contractor in addition to providing supervision may

also do specialty work that would typically be subcontracted (for example, concrete work). Construction lenders frequently hold an equity position in a development partnership in order 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. The auditor should thoroughly understand each participant's role in order to determine whether the transactions have received the proper tax treatment.

## **THE CONTRACTING PROCESS**

When the owner determines that the project is feasible and that construction financing is available, the owner 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. The notice will provide the contractors with the procedures to be followed in submitting a bid. The bidding contractor obtains a copy of the plans and specifications from the owner to prepare for 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. The owner evaluates the submitted bids and will award the contract to the successful bidder. The contract document contains the contract amount, project start/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.

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, working up the total cost of 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 actual expenditures are measured. 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. You may see situations where a contractor might pursue a "break-even" bid to generate enough cash flow to meet payroll, etc., particularly in recession periods.

Subcontractors bid jobs in much the same way as a general contractor. The general

contractor solicits bids from subcontractors in the various trades.

### **Scheduling Subcontractors**

It is the general contractor's job to schedule the subcontractors so the construction runs smoothly and is completed on schedule. The various specialty areas include, but are not limited to, the following:

1. Clearing the land, which may include demolition of existing structures
2. Excavating the land, which may include digging holes and leveling
3. Pouring the foundation
4. Steel and/or wood framing
5. Rough framing
6. Rough electrical
7. Wood or concrete flooring
8. Roofing
9. Heating and air conditioning
10. Ductwork for the heating and air conditioning
11. Installing elevators and/or escalators
12. Installing sprinklers and other safety equipment
13. Installing electrical fixtures
14. Insulating and weather-stripping
15. Framing window and door sashes
16. Installing tile and marble
17. Installation of suspended acoustic ceilings
18. Installing toilets, sinks and other plumbing fixtures
19. Painting walls, inside and out
20. Laying carpet and other floor coverings
21. Clean up

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.

### **CONTRACT INCOME**

Most companies use a standard construction contract. The most important information contained in the contract is the amount the general contractor will be paid and how often he or she will be paid. 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. The owner may have a supervisor at the site who confirms the contractor has completed the work for which he has billed.

The contract may also include provisions for retainages, which are usually kept by the general contractor until the project is complete. Retainages are usually 10 percent of the total due to the subcontractors. Depending on the subcontractor's method of accounting, the retainages may be reportable as income when accrued, or when received. (Cash or Accrual).

## **TYPES OF CONTRACTS**

### **Long-Term Contracts**

Long-term contracts are defined in IRC section 460(f)(1) as any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.

### **Short-Term Contracts**

Short-term contracts are contracts started and completed within the taxpayer's taxable year. For short-term contracts, construction costs are treated as current period costs under all methods of accounting.

### **Fixed Price or Lump Sum Contracts**

A fixed price or lump sum contract states that the contractor will complete the project for an agreed upon price despite unforeseen costs that might exist during the construction phase. Most fixed price contracts in reality provide for some variations for economic price adjustments, incentives, etc. If there are any modifications to the original contract, change orders are executed which often increase or decrease the contract amount.

### **Cost-Plus Contracts**

Cost-plus contracts stipulate that the contract amount will be the cost of the construction project plus a fee. The fee may be earned in various ways. A fixed fee is generally earned 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 project comes in under budgeted cost.

## **Time and Material Contracts**

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.

## **Unit Price Contracts**

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 unit-price method is generally used where the number of units required has not been determined when the contract is bid.

## **Change Orders**

Change orders can be initiated by the contractor or the owner. A change order modifies the original contract and either increases or decreases the contract costs and/or contract price.

## **BONDING**

Owners often require the general contractor to be bonded. In these cases the general contractor is required 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.

A general contractor's bonding capacity is based their financial statements and past performance. A bond request will be denied if it exceeds their the bonding capacity. A contractor may leave what appears to be an unusually large amount of cash in the company to increase his or her bonding capacity. This should be considered when determining whether or not accumulated earnings tax is applicable.

The following types of bonds are available:

1. **BID BONDS:** provide for payment to the owner of the difference between the bid that is accepted and the next lowest bid if the general contractor with the accepted bid fails to enter into a contract.
2. **CONTRACT BONDS:** indemnify the owner against the failure of a general contractor to comply with the requirements of a contract.

3. **PERFORMANCE or COMPLETION BONDS:** Guarantee completion of the project by the general contractor.
4. **LABOR and MATERIAL PAYMENT BONDS:** Guarantee the owner that all costs of labor, material, and supplies incurred by the general contractor in connection with the project will be paid, thus voiding mechanics' liens.
5. **MAINTENANCE BONDS:** Guarantee the owner against defects in workmanship and are usually one year in duration.
6. **SUBCONTRACTOR 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.

State and Federal contracts usually require surety bonds. In other cases, collateral bonds in which the contractor pledges real or personal property as collateral in value equivalent to the contract price, are used.

When a performance bond is defaulted, it is not unusual for the insurer or bonding company to hire the defaulted contractor to complete the job. 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.

## **BUILDING PERMITS**

Before construction can begin on a project the necessary building permits must be received from the appropriate municipality. The specifications and blueprints of the project are turned into the Building Department, along with an application for a permit. It can take a period of time for a permit to be issued because the approval process may be quite involved, especially in the case of new construction. The general contractor or owner may have to submit results of soil testing, environmental impact studies, and any other information required. Sometimes a public hearing is mandated if there is opposition to the project, but in most cases the permit is issued within a few months. The cost of the permit may be the responsibility of the general contractor or the owner may directly pay for the permit and any related studies.

Construction projects follow the standards of the Uniform Building Code. A Building Inspector inspects the project at various stages to verify the project is being constructed according to Code.



## **NOTICE OF COMPLETION**

Once the building is completed a Notice of Completion is requested. The project must then pass a final inspection. Once the project passes final inspection, a Notice of Completion is issued by the municipality along with a Certification of Occupancy. These documents are recorded at the office of the local recorder. At this point the property is appraised for property tax purposes. As a source of information, several appraisals are made throughout the construction process that may be helpful for timing or allocation issues.

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## Chapter 2

### SMALL CONTRACTORS

#### LONG-TERM CONTRACTS

IRC section 460 and Treas. Reg. section 1.451-3 provide rules governing the accounting treatment of long-term contracts. A long-term contract is defined in IRC section 460(f) as a contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which the contract is entered into. IRC section 460 is effective for long-term contracts entered into after February 28, 1986. IRC section 460 generally requires the use of the percentage of completion method or the percentage of completion -- capitalized cost method.

There are, however, certain exceptions to IRC section 460 for construction contracts. See IRC section 460(e). There is an exception for home construction contracts (IRC section 460(e)(1)(A)) and there is an exception for small construction contractors (IRC section 460(e)(1)(B)). Contractors meeting these exceptions may apply the pre-section 460 rules contained in Treas. Reg. section 1.451-3. These contractors, therefore, may use the cash method (if available), the accrual method, the percentage of completion method, or the completed contract method.

In order to meet the small construction contractor exception contained in IRC section 460(e)(1)(B), there are two requirements. First, the contractor must estimate (at the time the contract is entered into) that the contract will be completed within 2 years after the contract commencement date. Second, the contractor's average annual gross receipts for the 3 tax years preceding the tax year in which the contract is entered into must be \$10 million or less. The discussion of this chapter largely presumes that the contractor at issue qualifies under IRC section 460(e)(1)(B) as a small construction contractor. As a small construction contractor, Treas. Reg. section 1.451-3 provides the applicable accounting rules for the contractor's long-term contracts.

#### CASH METHOD

A contractor using the cash method reports revenue when it is actually received or constructively received. Contractors may not defer income by having the owner delay payment. Revenue includes advance payments received. Contract job costs are deductible in the year paid unless they should be taken in a different period in order to clearly reflect income. IRC section 448 requires many contractors to use an accrual

method of accounting, such as straight accrual, completed contract method or percentage of completion method. Other limitations exist as discussed below.

### **ACCRUAL METHOD**

Accrual method contractors should recognize income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. section 1.451-1(a). Ordinarily, the contractor's right to income is fixed under the all events test when either the amount is unconditionally due or the contractor has performed. The general rule is that accrual basis contractors record income when it is received, due, or earned, whichever occurs first. See for example, *Schulde v. Commissioner*, 372 U.S. 128, 133 n.6; Rev. Rul. 84-31, 1984-1 C.B. 127, 128.

Accrual method contractors are entitled to treat expenses as incurred when all events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy. IRC section 461(h)(1), however, provides that the all events test shall not be treated as met any earlier than when economic performance with respect to the item occurs. In the case of services and property provided to the contractor, economic performance occurs as the services and property are provided.

Taxpayers using the accrual method may make an election to exclude retentions until billable. Rev. Rul. 69-314, 1969-1 C.B. 139.

### **PERCENTAGE OF COMPLETION METHOD**

The percentage of completion method (PCM) under Treas. Reg. section 1.451-3 (which applies to small contractors) differs significantly from the percentage of completion method under IRC section 460 (which applies to large contractors). The rules for large contractors are addressed in Chapter 3.

The percentage of completion method recognizes income as work on the contract progresses. The amount of gross income reportable each year is that portion of the gross contract price that represents the percentage of the entire contract completed during the year. The determination of the percentage of completion on a contract under the regulations may be made using either of the following methods:

#### **Cost Comparison Method**

The cost comparison method involves the comparison as of the end of the taxable year

between the costs incurred with respect to each contract and the estimated total contract costs for each contract. A taxpayer using the cost comparison method may use any method of cost comparison to determine the percentage of completion on a contract, as long as the method is used consistently with respect to that contract and the method clearly reflects income. The most common methods used include:

1. Contract costs to total estimated contract costs
2. Direct labor costs to total estimated direct labor costs.
3. Direct labor hours to total estimated direct labor hours.

All contract costs are currently deductible under the percentage of completion method. Materials and supplies on hand at the end of the taxable year must be inventoried if the sale of these materials and supplies is deemed to be an income-producing factor. See Treas. Reg. section 1.446-1(a)(4)(i).

### **Work Comparison Method**

The work comparison method compares, as of the end of the taxable year, the work performed on the contract with the estimated total work to be performed. Examples of this method include measuring output based upon units produced or delivered, phases completed, or value added. The method used must clearly reflect the earnings from the contract. The work comparison method may not be used by taxpayers falling under IRC section 460. These taxpayers must use the cost-to-cost method described above.

### **COMPLETED CONTRACT METHOD**

Under the completed contract method (CCM), income or loss is reported on a contract by contract basis in the year in which a contract is completed and accepted. Treas. Reg. section 1.451-3(b)(2). A contractor may not delay the completion of a contract for the principal purpose of deferring federal income tax. An anticipated loss on a contract cannot be deducted in advance of completion.

Any item of income or deduction with respect to an amount reasonably in dispute is taken into account in the taxable year in which such dispute is resolved. Treas. Reg. section 1.451-3(d)(2)-(4).

The capitalized cost rules for completed contract taxpayers are contained in Treas. Reg. section 1.451-3(d)(5). Appendix B is a flowchart comparing the various sections dealing with contract cost capitalization. Production period interest must also be

capitalized in accordance with IRC section 263A(f). IRC section 263A(f) rules are discussed in Chapter 4.

## **CASH VERSUS ACCRUAL**

### **General Background**

The cash v. accrual accounting method issue as it relates to the construction industry, especially small general and subcontractors (that is, electricians, plumbers, drywallers, bricklayers, carpenters, HVAC installers, etc.), is to be analyzed by examiners. Generally, merchandise is an income producing factor in these types of business activities; therefore, generally, they should be using an accrual method of accounting for items affecting gross income from the trade or business. See Treas. Reg. section 1.446-1(a)(4)(i) and (c)(2)(i).

The examiner, however, must be aware that the cash receipts and disbursements method is a permissible method of accounting. For example, when merchandise is not an income producing factor the cash method may be appropriate. Absent inventory accounting requirement (that is, where merchandise is not an income producing factor) factors, such as, the presence of accounts receivable, steadily increasing accounts receivables, and lack of financial statement conformity are NOT to be used as a basis to disallow the cash method of accounting.

Further, be aware that the regulations pursuant to IRC section 446 allow a "hybrid" method of accounting. Treas. Reg. section 1.446-1(c)(1)(iv) indicates that any combination of permissible methods of accounting can be used with a trade or business if such combination clearly reflects income and is consistently used. For example, a taxpayer using an accrual method of accounting with respect to purchases and sales of inventory may use the cash method in computing all other items of income and expense if this hybrid method clearly reflects income and is consistently used.

Be aware that a taxpayer's books and records can be on the accrual method of accounting and the tax return can be reported on the cash method of accounting as long as there are proper reconciling entries. The Service has ruled that a taxpayer could satisfy the book conformity requirement by using reconciling entries to convert accrual books to the cash method. See Revenue Rulings 68-35, 1968-1 C.B. 190, and 74-383, 1974-2 C.B. 146.

### **When the Accrual Method Should Be Required**

Generally, the cash to accrual accounting method change issue should be raised by the examiner when the production, purchase, or sale of merchandise is an income producing factor.

The first step in determining whether merchandise is an income producing factor is to analyze what items are considered to be merchandise. Items are considered merchandise if they are transferred to a customer or are physically incorporated in that which is transferred to a customer. The bricks, cement, drywall, electrical supplies, and wood provided by bricklayers, driveway pavers, drywall installers, electricians, and carpenters, respectively, are items of merchandise.

The second step is to determine when merchandise is an income producing factor. Several recent court decisions involving contractors and the cash to accrual method change issue provide us with examples of the type of analysis needed to determine when merchandise is an income producing factor. These court decisions have concluded that the Service properly exercised its discretion to require taxpayers that provide both services and merchandise to change from the cash to an accrual method of accounting. *Thompson Electric, Inc. v. Commissioner*, T. C. Memo. 1995-292; *Independent Contracts, Inc. v. United States*, 73 A.F.T.R. 2d. (RIA) 94-1406 (N.D. Ala. 1994), *aff'd per curiam*, 74 A.F.T.R. 2d. (RIA) 94-7135 (11th Cir. 1994); *J. P. Sheahan Associates, Inc. v. Commissioner*, T.C. Memo. 1992-239.

The starting point for determining whether or not merchandise is an income producing factor is to analyze the cost of materials as a percent of gross receipts. Although this percentage in the *Thompson Electric* case was over 30 percent, an earlier court decision, *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo. 1969-79, *aff'd.*, 420 F.2d 352 (1st Cir. 1970), involving the providing of caskets in combination with funeral services indicated that approximately 15 percent was considered to be an income producing factor. Accordingly, there is authority that merchandise is an income producing factor if the material cost as a percentage of gross receipts (under the cash method) is 15 percent or more.

Generally, the information needed to make the materials to gross receipts computation is found in the (cash basis) income statement of the tax return and the cost of goods section on the tax return. The computation is made by taking the total yearly cost of materials purchased that are considered merchandise as the numerator and using total yearly gross receipts on the cash method as the denominator. The resulting ratio (percentage) is used to determine if merchandise is an income producing factor. Care must be used to not include in the computation the cost of items (for example, labor or overhead) that are not merchandise.

#### **Requirement for the Accrual Method When Merchandise Is an Income Producing Factor**

When the taxpayer's materials are merchandise and the merchandise is an income producing factor, the taxpayer is required to use an inventory accounting method pursuant to Treas. Reg. section 1.471-1. Accordingly, the taxpayer must use an

accrual method of accounting for determining items of gross income pursuant to Treas. Reg. section 1.446-1(c)(2)(i).

### **What Happens if There Is No Beginning or Ending Inventory Amounts or if Inventory Is Sold at Cost**

Treas. Reg. sections 1.446-1(a)(4)(i) and 1.471-1 provide that the use of an inventory accounting method is required in every case in which the sale of merchandise is an income producing factor. The fact that the use of an inventory accounting method may result in inventory balances that are zero or minimal is irrelevant. See *J.P. Sheahan Associates, Inc., supra*. In addition, it does not matter if the inventory (merchandise) is sold at cost. See *Wilkinson-Beane, Inc. v. Commissioner, supra*.

### **Can a Taxpayer Use Both the Cash and Accrual Method for the Same Trade or Business**

Generally, if the facts are similar to the *Thompson Electric, Inc.* case, the taxpayer must use an accrual method of accounting for all items of gross income from its contracting business activities. Taxpayer's "sale" of contracting services and materials used for those services are not separable for purposes of deciding which accounting method may be used.

### **What if Business Activity Includes Long-Term Construction Contracts**

If the taxpayer's business activity includes "long-term" construction contracts and the taxpayer is not required to use IRC section 460, the taxpayer can elect to use any accrual method of accounting (that is, percentage of completion, completed contract, full accrual, etc.). Of course, the method elected must clearly reflect income. During an examination, if it is necessary to change from the cash method of accounting, the taxpayer should be requested to elect an accrual method. If such elected accrual method clearly reflects income, use that method in the RAR. If the taxpayer is not in agreement that its cash method should be changed to any accrual method, document that fact, and place the taxpayer on full accrual in the RAR.

### **Is IRC section 448 a "Safe Harbor" to Use the Cash Method**

IRC section 448 does not authorize the taxpayer to use the cash method of accounting when such cash method does not clearly reflect income. Basically, the cash method does not clearly reflect income when the taxpayer's method does not comport with the provisions of Treas. Reg. sections 1.471-1 and 1.446-1(c)(2).



### **The Importance of the *Thompson Electric, Inc.* Case**

In most circumstances the fact pattern as developed in the *Thompson Electric, Inc.* case will be present. Accordingly, it is recommended that the factual development of the issue be patterned after the *Thompson Electric, Inc.* case (that is, presentation of Facts and Tax Law and Conclusions). For example, information about the acquisition and distribution of materials and billing practices should be fully developed. See full text of *Thompson Electric, Inc.* case.

### **What Is the Impact of the *Ansley-Sheppard-Burgess Company*, 104 T. C. 367 (1995)**

Examiners should be aware that the Tax Court in *Ansley-Sheppard-Burgess Company*, 104 T.C. 367 (1995), decided that a general contractor was not required to use an accrual method of accounting. The court found that the taxpayer did not maintain an inventory and held that the cash method was proper and clearly reflected the taxpayer's income. Further, the court indicated that the Commissioner cannot require a taxpayer to change from an accounting method that clearly reflects income to an alternative method of accounting merely because the Commissioner considers the alternate method to more clearly reflect income.

Taxpayers' representatives are using this court decision to justify the cash method of accounting for contractors. *Ansley-Sheppard* does not stand for the proposition that for all general contractors, merchandise is not an income producing factor. The examiner must establish the fact that merchandise is an income producing factor in order to distinguish the situation under examination from the *Ansley)Sheppard* case fact pattern. Therefore, examiners need to explain in the RAR that in their situation merchandise is an income producing factor to distinguish the *Ansley)Sheppard* case.

Generally, if a general contractor enters into transactions with several subcontractors (that is, bricklayers, carpenters, electricians, etc.), what is being purchased is merchandise and services. So, when the general contractor enters into a transaction with its customer (to pass along what was obtained from the subcontractor), what is being billed to its customer is merchandise and services. Accordingly, even for a general contractors merchandise can be an income producing factor.

### **Effect of *Galedridge Construction, Inc.***

Examiners should be aware of the Tax Court's recent decision in *Galedrige Construction, Inc. v. Commissioner*, T.C. Memo. 1997-240. In *Galedrige*, the Tax Court held that emulsified asphalt is not merchandise in the hands of a paving contractor. The asphalt had to be laid within 2 to 5 hours from the time it was picked up from the supplier and the taxpayer did not have the capability to extend the time

the asphalt was in an emulsified state. The court concluded that the ephemeral quality of the emulsified asphalt precluded a finding that the asphalt is merchandise. The court distinguished *Asphalt Products Co. v. Commissioner*, 796 F.2d 843 (6th Cir. 1986), on the grounds that it maintained an inventory of raw materials and had a fixed production plant with large tanks in which it was able to preserve the emulsified state of its finished product. The court also distinguished *Knight-Ridder Newspaper, Inc. v. United States*, 743 F.2d 781 (11th Cir. 1984), on the ground that the taxpayer maintained an inventory of raw materials.

The rationale and holding of *Galedrige* are inapplicable beyond the narrow facts of the case. For example, in the Tax Court's recent decision in *Tebarco Mechanical Corporation v. Commissioner*, T.C. Memo 1997-311, the court held that a mechanical subcontractor that provides plumbing, heating, and air conditioning installation is required to maintain inventories. Although the taxpayer ordered most of its materials on a job-by-job basis and had the materials delivered directly to the job-site, the court concluded that, under state law, the taxpayer acted as a buyer pursuant to the contract with its supplier and as a seller pursuant to the contract with the general contractor. The court also emphasized that the taxpayer kept some materials on hand in a warehouse, that the cost of the materials was the most significant factor used in computing its bid, and that the costs of the materials represented 33 percent of its gross receipts. See also *Independent Contracts, Inc. v. United States*, 94-1 U.S.T.C. Paragraph 50,135 (N.D. Ala. 1994), *aff'd per curiam*, 40 F.3d 390 (11th Cir. 1994); *Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970); *McGrath v. United States*, 549 F.Supp. 491 (S.D.N.Y. 1982); *Thompson Electric, Inc. v. Commissioner*, T.C. Memo. 1995-292; *Surtronics, Inc. v. Commissioner*, T.C. Memo. 1995-277; and *J.P. Sheahan Associates, Inc. v. Commissioner*, T.C. Memo. 1992-239.

### **What Is the Substantial Identity of Results Test (SIRT)**

This is a court-imposed test which compares taxable income that was used on the return and the taxable income computed using the Commissioner's proposed method. The court has indicated where the Commissioner has determined that the accounting method used by a taxpayer does not clearly reflect, in order to prevail, the taxpayer must demonstrate substantial identity of results between his or her method and the method selected by the Commissioner. *Asphalt Products Co. v. Commissioner*, 796 F.2d 843, 849. A taxpayer that is required to use the inventory method of accounting must meet the substantial identity-of-results test to show that the Commissioner's determination requiring a change in its method of accounting was an abuse of discretion. *Ansley-Sheppard-Burgess Co. v. Commissioner*, 104 T.C. at 377.

The RAR should not address the SIRT unless the taxpayer has protested the findings based upon the SIRT.

## **General Guidelines for Examiners**

### **Taxpayers Under Examination**

Taxpayers should be made aware that the Service is going to raise the cash v. accrual method issue in fact patterns similar to the *Thompson Electric, Inc. v. Commissioner*, *Independent Contracts, Inc. v. United States*, and *J. P. Sheahan Associates, Inc. v. Commissioner* court cases.

Generally, examiners should conclude that merchandise is an income producing factor when material costs as a percentage of gross receipts (on cash method) is 15 percent or more. The 15 percent ratio is not absolute; depending on facts and circumstances, the issue could be raised when ratio is less than 15 percent.

As soon as possible in the examination process the taxpayer should be advised (preferably in writing) that a cash to accrual accounting method change is being raised. The examiner should simultaneously advise the taxpayer that Revenue Procedure 97-27 may be available for the taxpayer to request a method change.

### **Taxpayers Under Examination and Requesting to Use Rev. Proc. 97-27**

Rev. Proc. 97-27, 1997-21 I.R.B. 10, provides the general procedures under IRC section 446(e) and Treas. Reg. section 1.446-1(e) for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes. The revenue procedure provides incentives to encourage prompt voluntary compliance with proper tax accounting principles. Under this approach, a taxpayer generally receives more favorable terms and conditions (for example, a later year of change and a longer IRC section 481(a) adjustment period for a positive adjustment) if the taxpayer files its request for change in accounting method before the taxpayer is contacted for examination. A taxpayer that is contacted for examination and required to change its method of accounting by the Service generally receives less favorable terms and conditions and may also be subject to penalties.

A taxpayer that is under examination may only request a change in accounting method during specified window periods (or with the district directors's consent). A taxpayer under examination may request a change in accounting method during the first 90 days of any taxable year ("90-day window") if the taxpayer has been under examination for 12 consecutive months as of the first day of the taxable year. A taxpayer under examination may also request a change in accounting method during the 120-day period following the date an examination ends ("120-day window") regardless of whether a subsequent examination has commenced. The 90-day and 120-day windows are not available if the method of accounting the taxpayer is requesting to change is an issue the examining agent has placed in suspense or is an issue under consideration at the time the request is filed.

A taxpayer filing a Form 3115 during one of the window periods is required to pay a user fee (\$900 for taxpayers with gross receipts of \$150,000 or more and \$500 for taxpayers with gross receipts of less than \$150,000). The year of change is the taxable year in which the Form 3115 is filed. The IRC section 481(a) adjustment period is generally 4 taxable years.

If a taxpayer under examination is not eligible to request an accounting method change under Rev. Proc. 97-27, the change may be made by the examiner. A change resulting in a positive adjustment will ordinarily be made in the earliest taxable year under examination with a 1-year IRC section 481(a) adjustment period.

### **Summary of Guidelines for Examiners**

In summary, the examiner can use these broad guidelines to determine if and how the cash v. accrual method issue should be raised in the construction business environment. No absolute dollar criteria relative to the proposed effect on taxable income is being recommended in determining when the issue should be raised. The examiner should use her or his professional judgment as to when the issue should be raised. However, the cash v. accrual issue should be raised only when there is specific tax law authority in the statute, regulations, Service pronouncements or court cases. The examiner must be aware that the cash method of accounting is a permissible method in the Code and regulations.

## **ALTERNATIVE MINIMUM TAX**

Many contractors who are exempt from IRC section 460 must compute alternative minimum taxable income using the percentage of completion method (PCM) cost-to-cost method. Generally these rules apply to small commercial contractors because contractors with home construction contracts are exempt. The adjustment to PCM for AMT purposes is also subject to look-back rules. This subject is discussed in Chapter 3 in detail.

## **POTENTIAL ISSUES AND AUDIT TECHNIQUES**

### **Obtaining Audit Information**

Taxpayers records are occasionally inadequate and/or unorganized. They may be adequate to carry on daily business operations but not for auditing purposes. In the case of a contractor, there are frequently sufficient records to establish an audit trail. The easiest way to determine the information to request from the contractor is to have a clear understanding of how the taxpayer conducts his or her business and how he or she keeps his or her records.

It is generally necessary to inspect documents from a prior tax year. Normally this does not constitute an examination of the prior year tax return.

### **Information Retained by a Contractor**

The contractor will usually maintain all or some of the following:

1. A copy of the contract with the owner
2. A copy of the formal bid and budget estimates
3. Bonding information
4. Contracts with subcontractors
5. Change orders with subcontractors and owner
6. Bills received from the subcontractors
7. Lien releases from subcontractors
8. Billings to owner
9. Invoices of other costs and materials
10. Correspondence with the owner, subcontractors, and city/county officials
11. Loan agreements and monthly statements
12. Notice of completion
13. Financial statements (submitted for loan and bonding purposes).

If the examiner is informed that critical information is not being made available, a summons should be considered.

### **Information Filed by Job**

Most contractors maintain accounting records by job. The job file will contain all documents relating to each specific job. If he or she pays an invoice that affects more than one job, a copy will often be placed in the second job file.

## **Information Filed by Vendor/Payee**

In the case of a contractor who keeps his or her files by vendor or payee, his or her records will look like those in most other audits and can be requested and sampled in much the same way as any other audit.

## **Income Recognition Issues**

Improper use of the cash, accrual, and completed contract methods by contractors required to report under IRC section 460 (although this chapter generally deals with small contractors meeting the IRC section 460(e)(1)(B) exception).

Improper computation of the \$10,000,000 average annual gross receipts for small contractors under IRC section 460.

Improper use of the cash method by contractors who carry inventory or where sales of merchandise are a significant income producing factor, which requires the use of an accrual method of accounting under IRC section 446.

Netting of gross receipts to avoid the \$5,000,000 limitation on the use of the cash method under IRC section 448, by "C)Corporations."

Improper computation of the contract amount in percentage of completion computations. Failure to include change orders.

Improper computation of the total estimated contract costs in percentage of completion computations, such as overstated estimates, inclusion of nondeductible costs, and allowances for contingencies.

Improper recognition of losses on contracts in progress when contractor is on the completed contract method. Contract improperly severed into two or more contracts to accelerate recognition of losses on contracts in progress.

Improper deferral of income under the completed contract method. Failure to close a contract when it meets the "final completion and acceptance standard." Treas. Reg. section 1.451-3(d)(2),(3), and (4). Improper aggregation to subsequent contracts. Treas. Reg. section 1.451-3(e).

Improper expense recognition under the completed contract method by allocating costs from contracts in progress to completed contracts.

## **Income Omission Issues**

Failure to report interest income earned on funds such as retainages, deposits, 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.

Failure to include claim revenue (to the extent of claim expenses) in total estimated contract price when using the percentage of completion method.

## **Audit Techniques for Income Issues**

The examiner's initial focus should be to determine the proper method of accounting. The initial interview is critical in establishing what type of construction is involved, how the contractor accounts for income, construction costs, work in process, and duties and responsibilities of key personnel.

The flow charts and definitions in Appendix A are applicable to general contractors, developers, and home builders. The flow chart includes the factors in IRC section 460, Treas. Reg. section 1.451-3, and IRC section 263A. The charts are presented in a question and answer format. They will direct you to the correct accounting method. The charts will alert you to any applicable special rules such as production period interest, look-back or alternative minimum tax.

## **Underreported Income**

Smaller contractors, not faced with bonding or similar requirements for financial statements and performance verification, may report income for only a portion of their work, for example, limiting income to the amount reported on Form 1099. Some contractors have been willing to work for 20-25 percent less on the condition that no Form 1099 be issued. This has an adverse affect on the industry as well as the IRS. 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 records information and life-style/assets to gain a reasonable assurance as to the economic reality of reported income.

## **Miscellaneous Construction Issues**

### **Personal Use**

Small contractors may incur expenses for improvements to a personal residence. These expenses are frequently expensed through cost of sales along with other third party contract costs. If the taxpayer is a corporation and the expenses are incurred to improve a shareholder's residence a potential dividend issue exists, and the expenses are not deductible. If improvements are made to an employee's residence then a possible employment tax issue exists.

### **Unreasonable Compensation**

Officer/owner compensation often fluctuates significantly. An argument may be made that the compensation is due to artificially low compensation in earlier years. This argument may be valid and will be sustained where the early years of the operation were used to build up capital. However, if the operation is well established and the profits of a high volume year are being reduced through high compensation, the examiner should seriously consider raising the issue.

### **Double Deductions**

Double deductions can 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 auditor should be alert to the potential abuses that may occur.

### **Deducting Unpaid Interest Expense**

For a contractor on the cash method of accounting, interest expense on a construction loan is not deductible until it is paid. A construction loan differs from a conventional loan in that a construction loan usually does not require interim payments. Even the loan origination fees may be financed. These expenses are not deductible until the payments are made. The loan documents should be examined to determine the terms for principle and interest payments as well as the actual payments made during the year. *Heyman v. Commissioner*, 70 T.C. 482 (1978), *aff'd*, 652 F.2d 598 (6th Cir. 1980).

### **Other Compensation Income**

A contractor may receive an interest in a project for his or her services. Inspecting the contractor's partnership returns will frequently reveal an interest in a construction project. Review electronic databases (that is, LEXIS, etc.) for public records. The



contract between the owner and the general contractor will often specify what the general contractor will receive in lieu of cash payment. IRC section 83.

### **Delayed Billings**

Depending on the method of accounting, the contractor may delay billings and/or receivables in an effort to defer reporting of gross receipts. The auditor might consider selecting a sample of jobs and inspecting 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 cutoff.

### **Abandonment Losses**

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 an intent to abandon the asset and make some affirmative act of abandonment. The loss is deductible in the year the abandonment is sustained with regard to nondepreciable property.

In general, abandonment losses occur with "spec" home builders, real estate developers, and related party entities more frequently than with other types of contractors. Some reasons for abandonment losses are due to lack of financing, bonding, disapproval of zoning changes, cost overruns or, in the case of related parties, possible tax avoidance.

### **Anticipated Losses**

For financial reporting purposes (ARB 45), contractors are required to recognize the full amount of any anticipated loss in the current period, regardless of degree of completion in which the loss becomes evident. For tax reporting purposes, loss accruals are not allowed. The losses are not recognized until they are incurred.

### **Bad Debt/Forgiveness of Indebtedness Income**

The typical bad debt issue must be reviewed when there are related party transactions involved. If one party has a legitimate bad debt, the other related party should have forgiveness of indebtedness income. Bad debts are deductible under IRC section 166. Forgiveness of indebtedness is income pursuant to IRC section 108. Be aware that the bankruptcy rules may be involved with regard to recognizing forgiveness of indebtedness income. Net operating losses may have to be reduced if the bankruptcy laws apply. Bad debts require an inquiry into the following:

1. Whose debt is it?

2. Business or nonbusiness?
3. Have the funds actually been transferred or were there only adjusting journal entries?
4. Has interest been charged and reported?
5. Are there documents to support the transactions?

### **Accumulated Earnings Tax**

In general, construction entities in activity code 219 and below are closely-held corporations, which are more likely to accumulate earnings and profits beyond the reasonable needs of the business for the purpose of avoiding income taxes on its shareholders.

The following information is included to assist an examiner in determining whether, during an examination of a construction company, an accumulated earnings tax issue may exist. See IRC section 531. For a discussion of the general audit techniques on accumulated earnings tax, see IRM 4233, Chapter 600.

In considering whether an IRC section 531 issue exists, examiners are advised to employ the Bardahl, Mead or similar method used in determining reasonable business needs. For use in an examination of a construction contractor a modified Bardahl formula is normally more appropriate due to taxpayers construction in-process inventory and unusual billing practices. In addition, the construction business is normally seasonal in nature. An example of this modified Bardahl formula can be found in *Ready Paving and Construction Co. v. Commissioner*, 61 T.C. 826 (1974).

In considering whether or not 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 assure adequate bonding capacity.

It is customary in the area in which the corporation conducts its business that, in order for a general contractor to have its bid considered, it must submit a bid bond and qualify for a performance bond equal to the amount of the contract. To obtain a bid bond and qualify for a performance bond a rule of thumb adopted by most companies in the surety industry is that net liquid assets (or working capital) should be at least 10 percent of the work program contemplated, expressed in dollars. For example, \$100,000 of working capital would qualify for a work program of \$1,000,000, including both the unfinished work on hand at the time of the bid and the amount of the bid, provided other related factors such as the contractor's reputation, credit rating, general experience, organizational set-up etc., are acceptable. In addition, bonding

companies generally require contractors and subcontractors to have exceptional financial strength before granting bonds without personal indemnity.

Surety companies normally set different bonding capacity standards for subcontractors due to their greater risk. Subcontractors are normally limited to six and one-half to seven times their working capital. Performance bonds may be waived by the owner. Performance bonds are normally required on government contracts.

When considering reasonable needs of a construction contractor, an examiner should consider the amount of working capital needed to satisfy the contractor's bonding needs. Information from the bonding company should be secured reflecting the bonding capacity of the contractor. This information can then be used to determine if the taxpayer has accumulated earnings beyond the reasonable needs of the business.

### **SCHEDULE M-1 ADJUSTMENTS**

M-1 Adjustments have the tendency to understate income and assets under the theory of conservatism.

Schedule M-1 adjustments result from timing differences and permanent differences between financial accounting and tax accounting. Timing differences arise when the time of recognizing items of income and expense differs for financial and tax purposes. Permanent differences arise when items of income or expense are included for financial purposes but excluded for tax purposes (or vice versa).

Although many M-1 adjustments of contractors are similar to those of any taxpayer, certain adjustments are unique due to the nature, cause, and magnitude of those adjustments. Some of the most common adjustments found in a contractor's tax returns are:

1. Differences in percentage of completion method for financial statement income and another method for tax purposes. If a taxpayer does not use the percentage of completion method for tax purposes (uses percentage of completion-capitalized cost method, completed contract, accrual, or cash) timing differences occur. Prior to the enactment of IRC section 460, taxpayers typically reported financial accounting income under the percentage of completion method and used the completed contract method for tax purposes to achieve the maximum deferral possible.
2. Differences between the method of computing percentage of completion for financial accounting purposes and for tax purposes. Taxpayers can use the percentage of completion for both book and tax purposes however the method

used to compute the degree of completion may vary, which will result in different income figures.

- a. Certain general and administrative expenses incurred by the taxpayer must be allocated to the contract for tax purposes but not for book purposes.
  - b. Taxpayers must use the cost-to-cost method to determine the percentage of completion for tax purposes but may use engineering estimates for book purposes.
  - c. Uninstalled materials must be excluded from job costs for book purposes, but can be included for tax purposes.
  - d. The simplified cost-to-cost method for tax purposes may be different from the cost-to-cost method used for book purposes.
3. Differences in Accounting for Depreciation. Contractors typically have a large investment in construction equipment.
  4. Differences Caused by Loss Accruals. Under generally accepted accounting principles taxpayers will recognize loss on construction contracts in the period the loss becomes evident. For tax purposes losses are not recognized until they are incurred, no loss accruals are allowed.
  5. Differences in Accounting for Investments. Contractors frequently invest in joint ventures, partnerships, and corporations. The method of accounting for income or loss from these investments can be different for book and tax purposes.

## Chapter 3

### LARGE CONTRACTORS

#### LONG-TERM CONTRACTS UNDER IRC SECTION 460

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, or percentage of completion method. Many contractors adopted the completed contract method for tax purposes because they could defer taxes until the completion of the contract.

The Joint Committee on Taxation conducted a study on the effective tax rates of selected large corporations during 1983. The study concluded that selected corporations were deferring large amounts of income tax by using the completed contract method of accounting. Results of the study formed a basis for some of the tax law changes enacted by the Tax Reform Act of 1986. Section 804 of the Act introduced IRC section 460, Special Rules for Long-Term Contracts, effective for contracts entered into after February 28, 1986 (with a phase-in period). IRC section 460 generally requires the use of the percentage of completion method (as revised) or prior to September 30, 1990, the percentage of completion capitalized cost method. Additionally IRC section 460 introduced the "Look-back Method." The look-back method requires certain taxpayers to pay additional interest or receive a refund of interest when a long-term contract is completed.

#### Definition of Long-Term Contracts

IRC section 460 defines the term "long-term contract" as follows:

In general, a long-term contract is any contract for the manufacture, building, installation, or construction of property if the contract is not completed within the taxable year in which it is entered into.

The definition under IRC section 460 includes a provision that requires manufacturing contracts to use long-term contract treatment if the contract meets the requirements of IRC section 460(f)(2) discussed below. A contract for the production of personal property is generally considered a contract for the manufacture of property. A contract for the production or installation of real property or any improvements to real property is considered a contract for the building, installation, or construction of property.

## **Contracts Subject to IRC Section 460**

Under IRC section 460 taxpayers must use the percentage of completion method (PCM), by comparing the current years actual costs with the estimated total contract costs to determine the degree of completion. Engineering estimates or other approaches to determine the degree of completion may not be used. A Simplified Method under IRC section 460(c)(3) which considers only certain costs, can be used in some situations.

## **Contracts Exempt from IRC Section 460**

IRC section 460(e) provides that the percentage of completion rules under IRC section 460 do not apply to:

1. Home construction contracts (IRC section 460(e)(1)(A)) entered into after June 20, 1988. Home construction contractors not meeting the small contractor exception (discussed below) are required to capitalize costs using IRC section 263(a). See the flowchart in Appendix A.
2. Small construction contracts require that:
  - a. At the time the contract was entered into, it was estimated that such contract would be completed within a 2-year period beginning on the commencement date of such contract; and
  - b. The contractor's average annual gross receipts for the 3 taxable years preceding the year in which such contract was entered into did not exceed \$10 million.

Long-term contracts exempted from IRC section 460 must account for these contracts under Treas. Reg. section 1.451-3: General Rules for Long-Term Contracts, which allows the percentage of completion method, completed contract method, cash method (if allowed under IRC section 448), or the accrual method.

## **Ten Percent Election**

After July 10, 1989, the taxpayer may elect under IRC section 460(b)(5) to defer recognition of revenue until 10 percent of the total costs are incurred and allocated. This election is unavailable if the taxpayer elected to use the simplified method for allocation of costs under IRC section 460(b)(3), or who are exempt under IRC section 460(e).

After October 13, 1987, residential construction contracts are the only contracts that

may remain on the percentage of completion capitalized cost method (70 percent PCM and 30 percent method used prior to February 28, 1986, see IRC section 460(e)(5) and Notice 89-15 Q&A 14-18).

### **Gross Receipts Test**

In determining the taxpayer's gross receipts for the 3 taxable years preceding the year in which the contract was entered into, the gross receipts from the following must be considered:

- a. All trades or businesses (whether or not incorporated) which are under common control with the taxpayer (within the meaning of IRC section 52(b)).
- b. All members of any controlled group of corporations of which the taxpayer is a member, and
- c. Any predecessor of the taxpayer or a person described in (A) or (B) above.

### **Explanation of a Controlled Group**

Two or more corporations whose stock is substantially held by five or fewer persons. 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 (income/deduction matching and loss deferrals on sales between members). See Treas. Reg. section 1.451-3(b)(3)(iii)(C)(3).

### **Determining Degree of Contract Completion**

There are two methods of determining the degree of contract completion. They are the cost-to-cost method and the simplified cost-to-cost method.

#### **Cost-To-Cost Method**

The cost-to-cost method of determining the degree of contract completion is computed by dividing the total cumulative costs incurred by the estimated total contract costs.

$$\frac{\text{Total Cumulative Costs Incurred to Date}}{\text{Estimated Total Contract Costs}} = \text{Percent Complete}$$

### **Example 1**

Corporation A previously determined the degree of contract completion by comparing at the end of the taxable year the work performed with the estimated total work to be performed (the engineering cost method).

For contracts entered into after February 28, 1986, Corporation A may only use the cost-to-cost method of determining the degree of contract completion.

### **Simplified Cost-To-Cost Method**

The Service issued Notice 87-61, 1987-2 C.B. 370, which provides an elective simplified cost-to-cost method for determining the degree of contract completion for taxpayers using the percentage of completion method of accounting as modified by IRC section 460 for long-term contracts.

Under the simplified cost-to-cost method, only the following costs are used in determining the percentage of completion:

1. Direct material costs and direct labor costs as described in Treas. Reg. section 1.451-3(d)(6)(i)
2. Depreciation, amortization, and cost recovery allowance on equipment and facilities directly used to construct or produce the subject matter of the long-term contract (Notice 89-15, Q & A 22-23).

The simplified method may be used by the following taxpayers:

1. Taxpayers using the percentage of completion method for all items under all long-term contracts in a particular trade or business
2. Taxpayers using the percentage of completion capitalized cost method that properly use the cash method as their normal method of accounting.

A taxpayer using the simplified cost-to-cost method must 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.

### **Revenue Earned Allocation Rules**

The amount of revenue earned each year by a contract is determined by multiplying the estimated total contract price times the percentage of completion at the end of the tax year less any income recognized in the prior tax years of the contract.



$$\begin{array}{rcccl} \text{Estimated} & & \text{Percentage} & & \text{Prior} & & \text{Current} \\ \text{Total Contract} & \times & \text{of} & - & \text{Year} & = & \text{Years} \\ \text{Price} & & \text{Completion} & & \text{Income} & & \text{Revenue} \end{array}$$

**Example 2**

Calendar-year Corporation X uses the percentage of completion method of accounting as modified by IRC section 460 for long-term contracts. Corporation X entered into a qualified long-term contract in August 1986, that will be completed in August 1990. The total estimated cost at completion is \$40 million and the estimated contract price is \$50 million.

The cost incurred and allocated to the contract was \$4 million in 1986 and \$10 million in 1987.

Cost-to-Cost Method	<u>1986</u>	<u>1987</u>
Cumulative Costs	\$ 4,000,000	\$14,000,000
	-----	-----
Total Estimated Costs	\$40,000,000	\$40,000,000
Percent Complete	10%	35%
Profit & Loss	<u>1986</u>	<u>1987</u>
Earned Revenue:		
(\$50M x 10%)	\$ 5,000,000	
[((\$50M x 35%) - \$5M)]		\$12,500,000
Cost incurred	\$ 4,000,000	\$10,000,000
	-----	-----
Gross profit	\$ 1,000,000	\$ 2,500,000
	=====	=====

**Allocation of Cost to Long-Term Contracts**

IRC section 460(c)(1) provides that all costs that are incurred for reason of a long-term contract or directly benefit the long-term contract activities of the taxpayer shall be allocated to such contract in the same manner as costs are allocated to extended period long-term contracts under Treas. Reg. section 1.451-3.

The cost allocation rules for extended period long-term contracts under current Treas. Reg. section 1.451-3(d)(6) pertain to direct materials, direct labor, and indirect costs.

### **Direct Material Costs**

All direct material costs which become an integral part of the subject matter of a long-term contract and all materials that are consumed in the ordinary course of building, constructing, installing, or manufacturing the subject matter of a long-term contract shall be allocated to such contract. (Treas. Reg. section 1.451-3(d)(6)(i)).

The elements of direct material costs include the invoice price less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the goods.

### **Direct Labor Costs**

All direct labor costs that can be identified or associated with a long-term contract shall be allocated to such contract. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

### **Indirect Costs**

All indirect costs incurred for reason of a long-term contract or that directly benefit the long-term contract must be allocated unless otherwise provided in the regulations. Indirect costs include all costs other than direct material costs and direct labor costs.

Some indirect costs may benefit both the long-term contract activity of the taxpayer and other business activities of the taxpayer. Accordingly, these costs will require a **reasonable allocation** between the portion of the costs that are attributable to long-term contracts and the portion of the costs attributable to the other business activities of the taxpayer.

Indirect costs must be allocated to a long-term contract by either the specific identification (or tracing) method, or a method using burden rates, such as ratios based on direct cost, hours, or other items which results in a reasonable allocation of cost.

Under Treas. Reg. section 1.451-3(d)(6)(ii) the indirect costs that must be allocated to particular long-term contracts that they benefit include:

1. Repairs of equipment or facilities.
2. Maintenance of equipment or facilities.
3. Utilities, such as heat, light, and power, relating to equipment or facilities.

4. Rent of equipment or facilities.
5. Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan.
6. Indirect materials and supplies.
7. Tools and equipment not capitalized.
8. Cost of quality control and inspection.
9. Taxes otherwise allowable as a deduction under IRC section 164 (other than state, local, and foreign income taxes) to the extent such taxes are attributable to labor, materials, supplies, equipment or facilities.
10. Depreciation, amortization, and cost recovery allowances on equipment and facilities.
11. Depletion, whether or not in excess of cost.
12. **Administrative costs directly attributable to the performance of a long-term contract** but not including any cost of selling or any return on capital.
13. Direct and indirect costs incurred by any service, administrative, or support function to the extent such costs are allocable to a long-term contract pursuant to Treas. Reg. section 1.451-3(d)(9).
14. Officers compensation paid for services performed on long-term contracts but not including any cost of selling.
15. Insurance costs, such as insurance on machinery and equipment used in the construction of the subject matter of a long-term contract.
16. Stock bonus, pension, profit-sharing or annuity plan contributions or other plans deferring the receipt of compensation, whether or not the plan qualifies under IRC section 401(a), and other employee benefit expenses paid or accrued on behalf of labor, to the extent such contributions or expenses are otherwise allowable as deductions.
17. Research and experimental expenses as described in IRC section 174 and the regulations directly attributable to a long-term contract in existence at the time the expenses are incurred, or any expenses incurred under an agreement to perform

research or experimentation.

18. Rework labor, scrap and spoilage to the extent incurred in the performance of a long-term contract.
19. Bidding expenses incurred in the solicitation of a long-term contract awarded to the taxpayer. Bidding expenses do not include any research and experimental expenses described in IRC section 174. **The taxpayer shall defer all bidding expenses paid or incurred in the solicitation of a long-term contract until the contract is awarded.** If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs assigned to the contract. If the contract is not awarded to the taxpayer, bidding costs become deductible in the taxable year the contract is awarded, or the taxable year the taxpayer is notified in writing that no contract will be awarded and the contract will not be re-bid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first.

Interest expense incurred in connection with long-term contracts generally must be allocated to long-term contracts in the same manner as in IRC section 263A(f) dealing with interest cost being allocated to property not produced under a long-term contract (IRC section 460(c)(3)).

Pension expense that represents past service costs is subject to the cost allocation rules under IRC section 460(c) and the uniform capitalization rules of IRC section 263A, for cost incurred after December 31, 1987, with respect to contracts entered into after February 28, 1986, (The Revenue Act of 1987).

Treas. Reg. section 1.451-3(d)(9) requires the allocation of administrative, service, or support costs to extended period long-term contracts, if a function or department of the taxpayer incurs costs that directly benefit or are incurred by reason of the extended period long-term contract activities of the taxpayer, the costs of such function or department are allocable to such extended period long-term contracts.

#### **Extract**

##### **Treas. Reg. section 1.451-3(d)(9)**

(vi) *Illustration of types of activities with respect to which these costs ordinarily are required to be allocated.* Costs incurred by the following types of functions or departments ordinarily are required to be allocated to extended period long-term contracts:

(A) The administration and coordination of manufacturing or construction projects (wherever performed in the business organization of the taxpayer);

(B) Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records of employees whose labor cost is allocable to extended period long-term contracts;

(C) Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery and return of materials and equipment to or from factories or jobsites, and expediting and follow-up;

(D) Materials handling and warehousing operations;

(E) Accounting and data services operations related to contract activities, including cost accounting, accounts payable, disbursements, billing, accounts receivable, and payroll;

(F) Data processing;

(G) Security services; and

(H) Legal departments that provide legal services to contracts.

The regulations also provide illustrations of types of activities with respect to which costs ordinarily are not required to be allocated.

Treas. Reg. section 1.451-3(d)(6)(iii) -- provides that costs that are not required to be allocated to long-term contracts include:

1. Marketing, selling, and advertising expenses.
2. Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer.
3. Interest expense incurred that is not allocated to long-term contracts under IRC section 263A(f) rules dealing with production period interest.
4. General and administrative expenses (but not including any cost described above as administrative costs and direct and indirect costs incurred by any service, administrative, or support function) and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred for reason of any long-term contracts.
5. Research and experimental expenses as described in IRC section 174 and the regulations neither directly attributable to a long-term contract in existence at the time the expenses are incurred, nor any expenses incurred under an agreement to perform research or experimentation.
6. Losses under IRC section 165.

7. Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle. An asset is not considered to be temporarily idle on nonworking days. An asset used in construction is considered to be idle when it is not in route to or not located at a jobsite.
8. Income taxes attributable to income received from long-term contracts.
9. Contributions paid with respect to contracts entered into before March 1, 1986, under a pension or annuity plan under IRC sections 404 and 404A to the extent such contributions represent past service costs.
10. Costs attributable to strikes.

**Extract**

Treas. Reg. section 1.451-3(d)(9)(vii)

\* \* \* Costs incurred by the following types of functions or departments ordinarily are not required to be allocated to extended period long-term contracts:

(A) Functions or departments responsible for overall management of the taxpayer, or for setting overall policy for all of the taxpayer's activities or trades or businesses (such as, the board of directors (including their immediate staff), and the chief executive, financial, accounting and legal officers (including their immediate staffs) of the taxpayer, provided that no substantial part of the costs of such departments or functions directly benefit extended period long-term contracts);

(B) General business planning;

(C) Financial accounting (including the accounting services required to prepare consolidated reports, but not including any accounting for particular contracts);

(D) General financial planning (including general budgeting) and financial management (including bank relations and cash management);

(E) General economic analysis and forecasting;

(F) Internal audit;

(G) Shareholder, public and industrial relations;

(H) Tax department; and

(I) Other departments or functions that are not responsible for day-to-day operations but are instead responsible for setting policy and establishing procedures to be used by all of the taxpayer's activities or trades or businesses.

## Independent Research and Development Costs

The Act of 1986 added IRC section 460(c)(4) which states that independent research and development (IR&D) cost are specifically excepted from the long-term contract costs allocation rules. IR&D costs are expenses incurred in the performance of research or development which are not directly attributable to a long-term contract in existence when incurred or any expense incurred under an agreement to perform research or development. Any costs that qualify as independent research and development expenses under the Federal Acquisition Regulations System, 48 C.F.R. section 31.205-18 (1985) will be excepted from the long-term contract costs allocation rules.

## Special Rules for Cost-Plus and Federal Long-Term Contracts

The '86 Act added special costing rules that apply only to cost-plus and federal long-term contracts. In addition to the costing rules under IRC section 460(c)(1) as noted above, the taxpayer must also allocate to the contract any cost that is identified by the taxpayer (or a related person) pursuant to the terms of the contract or pursuant to federal, state, or local laws and regulations (Notice 89-15, Q & A 39).

### Example 3

General and administrative expenses identified pursuant to a cost-plus contract, or pursuant to a contract with a Federal agency in which costs are certified under Federal statute or regulations, must be capitalized, regardless of whether such costs may be treated as period costs under existing regulations.

### **COST TO COST EXAMPLE - WITH CHANGE ORDERS**

Contract price = \$1,000 Estimated contract cost = \$800

#### Year one

Actual cost = \$200  
Total est. cost = \$800 = 25% complete x \$1,000 = \$250 income

=====

Year two Change order, increase inc. \$400, increase cost \$200

Actual cost = \$ 600  
Total est. cost = \$1,000 = 60% x \$1,400 = \$840 - 250 = \$590 income

=====

Year three Change order, increase inc. \$100, cost \$50

Actual cost = \$1,050 Actual inc. \$1,500 - 840 = \$ 660 income

=====

\*\*\*\*\*

**LOOK-BACK WITH OUT ADJUSTMENTS**

**Year one**

Actual cost	<u>\$ 200</u>		
Total cost	\$1,050 = 19% x \$1,500	=	\$285(h)
Taxable inc. as last computed		=	<u>\$250</u>
Look-back inc. hypothetical adj.		=	\$ 35
			=====

**Year two**

Actual cost	<u>\$ 600</u>		
Total cost	\$1,050 = 57.1% x \$1,500 = 857 - 285	=	\$572(h)
Taxable inc. as last computed		=	<u>\$590</u>
Look-back inc. hypothetical adj.		=	\$ (18)
			=====

**COST TO COST EXAMPLE - WITH UP-FRONT ADJUSTMENT**

Bid & proposal - environmental - storage or some other type cost that is incurred up-front = \$50

**Year one adjustment**

Actual cost	= <u>\$250</u>		
Total est. cost	= \$850 = 29.4% x \$1,000 =	\$ 294 inc.	
Less income per return		<u>(250)</u>	
Year one adj.		\$ 44	
			=====

**Year two adjustment**

Actual cost	= <u>\$ 650</u>		
Total est. cost	= \$1,050 = 62% x 1,400 = \$868 - 294	=	\$ 574 inc.
Less income per return		<u>(590)</u>	
Year two adj.		\$ (16)	
			=====

**Year three adjustment**

Actual cost	= \$1,100	Actual inc. \$1,500 - 868	=	\$ 632 inc.
Less income per return				<u>(660)</u>
				\$ (28)
				=====

<b><u>Total adjustments:</u></b>	year one	\$ 44
	year two	(16)
	year three	<u>(28)</u>
		-0-



**LOOK-BACK WITH ADJUSTMENTS**

Computations only reflect changes in taxable income. You would still have to compute Hypothetical tax and then compute interest.

**Year one**

Actual cost as adj.	<u>\$ 250</u>		
Total cost	\$1,100	= 22.7% x \$1,500	= \$341 (h)
Taxable inc. as last computed			= <u>294</u>
Look-back inc. adj.			\$ 47
			=====

**Year two**

Actual cost as adj.	<u>\$ 650</u>		
Total cost	1,100	= 59.1% x \$1,500 = \$887 - 341	= \$546
Taxable inc. as last computed			= <u>\$574</u>
			\$ (28)
			=====

**COST TO COST WITH INDIRECT COST ADJUSTMENT**

Allocated indirect cost adjustment that is allocated to labor. Materials and Labor are 25 percent complete. Adjustment is \$50.

**Year one adjustment**

Actual cost	= \$ <u>250</u>	= 25%
Total est. cost	= \$1,000 (50 divided by 25% = 200 + 800)	

This is assuming that labor is tracking at same percent as the other contract cost.

If materials were an up-front cost and labor was only 15 percent complete the calculation would be.

**Year one adjustment**

Actual cost	= \$ <u>250</u>	= 22%
Total est. cost	= \$ 1,133 (50 divided by 15% = 333 + 800)	

If labor was an up-front cost and was 35 percent complete the calculation would be.

**Year one adjustment**

Actual cost	= \$ <u>250</u>	= 26.5%
Total est. cost	= \$ 943 (50 divided by 35% =143 + 800)	

For a general contractor, the most common scenario would be site preparation which would be mostly labor and equipment. Followed by delivery of a large portion of the materials. At the end of the project there would be clean-up cost, mostly labor.

For a subcontractor, other than site preparation and clean-up, the most common scenario would be delivery of a large portion of the materials followed by labor to install the materials.

The costs of direct materials and supplies that are purchased specifically for a particular long-term contract are allocable to the contract in the taxable year in which such costs are incurred. The costs of other direct materials and supplies (such as those previously held by the

taxpayer) are allocable to the contract in the taxable year in which such materials and supplies are dedicated to the contract. Examples of dedication include the following: (1) delivery of materials to a jobsite (if only one contract is being performed at that site); (2) association of materials with a specific contract (for example, by purchase order, entry on books and records, or shipping instructions); and, (3) if not previously assigned, the physical incorporation of the materials into the subject matter of the contract, or the consumption of the materials in the production of the subject matter of the contract. The cost that is allocated to a contract is to be determined using the taxpayer's method of accounting for such materials or supplies (for example, specific identification, FIFO, or LIFO) based on the taxable year in which such items are dedicated to the contract Notice 89-15, 1989-1 C.B. at 642, Q&A 35.

## **SEVERING OF CONSTRUCTION OR MANUFACTURING CONTRACTS**

### **Issue**

Whether a single long-term contract subject to IRC section 460 should be treated as more than one contract for the purpose of clearly reflecting income.

### **Facts**

In March 1986, a calendar year taxpayer (TP) engaged in the construction business and using the percentage of completion method enters into an agreement to construct an office building and a separate agreement to make tenant improvements to the building. TP treats these "back-to-back" agreements as one contract.

The amount attributable to the building and the amount attributable to the improvements are stated separately in the contract. The contract also states that full payment for the building shall be due and payable when completed and ready for occupancy. All retainage is to be paid at that time. The improvements are added as tenants are secured for the building, and the building owner pays TP as the improvements are completed.

TP realizes a 20 percent profit percentage on the building, a 12 percent profit percentage on the tenant improvements and, an 18 percent overall profit percentage. By combining the two agreements, a portion of the gain from the more profitable building project is deferred until construction of the tenant improvements takes place.

### **Law**

IRC section 460 applies to contracts entered into after February 28, 1986.

**Extract**

IRC section 460 (f)(3)

AGGREGATION, ETC.--For purposes of this subsection, under regulations prescribed by the Secretary--

(A) 2 or more contracts which are interdependent (by reason of pricing or otherwise) may be treated as 1 contract, and

(B) a contract which is properly treated as an aggregation of separate contracts may be so treated.

Notice 89-15, 1989-1 C.B. reads in part:

**Extract**

Notice 89-15, 1989-1 C.B.

\* \* \* \* \*

VIII. SEVERING AND AGGREGATION OF CONTRACTS

Q-37: What standards apply in determining whether an agreement should be treated as more than one contract ("severed"), or whether two or more agreements should be treated as a single contract ("aggregated") under section 460(f)(3)?

A-37: Except as provided in Q&A-38, the rules set forth in section 1.451-3(e) of the regulations apply in making this determination.

Q-38: May the taxpayer sever and aggregate contracts, or may such action be taken only by the Commissioner?

A-38: Under section 460(f)(3), a taxpayer is permitted and required to sever and aggregate contracts, notwithstanding the statement to the contrary in section 1.451-3(e)(1)(i)(C) of the regulations, which does not apply to contracts subject to section 460 and this Notice. Forthcoming regulations may require any taxpayer that severs or aggregates contracts under this Q&A-38 to attach a statement to its Federal income tax return for the first year in which it has entered into two or more agreements that are properly treated as a single contract, or a single agreement that is properly treated as more than one contract. If required, such a statement would describe the criteria used by the taxpayer in determining to sever or aggregate the agreements.

\* \* \* \* \*

Treas. Reg. section 1.451-3(e)(1) states in part:

**Extract**

Treas. Reg. section 1.451-3(e)(1)

*(e) Severing and aggregating contracts--(1) In general. (i)(A)* For the purpose of clearly reflecting income (e.g., to prevent the unreasonable deferral of recognition of income or the premature recognition of loss), it may be necessary in some instances for the Commissioner either to treat one agreement as several contracts or to treat several agreements as one contract.

\* \* \* \* \*

(ii) Whether an agreement should be so severed or several agreements so aggregated will depend on all the facts and circumstances. Such facts and circumstances may include whether there is separate delivery or separate acceptance of units representing a portion of the subject matter of the contract, whether such units are independently priced, whether there is no business purpose for one agreement rather than several agreements or several agreements rather than one agreement, and such other factors as customary commercial practice, the dealings between parties to the contract, the nature of the subject matter of the contract, the total number of units to be constructed, manufactured, or installed under the contract, and the contemplated time between the completion of each unit.

\* \* \* \* \*

(v) An agreement generally will be treated as several contracts where there is no business purpose for entering into one agreement rather than several agreements. A factor which may evidence that no such business purpose exists is that the agreement covers two or more subject matters, none of which readily can be determined to be the primary subject matter of the contract (within the meaning of paragraph (b)(2)(ii) of this section); such factor must be considered along with other factors indicating the presence or absence of business purpose.

\* \* \* \* \*

(2) Examples. The application of paragraph (e) of this section maybe illustrated by the following examples.

\* \* \* \* \*

Example (7). R, a calendar year taxpayer engaged in the manufacture of industrial machinery, enters into one agreement in 1982 with Z to manufacture five specialized machines and to manufacture spare and replacement parts for the machines. The machines are to be delivered in 1982 and 1983, and the spare and replacement parts are to be delivered in 1983 through 1985. The portion of the total contract price attributable to the five machines and to the spare and replacement parts reasonably can be determined. The portion of the total contract price reasonably attributable to the spare and replacement parts is more than an insignificant amount of the total contract price. Assume that, under all the facts and circumstances, it is determined that the

portion of the agreement attributable to the five machines need not be severed as between the machines. In these circumstances, because the agreement contemplates separate delivery of the machines and the parts, because more than an insignificant amount of the total contract price is allocable to the spare and replacement parts, and because spare or replacement parts are items different than an entire machine, it may be necessary for the Commissioner to sever the agreement, treating the agreement to manufacture the five machines as a separate contract and the agreement to manufacture the spare and replacement parts as another separate contract (or as several separate contracts depending on the facts and circumstances) for purposes of applying R's long-term contract method.

\* \* \* \* \*

### **Discussion**

For the purpose of clearly reflecting income, it may be necessary to treat one contract as more than one contract. The Commissioner will base his decision as to whether a construction or manufacturing contract should be severed on all the facts and circumstances of each case.

An agreement generally will be treated as several contracts where there is no business purpose for entering into one agreement rather than several agreements. With regard to severing or aggregating long-term contracts, the Court said in *Sierracin Corporation v. Commissioner*, 90 T.C. 341 (1988), *acq. in part, acq. in result in part*, 1990-2 C.B. 1: "Of all the facts and circumstances to be considered on this issue, special emphasis should be placed on independent pricing." 90 T.C. at 369 it stated further: "A subsequent revision of section 1.451-3(e), Income Tax Regs., underscores the importance of independent pricing."

In the instant case, the TP has a contract that covers two separate subject matters: (1) construction of an office building and (2) improvements to the basic office design if requested by the tenant. If the tenant wants anything other than the basic design, the cost would be negotiated with the building owner. The agreements contemplate independent pricing, separate acceptance, and independence with respect to all other standards enumerated in Treas. Reg. section 1.451-3(e)(1)(ii).

### **Recommended Position**

It is likely that TP would have entered into either of these agreements independent of the other. The price awarded for each agreement takes into account the expected total costs and risks for that agreement -- and only that agreement; the agreements should be severed and considered separate contracts.

## AGGREGATION OF CONSTRUCTION OR MANUFACTURING CONTRACTS

### Issue

Whether back-to-back long-term contracts subject to IRC section 460 should be treated as one contract for the purpose of clearly reflecting income.

### Facts

A calendar year taxpayer (TP) engaged in the manufacture of industrial machinery and using the percentage of completion method (PCM) enters into three contracts with P in March 1986. The items to be manufactured are unique and not normally included in TP's inventory. TP treats each contract separately for IRC section 460 reporting purposes. Contract 1 provides that TP will manufacture 10 highly specialized machines for delivery in 1987; contract 2 provides that TP will manufacture 25 of the specialized machines for delivery in 1988; and contract 3 provides for the delivery of an additional 30 of the specialized machines in 1989. The specifications for the 65 machines are similar.

Since TP has never manufactured this type of machine before, it is estimated that the costs incurred in producing the first 10 will be substantially greater than the costs incurred in producing the remaining 55. The first contract will likely result in little or no gain, while the second and third contracts will likely result in substantial profits.

### Law

IRC section 460 applies to contracts entered into after February 28, 1986. Refer to IRC section 460(f)(3) and Q & A 37 and 38 of Notice 89-15, 1989-1 C.B.

Reg. 1.451-3(e)(1) states in part:

#### Extract

Treas. Reg. section 1.451-3(e)(1)

*(e) Severing and aggregating contracts--(1) In general. (1)(A) For the purpose of clearly reflecting income (e.g., to prevent the unreasonable deferral of recognition of income or the premature recognition of loss), it may be necessary in some instances for the Commissioner either to treat one agreement as several contracts or to treat several agreements as one contract.*

\* \* \* \* \*

(ii) Whether an agreement should be so severed or several agreements so aggregated will depend on all the facts and circumstances. Such facts and circumstances may include whether there is separate delivery or separate acceptance of

units representing a portion of the subject matter of the contract, whether such units are independently priced, whether there is no business purpose for one agreement rather than several agreements or several agreements rather than one agreement, and such other factors as customary commercial practice, the dealings between parties to the contract, the nature of the subject matter of the contract, the total number of units to be constructed, manufactured, or installed under the contract, and the contemplated time between the completion of each unit.

\* \* \* \* \*

(vi) Several agreements generally will not be aggregated unless there is no business purpose for entering into several agreements rather than one agreement.

(vii) An example of a factor which is evidence that two agreements entered into between the same parties should be aggregated is that (without regard to the order in which the agreements were entered into or performed, and without regard to whether one of the agreements could actually be performed without the prior or contemporaneous performance of the other agreement) a reasonable business-person would not have entered into one of the agreement[s] for the terms agreed upon but for entering into the other agreement for the terms agreed upon in such other agreement (or for more favorable terms). See example (2) of paragraph (e)(2) of this section. An example of a factor that is not evidence that two agreements entered into between the same parties should be aggregated is that one of the agreements would not have been entered into containing the terms agreed upon but for the expectation that the parties would enter into the other agreement.

\* \* \* \* \*

(2) *Examples.* The application of paragraph (e) of this section may be illustrated by the following examples.

\* \* \* \* \*

*Example (2).* Y, a calendar year shipbuilder using a long-term contract method, enters into two agreements at about the same time during 1982 with M. These agreements are the product of a single negotiation. Under each agreement the taxpayer is to construct for M a submarine of the same class. Although the specifications for each submarine are similar, it is anticipated that, since the taxpayer has never constructed this class of submarine before, the costs incurred in constructing the first submarine (to be delivered in 1983) will be substantially greater than the costs incurred in constructing the second submarine (to be delivered in 1984). If the agreements are treated as separate contracts, it is estimated that the first contract could result in little or no gain, while the second contract would result in substantial profits. A reasonable business person would not have entered into the agreement to construct the first submarine for the price specified without entering into the agreement to construct the second submarine. In these circumstances, it may be necessary for the Commissioner to aggregate the two agreements for purposes of applying Y's long-term contract method.

\* \* \* \* \*

## **Discussion**

For the purpose of clearly reflecting income, it may be necessary to treat several contracts as one contract. The Commissioner will base his decision as to whether a construction or manufacturing contract should be aggregated on all the facts and circumstances of each case.

In the instant case, the items to be manufactured pursuant to contract 1 will generate little or no gain, whereas the items to be manufactured pursuant to contracts 2 and 3 will likely result in substantial gain. If the three contracts are treated as one, the combined gain will be reported ratably over the production period. However, if the PCM is applied separately to each contract, gain from the profitable contracts (2 and 3) will be deferred until after production of contract 1 has been completed.

Regarding the aggregation of separate contracts, the Court said in *Sierracin Corporation v. Commissioner*, 90 T.C. 341 (1988), *acq. in part, acq. in result in part* 1990-2 C.B. 1: "Of all the facts and circumstances to be considered on this issue, special emphasis should be placed on independent pricing." 90 T.C. at 369 reinforced this point as follows: "A subsequent revision of section 1.451-3(e), Income Tax Regs., underscores the importance of independent pricing." 90 T.C. at 369.

It is unlikely that TP would have entered into the first contract without the opportunity to enter into additional production contracts with greater profit potential. The decision to enter into contract 1 which has little, if any, expectation of profit is clearly tied to the other two contracts.

## **Recommended Position**

TP would not have entered into contract 1 without the understanding that additional production with greater profit potential would follow. The three contracts were not independently priced and should be treated as a single contract.

## **LOOK-BACK**

IRC section 460(b)(2) established the look-back method which provides that: in the taxable year in which the contract is complete, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if the actual cost and contract price, rather than anticipated contract price and cost, had been used to compute gross income. Interest must be paid by the taxpayer if there is an underpayment with respect to a taxable year under this "lookback" method and is paid to the taxpayer if there is an overpayment. The rate of interest for both overpayments and underpayments is the



overpayment rate under IRC section 6621, compounded daily. IRC section 460(b)(2); Treas. Reg. section 1.460-6.

The look-back method does not apply to any contract where the gross price does not exceed the lesser of \$1,000,000 or 1 percent of the average annual gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the contract was completed, and which is completed within 2 years of the contract commencement date.

The above de minimis test provides that: In the year the contract is complete, if the contract took more than 2 years (24 months) to complete, lookback is required. If a contract takes less than 2 years to complete and is less than the gross price or gross receipts test, look-back does not apply. Also see special alternative minimum tax rules later in this chapter. The look-back rules apply to all long-term contracts entered into after February 28, 1986, that use the percentage of completion method of accounting as modified by IRC section 460 or the 40-70-90 percentage of completion-capitalized cost method. Look-back applies only to the percentage of completion portion of the percentage of completion capitalized cost method.

### **Form 8697, Interest Computation Under the Look-Back Method for Long-Term Contracts**

A taxpayer must file a Form 8697 in each year it completes a long-term contract. In addition, a taxpayer generally must file a Form 8697 in each post-completion year that revenues or costs attributable to a long-term contract change. If the taxpayer was an owner of an interest in a partnership or an S-Corporation during any year in which long-term contracts were being accounted, Form 8697 must be filed for the tax year that ends with or includes the end of the entity's tax year in which the contract was completed.

Interest required to be paid on Form 8697 will be added to the tax on the income tax return and the Form 8697 will be attached to the income tax return. (Note: For a corporation the interest due would still be an interest deduction even though it is added to the total tax on the return). For an individual the interest is nondeductible personal interest. In cases where the taxpayer is entitled to receive interest, the Form 8697 must be filed separately.

Administrative procedures provide that Form 8697 is the required reporting format for the look-back method. Following are various reporting procedures which pertain to this form:

### **For Refunds**

When the Form 8697 is received in the service center and there is an overassessment (Form 8697 filed separately), a TY-32 Index Card is prepared (IRM 3(17)(46)6.1). The Form 8697 is non-master file (NMF); therefore, the agent will need a certified transcript of account when Form 8697 is examined. Transaction codes for refunds will not appear on a MFTRA transcript of account because they are non-master file. However, an agent can verify that a taxpayer filed a Form 8697 by using Form 4338 (Information or Certified Transcript Request). On the Form 4338, in the section for Non-ADP, (manually processed) line out the words "Unit Ledger Card: and insert "TY-32, Index Card." The MFT code is 69 and the activity code is the same as the return under audit. The DLN should be used if known; otherwise, leave it blank.

### **For Assessments**

In years beginning after December 31, 1991, a look-back interest indicator will appear on the transcripts of account. For years prior to January 1, 1992, the look-back assessments were non-master file and you must follow the same rules as for refunds.

### **Computation of the Look-Back Method.**

The look-back method is computed as follows:

1. In the taxable year a long-term contract is completed, recompute the income under the contract in all the taxable years before the year in which the contract is completed using the actual contract price and contract costs instead of the estimated contract price and contract costs.
2. Determine the overpayment or underpayment of tax for each taxable year based on No.1 above for the sole purpose of computing the interest under the look-back method.
3. Using the overpayment rate under IRC section 6621, compute the interest paid to or by the taxpayer based on the overpayment or underpayment of taxes determined in No. 2 above.
4. Rev. Proc. 95-17, 1995-1 C.B. 556, provides uniform tables and procedures for computing interest using the daily compounding rules under IRC section 6622.
5. Interest on amounts arising after December 31, 1982, are computed by using Tables 7-30 for non-leap years and Tables 31-54 for leap years as listed in the Rev. Proc. 95-17.

6. Since IRC section 6621 requires redetermination of the interest rate semi-annually, only the effective daily rates for 184 days are published in the tables.

**Special rule for computation of interest on look-back interest.** For each filing year, interest for look-back method purposes is compounded daily from the due date of the return for the redetermination year, not including extensions, until the due date of the completion year. Interest on look-back interest is paid, if the return is filed under an extension, from the due date of the completion year until the date filed. See Treas. Reg. section 1.460-6(c)(4)(iv). Treas. Reg. section 1.460-6(h)(9) example (8), is an illustration of how this computation is made. Interest is computed using the overpayment rate under IRC section 6621. Interest on look-back interest owed to the taxpayer does not start until after the Form 8697 is filed requesting the look-back interest overpayment.

**Special rules for subsequent (amended) filings of Form 8697.** Upon completion of a long-term contract, there are times on or after a taxpayer tenders the subject matter of a long-term contract to the party with whom he is contracting, when there exists an amount reasonably in dispute because such party wishes to have the original contract price reduced or to have additional work performed on the contract. In these cases, any item of income or deduction with respect to an amount reasonably in dispute shall be taken into account in accordance with the appropriate sections of Treasury Regulation 1.460-6. Subsequent Forms 8697 are in accordance with the appropriate sections of Treasury Regulation 1.460-6. Any year in which the look-back method must be applied is treated as a filing year.

The rules that should be addressed when auditing subsequent filing of Form 8697 are contained in the following regulations:

1. When a contract is considered complete. Treas. Reg. section 1.460-6(c)(1)(ii)(B).
2. Additional interest due on look-back interest only after tax liability due. Interest on hypothetical tax stops on filing date. If the return is filed under extension, interest is due on interest. See Exhibit 300-4, Treas. Reg. section 1.460-6(c)(4)(i).
3. Discounting rules. Must make election not to discount. Contract by contract election. Treas. Reg. section 1.460-6(c)(1)(ii)(C).
4. Revenue acceleration. Year following completion. All contracts with disputed items. Treas. Reg. section 1.460-6(c)(1)(ii)(D).
5. Delayed reapplication. Binding election constitutes an accounting method. Treas. Reg. section 1.460-6(e).

6. Simplified marginal impact method. Required for pass-through entities that are not closely held and elective for all other entities. Treas. Reg. section 1.460-6(d)(1).

### **Completed Contracts**

A contract is considered to be completed for purposes of the look-back method no later than the year in which final completion and acceptance within the meaning of Treas. Reg. section 1.451-3(b)(2) have occurred. Accordingly, determination of the completion year for any long-term contract is based on an analysis of all the relevant facts and circumstances, including the manner in which the parties to the contract deal with each other and with the subject matter of the contract and the nature of any work or costs remaining to be performed or incurred on the contract. Therefore, the first application of the look-back method must occur no later than the tax year in which the subject matter of the contract has been delivered and is available for use by the customer, even if the taxpayer reasonably expects at that time to incur additional allocable contract costs. Treas. Reg. section 1.460-6(c)(1)(ii)(B). Treas. Reg. section 1.451-3(b)(2) contains 4 examples of when a contract is complete.

### **Post-Completion Revenue and Expenses**

#### **Extract**

#### **Treas. Reg. section 1.460-6(c)(1)(ii)**

\* \* \* The look-back method is applied upon the completion of any long-term contract and (unless the taxpayer elects the delayed reapplication method of this section) is applied in any subsequent tax year for which there are taken into account any increases or decreases in either total contract price or total contract costs allocable to the contract under section 460(c) \* \* \* to the extent those increases or decreases were not previously taken into account under the percentage of completion method. Any year in which the look-back method must be reapplied is treated as a filing year. See Example (3) of paragraph (h)(4) for an illustration of how the look-back method is applied to post-completion adjustments.

This differs from Treas. Reg. section 1.451-3(d)(2)(ii) through (v) since IRC section 460 requires subsequent look-back computations for prior years. Where as Treas. Reg. section 1.451-3(d)(2) closes the contract and the taxpayer accounts for the disputed items in the year that the dispute is settled.

### **Discounting Rules**

To prevent any hardships from economic changes that may take place between the time that the contract was completed and the time the dispute is settled the regulations provide the following discount rules:

**Extract**

**Treas. Reg. section 1.460-6(c)(1)(ii)(C)**

\* \* \* \* \*

(1) \* \* \* The amount of any post-completion adjustment to the total contract price or contract costs is discounted, solely for purposes of applying the look-back method, from its value at the time the amount is taken into account in computing taxable income to its value at the completion of the contract. The discount rate for this purpose is the Federal mid-term rate under section 1274(d) in effect at the time the amount is properly taken into account. For purposes of applying the look-back method for the completion year, no amounts are discounted, even if they are received after the completion year.

(2) *Election not to discount.* Notwithstanding the general requirement to discount post-completion adjustments, a taxpayer may elect not to discount contract price and contract cost adjustments with respect to any contract. The election not to discount is to be made on a contract-by-contract basis and is binding with respect to all post-completion adjustments that arise with respect to a contract for which an election has been made. An election not to discount with respect to any contract is made by stating that an election is being made on the taxpayer's timely filed Federal income tax return (determined with regard to extensions) for the first tax year after completion in which the taxpayer takes into account (i.e., includes in income or deducts) any adjustment to the contract price or contract costs. \* \* \*

(3) *Year-end discounting convention.* In the absence of an election not to discount, any revisions to the contract price and contract costs must be discounted to their value as of the completion of the contract in reapplying the look-back method. For this purpose, the period of discounting is the period between the completion date of the contract and the date that any adjustment is taken into account in computing taxable income. Although taxpayers may use the period between the months in which these two events actually occur, in many cases, these dates may not be readily identifiable. Therefore, for administrative convenience, taxpayers are permitted to use the period between the end of the tax years in which these events occur as the period of discounting provided that the convention is used consistently with respect to all post-completion adjustments for all contracts of the taxpayer the adjustments to which are discounted. In that case, the taxpayer must use as the discount rate the Federal mid-term rate under section 1274(d) as of the end of the tax year in which any revision is taken into account in computing taxable income.

(4) The regulation requires discounting. Therefore, the taxpayer must make an election not to discount. Also, the election is a contract by contract election. The discounting rules only apply to the hypothetical computations for the purpose of calculating interest due or owed. A comparison of hypothetical computations using discounting vs. not discounting demonstrates that if income is received, discounting will reduce the amount of interest owed. Conversely, if expenses are paid, discounting will increase the amount of interest owed. For an excellent example of how discounting works, see Treas. Reg. section 1.460-6(h)(4) example (3). Note that the income is reported in the year it is received.

## **Revenue Acceleration**

### **Extract**

#### **Treas. Reg. section 1.460-6(c)(1)(ii)(D)**

\* \* \* for the tax year immediately following the year of completion, any previously unreported portion of the total contract price (including amounts that the taxpayer expects to receive in the future) must be reported in that year, even if the percentage of completion ratio is less than 100 percent because the taxpayer expects to incur additional allocable contract costs in a later year. At that time any remaining portion of the contract price is includible in income under this rule, no offset against this income is permitted for estimated future contract costs. To achieve the requirement to report all remaining contract revenue without regard to additional estimated costs, a taxpayer must include only costs actually incurred through the end of the tax year in the denominator of the percentage of completion ratio in applying the percentage of completion method for any tax years after the year of completion. The look-back method also must be reapplied for the year immediately following the year of completion if any portion of the contract price is includible in income in that year by reason of section 460(b)(1). For purposes of reapplying the look-back method as a result of this inclusion in income, the taxpayer must only include in the denominator of the percentage of completion ratio the actual contract costs incurred as of the end of the year, even if the taxpayer reasonably expects to incur additional allocable contract costs. To the extent that costs are incurred in a subsequent tax year, the look-back method is reapplied in that year (or a later year if the delayed reapplication method is used), and the taxpayer is entitled to receive interest for the post-completion adjustment to contract costs. Because this reapplication occurs subsequent to the completion year, only the cumulative costs incurred as of the end of the reapplication year are includible in the denominator of the percentage of completion ratio.

Revenue acceleration generates a look-back computation. The income is reported even if it was not received. If expenses are incurred, they are included in the look-back computation unless the delayed reapplication method is elected.

## **Delayed Reapplication**

### **Extract**

#### **Treas. Reg. section 1.460-6(e)**

For purposes of reapplying the look-back method after the year of contract completion, a taxpayer may elect the delayed reapplication method to minimize the number of required reapplications of the look-back method. Under this method, the look-back method is reapplied after the year of completion of a contract (or after a subsequent application of the look-back method) only when the first one of the following conditions is met with respect to the contract:

(i) The net undiscounted value of increases or decreases in the contract price occurring since the time of the last application of the look-back method exceeds the lesser of \$1,000,000 or 10 percent of the total contract price as of that time.

(ii) The net undiscounted value of increases or decreases in the contract costs occurring since the time of the last application of the look-back method exceeds the lesser of \$1,000,000 or 10 percent of the total contract price as of that time.

(iii) The taxpayer goes out of existence.

(iv) The taxpayer reasonably believes the contract is finally settled and closed.

(v) Neither condition (i), (ii), (iii) nor (iv) above is met by the end of the fifth tax year that begins after the last previous application of the look-back method.

### **Simplified Marginal Impact Method**

#### **Extract**

#### **Treas. Reg. section 1.460-6(d)(4)(i)**

\* \* \* \* \*

(A) \* \* \* The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S-Corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. For determining the amount of any hypothetical underpayment or overpayment, the applicable regular and alternative minimum tax rates, respectively, are generally the highest rates of tax in effect for corporations under IRC section 11 and section 55(b)(1). However, the applicable regular and alternative minimum tax rates are the highest rates of tax imposed on individuals under section 1 and section IRC 55(b)(1) if, at all times during the redetermination year involved (that is, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

(B) \* \* \* A pass-through entity is closely held if, at any time during any redetermination year, 50 percent or more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons. For this purpose, the term "person" has the same meaning as in section 7701(a)(1), except that a pass-through entity is not treated as a person. In addition, the constructive ownership rules of section 1563(e) apply by substituting the term "beneficial interest" for the term "stock" and by substituting the term "pass-through entity" for the term, "corporation" used in that section, as appropriate, for purposes of determining whether a beneficial interest in a pass-through entity is indirectly owned by any person.

See Treas. Reg. section 1.460-6(d)(4)(i)(C) for examples of these rules.

**Extract**

**Treas. Reg. section 1.460-6(d)(1) and (2)**

(1) \* \* \* Any taxpayer may elect this simplified marginal impact method, except that pass-through entities described in paragraph (d)(4) of this section are required to apply the simplified marginal impact method at the entity level with respect to domestic contracts and the owners of those entities do not apply the look-back method to those contracts. Under the simplified marginal impact method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on an assumed marginal tax rate. A taxpayer electing to use the simplified marginal impact method must use the method for each long-term contract for which it reports income (except with respect to domestic contracts if the taxpayer is an owner in a widely held pass-through entity that is required to use the simplified marginal impact method at the entity level for those contracts).

(2)(i) \* \* \* Under the simplified marginal impact method, income from those contracts that are completed or adjusted in the filing year is first reallocated in accordance with the procedures of Step One contained in paragraph (c)(2) of this section. Step Two is modified in the following manner. The hypothetical underpayment or overpayment of tax for each year of the contract (a "redetermination year") is determined by multiplying the applicable regular tax rate (as defined in paragraph (d)(2)(iii)) by the increase or decrease in regular taxable income (or, if it produces a greater amount, by multiplying the applicable alternative minimum tax rate by the increase or decrease in alternative minimum taxable income, whether or not the taxpayer would have been subject to the alternative minimum tax) that results from reallocating income to the tax year under Step One. Generally, the product of the alternative minimum tax rate and the increase or decrease in alternative minimum taxable income will be the greater of the two amounts described in the preceding sentence only with respect to contracts for which a taxpayer uses the full percentage of completion method only for alternative minimum tax purposes and uses the completed contract method, or the percentage of completion-capitalized cost method, for regular tax purposes. \* \* \*

\* \* \* \* \*

(ii) \* \* \* For purposes of determining hypothetical underpayments or overpayments of tax under the simplified marginal impact method, the applicable regular tax rate is the highest rate of tax in effect for the redetermination year under section 1 in the case of an individual and under section 11 in the case of a corporation. The applicable alternative minimum tax rate is the rate of tax in effect for the taxpayer under section 55(b)(1). The highest rate is determined without regard to the taxpayer's actual rate bracket and without regard to any additional surtax imposed for the purpose of phasing out multiple tax brackets or exemptions.

(iii) \* \* \* The net hypothetical overpayment of tax for any redetermination year is limited to the taxpayer's total federal income tax liability for the redetermination year reduced by the cumulative amount of net hypothetical overpayments of tax for that redetermination year resulting from earlier applications of the look-back method. If the reallocation of contract income results in a net overpayment of tax and this amount exceeds the actual tax liability (as of the filing year) for the redetermination year, as



adjusted for past applications of the look-back method and taking into account net operating loss, capital loss, or credit carryovers and carrybacks to that year, the actual tax so adjusted is treated as the overpayment for the redetermination year. This overpayment ceiling does not apply when the simplified marginal impact method is applied at the entity level by a widely held pass-through entity in accordance with paragraph (d)(4) of this section.

See Treas. Reg. section 1.460-6(d)(2)(iv) for an example of how this ceiling applies to a non-pass-through entity.

### **Computation of the Look-Back Method**

Interest under the look-back method is computed as follows:

1. In the taxable year a long-term contract is completed, recompute the income under the contract in all the taxable years before the year in which the contract is completed using the actual contract price and contract costs instead of the estimated contract price and contract costs.
2. Determine the overpayment or underpayment of tax for each taxable year based on #1 above for the sole purpose of computing the interest under the look-back method.
3. Using the overpayment rate established by IRC section 6621, compute the interest paid to or by the taxpayer based on the overpayment or underpayment of taxes determined in #2 above.

Rev. Proc. 83-7, 1983-1 C.B. 583 established uniform tables and procedures for computing interest using the daily compounding rules under IRC section 6622.

Interest on amounts arising after December 31, 1982, are computed by using Tables 7-30 for non-leap years and Tables 31-54 for leap years as listed in the Revenue Procedure.

Since IRC section 6621 requires redetermination of the interest rate semiannually, only the effective daily rates for 184 days are published in the tables.

Example of a basic look-back computation:

Calendar year Corporation Z uses the percentage of completion method of accounting as modified by IRC section 460 for long-term contracts. Corporation Z entered into a qualified long-term contract in August 1986, which was completed in December 1987.

The total estimated cost at completion is \$40 million and the estimated contract price is \$50 million.

The cost incurred and allocated to the contract was \$14 million in 1986 and \$21 million in 1987. (No other income or expenses were incurred by Z in 1986 or 1987).

Percent Complete

<u>Per Return</u>	<u>1986</u>	<u>1987</u>
Cumulative Costs	\$14,000,000	\$35,000,000
	-----	-----
Total Costs	\$40,000,000	\$35,000,000
Percent Complete	35%	100%
Profit Per Return	<u>1986</u>	<u>1987</u>
Earned Revenue:		
\$50M x 35% =	\$17,500,000	
(\$50M x 100%) - \$17.5M =		\$32,500,000
Cost incurred	\$14,000,000	\$21,000,000
	-----	-----
Gross profit	\$ 3,500,000	\$11,500,000
	-----	-----
Tax Per Return	\$ 1,589,750	\$ 5,269,750
	-----	-----

STEP 1. Computation of the Look-Back Provision Percent Complete Based on Actual Total Cost

	<u>1986</u>	<u>1987</u>
Cumulative Actual Costs	\$14,000,000	\$35,000,000
	-----	-----
Total Actual Costs	\$35,000,000	\$35,000,000
Percent Complete	40%	100%

STEP 2. Computation of Under(Over) Payment of Tax Under the Look-Back Method

	1986
Earned Revenue (\$50M x 40%)	\$20,000,000
Cost incurred	\$14,000,000
	-----
Gross profit	\$ 6,000,000
	-----
Tax Per Look-Back	\$ 2,739,750
Tax Per Return	\$ 1,589,750
	-----
Under(Over) Payment	\$ 1,150,000
	-----

STEP 3. Computation of the Interest, Form 8697 Filed on March 31, 1988.

<u>Period</u>	<u>Rate</u>	<u>Days</u>	<u>Factor</u>	<u>Amount</u>
Mar 15-31, 1987	8%	17	.003732560	\$ 4,292
Apr 1-June 30, 1987	8%	91	.020143161	\$ 23,165
Jul 1-Sept. 30, 1987	8%	92	.020366753	\$ 23,422
Oct 1-Dec 31, 1987	9%	92	.022941248	\$ 26,382
Jan 1-Mar 15, 1988	10%	74	.020421501	\$ 23,485
				-----
Total Look-back Interest Due				\$100,746
				=====

Taxpayer will owe interest on the \$100,746 for 17 days at the overpayment rate of 10 percent.

**Simplified Look-Back (Marginal Impact) Method Example**

Corporation X, a calendar-year taxpayer, reports income from long-term contracts and elected the Simplified Method when it filed its income tax return for 1989. X uses only the Percentage of Completion Method for both regular taxable income and alternative minimum taxable income. Corporation X completed contracts A, B, and C in 1989 and, therefore, was required to apply the look-back method in 1989. Income was actually reported for these contracts in 1987, 1988, and 1989. X's applicable tax

rate, as determined under IRC section 11, for the redetermination years 1987 and 1988 were 40 percent and 34 percent, respectively. The amount of contract income originally reported and re-allocated for contracts A, B, and C, and the net overpayments and underpayments for the re-determination years are shown below.

**Computation of HYPOTHETICAL Overpayment/Underpayment**

	<u>1987</u>	<u>1988</u>
<u>Contract A:</u>		
Originally reported	\$5,000	\$4,000
Re-allocated	<u>3,000</u>	<u>5,000</u>
Increase/(Decrease)	(2,000)	1,000
	=====	=====
<u>Contract B:</u>		
Originally reported	6,000	2,000
Re-allocated	<u>7,000</u>	<u>1,500</u>
Increase/(Decrease)	1,000	(500)
	=====	=====
<u>Contract C:</u>		
Originally reported	8,000	5,000
Re-allocated	<u>4,000</u>	<u>7,000</u>
Increase/(Decrease)	(4,000)	2,000
	=====	=====
Sum of Increase/Decrease on Contracts A,B and C	(5,000)	2,500
Tax at 40% rate	2,000	
Tax at 34% rate		(850)
	=====	=====
<u>Ceiling:</u>		
Actual Tax Liability (After Carry-overs)	1,500	500
	=====	=====
FINAL: Figure Used to Arrive at Look-Back		
Interest	1,500 *	(850)
	=====	=====

\* Limited to tax paid (lesser of actual or as recomputed)

Look-Back Interest is computed on the Final figure in the Hypothetical tax calculation.

Under the Simplified method, X determined a hypothetical net overpayment for 1987 and a net underpayment for 1988. X determined these amounts by aggregating the difference for contracts A, B, and C. This was done by comparing the contract income as reported for each individual contract with the re-computed contract income using the actual figures available at the close of the contract. Next, the highest regular tax rate for each year was applied to the aggregate increase or decrease in income from all contracts in each specific year. This resulted in a decrease to income in 1987 and an increase to income in 1988.

However, X's overpayment for 1987 is subject to a ceiling based on X's total tax liability. Because the tentative net overpayment of tax for 1987 exceeds the actual tax liability for that year after taking into account carry-overs and carry-backs to that year, the final overpayment under the Simplified Method is the tax paid instead of the tentative net overpayment. Since the look-back method for 1988 results in a tentative underpayment of tax, it is not subject to a ceiling.

X is entitled to receive interest on the hypothetical overpayment from March 15, 1988, to March 15, 1990. X is required to pay interest on the underpayment from March 15, 1989, to March 15, 1990.

**Look-Back for Taxpayers That Pay Alternative Minimum Tax or Would Have Been Required to Pay Alternative Minimum Had They Used Actual Rather Than Estimated Figures**

Treas. Reg. section 1.460-6(c)(3)(vi) requires the alternative minimum tax to be taken into account in making the look-back interest calculation. For example, if a taxpayer would have been liable for alternative minimum tax during a construction year if actual rather than estimated contract prices and costs had been used in determining contract income for the year, the overpayment or underpayment of tax on which the look-back interest is calculated would include the alternative minimum tax liability. See also Treas. Reg. section 1.460-6(h)(5), Example (4).

Treas. Reg. section 1.460-6(b)(4) requires a (cash, accrual or completed contract) taxpayer using the percentage of completion method only for the purposes of computing alternative minimum taxable income is required to apply the look-back method to the alternative minimum taxable income in the year of contract completion and other filing years whether or not the taxpayer was liable for the alternative minimum tax in the filing year or any prior year. Interest is computed under the look-back method to the extent that the taxpayer's total regular and alternative minimum tax liability would have differed if the percentage of completion method had been applied using actual rather than estimated contract prices and contract costs. See also, Treas. Reg. section 1.460-6(h)(8), Example (7).

The de minimis exception to the look-back rules applies for both regular and AMT purposes. The exception is available with respect to any long-term contract that is completed within two years of the contract commencement date and has a gross contract price that does not exceed the lesser of \$1 million or 1 percent of the average annual gross receipts of the taxpayer for the 3 tax years preceding the tax year in which the contract is completed. Treas. Reg. section 1.460-6(b)(3).

## **INFORMATION GENERALLY NEEDED TO AUDIT A CONSTRUCTION COMPANY**

1. Accounting manual/instructions that provide guidelines as to what accounts are debited/credited, for contract transactions, and under what circumstances.
2. General ledgers by entity.
3. Revenue Journals/Reports.
4. General journals by entity.
5. Schedule of contracts in process at yearend.
6. Detail/stratification of work in process by job number.
7. Detail/stratification of yearend: prepaid expenses, account payable, and deferred income accounts.
8. Contract manager's file, or individual contract cost and income summaries, for select contracts.
9. Index of internal audit reports. Scan the report titles to identify those with audit potential.

The above information may be obtained by the examiner or the assisting Computer Audit Specialist.

## **SUGGESTED AUDIT TECHNIQUES**

1. Determine if the contract qualifies as a long-term contract.
  - a. The scope of work to be performed, article 2 or 3 of the contract and pricing, around article 6 of the contract are the most determining factors.

- b. Contracts for services, Construction Management, Maintenance and warranty work do not qualify for long-term contract accounting. Advance Payments are taxable when received.
2. Determine if the taxpayer considered all contracts which have commenced during the year. They may elect to defer contracts that are less than 10 percent complete.
  3. Determine if the contract price is correct.
    - a. In determining the contract price of a cost-plus contract, the gross contract price is usually computed by adding the costs incurred to date plus the estimated costs to complete the project plus the estimated fee. Labor and materials make up different percentages of the contract and their mark-ups are different. Therefore, cost plus and percentage of completion may be different.
    - b. The terms of the contract should be reviewed to identify how contract price revisions, such as change orders, options and additions are processed.
    - c. Request the change orders on selected contracts. Have change orders been included in total expected contract income in the year they were incurred? Look-back interest is computed under IRC section 6621(a)(1) and stops at the due date of the filing year. Look-back interest is then added to the deficiency. Audit adjustment interest is computed under IRC section 6621(a)(2) and continues until 30 days after the agreement is signed by the taxpayer.
  4. Determine if the costs to date and the estimated costs to complete are correct.
    - a. Determine if the taxpayer is properly following the cost allocation rules applicable at the time the contract was entered into. Notice 89-15.
    - b. Materials and supplies on hand (at jobsite) at the beginning and end of the taxable year are job costs. They are not included in inventory.
    - c. Specially ordered materials and supplies for a project are not included in inventory. They must be included in the costs incurred to measure the percentage of completion.
    - d. Review General Ledger expense accounts that contain indirect contract cost, determine which cost should be allocated directly to contracts and which cost should be allocated by the use of burden rates.

- e. For contracts entered into after February 28, 1986, the taxpayer must allocate to cost-plus and federal long-term contracts any cost that is identified by the taxpayer pursuant to the terms of the contract or to Federal, state, or local laws and regulations.
5. Determine if the taxpayer has any contingency reserves included in the estimated costs to complete a contract.
  6. Determine if the taxpayer has adjusted the percent of completion by any risk factors because of some potential risk involved in certain phases of construction.
    - The terms of the contract should be reviewed to identify contract price revisions, such as change orders, options and additions.
  7. Determine when a contract is finally completed and accepted for purposes of the taxpayer's normal method of accounting.
    - a. Review the terms of the contract.
    - b. Prior to January 1, 1983, a long-term contract is considered completed when final completion and acceptance have occurred.
    - c. After December 31, 1982, a long-term contract will be considered to be finally completed and accepted when the contractor and the project owner have dealt with each other in a manner that indicates the subject matter of the contract has been completed and accepted.
    - d. After December 31, 1982, in the case of a long-term contract for one or more units that represent the primary subject matter of a single contract and for other items that do not represent the primary subject matter of the contract, final completion and acceptance will be determined based on the completion and acceptance of the primary subject matter.
    - e. Completion of a long-term contract is determined without regard to whether a dispute exists at the time the taxpayer tenders the subject matter of the contract to the party with whom the taxpayer has contracted.
    - f. Some contractors do not close their contracts until after they complete their audit of the contract. The contracts should be closed in the year that they are completed and Form 8697 should be filed. If their audit in the subsequent year results in changes to contract cost or income a subsequent Form 8697 would then be due.



## Chapter 4

### HOME BUILDERS AND DEVELOPERS

#### HOME CONSTRUCTION CONTRACT DEFINED

The definition of what constitutes a home construction contract is addressed in the Joint Committee Report on P.L. 100-647 (Technical and Miscellaneous Revenue Act of 1988). Under the conference agreement, a contract is a home construction contract if 80 percent or more of the estimated total costs to be incurred under the contract are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, or improvements to real property directly related to and located on the site of, dwelling units in a building with four or fewer dwelling units. For this purpose, a townhouse or rowhouse will be considered a separate building irrespective of the number of other townhouses or rowhouses attached.

The conference agreement applies the use of the uniform capitalization rules of IRC section 263A to home construction contracts other than home construction contracts of small contractors as defined by section 460(e) of present law. This sentence was added to the committee report because the small contractor has a choice of accounting methods under Treas. Reg. section 1.451-3. In addition, under the conference agreement, home construction contracts of small contractors will not be considered long-term contracts for purposes of the adjustments in computing alternative minimum taxable income of IRC section 56.

Effective June 21, 1988, IRC section 460(e) was modified to read:

#### Extract

#### IRC section 460(e)

(e) EXCEPTION FOR CERTAIN CONSTRUCTION CONTRACTS.--

(1) IN GENERAL.--Subsections (a), [percentage of completion] (b), [look-back] and (c)(1) [cost to cost] and (2) [cost plus and federal contracts] shall not apply to --

(A) any home construction contract,

In the case of a home construction contract with respect to which the requirements of clauses (i) and (ii) of subparagraph (B) are not met, [contract exceeded two years or gross receipt in excess of \$10,000,000] section 263A

shall apply notwithstanding subsection (c)(4) thereof.

\* \* \* \* \*

Further clarification of what is a home construction contract is provided in Notice 89-15, which provides in part:

Q-42: Which long-term contracts are exempt under IRC section 460(e) from the requirements of IRC section 460?

A-42: IRC section 460(e) provides that, except for the interest capitalization requirement of IRC section 460(c)(3), the rules of IRC section 460 do not apply to (1) any home construction contract entered into after June 20, 1988.

Q-43: What is a "home construction contract" for purposes of IRC section 460(e)?

A-43: For purposes of IRC section 460(e), the term "home construction contract" means any construction contract if 80 percent or more of the estimated total contract costs are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of (i) dwelling units contained in buildings containing four or fewer units, and (ii) improvements to real property directly related to such dwelling units and located at the site of such dwelling units.

## **CLASSES OF HOME CONSTRUCTION CONTRACTS**

In the area of home construction and developers, the law differs by type of contract and/or transaction. The first thing you have to consider is who has title? After you determine who has title, you must determine which Code sections apply. The different scenarios that you may address are:

**Home builder building for speculation.** = IRC sections 263 and 263A. Building an asset, income is reported and basis is taken into account at settlement to determine gain or loss.

**Home builder with a contract building on his or her land.** = Treas. Reg. section 1.451-3, completed contract or IRC section 446, deferred accrual (economic performance takes place at settlement) methods only. If taxpayers elect the completed contract method, they follow the cost capitalization rules of Treas. Reg. section 1.451-3(d)(5). If taxpayers elect the deferred accrual method under IRC section 446, they follow the cost capitalization rules of IRC section 263A. Under IRC section 460, if the home takes over 2 years to build or the home builder's average annual gross receipts for the prior 3 years exceed \$10,000,000, costs must be capitalized under IRC

section 263A, if they are not capitalized under Treas. Reg. section 1.451-3(d)(5). Title does not transfer until settlement, therefore, income is reported and work in process/basis is taken into account at settlement.

**Home builder building on buyer's property.** = Title to work transfers as it is performed. Home builders usually receive advance payments and may use accrual, PCM or completed contract method. Reg. 1.451-3(a).

**Contractor working for a home builder, (commonly referred to as a subcontractor).** = Treas. Reg. section 1.451-3 or IRC section 460 are applied in accordance with the subcontractor's contract.

**Land developer.** = IRC sections 263 and 263A. Can elect Rev. Proc. 92-29. See *Carpenter*, T.C.M. 1994-289, home builder cannot use cash method. See *Von-Lusk*, 104 T.C. 207. Some pre-development cost must be capitalized.

### **Law and Analysis**

Section 446(a) of the Code states the general rule that taxable income shall be computed by a taxpayer under the method of accounting it regularly uses in keeping its books. IRC section 446(b), however, provides that where a taxpayer's accounting method does not clearly reflect income, the computation of taxable income shall be made under such method as, in the Secretary's opinion, does clearly reflect income.

#### **Extract**

##### **IRC section 446, General Rule for Methods of Accounting**

(a) GENERAL RULE.--Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS.--If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) PERMISSIBLE METHODS.--Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting--

- (1) the cash receipts and disbursements method;
- (2) an accrual method;
- (3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

\* \* \* \* \*

**Extract**

**Treas. Reg. 1.451-3(a)**

*Introduction and effective date--(1) In general.* Income from a long-term contract \* \* \* may be included in gross income in accordance with one of the two long-term contract methods, namely, the percentage of completion method or the completed contract method \* \* \* or any other method [cash or accrual]. Whichever method is chosen must, in the opinion of the Commissioner, clearly reflect income. See section 1.446-1(a)(2) and (c). \* \* \*

IRC section 263(a)(1) and Treas. Reg. section 1.263(a)-1(1) provide that no deductions shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Treas. Reg. section 1.263(a)-2 sets forth examples of capital expenditures, including the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the tax year.

IRC section 471 provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Treas. Reg. section 1.471-1 provides that inventories at the beginning and end of each tax year are necessary in every case in which the production, purchase or sale of merchandise is an income producing factor.

Taxpayers engaged in the real estate business are not allowed to argue that their holdings represent "inventory" in order to write their holdings down to market value using a lower of cost or market valuation. *Atlantic Coast Realty Co. v. Commissioner*, 11 B.T.A. 416 (1928); Rev. Rul. 69-536, 1969-2 C.B. 109. In *Atlantic Coast Realty Co.*, the United States Board of Tax Appeals concluded that, based on the purpose and legislative intent of the inventory provisions, the use of inventories is inappropriate for a taxpayer engaged in buying and selling land.

There is a fundamental difference between capitalization and an inventory method. Under capitalization, gain will be determined pursuant to IRC section 1001 on each individual home when it is sold, and such gain is to be determined based generally on the taxpayer's actual cost for that particular home. A taxpayer engaged in the real estate business capitalizes its costs in accordance with section 263 of the Code. Under IRC section 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, is recovered either through a depreciation allowance if the property is used in a trade or business, or as an offset against the price received in the subsequent sale or disposition of such property.

The uniform capitalization rules of IRC section 263A(a)(1) mandate that the costs allocable to certain property be capitalized. Property subject to these provisions includes property produced by the taxpayer, and property described in IRC section 1221(1) (for example, inventory) that is acquired by the taxpayer for resale. IRC section 263A(b). IRC section 263A(b)(1) defines property produced by the taxpayer as "Real or tangible personal property produced by the taxpayer." Per Treas. Reg. section 1.263A-2(a)(1)(i), the term "produce includes \* \* \* construct, build, install \* \* \* develop, [and] improve, \* \* \*."

### **Houses Built For Speculation**

In the industry these are referred to as inventory of unsold houses. These speculation houses do not meet the definition of inventory in the Code. The Internal Revenue Code defines inventory as personal tangible property. Speculation houses are capital assets as defined in IRC section 263. The builder owns the real property (land) and the house inherently attached to the land. This position has been upheld by various courts that have held that developed real property must be accounted for 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). See also Rev. Rul. 66-247, 1966-2 C.B. 198, and Rev. Rul. 86-149, 1986-2 C.B. 67.

### **Rev. Rul. 66-247**

[Also IRC sections 266, (permits capitalization of taxes and carrying charges) and 446; Treas. Reg. sections 1.266-1 and 1.446-1].

The costs incurred by a taxpayer in the construction of a house for speculative sale (including the cost of the land, but not taxes and carrying charges [\*\*\* effective 3/1/86 taxes and interest are capitalized under Section 263A \*\*\*] which the taxpayer has not elected to capitalize under section 266 of the Internal Revenue Code of 1954) should

be capitalized regardless of the taxpayer's overall method of accounting. Such costs shall be applied against the amount realized upon the sale of the house for purposes of determining gain or loss in computing taxable income. However, if, under the taxpayer's method of accounting for administrative and selling expenses (such as those incurred in a home office away from any building site and not directly connected with the construction), such expenses are deducted in the year they are incurred or paid, the taxpayer may employ this method insofar as such expenses are concerned if such method clearly reflects income.

### **Issue**

Whether a taxpayer engaged in the business of developing real estate may use the last-in, first-out (LIFO) inventory identification method in accounting for the costs of its completed homes and homes under construction, exclusive of land costs?

### **Facts**

The taxpayer is a real estate developer that keeps its books and records and files its federal income tax returns on an accrual method of accounting. Its principal business activity is developing real estate upon which it constructs residential homes.

The taxpayer uses an accumulated "job cost" method to account for its construction and development costs. Under this method, each home is treated as a separate costing unit to which all direct identifiable costs are charged and all overhead costs, including the variable overhead as well as the construction and architectural costs, are allocated. All costs that have been accumulated for a particular home under the job cost method are charged to cost of sales at the time of settlement with the purchaser of the home.

In *Homes by Ayres v. Commissioner*, T.C. Memo 1984-475, *aff'd.*, 795 F.2d 832 (9th Cir. 1986), the court addressed job costing methods. Normally each house is a separate cost center. But, when job cost are accumulate for a subdivision in phases a cost pool may be used. Costs may be allocated according standard cost accounting principals. Three examples of methods used to determine the cost basis of the houses sold in each phase follow:

1. One technique for allocating the pool of capitalized costs is the "relative sales value method." This method determines cost of houses sold by multiplying total capitalized costs (already incurred plus estimated costs of completion) by the ratio of the selling prices of the houses sold to the estimated selling prices of all the houses in the phase.

2. Another technique for cost allocation, called "average cost method," calls for multiplying total capitalized costs by the ratio of the total number of houses sold to the aggregate number of houses to be sold in a phase.
3. Finally, the "square footage method" allocates costs by multiplying total capitalized costs by the ratio of the aggregate square footage of houses sold to the aggregate square footage of all houses to be sold in the phase.

All three of these methods comport with generally accepted accounting principles and IRS admits that they accurately reflect income. *Homes By Ayres, supra.*

### **Houses Built Under Contract on Contractor's Land**

What happens when a home builder receives a down payment on a home? The down payment constitutes a contract. All the home builder has to do is perform on the contract and the down payment is its to keep.

The contract is a construction contract as defined in Treas. Reg. 1.451-3(b)(3)(ii). Title to the land and home attached to it do not transfer until settlement. Therefore, the only accounting methods that properly reflect income are completed contract or deferred accrual. Under both methods income is reported and expenses are deducted at settlement. The only difference between the two methods are the cost that have to be capitalized. Completed contract method requires less cost capitalization than the deferred accrual method.

### **Home Builder Building on Buyer's Land**

Title to work transfers as it is performed. Home builder has a mechanics lien on the property. Home builder usually receives advance payments, may use straight accrual, deferred accrual, completed contract method, or percentage of completion. See Treas. Reg. 1.451-3(a).

If the home builder uses the straight accrual method it will report income when it is entitled to receive the income and will deduct the expenses when they are incurred. If the home builder uses deferred accrual or completed contract methods income is reported and expenses are deducted at settlement. If the home builder uses the percentage of completion method it will compute the percentage of completion under Treas. Reg. 1.451-3(c).

### **Contractor Working for a Home Builder**

Regarding contractors (specialty contractors; that is, electricians, plumbers, concrete workers, carpenters, etc.) working for a home builder (commonly referred to as a

subcontractors), Treas. Reg. section 1.451-3 or IRC section 460 are applied in accordance with the terms of the subcontractor's contract. Title to work transfers as it is performed. Speciality contractors usually do not receive advance payments, and may use straight accrual, deferred accrual, completed contract or percentage of completion method. See Treas. Reg. section 1.451-3(a). The same rules apply as if the home builder was building on someone else's land.

### **Contract Severing**

The following issue is quite common with specialty contractors:

Whether a taxpayer's (speciality trade contractors, such as carpenters, electricians, plumbers, foundation workers, sheetrock workers, etc.) purported long-term contracts to provide all of the work for various housing developments must be severed into separate contracts under IRC section 460(f)(3) to clearly reflect income.

### **Facts**

Taxpayer is in the business of "home construction," as that term is defined in IRC section 460(e)(6). During the taxable years 199x and 199x, taxpayer entered into multiple contracts with various housing project developers to build the speciality trade part of homes within various subdivisions. A typical project involves the construction of an entire subdivision of multi- and single-family dwellings. Taxpayer contracts to build its part of such dwellings in a particular subdivision in phases. When one phase is complete, taxpayer agrees to build its part of the houses in another phase of the same subdivision. This process continues until all phases within a subdivision are complete.

The initial contract obligates taxpayer to perform work in the first phase of the subdivision. When the first phase is complete, the home builder executes an addendum to the initial contract with the taxpayer to perform work in the second phase of the development. This process continues until all phases of the subdivision are complete. But, there is no guarantee that the taxpayer will receive the addendum/contract for the next phase of the subdivision.

The contracts and addendums indicate that, at a minimum, a subdivision may consist of two or more phases. The documents also indicate that the time required to perform the work for all the phases in an entire subdivision spans more than one tax year, that the time required to perform the work in a particular phase is, generally, a matter of weeks, but that a lapse of months may occur between the completion of one phase and the execution of an addendum to begin building the next phase. Moreover, each contract and each addendum is very specific as to the work required in each respective phase. For instance, each document sets forth the number of units, the model styles,



and costs of the same on a per unit basis for each particular phase. In addition, the per unit cost for similar model styles in some cases remains constant, and in others, slightly varies from one phase to the next. Payment schedules for work performed are phase specific and percentage based. Disbursements are made upon the completion of certain construction requirements in the particular phase; the final retainage is due xx days after the completion and acceptance of the work in the phase by the developer. Notwithstanding the general contract terms contained in the initial contract, nothing regarding the particular construction requirements of one contract or addendum is incorporated to or from another addendum.

### **Taxpayer's Position**

Taxpayer contends the initial contract and all the addendums to that contract should be aggregated and, thus, are equivalent to one long-term contract to provide work for the entire subdivision. Taxpayer apparently reasons that it has entered one long-term contract for the entire subdivision because (1) it was "understood" that taxpayer would build their part of the house in all the phases in the subdivision, (2) in negotiating the price for the work, taxpayer considered the cost and risks associated with the entire subdivision, and (3) that taxpayer would have worked under the terms agreed only for the entire subdivision, not just one or two phases. We are aware of no other evidence that conclusively indicates that taxpayer indeed priced the work for each phase under the assumption it would be awarded all the work in the subdivision. Based on this theory, taxpayer believes it is entitled to defer the recognition of income under the completed contract accounting method until all the work within the entire subdivision is completed. Although taxpayer and the developer have a historical business relationship, nothing guarantees that the taxpayer will be retained to provide further work after the completion of a particular phase.

### **Law and Analysis**

For the taxable years at issue, IRC section 460(a) generally requires that the taxable income from any long-term contract be determined under the percentage of completion method of accounting. IRC section 460(b) provides the method by which the amount of income required to be reported as taxable under the percentage of completion method of accounting is calculated. IRC section 460(e)(1)(A), however, provides specifically that sections 460(a) and (b) do not apply to home construction contracts. Thus, assuming that taxpayer has entered into a long-term contract, taxpayer would be entitled to account for the income earned from such contract under the completed contract method of accounting described in Treas. Reg. section 1.451-3(d), because home construction contracts are exempt from treatment under IRC section 460(a). See Notice 89-15, 1989-1 C.B. 634, Q&A 1.

Although excluded from the reach of IRC sections 460(a) and (b), home construction

contracts continue to be subject to the aggregation and severing rules of IRC section 460(f)(3). Notice 89-15, 1989-1 C.B. at 643, Q&A 37, states that the rules set forth in Treas. Reg. section 1.451-3(e) apply in determining whether an agreement should be treated as more than one contract ("severed") under IRC section 460(f)(3). Treas. Reg. section 1.451-3(e)(1)(i)(A) states, that for the purpose of clearly reflecting income, for example, to prevent the unreasonable deferral of recognition of income, it may be necessary to treat one agreement as several contracts.

The rationale for severing construction contracts under the completed contract method of accounting is that, from a logical standpoint, there is no reason why a construction project that can be completed and accepted in sections should not be treated on a section by section basis for purposes of applying the completed contract method. To argue otherwise is to advance form over substance. Whether a project is evidenced by one or many contract documents should not affect its treatment for federal income tax purposes.

One of the reasons why permission to report on a completed contract basis is given in the case of building, installation, and construction contracts is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delays, and other unexpected difficulties in performing the work. These conditions make it almost impossible for any construction contractor, no matter how carefully the contractor may estimate, to tell with any certainty whether a gain or loss has been sustained until a particular contract is completed. See Rev. Rul. 70-67, 1970-1 C.B. 117, for a discussion of the completed contract method.

Once a portion of a project has been accepted, the contractor can tell with certainty whether a gain or loss has been sustained on that portion. To postpone such gain or loss once it becomes certain until other portions covered by the same document are completed and accepted is contrary to the underlying rationale of the completed contract method.

IRC sections 446(b) and 460(f)(3), and Treas. Reg. section 1.451-3(e) vest the Commissioner with broad discretion in determining whether a long-term contract should be severed to clearly reflect the taxpayer's income. See *Sierracin Corp. v. Commissioner*, 90 T.C. 341, 368 (1988), *acq. in part, acq. in result in part*, 1990-2 C.B. 1. "Since the Commissioner has '[m]uch latitude for discretion,' his interpretation of the statute's clear reflection standard 'should not be interfered with unless clearly unlawful'". *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979), quoting *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930). Thus, the Commissioner's determination that the taxpayer's failure to sever a long-term contract because it otherwise does not clearly reflect income is entitled to more than the usual presumption of correctness. The taxpayer's burden in overcoming such a determination is consequently a heavy one. See *Reco Industries, Inc. v.*

*Commissioner*, 83 T.C. 912, 920 (1984).

Whether an agreement should be severed to prevent the unreasonable deferral of the recognition of income attributable to a long-term contract depends on all the facts and circumstances. Treas. Reg. section 1.451-3(e)(1)(i)(A). One such factor is whether there is separate acceptance of units representing a portion of the subject matter of the contract. Treas. Reg. section 1.451-3(e)(1)(iii). Taxpayer and the developer clearly contemplated that the acceptance of and payment for work in the subdivision would occur in segments. Pursuant to the addendums, a separate final payment is required for each phase after completion and acceptance of the work in that phase by the developer.

One agreement may be severed when units are independently priced. Treas. Reg. section 1.451-3(e)(1)(iv). This is perhaps the most important consideration in the determination to sever a contract. *Sierracin Corp.*, 90 T.C. at 369. When the price for each multiple agreement takes into account the expected total costs and risks for each agreement standing alone, then the terms agreed upon for any of the agreements are independent of the terms agreed upon for the other agreements. Such multiple agreements may not be aggregated into one contract for purposes of applying the completed contract method of accounting. See Treas. Reg. section 1.451-3(e)(2) Example 6. However, the reason for treating one contract as several is less compelling when the product involves novel technology that changes over the duration of the project because the taxpayer cannot calculate with any certainty the total costs and hence the total profit until completion of the entire project. See *Sierracin Corp.*, 90 T.C. at 371.

As a preliminary matter, the model pricing and other terms for the work in each phase are specifically referenced in each respective addendum. Moreover, we do not consider the process performed one which involves the application of a novel technology. We believe that such a process is reasonably certain, and the costs and profits associated therewith are reasonably ascertainable with reference to a few units rather than with reference to the completion of all the units within the subdivision. Although in negotiating the price for the work taxpayer states that it considered the cost and risks associated with the entire subdivision, each separate addendum, nonetheless, stood on its own with respect to these factors. In other words, the construction risk was segregated and identified for each individual phase, not interdependent between the phases or identified with the overall success of the subdivision. Regardless of whether taxpayer completed all the work in the subdivision or if taxpayer completed only the first phase and no further addendums were executed, we doubt taxpayer was any less certain, under the price negotiated, of the costs and profit that each addendum would yield after the completion of the work in each respective phase. In our opinion, the construction called for in each addendum was independently priced.

We believe the business purpose implied from Treas. Reg. section 1.451-3(e)(1)(v) supports the aggregation of multiple contracts only when the subject matter involved is a separate indivisible unit. See, for example, Treas. Reg. section 1.451-3(e)(2) Example 4. In the instant case, taxpayer has agreed to build multiple units of similar design to which the construction risks are separately identified. Taxpayer's situation more closely resembles Treas. Reg. section 1.451-3(e)(2) Example 1 (Contract to build three homes in three successive years should be segregated by home because the portion of the total contract price for each home is reasonably determined). Not only is the contract price for each phase reasonably determined, taxpayer has specifically provided for such price, in addition to other terms, in each addendum. We believe this distinction sharply undercuts taxpayer's reliance on Treas. Reg. section 1.451-3(e)(1)(v). For the same reason, we also believe that taxpayer's other contended business reasons, while textually aligned with the letter of Treas. Reg. section 1.451-3(e)(1)(vii), fail to add any significant weight in support of aggregating all addendums for one subdivision into a single long-term contract. As it appears to us, taxpayer merely "understood" that it would be called upon after the completion of one phase to perform the work in a subsequent phase. Under Treas. Reg. section 1.451-3(e)(1)(vii), such an "expectation that the parties would enter into the other agreement \* \* \* is not evidence that [multiple] agreements entered into between the same parties should be aggregated."

If the number of items to be supplied is increased, as by the exercise of an option or the issuance of a change order, the supplying of such additional items generally should be treated as a separate agreement. Treas. Reg. section 1.451-3(e)(1)(viii). We believe a strong analogy exists between the treatment of the addendums in the instant case and the treatment of a change order for purposes of Treas. Reg. section 1.451-3(e)(1)(viii).

In addition, the lapse of time between the completion of one phase and the execution of another addendum for the commencement of work on the next phase also indicates that each addendum should be treated separately. See Treas. Reg. section 1.451-3(e)(1)(ii). Perhaps the most compelling evidence that each addendum should be treated as a separate contract is that taxpayer chose to structure its transactions in such a manner. (It should not be inferred that a single contract for the entire subdivision would not be severed.) Furthermore, we are unaware of any commercial practice or dealings between the parties that indicate that the addendums should not be treated separately. See Treas. Reg. section 1.451-3(e)(1)(ii).

### **Revenue Agent's Position**

Based on the preceding analysis, taxpayer's current method of accounting creates an unreasonable deferral of the recognition of income. Each segment of its construction obligations are memorialized in separate documents and each contemplates separate

acceptance and independent pricing of the subject matter of each segment. Further, taxpayer's process of executing an addendum to the original contract to perform additional work is no different than executing a new contract. Moreover, there appears to be no valid business purpose for treating taxpayer's contracts and addendums in the aggregate. Also, since the construction risks are specific to each segment and not interdependent between segments, taxpayer's claim to aggregation conflicts with the rationale underlying the completed contract method of accounting. Accordingly, in order to clearly reflect income, taxpayer must sever its purported long-term contracts by treating each addendum as a separate contract and account for its income therefrom accordingly.

Another event to be considered is the fact that the home builder, that the taxpayer has contracted with, has sold and settled on most if not all of the homes. The taxpayer, at a minimum, is required to treat each addendum as a separate contract and report its income with respect to each separate addendum accordingly.

### **Conclusion**

Taxpayer's current method of accounting creates an unreasonable deferral of the recognition of income. Each segment of its construction obligations are memorialized in separate documents that contemplate separate acceptance and independent pricing of the subject matter of each segment. Further, taxpayer's process of executing addendums to the original contract to perform additional work is no different than executing a new contract. The contract for the first phase contains all of the necessary contract language. The addendums incorporate the contract language by reference and address the number of houses and price of subsequent phases, that is, a new contract. Moreover, there appears to be no valid business purpose for treating taxpayer's contracts and addendums in the aggregate. Also, since the construction risks are specific to each segment and not interdependent between segments, taxpayer's claim to aggregation conflicts with the rationale underlying the completed contract method of accounting. Accordingly, to clearly reflect its income, taxpayer must sever its purported long-term contract by treating each addendum as a separate contract and account for its income therefrom accordingly.

## **LAND DEVELOPER ESTIMATED COST OF COMMON IMPROVEMENTS**

Revenue Procedure 92-29, 1992-1 C.B. 748, provides the procedure for a developer of real estate to obtain the Commissioner's consent to use an alternative to the general method under IRC section 461(h) for determining when common improvement costs may be included in the basis of properties sold for purposes of determining the gain or loss resulting from the sales.

Under the alternative cost method, a developer may include in the basis of properties sold their allocable share of the estimated total cost of common improvements without regard to whether the costs are incurred under section 461(h) of the Code. As of the end of any taxable year, however, the total amount of common improvement costs included in the basis of the properties sold may not exceed the amount of common improvement costs incurred under IRC section 461(h).

This revenue procedure is effective for, and obsoletes Rev. Proc. 75-25, 1975-1 C.B. 720, with respect to, sales of property after December 31, 1992. However, developers may use this revenue procedure with respect to sales of property after December 31, 1990. Thus, for sales of property during any portion of the period January 1, 1991, through December 31, 1992, developers have the option of using the provisions of this revenue procedure or the provisions of Rev. Proc. 75-25 (pursuant to Notice 91-4).

If a developer fails to timely request to use the provisions of this revenue procedure or Rev. Proc. 75-25 for sales of property after December 31, 1990, IRC section 461(h) will govern the treatment of the costs of common improvements to property sold after December 31, 1990, and until the first day of the first taxable year for which the developer receives consent to use these provisions. In such case, the developer will only be allowed to include in the basis of properties sold their allocable share of the amount of common improvement costs that have been incurred under IRC section 461(h) as of the end of the year in which the benefited properties are sold. As a result, a developer will be limited in the amount of common improvement costs that can be included in the basis of properties sold. This will be the case in any year in which benefited properties are sold while substantial common improvement costs have not yet been incurred under IRC section 461(h).

The provisions of Rev. Proc. 92-29 are illustrated as follows:

**Example 1**

A developer will build 10 houses of equal value on a tract of land. The developer is contractually obligated to provide common improvements that will benefit all the houses on the tract equally. The developer estimates that these common improvements will cost \$500,000 (including the cost of the land associated with the common improvements). The cost of these common improvements is not properly recoverable through depreciation by the developer. Each house's allocable share of the estimated cost of the common improvements is \$50,000 (\$500,000/10 houses).

During the first taxable year, the developer sells four houses and incurs, within the meaning of IRC section 461(h), \$250,000 of common improvement costs (including the cost of the land associated with the common improvements). In the second taxable year, the developer sells four houses and incurs, within the meaning of IRC section 461(h), \$150,000 of common improvement costs. In the third year, the developer sells two houses and incurs, within the meaning of IRC section 461(h), \$100,000 of common

improvement costs. The developer receives permission to use the alternative cost method.

Year 1

The developer may include \$200,000 of common improvement costs in the aggregate bases of the four houses sold during the taxable year in determining the gain or loss resulting from the sales. This amount represents the allocable share of the estimated cost of common improvements for the four houses ( $[\$500,000/10] \times 4$ ). This amount does not exceed the amount of common improvement costs incurred under IRC section 461(h) as of the end of the taxable year (\$250,000).

If the developer had not received permission to use the alternative cost method, the developer would include only \$100,000 of common improvement costs in the aggregate bases of the four houses sold during the taxable year ( $[\$250,000/10] \times 4$ ). This is IRC section 461(h).

Year 2

The developer may include \$200,000 of common improvement costs in the aggregate bases of the four houses sold during the taxable year in determining the gain or loss resulting from the sales. This amount represents the allocable share of the estimated cost of common improvements for the four houses ( $[\$500,000/10] \times 4$ ). This amount plus the amount of common improvement costs included in the aggregate bases of the four houses sold in the preceding taxable year (\$200,000) does not exceed the amount of common improvement costs incurred under section 461(h) as of the end of the second taxable year (\$400,000).

If permission had not been received to use the alternative cost method, the developer would similarly include \$200,000 of common improvement costs in the aggregate bases of the four houses sold during the taxable year ( $[\$300,000/6] \times 4$ ).

Year 3

The developer may include \$100,000 of common improvement costs in the aggregate bases of the two houses sold during the taxable year in determining the gain or loss resulting from the sales. This amount represents the allocable share of the estimated cost of common improvements for the two houses ( $[\$500,000/10] \times 2$ ). This amount plus the amount of common improvement costs included in the aggregate bases of the eight houses sold in the preceding taxable years ( $\$200,000 + \$200,000$ ) does not exceed the amount of common improvement costs incurred under IRC section 461(h) as of the end of the third taxable year (\$500,000).

If the developer had not received permission to use the alternative cost method, the developer would include \$200,000 of common improvement costs in the aggregate bases of the two houses sold during the taxable year ( $[\$200,000/2] \times 2$ ).

-----  
10 Houses

Estimated common improvements	\$500,000.		What if
1st. yr. common improvements incurred	=	\$250,000.	\$160,000.
2nd. yr.   "       "	=	150,000.	240,000.
3rd. yr.   "       "	=	100,000.	100,000.
		\$500,000.	
		=====	

Houses	SOLD YR. #1				SOLD YR. #2				SOLD YR. #3	
	1	2	3	4	5	6	7	8	9	10
75-25	50M	50M	50M	50M	50M	50M	50M	50M	50M	50M
*****										
92-29	50M	50M	50M	50M	50M	50M	50M	50M	50M	50M
		(20,000)			(50,000)	(150,000)			(100,000)	
*****										
461(h)	25M	25M	25M	25M	25M	25M	25M	25M	25M	25M = 250M
					25M	25M	25M	25M	25M	25M = 150M
					50M	50M	50M	50M	50M	50M = 100M
					====	====	====	====	====	100M 100M
									=====	=====
*****										
What if? 92-29	40	40	40	40	56,667 each house (50,000 - 160,000 = 340,000 /6) 4 x 56,667 = 226, 668				113,332 both 500,000-160,000- 226,226,668=)	
What if? 461(h)	16	16	16	16	16	16	16	16	16	16 = 160
					40	40	40	40	40	40 = 240
									50	50 = 100
*****										

## INTEREST CAPITALIZATION

All home builders are subject to the interest capitalization rules for all unsold homes and homes under construction. IRC section 460(c)(3). The alternative cost method does not affect the application of interest capitalization rules to developers of real estate. Thus, common improvement costs incurred under section 461(h) of the Code are allocated among the benefited properties and provide the basis for computing interest capitalization under IRC section 263A(f). In the event that a benefited unit is ready to be held for sale before the common feature is placed in service, a prorata portion of the common feature costs will be excluded from accumulated production expenditures (APE) of the remaining benefited units for measurement periods beginning after the unit is ready to be held for sale. This prorata apportionment is to be accomplished by applying the requirements of section 461, including the economic performance requirement of section 461(h). Thus, a benefited unit's allocable costs that are to be excluded from interest capitalization after it is ready to be held for sale do not include any portion of the common improvement costs incurred in



measurement periods beginning after the unit is ready to be held for sale.

The important distinction between the alternative method of Rev. Proc. 92-29 and the interest capitalization provisions involving common features in Prop. Treas. Reg. section 1.263A(f)-3 lies in the "allocable" or "prorata" computation. Rev. Proc. 92-29's alternative method allows a developer to include in the basis of properties sold their allocable share of the estimated total cost of common improvements so long as that amount does not exceed the amount of common improvement costs that have been incurred under IRC section 461(h) as of the end of the year in which the benefited properties were sold. In contrast, the interest capitalization rules provide that when a benefited unit is ready to be held for sale prior to placing a common feature in service, the reduction in APE for further interest capitalization with respect to remaining benefited units does not include costs incurred in measurement periods after the unit is ready to be held for sale. The following example illustrates these concepts:

### **Example 2**

A developer will build 10 houses of equal value on a tract of land. The developer is contractually obligated to provide common improvements that will benefit all the houses on the tract equally. The developer estimates that these common improvements will cost \$500,000 (including the cost of the land associated with the common improvements). The cost of these common improvements is not properly recoverable through depreciation by the developer. Each house's allocable share of the estimated cost of the common improvements is \$50,000 ( $\$500,000/10$  houses).

In addition, assume the developer sells the first four houses on December 31 of the first taxable year. The next four houses are sold on December 31 of the second taxable year and the final two houses are sold on December 31 of the third taxable year.

#### **Year 1**

APE attributable to common features totals \$250,000 the first year. The prorata portion of the accumulated costs attributable to the four units sold is \$100,000 ( $[\$250,000/10] \times 4$ ). APE at the end of year 1 is thus reduced by \$100,000.

#### **Year 2**

APE at the beginning of year 2 totals \$150,000 ( $\$250,000 - \$100,000$ ) and six units remain to be completed and sold. During year 2, the developer incurs, within the meaning of section 461(h), \$150,000 in additional accumulated costs. Thus, APE at the end of year 2 totals \$300,000. The prorata portion attributable to the four units sold in year 2 is \$200,000 ( $[\$300,000/6] \times 4$ ). APE at the end of year 2 is thus reduced by \$200,000.

#### **Year 3**

APE at the beginning of year 3 totals \$100,000 (\$300,000 - \$200,000) and two units remain to be completed and sold. During year 3, the developer incurs, within the meaning of section 461(h), \$100,000 in additional accumulated costs. The prorata portion of the APE attributable to each of the units sold in year 3 is \$100,000, and APE at the end of year 3 is reduced by \$200,000.

NOTE 1: As expected, the APE reduction attributable to benefited units sold during the taxable year is identical to the corresponding-year amount the developer would have included in the bases of houses sold if permission had not been received to use the alternative cost method.

NOTE 2: When the alternative cost method is not used, the amount included in the bases of houses sold for years after the initial sale is based on the remaining number of benefited units. The interest capitalization provisions with respect to common features are similar in that the apportionment of common feature costs for measurement periods beginning after a benefited unit is sold is determined based on the remaining number of benefited units.

## Chapter 5

### CHANGE OF ACCOUNTING METHOD

#### **WHAT IS A METHOD OF ACCOUNTING**

The term "method of accounting" is not specifically defined in the Code or regulations. However, IRC section 446 and the regulations, when read as a whole, provide a conceptual or working definition. An accounting method affects the timing of the recording of accounting transactions by determining the taxable year to which items of income and deductions will be allocated in a consistent and predictable way. The key concepts in determining what constitutes a method of accounting are timing (which year) and consistency (similar items treated the same).

#### **WHAT IS A CHANGE OF ACCOUNTING METHOD**

Under Treas. Reg. section 1.446-1(e)(2), a change in a method of accounting includes:

1. A change in the overall method of accounting for gross income or deductions; and
2. A change in the treatment of a "material item."

An example of a change in overall method of accounting would be a change from the cash to accrual method of accounting. An example of a change in method of accounting for a "material item" would be changing from deducting taxes when paid to deducting taxes when incurred.

#### **What Is a Material Item as It Relates to Timing**

A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.

In determining whether a practice involves the proper time for the inclusion of an item of income or the taking of a deduction, the relevant question is generally whether the practice permanently changes the amount of taxable income over the taxpayer's lifetime.

If the practice does not permanently affect the taxpayer's lifetime taxable income, but does or could change the taxable year in which taxable income is reported, it involves timing and is, therefore, considered a method of accounting. Revenue Procedure

92-20, section 2.01, 1992-2 C.B. 685.

The term "material item" should be read in the context as "material item of gross income or deductions" and not as meaning "a material item of net income."

### **Consent to Change a Method of Accounting Is Required**

For purposes of IRC section 446, a method of accounting may be a proper method or an improper method of accounting. Once an accounting method is adopted, whether or not the method is proper or permitted, permission to change it is required. See Treas. Reg. 1.446-1(e)(2).

### **Consistency of Treatment and Accounting Methods**

The treatment of a material item in the same way in determining the gross income or deductions in **two or more consecutively filed** returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item. A method of accounting is not established in most instances without consistent treatment. However, a method of accounting may exist under this definition without a pattern of consistent treatment of an item.

If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting. Rev. Proc. 92-20, Section 2.01, 1992-2 C.B. 685.

## **IDENTIFYING WHAT IS NOT A CHANGE IN AN ACCOUNTING METHOD**

An adjustment of any income or deduction item that does not involve the proper time for inclusion or deduction is a correction rather than an accounting method change.

### **Correction of an Error**

Mathematical or posting errors, in the computation of tax liability are corrections, rather than changes of accounting methods. See Treas. Reg. section 1.446-1(e)(2)(ii)(b).

### **Change in Underlying Facts**

There is no change in accounting method if the change merely reflects a change in underlying facts. The taxpayer uses a new accounting practice as a result of a change in business practice (that is, a change in contract terms between taxpayer and

customer). See Treas. Reg. section 1.446-1(e)(2)(ii)(b).

A change in underlying facts defense is generally used by a taxpayer to challenge an IRS contention that the taxpayer made an "unauthorized" accounting method change.

See *Decision, Inc. v. Commissioner*, 47 T.C. 58 (1966), *acq.*, 1967-2 C.B.2. Also see, *Hallmark Cards, Inc. v. Commissioner*, 90 T.C. 26 (1988).

### **Permanent Difference Not Involving Timing**

Recharacterizations or reclassifications of items that result in permanent taxable income effect (difference) is not a change in accounting method. Examples would be deducting a dividend payment to sole shareholder or deducting a loan payment as an expense item.

### **TAXPAYERS UNDER EXAMINATION AND REQUESTING TO USE REV. PROC. 97-27**

Rev. Proc. 97-27, 1997-21 I.R.B. 10, provides the general procedures under IRC section 446(e) and Treas. Reg. section 1.446-1(e) for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes. The revenue procedure provides incentives to encourage prompt voluntary compliance with proper tax accounting principles. Under this approach, a taxpayer generally receives more favorable terms and conditions (for example, a later year of change and a longer IRC section 481(a) adjustment period for a positive adjustment) if the taxpayer files its request for change in accounting method before the taxpayer is contacted for examination. A taxpayer that is contacted for examination and required to change its method of accounting by the Service generally receives less favorable terms and conditions and may also be subject to penalties.

A taxpayer that is under examination may only request a change in accounting method during specified window periods (or with the district directors's consent). A taxpayer under examination may request a change in accounting method during the first 90 days of any taxable year ("90-day window") if the taxpayer has been under examination for at 12 consecutive months as of the first day of the taxable year. A taxpayer under examination may also request a change in accounting method during the 120-day period following the date an examination ends ("120-day window") regardless of whether a subsequent examination has commenced. The 90-day and 120-day windows are not available if the method of accounting the taxpayer is requesting to change is an issue the examining agent has placed in suspense or is an issue under consideration at the time the request is filed.

A taxpayer filing a Form 3115 during one of the window periods is required to pay a user fee (\$900 for taxpayers with gross receipts of \$150,000 or more and \$500 for taxpayers with gross receipts of less than \$150,000). The year of change is the taxable year in which the Form 3115 is filed. The IRC section 481(a) adjustment period is generally 4 taxable years.

If a taxpayer under examination is not eligible to request an accounting method change under Rev. Proc. 97-27, the change may be made by the examiner. A change resulting in a positive adjustment will ordinarily be made in the earliest taxable year under examination with a one-year IR section 481(a) adjustment period.

### **Summary**

In summary, you can use these broad guidelines to determine if an accounting method issue should be raised in the construction business environment. No absolute dollar criteria relative to the proposed effect on taxable income is being recommended in determining when the issue should be raised. Use your professional judgment as to when the issue should be raised. However, the issue should be raised only when there is specific support found in the statute, regulations, Service pronouncements, or court cases.

## **EXAMPLE OF CHANGE IN ACCOUNTING METHOD**

### **CASH TO ACCRUAL METHOD CHANGE ISSUE COMPREHENSIVE RAR PRESENTATION EXAMPLE**

1. Computing an IRC section 481(a) adjustment in a cash to an accrual accounting method issue.
2. Computing the IRC section 481(b) tax limitation when the first year prior to the year of change is a net operating loss.

### **Facts**

A hybrid method taxpayer on a calendar year basis is under examination for 1993. The business activity of the taxpayer is to purchase and install drywall material for its customers. The taxpayer started business in 1985 and has always filed its return on the hybrid basis of accounting. Since 1985 the taxpayer's business activity has remained the same.

The taxpayer could not use Revenue Procedure 97-27, no windows of opportunity were available.

Merchandise was determined to be an income producing factor. The total yearly cost of materials (wallboard) as a percent of the cash basis gross receipts for the year was 35 percent. Accordingly, an accrual method of accounting was required. See *Thompson Electric Inc. v. Commissioner*, T.C. Memo 1995-292. The taxpayer agreed that the overall accrual method was the proper method of accounting.

The issue is being presented in the RAR as an examiner initiated method change. Thus, the year of change is the earliest year under examination (1993) and the entire IRC section 481(a) adjustment is being reported in the RAR for 1993.

**Summary of Analysis of Amounts**

	HYBRID 1/1/93 (old method) per return	ACCRUAL 1/1/93 (new method) per audit	ACCRUAL 12/31/93 (new method) per audit
Accounts Receivable.....	\$ -0-	\$200,000	\$190,000
Merchandise Inventory.....	40,000	50,000	67,000
Supplies Inventory.....	-0-	15,000	20,000
Prepaid Insurance.....	-0-	10,000	8,000
Accounts Payable.....	(5,000)	(63,000)	(53,000)
Salaries & Wages Payable..	-0-	(35,000)	(42,000)
State Income Tax Payable..	-0-	(22,000)	(25,000)
			<u>12/31/93</u>
Sales (per return).....			\$1,200,000
Taxable income (per return)....			* 70,000

\* Note: Taxable income before net operating loss carryforward of \$30,000 from 1992 was \$100,000

Per Return Information:

	Taxable Income	Tax
9312	*\$70,000	\$12,500
9212	(30,000)	-0-
9112	10,000	1,500

\* Note: Taxable income before net operating loss carryforward of \$30,000 from 9212 was \$100,000.

**IRC Section 481(a) Adjustment Calculation**

This illustrates the computation of the section IRC 481(a) adjustment due to the change from the hybrid to accrual method of accounting. The adjustment is the omitted or duplicated income or expense caused by the difference in balance sheet account amounts per return (old accounting method) and as corrected (new accounting method) on the first day of the year of change.

In this case, the IRC section 481(a) adjustment amount at January 1, 1993, is \$120,000.



January 1, 1993

Accounts Receivable	\$200,000	(omitted income)
Merchandise Inventory	10,000	(double deduction)
Supplies Inventory	15,000	(double deduction)
Prepaid Expense	10,000	(double deduction)
Accounts Payable	(58,000)	(omitted deduction)
Salaries & Wages Payable	(35,000)	(omitted deduction)
State Income Taxes Payable	<u>(22,000)</u>	(omitted deduction)
IRC section 481(a) Adj.	\$120,000	(increase to income)

=====

The omitted income, double deduction, or omitted deduction is determined by determining the accounting treatment of the item beginning in the year of change under the new method of accounting. For example, the accounts receivable at January 1, 1993, was not included in income prior to January 1, 1993, under the cash method and cash received in 1993 related to such receivables would not be included in income in 1993 under the new accrual method. Thus, an IRC section 481(a) adjustment is necessary to ensure that the accounts receivable at January 1, 1993, are not omitted from income.

**Computation of the "Current Year Adjustment" for 1993**

Assuming we are examining the 1993 tax year, in addition to the "IRC section 481(a) adjustment," another adjustment to the 1993 year is necessary. This adjustment is called the "current year adjustment" and is computed by determining the difference between the balance sheet account amounts at January 1, 1993, and December 31, 1993 (as per audit).

Thus, the "current year adjustment" of \$10,000 is computed as follows:

	ACCRUAL 1/1/93	ACCRUAL 12/31/93
Accounts Receivable.....	\$200,000	\$190,000
Merchandise Inventory.....	50,000	67,000
Supplies Inventory.....	15,000	20,000
Prepaid Insurance.....	10,000	8,000
Accounts Payable.....	(63,000)	(53,000)
Salaries & Wages Payable..	(35,000)	(42,000)
State Income Tax Payable..	<u>(22,000)</u>	<u>(25,000)</u>
Total	\$155,000	\$165,000
Less: Beginning Balance -----		<u>(155,000)</u>
Current Year Adjustment for 1993		<u>\$ 10,000</u>

=====

### **Computation of IRC Section 481(a) Adjustment and Current Year Adjustment**

The same rationale and mechanical logic in determining the IRC section 481(a) adjustment and the current year adjustment applies when other change in accounting method issues are raised. Examples of other accounting method change issues include changing the valuation of inventory (not deferring enough cost), changing the timing of recognizing income (deferred revenue account -- deferring recognition of revenue) or the timing for claiming a deduction (accrued liability -- accelerating a deduction). In these situations it is a matter of analyzing the beginning and ending balances of the accounts as shown above.

### **Computation of RAR Adjustment for 1993**

It is assumed in this situation that there are three adjustments in the RAR for 1993. In addition to the IRC section 481(a) adjustment and the current year adjustment related to the accounting method change there is one more audit adjustment (unrelated to the accounting method change issue) disallowing a miscellaneous expense of \$10,000. Accordingly, the proposed adjustments for 1993 are as follows:

	RAR 1993
IRC section 481(a) adjustment	\$120,000
Current year adjustment	10,000
Miscellaneous expense	<u>10,000</u>
 Total Proposed Adjustments	 \$140,000 <u>=====</u>

### **IRC Section 481(b) Tax Limitation**

Any positive IRC section 481(a) adjustment over \$3,000 is subject to IRC section 481(b) and the related regulations.

The IRC section 481(a) adjustment of \$120,000 in this example resulted from a change in the overall method of accounting from the hybrid to the accrual method. This adjustment to income is an accumulation of changes from several years in accounts receivable, inventory, accounts payable, etc. Congress found this "bunching of income" in the year of change was too severe and enacted IRC section 481(b). This Code section provides that the additional tax (increase in tax) attributable to the IRC section 481(a) adjustment is the LESSOR of the increase in tax computed:

1. With the net adjustment (IRC section 481(a)) included in income in the year of change
2. Under the 3-year (spread-back) allocation rule of IRC section 481(b)(1)
3. Under the specific allocation rule of IRC section 481(b)(2).

It should be noted that when the "specific allocation rule" of IRC section 481(b)(2) is appropriate or is requested by the taxpayer, the examiner should request the taxpayer to furnish the computation and all necessary data to support the computation.

These limitations affect only the amount of tax due for the year of change, not the year of income inclusion.

**Example of RAR Reporting Both IRC Sections 481(a) and 481(b) Computations**

See Figure 5-1 for an example RAR using the facts as presented above. This example includes a situation where there is a net operating loss (in a computation year 1992) for purposes of the IRC section 481(b)(1) computation. This example shows the presentation in the RAR of the IRC sections 481(a) and 481(b) computations.

**Figure 5-1 (1 of 5)**

1. Adjustments to Income	Year 9312						
a. IRC section 481(a) Adjustment	120,000						
b. IRC section 446 Current Yr. Adj.	10,000						
c. Miscellaneous Expense	10,000						
d.							
2. Total Adjustments	140,000						
3. Adjusted Gross, Taxable or Tax Table Income Shown on Return or as Previously Adjusted	70,000						
4. Corrected Adjusted Gross, Taxable or Tax Table Income	210,000						
5. Tax (Refer to Other Information)	45,350						
6. Alternative Tax, If Applicable	0						
7. Corrected Tax Liability	45,350						
8. Less Credits	<table border="1"> <tr> <td>a.</td> <td></td> </tr> <tr> <td>b.</td> <td></td> </tr> <tr> <td>c.</td> <td></td> </tr> </table>	a.		b.		c.	
a.							
b.							
c.							
9. Balance (Line 7 less total of Lines 8a through 8c)	45,350						
10. Plus:	<table border="1"> <tr> <td>a. Tax from Recomputing Prior Year Investment Credit</td> <td></td> </tr> <tr> <td>b. Self-Employment Tax</td> <td></td> </tr> <tr> <td>c.</td> <td></td> </tr> </table>	a. Tax from Recomputing Prior Year Investment Credit		b. Self-Employment Tax		c.	
a. Tax from Recomputing Prior Year Investment Credit							
b. Self-Employment Tax							
c.							
11. Total Corrected Income Tax Liability (Line 9 plus total of lines 10a through 10c)	45,350						
12. Total Tax Shown on Return or as Previously Adjusted	12,500						
13. Deficiency - Increase in Tax or (Overassessment - Decrease in Tax)	32,850						
14. Adjustment to Prepayment Credits							
15. Balance Due or (Overpayment) (Line 13 adjusted by Line 14) Not Including Interest	32,850						
16. Penalties, If Any (See Explanation)							

Other Information: (See notices on attached sheet.)

Adjustments 1a. and 1b. are the result of a change in the method of accounting used in computing taxable income. The adjustments are made under the authority of IRC sections 446 and 481(a) as indicated. The provisions of IRC section 481(b) were followed in determining the additional tax attributable to the IRC section 481(a) adjustment. Refer to Schedules 1-3 for the tax computation.

EXPLANATION OF ITEMS

9312 -- INCOME TAX COMPUTATION  
IN ACCORDANCE WITH IRC SECTION 481(b)

STEP #1 -- COMPUTE INCREASE IN TAX FOR YEAR OF CHANGE  
ATTRIBUTED TO THE IRC SECTION 481(a) ADJUSTMENT

A. COMPUTATION OF INCREASE IN TAX ON ADJUSTMENTS INCLUDING THE  
IRC SECTION 481(a) ADJUSTMENT

TOTAL PROPOSED ADJUSTMENTS	\$140,000
TAXABLE INCOME PER RETURN (BEFORE NOLD)	100,000
	-----
CORRECTED TAXABLE INCOME (BEFORE NOLD)	\$240,000
NOLD PER RETURN (CARRYFORWARD NOL FROM 9212)	30,000
	-----
CORRECTED TAXABLE INCOME	\$210,000
CORRECTED TAX	\$65,150
TAX PER RETURN	12,500
	-----
INCREASE IN TAX ON ADJUSTMENTS INCLUDING THE IRC SECTION 481(a) ADJUSTMENT	\$52,650 =====

B. COMPUTATION OF INCREASE IN TAX ON ADJUSTMENTS EXCLUDING THE  
IRC SECTION 481(a) ADJUSTMENT

IRC SECTION 446 CURRENT YEAR ADJUSTMENT	\$10,000
MISCELLANEOUS EXPENSES	10,000
	-----
PROPOSED ADJUSTMENTS EXCLUDING IRC SECTION 481(a) AMOUNT	\$20,000
TAXABLE INCOME PER RETURN (BEFORE NOLD)	100,000
	-----
CORRECTED TAXABLE INCOME (BEFORE NOLD)	\$120,000
NOLD PER RETURN (CARRYFORWARD NOL FROM 9212)	(30,000)
	-----

**Figure 5-1 (3 of 5)**

CORRECTED TAXABLE INCOME	\$90,000
CORRECTED TAX	\$18,850
TAX PER RETURN	12,500
	-----
INCREASE IN TAX ON ADJUSTMENTS EXCLUDING THE IRC SECTION 481(a) ADJUSTMENT	\$ 6,350 =====

C. INCREASE IN TAX ATTRIBUTABLE TO 481(a) ADJUSTMENT

INCREASE IN TAX ON ADJUSTMENTS INCLUDING THE IRC SECTION 481(a) ADJUSTMENT (SEE A.)	\$52,6500
LESS:	
INCREASE IN TAX ON ADJUSTMENTS EXCLUDING THE IRC SECTION 481(a) ADJUSTMENT (SEE B.)	\$6,350
	-----
INCREASE IN TAX ATTRIBUTABLE TO 481(a) ADJUSTMENT	\$46,300 =====

STEP # 2 -- COMPUTATION OF INCREASE IN TAX PER IRC SECTION 481(b)(1) --  
3-YEAR (SPREAD-BACK) ALLOCATION RULE

A. ADJUSTMENT FOR EACH OF 3 YEARS (EXAM YEAR AND 2 PRECEDING)

TOTAL 481(a) ADJUSTMENT/3	120,000/3 = \$40,000 PER YEAR =====
---------------------------	--

**Figure 5-1 (4 of 5)**

**B. INCREASE IN TAX BY APPLICATION OF 3-YEAR SPREAD-BACK**

	9112	9212	9312
TAXABLE INCOME PER RETURN	\$ 10,000	\$ 30,000	\$ 70,000
IRC SEC. 446 CURRENT YR. ADJ.			10,000
MICELLANEOUS EXPENSES			10,000
1/3 481(A) ADJUSTMENT	40,000	40,000	40,000
	50,000	10,000	130,000
ADD: ELIMINATED NOLD (ADJ. ELIMINATES 92 CARRYFORWARD)			30,000
TAXABLE INCOME FOR PURPOSES OF IRC SECTION 481(b)(1)	50,000	10,000	160,000
TAX WITH 3-YEAR SPREADBACK	7,500	1,500	37,850
LESS: TAX PER RETURN OR AS COMPUTED EXCLUDING IRC SEC. 481(a) ADJUSTMENT	1,500	0	18,850
INCREASE IN TAX ATTRIBUTABLE TO IRC SEC. 481(a) ADJUSTMENT	\$ 6,000	\$ 1,500	\$ 19,000
TOTAL FOR 3-YEARS			\$ 26,500

STEP #3 -- COMPARE TAX COMPUTED STEP #1 TO TAX COMPUTED STEP #2 TO  
DETERMINE THE INCREASE IN TAX ON THE 481(a) ADJUSTMENT

TAX IS LIMITED TO THE LESSOR OF:

INCREASE IN TAX COMPUTED STEP # 1C.	\$46,300
INCREASE IN TAX COMPUTED STEP # 2B.	\$26,500
INCREASE IN TAX ON IRC SECTION 481(a) ADJUSTMENT	\$26,500

=====

**Figure 5-1 (4 of 5)**

STEP #4 -- INCREASE IN TAX DUE TO ADJUSTMENTS FOR 9312

INCREASE IN TAX ON IRC SECTION 481(a) ADJUSTMENT	\$26,500
INCREASE IN TAX ON ADJUSTMENTS EXCLUDING THE IRC SECTION 481(a) ADJUSTMENT (STEP #1B)	\$6,350
	-----
INCREASE IN TAX DUE TO ADJUSTMENTS FOR 9312	\$32,850
	=====

STEP #5 -- TOTAL TAX FOR 9312

TAX PER RETURN	\$12,500
INCREASE IN TAX DUE TO ADJUSTMENTS FOR 9312	32,850
	-----
TOTAL TAX FOR 9312	\$45,350
	=====



## Chapter 6

### CONSTRUCTION JOINT VENTURES

#### CONSTRUCTION JOINT VENTURES

Construction companies that lack sufficient capital, resources, bonding capacity, or technical expertise to be awarded certain contracts often find it necessary to form joint ventures. Other construction companies have restricted access to international or domestic markets. By forming joint ventures, construction companies can often overcome these market limitations or restrictions. Although these forms of business have both advantages and disadvantages, they are often necessary for the construction company's survival and growth in a highly competitive industry.

#### TYPES OF JOINT VENTURES

Construction projects can be formed as joint ventures, which are considered partnerships under IRC sections 761(a) and 7701(a)(2). Joint ventures are generally formed for one specific purpose (a job, contract, or project) and with the intent of operating for a limited duration. Such construction projects may also be formed as corporations or, under state law, some other type of entity. Regardless of the form of the entity under state law, federal tax law applies to classify the entity for federal tax purposes.

The IRS and Treasury recently published new regulations for classifying business arrangements for federal tax purposes. The regulations are effective January 1, 1997.

When classifying a business arrangement, first determine if there is a separate entity for federal tax purposes. 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. Whether a joint venture is a separate entity for federal tax purposes is a question of federal law. See Treas. Reg. section 301.7701-1.

A separate entity conducting construction operations will generally be treated as a business entity under the new regulations. A business entity with two or more members is classified either (1) as an association taxable as a corporation or (2) as a partnership. Except for certain business entities that are defined as corporations, a business entity may elect to be treated as either an association or a partnership (an eligible entity). See Treas. Reg. section 301.7701-2.

The regulations provide default rules that classify eligible entities without requiring them to file elections. Unless it elects otherwise, a domestic eligible entity that is formed after January 1, 1997, is classified as a partnership if it has at least two members. Unless it elects otherwise, a foreign eligible entity that is formed after January 1, 1997, is classified as either (1) a partnership if it has at least two members and at least one member does not have limited liability, or (2) an association if all members have limited liability. Generally, an eligible entity in existence prior to January 1, 1997, maintains the classification it claimed under the classification regulations in effect prior to January 1, 1997. An eligible entity may elect to be classified 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. section 301.7701-3.

For financial statement purposes, investments in joint ventures are accounted for by the venturer under the cost method, the equity method, as a pro rata share, or the entity is consolidated 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 auditor with an extended view of the construction company's investment in joint ventures because both incorporated projects and joint ventures are often consolidated. In addition, financial information of unconsolidated joint ventures is frequently disclosed in the notes to the financial statements.

Joint ventures classified as partnerships are generally required to file separate income tax returns (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 are formed as general partnerships or limited partnerships. 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.

## **JOINT VENTURE EXAMINATIONS**

Auditors examining construction companies that are involved in joint ventures should be aware of the unique issues regarding the formation, operation, and liquidation of joint ventures. Each venturer brings individual resources to a joint venture and can be compensated in various ways. Each party should be viewed independently. Such a review often raises questions and potential issues.

- ) What resources (assets, capital, services, etc.) were 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?
- ) Do the partnership allocations have substantial economic effect within the meaning of IRC section 704(b)?
- ) Have there been changes in the ownership structure?
- ) Have there been distributions or partial liquidations from the joint venture?
- ) What type of property was distributed and to whom?
- ) How has the construction company been compensated (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 related transactions (compensation payments, leases, loans, etc.) between the joint venture and the venturers?
- ) What method of accounting does the joint venture use?
- ) What effect do long-term contracts have on the allocation of income to incoming/outgoing partners?
- ) Has construction period interest been properly capitalized?

### **INFORMATION DOCUMENT REQUESTS**

Auditors that have identified the existence of joint ventures should carefully design a document request that will assist in answering these and other questions that arise. To obtain general background information, the Information Document Request should specify the following information:

- ) Copies of certified, compiled, or reviewed financial statements of the construction company and individual joint ventures, prepared for external reporting purposes (credit, bonding, stock offerings, etc.).
- ) Copies of joint venture returns (Forms 1065, 1120, 1120-S) for inspection purposes.
- ) Joint venture agreements, partnership agreements, minutes of meetings, and any other documents reflecting agreements made between the parties (including amendments).
- ) Reconciliation of joint venture income/loss to the construction company's tax return (Schedule K-1 spreadsheet).
- ) Written narrative detailing related-party transactions between the joint venture and the construction company.

Once the auditor identifies a potential issue, steps should be taken to protect the necessary statute of limitations. Proper scheduling will ensure that TEFRA procedures are started timely.

## **POTENTIAL JOINT VENTURE ISSUES**

Auditors that examine joint ventures often deal with all the common issues found in the examination of any form of construction entity. However, joint ventures (classified primarily as partnerships) can and do have unique tax issues. These issues often can be divided into three broad categories: formation, operation, and liquidation/distribution issues.

### **Formation Issues**

Failure to file partnership returns (IRC sections 761, 6698).

Capitalization/amortization of organization and syndication fees (IRC section 709).

Contribution of construction services (by the construction company) in exchange for a capital interest in the partnership (Treas. Reg. section 1.721-1(b)(1)).

Contribution of construction services (by the construction company) in exchange for a profits interest in the partnership when a predictable income stream exists.

Deemed (money) distributions on the assumption of a partner's liability on property contributed (IRC section 752(b)).

### **Operation Issues**

Allocation of income, gains, deductions, losses, etc., not having substantial economic effect. (IRC section 704(b)).

Cancellation of indebtedness income (COD income) with bankruptcy or insolvency (IRC section 61(a)(12), IRC section 108).

Withholding tax on distributive share of partnership taxable income to a foreign partner (IRC 1446).

### **Liquidation/Distribution Issues**

Distributions of cash in excess of basis in the partnership interest (IRC section 731, 752 and 741, 751).

Interest expense deductions in connection with debt financed distributions (IRC section 163(h)).

Disguised sales (IRC section 707(a)(2)(B)).

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## APPENDIX A

### SECTION 460 FLOWCHART

#### IRC SECTION 460 TERMS AND DEFINITIONS

**LONG-TERM CONTRACT:** Any contract for the manufacture, building, installation, or construction of property if such contract is not completed in the taxable year in which such contract is entered into.

**CONSTRUCTION CONTRACT:** Any contract for the building, construction, reconstruction, rehabilitation, or the installation of any integral component to, or improvements of, real property.

**HOME CONSTRUCTION CONTRACT:** Any construction contract if 80 percent 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 activities defined as construction contracts with respect to:

1. buildings containing 4 or fewer dwelling units, and
2. improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

For purposes of this definition each townhouse or rowhouse shall be treated as a separate building.

**RESIDENTIAL CONSTRUCTION CONTRACT:** Any contract that would be described as a home construction contract except that:

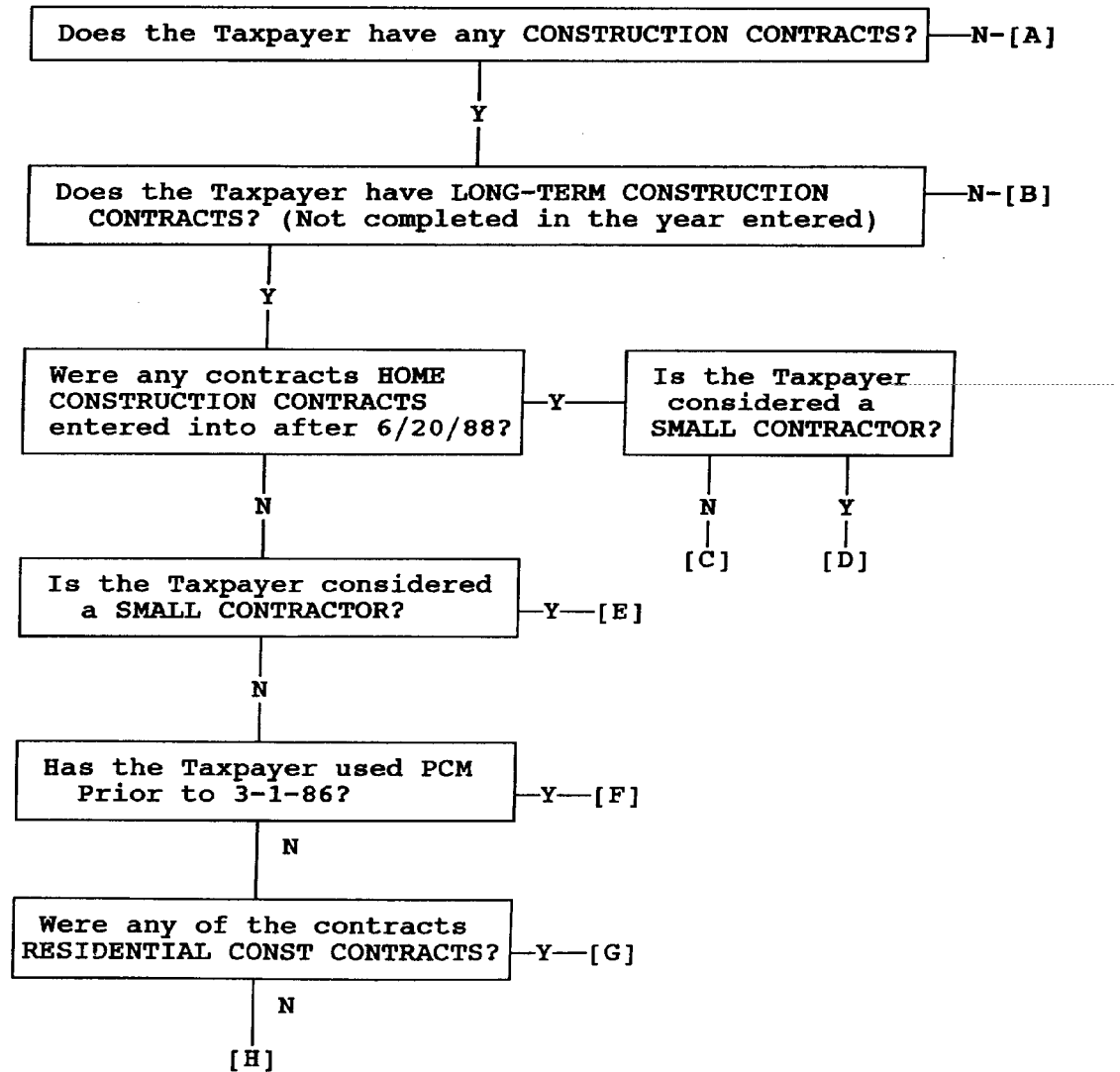
1. the dwelling units are defined as a house or an apartment,
2. that is used to provide living accommodations in a building or structure, but
3. does not include a unit in a hotel, motel, inn or other establishment more than one-half of which the units in which are used on a transient basis.

**SMALL CONTRACTOR:** Any contractor with construction contracts:

1. who estimates at the time such contract is entered into that such contract will be completed within the 2 year period beginning on the contract commencement date of such contract, and

2. whose average annual gross receipts for the 3 taxable preceding the taxable year in which such contract is entered into do not exceed \$10,000,000.

### METHOD OF ACCOUNTING FLOWCHART





## Flow Chart Reference Items

- [A] Taxpayer with no contracts is exempt from IRC section 460 and under Treas. Reg. section 1.451-3. Allowable Income Methods: IRC section 446 applies, thus the cash or accrual methods are allowable methods, as long as it clearly reflects the taxpayer's income. Construction Costs: capitalize under IRC section 263(a). For specific costs to be capitalized look to IRC section 263A. Production period interest: capitalized under IRC section 263A(f).
- [B] Contracts that do not fall under the definition of long-term contracts are exempt from IRC section 460 and Treas. Reg. section 1.451-3. The same methods of accounting are allowed as referenced in Item A. Short-term contracts (those beginning and ending within the same taxable year) do not require any construction cost capitalization. Contracts started and completed in one taxable year should report all income and expenses in the current period.
- [C] Long-term home construction contracts for contractors not meeting the definition of a small contractor. Exempt from IRC section 460. Treas. Reg. section 1.451-3 is applicable. Allowable Construction Income Methods: completed contract, PCM, or accrual must clearly reflect the taxpayer's income. Allowable Income Statement Methods: cash or accrual. Construction Costs: capitalize under IRC section 263A. Production Period Interest: capitalized under IRC section 263A(f). Alternative Minimum Tax: For contracts entered into prior to September 20, 1990, AMT is computed using 100 percent percentage of completion method.
- [D] Long-term home construction contract for contractors who meet the definition of a small contractor. Exempt from IRC section 460. Treas. Reg. section 1.451-3 applicable. Allowable Construction Income Methods: completed contract, PCM or accrual must clearly reflect the taxpayers income. Allowable Income Statement Methods: cash or accrual. Construction Costs: capitalize under Treas. Reg. section 1.451-3(d)(5). Production Period Interest: capitalize under IRC section 263A(f). Alternative Minimum Tax: PCM is not required for AMT. Ref: Notice 89-15, Section IX Q&A 39.
- [E] Small contractor who is not a home construction contractor. Allowable Income Methods: cash, accrual, percentage of completion or completed contract must clearly reflect the taxpayer's income. Construction Costs: capitalize under Treas. Reg. section 1.451-3(d)(5). Production Period Interest: capitalize under IRC section 263A(f). Alternative Minimum Tax: compute using 100 percent percentage of completion method. Lookback: applied to AMT calculation.
- [F] Taxpayer is not a home construction or small contractor and, prior to March 1, 1986, has used the percentage of completion method. Construction Income: The percentage of completion computation must comply with IRC section 460. An election for a 10 percent method is available under IRC section 460(b)(5). If this election is not made the taxpayer

may use the simplified method. Construction Costs: are part of the percentage of completion computation. Specific allocable costs are required by IRC section 460(c). Lookback Calculation: applicable. Alternative Minimum Tax: computed using 100 percent percentage of completion method.

- [G] Taxpayer is not a home construction contractor or a small contractor and has not previously used PCM, but does meet the definition of a residential construction contractor. IRC section 460 is applicable. Allowable Income Method: percentage of completion-capitalized cost method applies, using a 70/30 ratio. (70-percent percentage of completion, 30 percent using the previous accounting method). Lookback applies to the 70 percent. Construction Costs: part of the percentage of completion computation. Specific allocable costs are identified in IRC section 460(c) Alternative Minimum Tax: computed using 100-percent percentage of completion method.
- [H] Taxpayer is not a home construction contractor, or a small contractor, has not previously used PCM, and does NOT meet the definition of a residential construction contractor. IRC section 460 does apply. Construction Income and Construction Costs: percentage of completion computation must comply with IRC section 460. An election for a 10 percent method is available under IRC section 460(b)(5). If this election is not made the taxpayer may use the simplified method. Lookback: applicable at 100 percent. Alternative Minimum Tax: computed using 100-percent percentage of completion method.

**APPENDIX B**

**COST CAPITALIZATION**

**COST CAPITALIZATION METHODS COMPARISON CHART**

COST ALLOCATION METHOD: CITE:	Actual Cost Method or GAAP Capt'l Costs IRC 460(c)	Simplified Method IRC 460 (b)(4)(a)	Non Extended Contract 1.451-3	Extended Contract 1.451-3	Cap. Rules under 263(a) 263(A)
<b>DIRECT COSTS:</b>					
Materials	Yes	Yes	Yes	Yes	Yes
Labor	Yes	Yes	Yes	Yes	Yes
Sub-Contractors	Yes	Yes	Yes	Yes	Yes
<b>INDIRECT COSTS:</b>					
Add'l Costs Cost Plus or Gov't Contracts	Yes***	No	No	No	Yes
Administration (Contract)	Yes***	No	Yes	Yes	Yes
Advertising	No	No	No	No	No
Bidding: Successful	Yes***	No	No	Yes	Yes
Bidding: Unsuccessful	No	No	No	No	No
Casualty Loss	No	No	No	No	No
Depreciation: Financial Statement	No*	No	Yes	Yes	No
Depreciation: For Tax	Yes**	Yes	No	No	Yes
Depreciation: Idle Equipment	No	No	No	No	No
Engineering and Design	Yes***	No	No	Yes	Yes
G & A Contract Related	Yes***	No	No	Yes	Yes
G & A Not Contract Related	No	No	No	No	No
Indirect Labor	Yes	No	Yes	Yes	Yes
Insurance	Yes	No	Yes	Yes	Yes

COST ALLOCATION METHOD: CITE:	Actual Cost Method or GAAP Capt'l Costs IRC 460(c)	Simplified Method IRC 460(b)(4)(a)	Non Extended Contract 1.451-3	Extended Contract 1.451-3	Cap. Rules under 263(a) 263(A)
Maintenance	Yes	No	Yes	Yes	Yes
Marketing	No	No	No	No	No
Mat/Supplies	Yes	No	Yes	Yes	Yes
Obsolescence	No	No	No	No	No
Officer Salaries Contract Related	Yes***	No	Yes	Yes	Yes
Pension and/or Profit Sharing	Yes***	No	No	Yes	Yes
Prod. Period Interest	Yes	No	Yes		Yes
Purchasing	No***	No	No	Yes	Yes
Quality Control	Yes	No	Yes	Yes	Yes
R & D Direct	Yes**	No	No	Yes	No
R & D Indirect	No	No	No	No	No
Rent	Yes	No	Yes	Yes	Yes
Repairs	Yes	No	Yes	Yes	Yes
Repairs of Non Prod. Equip.	No	No	No	No	No
Re-Work (Scrap)	Yes***	No	No	Yes	Yes
Selling Exp.	No	No	No	No	No
Service Costs (Past)	Yes***	No	No	No	Yes
Small Tools & Equipment	Yes	No	Yes	Yes	Yes
Storage/Handling	No***	No	No		Yes
Strike Costs	No	No	No	No	No
Taxes	Yes	No	Yes	Yes	Yes
Taxes (Income)	No	No	No	No	No
Transporation	Yes	No	Yes		Yes
Utilities	Yes	No	Yes	Yes	Yes

- \* Yes for GAAP purposes
- \*\* No for GAAP purposes
- \*\*\* Maybe for GAAP purposes

## APPENDIX C

### NOTICE 89-15

*[NOTE: Rev. Proc. 97-27, 1997-21 I.R.B. 10,  
modified and superseded Q&A-13].*

OTHER REPORTING TIME RULES -- Special rules for long-term contracts. IRS released guidance in question and answer format on changes made to accounting rules for long-term contracts by TAMRA '88. Notice discusses definition of long-term contracts, effective date of new rules, methods to be used, rules for applying percentage of completion-capitalized cost method, rules for applying percentage of completion method, rules for severing and aggregating contracts, rules for determining which costs are allocable to long-term contracts, exceptions for certain construction contracts, and changing methods of accounting under Sec. 460.

### Long-Term Contracts

#### Notice 89-15

This notice provides guidance with respect to section 460 of the Code, relating to the accounting for long-term contracts.

#### I. BACKGROUND

Section 804 of the Tax Reform Act of 1986, Pub. L. No. 99-514 (the "1986 Act"), added section 460 to the Internal Revenue Code, effective for contracts entered into after February 28, 1986. Section 10203 of the Revenue Act of 1987, Pub. L. No. 100-203 (the "1987 Act"), amended section 460, effective for contracts entered into after October 13, 1987 (except for certain ship contracts described in section 10203(b)(2) of the 1987 Act). Section 5041 of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (the "1988 Act") further amended section 460, effective for contracts entered into after June 20, 1988 (except for certain ship contracts, as provided in section 5041(e)(1)(C) of the 1988 Act). The Questions and Answers in this notice discuss general rules under section 460, changes to section 460 made by the 1988 Act, and transitional rules under the 1988 Act. Previous guidance concerning section 460 was provided in Notice 87-61, 1987-2 C.B. 370, and Notice 88-66, 1988-1 C.B. 552.

Rules for determining whether a contract is a long-term contract within the meaning of section 460 are set forth in Q&A-2 through Q&A-8. The effective date of section 460 is discussed in Q&A-9 through Q&A-13. Rules for determining which of the two long-term

contracts methods must be used by a taxpayer are set forth in Q&A-14. Rules for applying the percentage of completion-capitalized cost method are set forth in Q&A-15 through Q&A-18. Question 17 addresses the application of the percentage of completion-capitalized cost method by a taxpayer using a LIFO method of valuing inventories. Rules for applying the percentage of completion method are set forth in Q&A-19 through Q&A-36. Q&A-37 and Q&A-38 address the rules that apply to severing and aggregating contracts. Rules for determining which costs are allocable to a long-term contract, and therefore taken into account under section 460, are set forth in Q&A-39 and Q&A-40. The exceptions applicable to certain construction contracts provided by section 460(e) are explained in Q&A-41 through Q&A-46. Rules governing changes in methods of accounting under section 460 are set forth in Q&A-7, Q&A-13, and Q&A-47 through Q&A-49.

The Internal Revenue Service expects to issue separate guidance relating to the look-back method of section 460(b). This notice does not address the look-back method. See Form 8697 and its instructions.

## **II. PERMISSIBLE METHODS OF ACCOUNTING FOR LONG-TERM CONTRACTS**

Q-1: Under section 460 of the Internal Revenue Code, what methods of accounting are to be used for items of income from and costs allocable to long-term contracts?

A-1: With the exception of certain construction contracts (including certain home construction contracts entered into after June 20, 1988) described in section 460(e)(1) (see Q&A-42 through Q&A-44), section 460(a) requires that items of income from and costs allocable to a long-term contract be taken into account under either of two methods of accounting: (1) the percentage of completion method, or (2) the percentage of completion-capitalized cost method. Rules for determining which of these two methods must be used by a taxpayer are set forth in Q&A-14.

## **III. DEFINITION OF LONG-TERM CONTRACT**

Q-2: What is a long-term contract for purposes of section 460?

A-2: In general, under section 460(f), a long-term contract is any contract for the manufacture, building, installation, or construction of property if the contract is not completed within the taxable year in which it is entered into. A contract for the manufacture of property, however, is not treated as a long-term contract unless certain additional conditions set forth in section 460(f)(2) (and explained in Q&A-5) are met. For these purposes, a contract for the production of personal property is generally considered to be a contract for the manufacture of property. In contrast, any contract for the production or installation of real property or any improvements to real property, is considered to be a contract for the building, installation, or construction of property.

In determining whether a contract is completed in the taxable year in which it is entered into, all activities of the taxpayer and any related parties in connection with the manufacture, building, installation, or construction must be taken into account. For additional rules applicable to related parties, see Q&A-8.

Q-3: In determining whether a contract is a long-term contract, is it relevant that the taxpayer reasonably believed at the time that the contract was entered into that it would be completed within the same taxable year?

A-3: No. A contract that satisfies the definition of a long-term contract set forth in Q&A-2 is considered a long-term contract even though the taxpayer expected that it would be completed within the taxable year.

Q-4: Is a contract considered to be for the "manufacture, building, installation, or construction of property," even though the contract provides that the contractor is to retain title to, control over, and risk of loss with respect to the property until it is completed and accepted by the customer, and even though the parties characterize the contract as a contract for the sale of property?

A-4: Such a contract is considered to be for the "manufacture, building, installation, or construction of property," if the manufacture, building, installation, or construction of the subject matter of the contract is necessary in order for the taxpayer's contractual obligations to be fulfilled, and if the manufacture, building, installation or construction has not been completed at the time that the contract is entered into. It is not relevant whether the customer has title to, control over, or risk of loss with respect to the property. Moreover, it is not relevant whether the parties characterize their agreement as a contract for the sale of property.

*Example (1).* Y notifies X, an aircraft manufacturer, that it wishes to purchase an aircraft of a particular type. At the time X receives the order, X has on hand several partially completed aircraft of this type; however, X does not have any completed aircraft of this type on hand. X and Y agree that Y will purchase one of these aircraft after it has been completed. X retains title to and risk of loss with respect to the aircraft until the sale takes place. The agreement between X and Y is a contract for the manufacture of property within the meaning of section 460(f)(1), even if characterized by the parties as a contract for the sale of property. (See Q&A-5 for additional conditions that must be met in order for a contract for the manufacture of property to be a long-term contract.)

*Example (2).* A, a calendar year builder with average annual gross receipts of more than \$10 million, begins construction of a house in October 1988, on speculation that it will find a buyer. In November 1988, A enters into a contract with B under which B agrees to purchase the house upon completion of construction. The construction of the home is not complete on December 31, 1988. A's contract with B is a contract for the building or construction of property within the meaning of section 460(f)(1), even if characterized by the parties as a contract for the sale of the house, since A must build or construct property to comply with the contract. Assuming, however, that the contract is a "home construction contract" within the meaning of section 460(e)(1)(A) and (e)(6)(A), A is not required to use the percentage of completion method or the percentage of completion-capitalized cost method of accounting for regular tax purposes because A entered into the contract after June 20, 1988. See Q&A-42. A must account for the contract using the rules of section 263A and the regulations thereunder. In addition, because A's average annual gross receipts exceed \$10 million, A is required to use the percentage of completion method for purposes of determining A's alternative

minimum tax liability. See Q&A-46.

*Example (3).* The facts are the same as in Example (2) except that A begins construction of the house in October 1987 and enters into a contract with B in November 1987. A is required to use the percentage of completion or percentage of completion-capitalized cost method of accounting for the contract under section 460 as amended by the 1987 Act.

*Example (4).* The facts are the same as Example (3) except that A completes construction of the house and subsequently enters into a contract with B for the purchase of the house. Because A is not required to build or construct property to complete the contract, the contract is not a long-term contract subject to section 460.

*Example (5).* C, a calendar year home builder with average annual gross receipts of more than \$10 million, enters into a contract with D on July 1, 1988 to build a house for D. D has title to the lot on which the house is built, provides C with all materials, and has title to the house while the house is under construction. The contract is completed in February 1989. The contract is a contract for the construction of property, notwithstanding the fact that C does not have title to the subject matter of the contract. The contract is, therefore, a long-term contract within the meaning of section 460(f). Assume that the contract is a "home construction contract" within the meaning of section 460(e)(1)(A). Because the contract was entered into after June 20, 1988, C is not required to use the percentage of completion method or the percentage of completion-capitalized cost method of accounting. C must account for the contract using the rules of section 263A and the regulations thereunder. Thus, C must capitalize all of its costs incurred in constructing the home, including labor costs, interest, and all indirect costs allocable to the construction activities under section 263A and the regulations thereunder. See section 460(e)(1). In addition, because C's average annual gross receipts exceed \$10 million, C is required to use the percentage of completion method for purposes of determining C's alternative minimum tax liability.

**Q-5:** What additional conditions apply in determining whether a contract for the manufacture of property is a long-term contract within the meaning of section 460(f)?

**A-5:** Under section 460(f)(2), a contract for the manufacture of property is not treated as a long-term contract unless the contract involves the manufacture of either (A) a unique item of a type that is not normally included in the finished goods inventory of the taxpayer, or (B) an item that normally requires more than 12 calendar months to complete (without regard to the period of the contract).

Since the item must meet only one of these two criteria, a manufacturing contract that is not completed in the taxable year in which it is entered into is a long-term contract within the meaning of section 460(f) if it is for the manufacture of an item that normally requires more than 12 calendar months to complete, even if the item is not unique. In determining the time normally required for the manufacture of an item, all activities of the taxpayer and of any related party relating to the manufacture must be taken into account. See H.R. Rep. No. 795, 100th Cong., 2d Sess. 470 (1988). Thus, the time required to manufacture an item is not limited to the time required to assemble the item and includes the time required for activities such as production of components and subassemblies by the taxpayer or by any related party. For purposes of this paragraph, a related party is a person whose relationship to the taxpayer is described in section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and determined by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation in subsections (b)(2), (b)(8), (b)(10)(A) and (b)(12) of section 267.



The rule of this Q&A-5 that the activities of related parties are to be taken into account in determining the normal production period of an item shall, in general, apply only to contracts entered into on or after June 21, 1988. However, this rule shall apply to any contract entered into after February 28, 1986 if (i) the taxpayer has arranged for a party whose relationship with the taxpayer is described in section 267(b) or 707(b) (and regardless of whether the degree of ownership requirements of the applicable section are satisfied) to perform a portion of the activities required to fulfill the contract, and (ii) a principal purpose of that arrangement is to avoid characterization of the contract as a long-term contract.

*Example.* X, a construction equipment manufacturer that is a calendar year taxpayer, produces a type of crane. X purchases a number of the components of the crane from suppliers that are related parties. The manufacture of these components and their shipment to X normally takes 5 months to complete. Completion of a crane using these components normally requires an additional 8 months from the time X receives them. Therefore, the crane is an item of a type that normally requires more than 12 months to complete. X normally does not produce the cranes under contracts with particular customers, but instead produces the goods for finished goods inventory, and enters into contracts for sale of the cranes after they are completed. X begins work on several cranes on July 1, 1988. Notwithstanding X's normal practice of completing cranes before contracting for their sale, on December 1, 1988, X enters into a contract with buyers for the cranes. On February 1, 1989, X completes the cranes, one month ahead of schedule. The contract is a long-term contract within the meaning of section 460(f), even though the cranes are an item of a type that X normally includes in finished goods inventory, and even though the duration of the contract was only two months, because the crane is an item of a type that normally requires more than 12 calendar months to complete.

Q-6: Do the additional conditions set forth in Q&A-5 apply in determining whether a contract for the building, installation, or construction of property is a long-term contract?

A-6: No. A contract for the building, installation, or construction of property that is not completed in the taxable year in which it is entered into is a long-term contract even if the property is not unique and does not normally require more than 12 months to complete. Thus, for example, a contract to build a house or other building is a long-term contract if it is not completed in the taxable year in which it is entered into, because the requirements applicable to manufacturing (that the property must be unique or that each item normally require more than 12 months to complete) do not apply to building, construction, or installation contracts.

Q-7: For taxpayers that used a long-term contract method for contracts entered into prior to the effective date of section 460, what restrictions apply with respect to the criteria used by the taxpayer for determining whether similar contracts entered into on or after the effective date of section 460 are long-term contracts?

A-7: Any taxpayer that, immediately prior to the effective date of section 460, accounted for contracts based on the position that such contracts were long-term contracts under section 1.451-3(b) of the Income Tax Regulations, is required to account for such contracts (and any successor contracts) under section 460 unless the taxpayer obtains the consent of the Commissioner to change its method of accounting. This is true even if the taxpayer's position under prior law was based on an erroneous application of the definition of "long-term" contract in

section 460(f) and this notice. For these purposes, the term "successor contracts" means all contracts which, under the criteria and methods used by the taxpayer prior to the effective date of section 460 in determining whether a contract was a long-term contract under section 1.451-3(b) of the regulations, would be or have been classified by such taxpayer as long-term contracts under section 1.451-3(b), regardless of whether those criteria and methods are correct. Thus, for example, it is anticipated that the criteria and methods used by a taxpayer in determining that items were "unique" prior to February 28, 1986, and thus were produced under long-term contracts, will continue to be used by the taxpayer unless the taxpayer obtains the consent of the Commissioner to change its method of accounting. See H.R. Rep. No. 495, 100th Cong., 2d Sess. 923 (1987).

Q-8: How does section 460 apply to activities performed by a taxpayer ("Y") for a related party ("X") that, considered by themselves, would not constitute a long-term contract between X and Y, but that benefit the performance of a long-term contract entered into by X with any customer of X?

A-8: If X has entered into a long-term contract after June 20, 1988, with a customer, and Y, a taxpayer that is related to X, performs any activities for or on behalf of X that benefit or are performed by reason of X's contract, then Y shall account under section 460 for its income and costs attributable to such activities. Such activities include, for example, the production of items, such as components or subassemblies, that are reasonably expected to be used in the production of the subject matter of X's contract. Y is required to account for such activities under section 460 regardless of whether Y's activities, considered by themselves, (i) constitute manufacture, building, construction, or installation of property, (ii) involve the manufacture of items that either are "unique" or require more than 12 months to complete, (iii) span the end of Y's taxable year, or (iv) are performed pursuant to a contract with X. For purposes of this paragraph, a related party is a person whose relationship to the taxpayer is described in section 707(b) or 267(b), determined without regard to section 267(f)(1)(A) and determined by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation in subsections (b)(2), (b)(8), (b)(10)(A) and (b)(12) of section 267.

In applying section 460, Y should treat as the total expected contract price the amount to be paid by X, if such amount represents an arm's length charge. If this amount does not represent an arm's length charge, then Y must use an arm's length charge as the total expected contract price. This arm's length charge must reflect both Y's contribution to the long-term contract being performed by X, and the contract price to be received by X. In addition, if Y treats as total expected contract price an arm's length charge that differs from the actual amount that X is obligated to pay, then X must treat that arm's length charge as the cost that X incurs with respect to Y's activities.

For purposes of determining its own percentage of completion, X shall take into account the amount that it accrues as payable to Y (or is treated as accruing as payable to Y under the preceding paragraph) at the time that X accrues such amount, rather than at the time that Y incurs

costs to perform activities benefiting X's long-term contract.

The rule of this Q&A-8 requiring that certain activities of related parties such as Y be accounted for under section 460 even though such activities do not, by themselves, constitute a long-term contract shall in general apply only to contracts entered into by X on or after June 21, 1988. However, this rule shall apply to any contract entered into after February 28, 1986, if X has arranged for a party whose relationship with X is described in section 707(b) or 267(b) (and regardless of whether the degree of ownership requirements of the applicable section are satisfied) to perform a portion of the activities required to fulfill the contract, and a principal purpose of that arrangement is to avoid the application of section 460 to the income and expenses attributable to such activities.

*Example.* On July 1, 1988, X, an accrual method taxpayer, enters into a long-term contract within the meaning of section 460(f) to produce 5 aircraft for C. Y1, an 80-percent-owned subsidiary of X and also an accrual method taxpayer, incurs costs in 1988 and 1989 to perform research, development, engineering and design work necessary to produce the aircraft. Assume that, if X had performed these activities itself, the costs would have been properly allocable to the contract. This work is completed in 1989. Y2, also an 80-percent-owned subsidiary of X, and also an accrual method taxpayer, manufactures engines in 1989 and 1990 for the aircraft. Y2's work is completed in 1990. Assume that X pays Y1 and Y2 amounts that are arm's length charges as determined under the principles of section 482, with such charges reflecting both the contributions of Y1 and Y2 to the contract being performed by X and the price to be received by X.

Both Y1 and Y2 must account for their activities under section 460 regardless of whether (i) Y1's activities considered by themselves would constitute the manufacture of property, (ii) the aircraft engines are "unique" or require more than 12 months to complete, and (iii) Y1 and Y2 have entered into contracts with X. Y1 must include the amount to be payable by X in income in 1988 and 1989, and Y2 must include the amount to be payable by X in 1989 and 1990, under either the percentage of completion or percentage of completion-capitalized cost method, under the rules applicable to long-term contracts entered into on July 1, 1988. Y1 and Y2 must apply the look-back method in 1989 and 1990, respectively. Y1 and Y2 are subject to the cost allocation rules of section 460(b). X is not required to take the costs incurred by Y1 and Y2 into account in determining its own percentage of completion for 1988 through 1990. Instead, X takes into account the amounts that it accrues as payable to Y1 and Y2 in determining its percentage of completion at the time that X incurs such amounts. See Q&A-32 and Q&A-33.

#### **IV. EFFECTIVE DATE OF SECTION 460**

Q-9: When is section 460 effective?

A-9: Section 460 (including the interest allocation requirements of section 460(c)(3)) and the rules set forth in this notice are, except as expressly provided to the contrary in this notice, effective for long-term contracts entered into after February 28, 1986, beginning with taxable years ending after February 28, 1986. For rules governing the accounting for costs allocable to contracts entered into after February 28, 1986, but incurred in taxable years ending before March 1, 1986, see Q&A-29 and Q&A-36. No inference is intended concerning the extent to which the rules applicable after the effective date of section 460 would apply to issues arising under the law

in effect before the enactment of section 460.

Q-10: Does section 460 apply to a contract that is entered into by the taxpayer before March 1, 1986, but is assigned by the taxpayer on or after that date to another person?

A-10: The assignee must account for such a contract under section 460 unless (i) none of the terms of the contract are changed in connection with the assignment, and (ii) the assignee agrees to perform all of the assignor's remaining obligations under the contract and becomes entitled to all remaining payments under the contract. If the conditions of the previous sentence are met, such a contract is not subject to section 460 even if the assignor does not remain liable to the customer after the assignment and even if the assignee becomes liable to the customer. This rule applies regardless of whether the assignor and assignee are related persons, and regardless of whether the assignment occurs in connection with a taxable sale or a nontaxable transaction. The assignee must account for contract income and costs using its "normal" method of accounting for long-term contracts (as defined in Q&A-18) as of the date of the transfer (which may or may not be the same as the normal method of accounting of the assignor), except as provided in section 381 of the Code, or any other applicable provision of the Code or regulations. If the assignee has not adopted a method of accounting for long-term contracts as of the time of the transfer (as may be the case if, for example, the assignee is a new taxpayer, or has never performed a long-term contract), the assignee generally may use any method of accounting for a long-term contract permitted under section 1.451-3 of the regulations (e.g., the completed contract method or the accrual method). If, however, such an assignee has a relationship to the assignor described in section 267(b) or 707(b) immediately after the assignment, then the assignee must use the assignor's normal method. For this purpose, whether the assignee and assignor have a relationship described in section 267(b) shall be determined without regard to section 267(f)(1)(A) and by substituting "80 percent" for "50 percent" with regard to the ownership of the stock of a C corporation in subsections (b)(2), (b)(8), (b)(10)(A) and (b)(12) of section 267.

*Example (1).* On February 1, 1986 X Corporation enters into a construction contract with Y. On November 1, 1987, X sells the assets of its division that was performing the contract to Z corporation. As part of the asset sale, Z agrees to perform all of X's obligations under the contract, and X assigns to Z all of its rights under the contract, including the right to all remaining payments under the contract. Y agrees to release X from its obligations under the contract, and Z becomes legally obligated to Y. There is no change in the terms of the contract. Thus, Z does not agree to perform any additional work that X was not obligated to perform, and no adjustment is made in the contract price that Y is obligated to pay. Because X's contract with Y was entered into prior to March 1, 1986, Z is not subject to section 460 in accounting for contract income and costs.

*Example (2).* The facts are the same as in Example (1), except that the terms of the contract (e.g., the total price to be paid by Y) are changed in connection with the transaction. Z is subject to section 460 in accounting for contract income and costs.

Q-11: Does section 460 apply to revenues and expenses attributable to a change order or other similar agreement entered into by the taxpayer and the customer after February 28, 1986 but relating to a contract entered into on or before that date?

A-11: A change order or other similar agreement entered into by the taxpayer and the customer after February 28, 1986, is subject to section 460 if it is treated as a separate contract under the rules for severing contracts described in Q&A-37 and Q&A-38.

*Example.* Y enters into a contract on February 1, 1986, with an agency of the Federal Government to build two submarines. On November 1, 1987, the customer and taxpayer agree to a change order providing for a third submarine of the same class to be built by Y. Because the change order is treated as a separate contract under the rules for severing contracts described in Q&A-37, Y must account for costs and income allocable to the third submarine in accordance with section 460.

Q-12: Is a contract considered to have been entered into even if the contract is subject to conditions that have not yet been met?

A-12: Yes. A contract is considered to have been entered into even if it is subject to conditions not within the control of the taxpayer that have not yet been met, so long as the contract is a binding contract under applicable law.

*Example.* On December 1, 1985, X, a builder, enters into a contract with Y to build a home. Although the contract is contingent on Y's obtaining financing, it is a binding contract under applicable law. Y obtains financing on March 1, 1986. The contract is not subject to section 460, because it was entered into before March 1, 1986, even though it was subject to a condition that was met on or after that date.

Q-13<sup>1</sup>: If a taxpayer has failed to comply with section 460 with respect to one or more contracts entered into after February 28, 1986 for one or more tax years ending after that date, how should the taxpayer correct its method of accounting?

A-13<sup>2</sup>: A taxpayer that has failed to comply with section 460 must change its method of accounting for long-term contracts to conform to section 460 under the following procedures. These procedures are to be used rather than the procedures provided in Rev. Proc. 84-74, 1984-2 C.B. 736. Under this notice, the taxpayer is directed to and is granted consent to conform its method of accounting to a method required under section 460, provided that (1) section 6501 (the applicable statute of limitations) would permit assessment of tax for all years for which the

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<sup>1</sup> [NOTE: Rev. Proc. 97-27, 1997-21 I.R.B. 10, modified and superseded Q&A 13.]

<sup>2</sup> [NOTE: Rev. Proc. 97-27, 1997-21 I.R.B. 10, modified and superseded Q&A 13.]

taxpayer has failed to report income and expenses in accordance with section 460, and (2) the taxpayer files amended returns for all such years.

If section 6501 would not permit assessment of tax for all tax years for which the taxpayer has failed to report income and expenses in accordance with section 460, then the taxpayer shall, pursuant to section 446, request the consent of the Commissioner to change its method of accounting for all contracts entered into after February 28, 1986 to a method required by section 460. Such change shall be effective for the earliest tax year for which section 6501 would permit assessment of tax. As a condition of such change, the taxpayer shall file amended returns for the year of change and all subsequent years. Any adjustment required under section 481 as a result of such change shall be taken into account under such terms as may be prescribed by the Commissioner.

## **V. DETERMINATION OF WHETHER PERCENTAGE OF COMPLETION OR PERCENTAGE OF COMPLETION-CAPITALIZED COST METHOD IS TO BE USED**

Q-14: What rules apply in determining whether the percentage of completion method of accounting rather than the percentage of completion-capitalized cost method of accounting is to be used by a taxpayer for a particular long-term contract entered into after February 28, 1986?

A-14: If, immediately prior to the effective date of section 460, the taxpayer used the percentage of completion method of accounting for all long-term contracts within a particular trade or business, then the taxpayer is required to use the percentage of completion method of accounting (as modified by section 460 and explained in Q&A-19 through Q&A-36) for all times of income from and all costs allocable to all long-term contracts within that trade or business entered into after February 28, 1986, unless the taxpayer has obtained the consent of the Commissioner to use a different method of accounting.

If, immediately prior to the effective date of section 460, a taxpayer used a method of accounting other than the percentage of completion method for all long-term contracts within a particular trade or business, then the taxpayer shall use the percentage of completion-capitalized cost method for all long-term contracts within that trade or business (other than contracts exempt under section 460(e)(1)) entered into after February 28, 1986, unless one of the following conditions is met: (1) the taxpayer has changed its method of accounting to the percentage of completion method (e.g., pursuant to Notice 87-61, 1987-2 C.B. 370, or Notice 88-66, 1988-1 C.B. 552, or Q&A-47) for all items under all long-term contracts within that trade or business entered into after February 28, 1986; (2) the taxpayer has changed its method of accounting (e.g., pursuant to Notice 88-66 or Q&A-47) to the percentage of completion method for all items under all long-term contracts within that trade or business entered into after October 13, 1987; or (3) the taxpayer has changed its method of accounting (e.g., pursuant to Q&A-47) to the percentage of completion method for all long-term contracts entered into after June 20, 1988; or (4) the taxpayer has obtained the consent of the Commissioner to use a different method of

accounting.

Immediately prior to the effective date of section 460, under section 1.451-3(a)(1) of the regulations, some taxpayers were permitted to use the percentage of completion method for certain long-term contracts within a particular trade or business, but to use another method of accounting for other long-term contracts within that trade or business. For example, the taxpayer might have used the percentage of completion method for long-term contracts of substantial duration and an accrual method for long-term contracts of less than substantial duration. Such a taxpayer must use the percentage of completion method, as modified by section 460, to account for all items under all long-term contracts entered into after February 28, 1986 that are of a duration such that they would have been accounted for under the percentage of completion method, based on the standards applied by the taxpayer, prior to the effective date of section 460. Such a taxpayer must use the percentage of completion-capitalized cost method to account for all items under all long-term contracts entered into after February 28, 1986 that are of a duration such that they would have been accounted for under a method other than the percentage of completion method, based on the standards applied by the taxpayer prior to the effective date of section 460. The requirements of the two preceding sentences shall apply unless the taxpayer has changed to the percentage of completion method pursuant to Notice 87-61, Notice 88-66, or Q&A-47, or has obtained the consent of the Commissioner.

## **VI. PERCENTAGE OF COMPLETION-CAPITALIZED COST METHOD**

Q-15: Under the percentage of completion-capitalized cost method, when are items of revenue from, and items of cost allocable to, a long-term contract taken into account?

A-15: Under the percentage of completion-capitalized cost method of accounting, a certain percentage of each item of revenue and each item of cost is taken into account at the time that such item would be taken into account using the percentage of completion method for the contract, and the remaining percentage is taken into account at the time that such item would be taken into account using the taxpayer's "normal" method of accounting for the contract. The percentage of each item to be taken into account under each of these two methods of accounting depends on the date that the contract was entered into. For contracts entered into after February 28, 1986, but before October 14, 1987, 40 percent of each item of revenue or cost is taken into account under the percentage of completion method and the remaining 60 percent is taken into account under the taxpayer's normal method of accounting (the "40/60 method"). In general, for contracts entered into after October 13, 1987, but before June 21, 1988, 70 percent of each item of revenue or cost is taken into account under the percentage of completion method and the remaining 30 percent is taken into account under the taxpayer's normal method of accounting (the "70/30 method"). In general, for contracts entered into on or after June 21, 1988, 90 percent of each item of revenue or cost is taken into account under the percentage of completion method and the remaining 10 percent is taken into account under the taxpayer's normal method of accounting (the "90/10 method").

The following exceptions apply to these general rules, however. First, certain ship contracts described in section 10203 of the Revenue Act of 1987 entered into after October 13, 1987, are not required to be accounted for under either the 70/30 method or the 90/10 method. Such ship contracts are required to be accounted for using either the percentage of completion method or the 40/60 method. Second, "residential construction contracts" entered into on or after June 21, 1988, are not required to be accounted for under the 90/10 method. Unless they meet the requirements of section 460(e)(1)(B), such residential construction contracts are required to be accounted for under either the percentage of completion method or the 70/30 method. Third, a contract is not required to be accounted for under the 90/10 method if the contract results from the acceptance of a bid made before June 21, 1988, and the bid could not have been revoked or altered at any time on or after June 21, 1988. Fourth, except for the interest capitalization requirements of section 460(c)(3), section 460 does not apply to any "home construction contract" entered into after June 20, 1988. Unless such a contract meets the requirements of section 460(e)(1)(B), the uniform capitalization rules of section 263A and the regulations thereunder will apply to it. See Q&A-41 through Q&A-44 for definitions and rules relating to "residential" and "home" construction contracts. See Q&A-46 for rules relating to the application of the alternative minimum tax to long-term contracts described in section 460(e).

Q-16: In applying the percentage of completion-capitalized cost method of accounting, is a taxpayer permitted to reduce the amount of contract revenue required to be taken into account in a particular year under the taxpayer's normal method of accounting by the amount of contract revenue taken into account under the percentage of completion method in that year and previous years?

A-16: No. The amount of contract revenue taken into account in a particular year under the taxpayer's normal method of accounting is not affected by the amount of contract revenue required to be taken into account in any year under the percentage of completion method. Similarly the amount of contract revenue taken into account under the percentage of completion method is not affected by the amount of contract revenue taken into account in any year under the taxpayer's normal method.

*Example.* After October 13, 1987, but before June 21, 1988, X enters into a long-term contract that is accounted for under the percentage of completion-capitalized cost method using the 70/30 method. X's normal method of accounting is an accrual method. Assume that if X were using the percentage of completion method for the contract, X would be required to take into account \$500,000 of contract revenue in 1988. Assume that if X were using the accrual method, X would be required to take into account \$200,000 of contract revenue in 1988. Under the percentage of completion-capitalized cost method, X is required to take into account the following amounts of contract revenue in 1988: 70 percent of \$500,000, or \$350,000, plus 30 percent of \$200,000, or \$60,000, for a total of \$410,000.

Q-17: How should a taxpayer that (i) uses the percentage of completion-capitalized cost method of accounting, with an accrual method as its normal method, and (ii) uses the dollar value last-in, first-out (LIFO) method of valuing its inventories apply the LIFO method to value inventories in a pool that includes items being produced under a long-term contract?



A-17: The taxpayer should include in inventory only that percentage of each unit being produced under a long-term contract that is equal to the percentage (60%, 30%, or 10%) of income and costs for such contract that is accounted for under the taxpayer's normal method. To the extent that raw materials included in the pool have been dedicated to a long-term contract, only that portion of such raw materials that is equal to such fraction (i.e., 60%, 30%, or 10%) should be treated as remaining in inventory. Thus, inventory will include fractional units of raw materials, goods in process, and finished goods (as well as whole units if the same pool includes items that are not being produced under a long-term contract).

The following example illustrates the use of the dollar-value LIFO inventory method in conjunction with the percentage of completion-capitalized cost method for long-term contracts:

*Example.* X is engaged in the manufacture of a single type of metal component for customers in the aerospace industry. The metal component normally takes more than 12 months to manufacture. Since it began business, X sold metal components to customers only from its inventory of finished goods. However, for financial reasons, X modified this practice in 1987 and decided to obtain contracts from a customer in some cases prior to completing the manufacture of a component. X continued to manufacture and sell approximately one-half of its components without first obtaining a contract.

X uses a calendar-year tax year and an overall accrual method to report taxable income. X accounts for the cost of its inventory using the dollar-value LIFO inventory method and the natural business unit pooling method. X uses the double-extension method to compute its LIFO index. X's metal components consist of one type of raw material, and each finished component requires 6 units of raw material and 10 units of labor. X's unit costs are determined on a fully capitalized basis and, therefore, reflect all indirect costs required to be capitalized. Moreover, X does not incur research and experimental expenses and, consequently, its unit costs for items produced under a contract and for items sold from inventory do not differ.

Assume that, since the year X began business, X's ending inventory has always consisted of 20 units of raw material, two half-completed components in work-in-process, and two completed components. Thus, at the beginning of 1987, the LIFO value of X's inventory equals the base-year cost of these items and, accordingly, represents a single LIFO layer accumulated in the base year as shown below in Table 1.

TABLE 1

1987 Beginning Inventory

		Units		M Value (\$5 x Unit)	Base-year Cost L Value (\$10 x Unit)	Total
	%	M	L			
Raw Material	100%	20	--	\$100 x	--	\$100 x
Work-in-process:						
Noncontract C	100%	3	5	15 x	50 x	65 x
Noncontract D	100%	3	5	15 x	50 x	65 x
Finished Goods:						
Noncontract A	100%	6	10	30 x	100 x	130 x
Noncontract B	100%	6	10	30 x	100 x	130 x
Total Base-year cost = Total LIFO value						\$490 x

At the end of 1987, X's physical inventory consisted of the same number of components at the same stages of completion. However, the two components carried in ending work-in-process, which were one-half completed (Contract E, entered into in September 1987, and Contract F, entered into in November 1987) were being manufactured under long-term contracts that are subject to section 460.

Because X's components normally require more than 12 months to complete, X's contracts to manufacture the components meet the definition of a long-term contract under section 460(f) of the Code. Assuming that X uses an accrual method as its normal method of accounting for long-term contracts, X must account for the cost of components manufactured under a contract using the percentage of completion-capitalized cost method and, therefore, must apply the dollar-value LIFO inventory method to less than 100 percent (i.e., 60%, 30%, or 10% depending on the date each particular long-term contract is entered into) of the cost of each of these components. Accordingly, assuming again that the volume and mix of raw materials, unfinished components and finished components remains unchanged at the end of 1987, the LIFO value of X's ending inventory will change because X is required by the operation of section 460 to include only a percentage of the cost of components manufactured under a long-term contract in its dollar-value LIFO pool as shown below in Table 2. Note, however, that X does not remove a percentage of the cost of any of the 20 units of raw material from the LIFO pool until those units are dedicated to one of its long-term contracts. See Q&A-35.

TABLE 2

1987 Ending Inventory:

	Units			M Value (\$5 x Unit)	Base-year Cost L Value (\$10 x Unit)	Total
	%	M	L			
Raw Material	100%	20	--	\$100 x	--	\$100 x
Work-in-process:						
Contract E-9/87	60%	1.8	3.0	9 x	30 x	39 x
Contract F-11/87	30%	.9	1.5	4.5 x	15 x	19.5 x
Finished Goods:						
Noncontract C	100%	6	10	30 x	100 x	130 x
Noncontract D	100%	6	10	30 x	100 x	130 x
Total Base-year cost						\$418.5 x
Beginning-of-year Base-year cost						490.0 x
Decrease in LIFO value						(71.5 x)
Total LIFO value of ending inventory						\$418.5 x

For contracts entered into after the effective date of the 1988 Act (June 20, 1988), X must, for purposes of pricing the items in its dollar-value pool, further reduce the percentage of long-term contract items taken into account to 10 percent. Table 3 reflects the sale of Noncontract items C and D; the inclusion in work in process of the partially completed Contract G, entered into in July 1988, and the partially completed Noncontract item H; and the inclusion in finished goods of Noncontract items I and J, which were started and completed in 1988. Notwithstanding the fractional inclusion of components manufactured under long-term contracts, an increment in X's LIFO pool occurs in 1988

because one fractional component included in 1987 work in process is replaced by a whole component that is being manufactured without a long-term contract.

TABLE 3

1987 Ending Inventory:

	Units			M Value (\$20 x Unit)	Current-year Cost L Value (\$40 x Unit)	Total
	%	M	L			
Raw Material	100%	20	--	\$400 x	--	\$400 x
Contract G-7/88	10%	.3	.5	6 x	20 x	26 x
Noncontract H	100%	3.0	5.0	60 x	200 x	260 x
Finished Goods:						
Noncontract I	100%	6	10	120 x	400 x	520 x
Noncontract J	100%	6	10	120 x	400 x	520 x
Total Current-year cost						\$1726 x

	Units			M Value (\$5 x Unit)	Base-year Cost L Value (\$10 x Unit)	Total
	%	M	L			
Raw Material	100%	20	--	\$100 x	--	\$100 x
Work-in-process:						
Contract G-7/88	10%	.3	.5	1.5 x	5 x	6.5 x
Noncontract H	100%	3.0	5.0	15 x	50 x	65 x
Finished Goods:						
Noncontract I	100%	6	10	30 x	100 x	130 x
Noncontract J	100%	6	10	30 x	100 x	130 x
Total Base-year cost						\$431.5 x
Beginning Inventory Base-year cost						418.5 x
Increment--Base-year cost						13.0 x

LIFO Index =  $\$1726 \text{ x } / \$431.5 \text{ x } \times 4$

LIFO value of Increment =  $4 \text{ x } \$13.0 =$  52 x

Ending Inventory LIFO value \$470.5 x

As Table 3 demonstrates, the interaction of section 460 and the LIFO inventory method of accounting can cause changes in the value of LIFO layers, even if there is no change in the physical content of raw materials, work in process, and finished goods.

Q-18: What is meant by a taxpayer's "normal" method of accounting?

A-18: In general, a taxpayer's normal method of accounting is the method of accounting that the taxpayer used immediately prior to the effective date of section 460 to account for its long-term contracts within a particular trade or business. This method of accounting might have been, for example, the completed contract method provided by section 1.451-3(d) of the regulations, the cash method, an accrual method such as the accrual shipment, or accrual delivery method.

If, however, the taxpayer has been required by law or has obtained the consent of the Commissioner to change from its normal method to a new method of accounting, then the new method is treated as the taxpayer's normal method of accounting. For example, section 263A may require a change in the taxpayer's normal method of accounting. Similarly, section 448 may require a taxpayer that used the cash method of accounting for long-term contracts immediately prior to the effective date of section 460, to change from the cash method to another method of accounting pursuant to section 448. In this case, that other method of accounting becomes the taxpayer's normal method of accounting for purposes of applying the percentage of completion-capitalized cost method. Although section 448 generally requires that certain taxpayers change from the cash to the accrual method, section 1.448-1T(h)(3) of the regulations may permit a change to the completed contract method in certain cases.

## VII. PERCENTAGE OF COMPLETION METHOD

Q-19: Under the percentage of completion method, what portion of the total price under a particular contract is required to be included in gross income in a particular taxable year?

A-19: Under the percentage of completion method, the taxpayer must include in gross income in each taxable year ending after the date that the contract is entered into an amount equal to the excess of (1) the product of (a) the total amount of revenue that the taxpayer estimates it will receive with respect to the contract, multiplied by (b) the cumulative percentage of the contract that has been completed as of the end of the taxable year, over (2) the total cumulative amount of contract revenue required to be included in gross income in all preceding taxable years. This amount may be expressed by the following formula:

$$(TCR \times PC) - I$$

where

- TCR = the total amount of revenue that the taxpayer expects to receive with respect to the contract;
- PC = the cumulative percentage of the contract that has been completed as of the end of the taxable year;
- I = the total cumulative amount of contract revenue required to be included in gross income in all preceding taxable years.

It should be noted that total estimated contract revenues may be different for the different years of the contract. See Q&A-24.

If the total cumulative amount of contract revenue required to be included in gross income in all preceding taxable years exceeds the product of total expected contract revenues for the taxable year multiplied by the cumulative percentage of the contract completed as of the end of the taxable year, then the taxpayer shall be permitted to deduct the excess as a loss for the taxable year. This may occur, for example, as a result of increases in total estimated contract costs occurring after the end of the tax year in which the contract is entered into.

Q-20: How does a taxpayer determine the percentage of the contract that has been completed as of the end of the taxable year?

A-20: Unless the taxpayer uses the simplified method described in Q&A-22 and Q&A-23, the percentage of the contract considered completed as of the end of the taxable year is equal to the ratio of (a) the total cumulative amount of costs allocable to the contract and incurred in the taxable year and in all preceding taxable years, to (b) the total amount of costs allocable to the contract that the taxpayer expects to incur. The total estimated contract costs may be different for the different years of the contract. See Q&A-24.

Q-21: Should a taxpayer that properly uses the cash method as its over-all method of accounting treat a cost as incurred in the taxable year in which it is paid for purposes of determining the total amount of costs allocable to the contract incurred in a particular taxable year?

A-21: No. Section 460 provides that, in determining percentage of completion, costs are taken into account in the taxable year that they are incurred, regardless of the taxpayer's over-all method of accounting. Similarly, under the percentage of completion method, costs allocable to the contract are deductible in the year incurred, regardless of the taxpayer's overall method of accounting. For this purpose, an item is treated as incurred when it would properly be taken into account under an accrual method of accounting, including the rules of section 461(h). See Q&A-33 through Q&A-35 for further discussion.

Q-22: How is percentage of contract completion determined under the simplified method?

A-22: Under the simplified method, only certain costs are used in determining both (i) costs allocated to the contract and incurred before the close of the taxable year, and (ii) total estimated contract costs. These costs are: (a) direct material costs and direct labor costs, and (b) depreciation, amortization and cost recovery allowances on equipment and facilities (to the extent allowable as deductions under Chapter 1 of the Code) directly used to construct or produce the subject matter of the long-term contract. Direct material costs include the costs of materials such as raw materials, land, equipment and components that become an integral part of the subject matter of a long-term contract and the costs of those materials that are consumed in the ordinary course of building, constructing, installing, or manufacturing the subject matter of a long-term contract.

Q-23: Which taxpayers may use the simplified method?

A-23: The simplified method may be used by taxpayers using the percentage of completion method for all items under all long-term contracts in a particular trade or business. A taxpayer that, pursuant to Q&A-14, uses the percentage of completion method for long-term contracts of substantial duration and the percentage of completion-capitalized cost method for long-term contracts of less than substantial duration, may not use the simplified method for its long-term contracts of substantial duration.

A taxpayer using the percentage of completion-capitalized cost method that properly uses the cash method as its normal method of accounting may also use the simplified method. However, any such taxpayer must automatically change from the simplified method for the first taxable year that the taxpayer is required to change from the cash method under any provision of law, including section 448, unless the taxpayer properly changes its method of accounting to the percentage of completion method for all items under all long-term contracts in its trade or business.

Use of the simplified method is a method of accounting and may not be revoked without the consent of the Commissioner. The Commissioner may, by revenue procedure, or other administrative pronouncement, permit taxpayers to adopt the simplified method without obtaining consent. See. e.g., Notice 87-61.

Q-24: In determining percentage of completion for a particular taxable year, when are total contract costs and total contract revenues to be estimated?

A-24: Total contract revenue and total contract costs are to be estimated based on the facts and reasonable estimates as of the last day of the taxable year. Events that occur after the end of the taxable year that were not reasonably subject to estimate as of the last day of the taxable year are not taken into account.

*Example.* X, a calendar year taxpayer, enters into a long-term contract on January 1, 1987. Based on the facts as of December 31, 1987, X reasonably estimates that total contract revenue will be \$10m and total contract costs will

be \$5m. X's employees go on strike in February, 1988, causing X to increase its estimate of total contract costs to \$6m. After the strike is settled, X receives an order from the customer for additional work under the contract. Assume that this order would not be treated as a separate contract under the rules for severing contracts set forth in Q&A-37. Based on this order, X increases its estimate of total contract costs to \$8m, and increases its estimate of total contract revenues to \$15m. In applying the percentage of completion method to determine the amount of contract revenue required to be included in gross income in 1987, reasonable estimates of total contract revenue and costs based on the facts as of December 31, 1987, are to be used. Revisions to these estimates based on the strike and the change order occurring in 1988 are not taken into account, even though these revisions were made before X filed its tax return for 1987.

Q-25: Are contingency allowances for extraordinary costs to be included in total estimated contract costs for purposes of computing percentage completion?

A-25: Total estimated contract costs do not include any contingency allowance for costs that, as of the end of the year for which the estimate is made, are unforeseeable or extraordinary and are not reasonably expected to be incurred in the performance of the contract. Thus, for example, total estimated costs do not include costs attributable to abnormal factors not reasonably foreseeable as of the end of the tax year for which the estimate is made, such as prolonged third-party litigation, abnormal weather conditions (considering the season and the job site), prolonged strikes, and prolonged delays in securing required permits and licenses, and other factors that, as of the end of the year for which the estimate is made, could not be reasonably anticipated considering the nature of the contract and prior experience of the taxpayer.

Q-26: Are estimated costs of performing other contracts (such as "follow-on contracts") that the taxpayer expects to enter into with the same customer as a result of having entered into a particular contract included in total estimated contract costs for the initial contract?

A-26: No. The estimated costs of performing such a contract are not included in total estimated contract costs for the initial contract unless the contract would not be treated as a separate contract under the severing and aggregating rules described in Q&A-37.

Q-27: For purposes of applying the percentage of completion method, are "retainages" and "holdbacks" included in total expected contract revenues?

A-27: Yes. All amounts that the taxpayer is or will be entitled to receive from the customer under the contract, or any other rule of law (including, for example, the contract law rule of quantum meruit, or other quasi-contractual remedies) must be included in total expected contract revenues, including amounts, such as retainages, that the customer has contracted to pay only upon satisfactory completion of the contract. (See also section 460(b)(2)(B), which requires that such amounts, including amounts received after contract completion, be included in total contract price for purposes of applying the look-back rule.)

Q-28: For purposes of applying the percentage of completion method, does a taxpayer include in total expected contract revenues award fees and similar incentive payments that the taxpayer is entitled to receive under the contract if certain requirements, in addition to satisfactory

completion and acceptance, are met?

A-28: Payments such as award fees, or incentive payments, are to be included in total expected contract revenues at the time and to the extent that the taxpayer can reasonably predict that the corresponding performance objectives will be met.

Q-29: If a taxpayer incurs costs allocable to a contract in a taxable year ending prior to the date that the contract is entered into, does the percentage of completion method require inclusion of any portion of the expected contract revenue in gross income in such prior taxable year?

A-29: No. Under the percentage of completion method the taxpayer is not required to include any amount in gross income in any taxable year ending prior to the date that a contract is entered into, even if costs allocable to the contract are incurred in such a taxable year. With respect to costs incurred in a taxable year prior to the year a contract is entered into, if (i) it is reasonably foreseeable at the time that the costs are incurred that they relate to a long-term contract that will be entered into during a future year, and (ii) the costs are of a nature such that they would otherwise be allocable to the contract under section 460(c), then such costs are to be capitalized in the year in which they are incurred. If, in contrast, it is not reasonably foreseeable at the time that costs are incurred that they relate to a long-term contract that will be entered into during a future year, then such costs are to be accounted for and capitalized under the provisions of section 263A (if such costs are incurred in a taxable year to which section 263A applies). In either case, in the subsequent year in which the contract is entered into, all such costs are to be allocated to the contract and taken into account in determining the completion percentage and, thus, in determining the amount of contract revenue required to be taken into account in the subsequent taxable year in which the contract is entered into. See Q&A-36, which provides for the time for deducting such costs.

Q-30: For the purpose of computing percentage of completion, are nondeductible costs taken into account in determining (i) expected total costs allocable to a contract, or (ii) costs allocable to a contract and incurred through the end of the taxable year?

A-30: No. For these purposes, nondeductible costs are not taken into account, even if otherwise allocable to a contract under section 460(c) and Q&A-39 and Q&A-40. Thus, for example, the following costs would not be taken into account in computing percentage of completion: (i) any payments disallowed under section 162(c); and, (ii) meals and entertainment costs disallowed under section 274.

Q-31: Under the percentage of completion method, what is the treatment of amounts received or to be received by the taxpayer from the customer as reimbursements for costs incurred in performing a long-term contract?

A-31: These reimbursements are included in total contract price in determining the



amount included in gross income in the taxable year under the percentage of completion method. Similarly, reimbursed costs allocable to a contract that have been incurred by the taxpayer are treated as contract costs in determining percentage of completion for the taxable year in which such costs are incurred. See Q&A-32 and Q&A-33.

Q-32: How are costs that are allocable to a contract taken into account under the percentage of completion method?

A-32: Under the percentage of completion method, costs that are allocable to a contract are allowable as deductions from gross income in computing taxable income in the year in which they are incurred. The preceding sentence shall not apply if such costs are disallowed permanently under any provision of the Code or regulations, including, for example, section 162(c) or section 274.

Q-33: Under the percentage of completion method, when is a cost that is allocable to a long-term contract treated as incurred, and therefore as deductible and taken into account in computing percentage of completion for the taxable year?

A-33: Regardless of the taxpayer's overall method of accounting, contract costs generally are treated as incurred in the taxable year in which the "all events" test of section 461 and section 1.461-1(a)(2) of the regulations, as modified by section 461(h), is met. Thus, costs that are not treated as incurred as of the end of the taxable year for failure to satisfy the economic performance rules of section 461(h) are not deductible. Similarly, such costs are not treated as contract costs incurred through the end of the taxable year in determining percentage of completion (although those costs are taken into account in determining total expected contract costs). See Q&A-35 for rules relating to the time at which costs of direct materials and supplies are allocable to a contract.

Q-34: When are the costs of materials and supplies deductible under the percentage of completion method?

A-34: These costs are deductible under the percentage of completion method for the first taxable year in which the costs both are allocable to the contract and have been incurred. See Q&A-33 for rules as to when a cost that is allocable to a contract are treated as incurred. See Q&A-35 for rules as to when costs of materials and supplies are allocable to a contract.

Q-35: When are costs of direct materials and supplies treated as allocable to the contract under the percentage of completion method?

A-35: The costs of direct materials and supplies that are purchased specifically for a particular long-term contract are allocable to the contract in the taxable year in which such costs are incurred. The costs of other direct materials and supplies (such as those previously held by the taxpayer) are allocable to the contract in the taxable year in which such materials and supplies

are dedicated to the contract. Examples of dedication include the following: (i) delivery of materials to a job site (if only one contract is being performed at that site); (ii) association of materials with a specific contract (for example, by purchase order, entry on books and records, or shipping instructions); and, (iii) if not previously assigned, the physical incorporation of the materials into the subject matter of the contract, or the consumption of the materials in the production of the subject matter of the contract. The cost that is allocated to a contract is to be determined using the taxpayer's method of accounting for such materials or supplies (e.g., specific identification, FIFO, or LIFO) based on the taxable year in which such items are dedicated to the contract.

Q-36: When are costs that are allocable to a long-term contract, but are incurred prior to the date that the contract is entered into, deductible and taken into account for purposes of determining degree of contract completion?

A-36: Such costs are treated as allocated to the contract and are deductible in the taxable year in which the contract is entered into. These costs might include, for example, bidding and proposal costs allocable to the contract, raw land purchased before a construction contract was entered into, and labor costs incurred in anticipation that a contract will be awarded. See Q&A-29 regarding accounting for income attributable to such costs.

*Example.* In 1988 X Corporation, a calendar year taxpayer using the percentage of completion method, incurs costs to prepare a bid and proposal for a manufacturing contract with an agency of the United States government. In anticipation that the contract will be awarded, X also begins work in 1988 to produce the property that is expected to be the subject matter of the contract, incurring labor, materials, storage costs incurred to store the raw materials, and other costs allocable to this property under section 263A and the regulations thereunder. Then, on February 1, 1989, the contract is awarded and becomes legally binding on both the taxpayer and the agency. None of the bidding and proposal costs are deductible in 1988. Similarly, none of the other costs allocable to the property that is expected to be the subject matter of the contract are deductible in 1988. All of these costs are allocated to the contract on February 1, 1989. Therefore, all of these costs (bidding and proposal costs, as well as labor, materials, storage costs incurred to store the raw materials, and indirect costs allocable under section 263A to the property that is expected to be the subject matter of the contract) are deductible by X in 1989, and are taken into account by X in determining percentage of completion for 1989.

## **VIII. SEVERING AND AGGREGATION OF CONTRACTS**

Q-37: What standards apply in determining whether an agreement should be treated as more than one contract ("severed"), or whether two or more agreements should be treated as a single contract ("aggregated") under section 460(f)(3)?

A-37: Except as provided in Q&A-38, the rules set forth in section 1.451-3(e) of the regulations apply in making this determination.

Q-38: May the taxpayer sever and aggregate contracts, or may such action be taken only by the Commissioner?

A-38: Under section 460(f)(3), a taxpayer is permitted and required to sever and aggregate contracts, notwithstanding the statement to the contrary in section 1.451-3(e)(1)(i)(C) of the regulations, which does not apply to contracts subject to section 460 and this Notice. Forthcoming regulations may require any taxpayer that severs or aggregates contracts under this Q&A-38 to attach a statement to its Federal income tax return for the first year in which it has entered into two or more agreements that are properly treated as a single contract, or a single agreement that is properly treated as more than one contract. If required, such a statement would describe the criteria used by the taxpayer in determining to sever or aggregate the agreements.

## **IX. ALLOCATION OF COSTS TO CONTRACTS**

Q-39: What costs are required to be allocated to a long-term contract?

A-39: All costs (including, where applicable, research and experimental costs and interest costs) that directly benefit or are incurred by reason of the long-term contract activities of the taxpayer must be allocated to those contracts in the same manner that costs are allocated to extended period long-term contracts under section 1.451-3(d) of the regulations. For purposes of section 460(c), costs included in the preceding sentence and thus allocated to long-term contracts include all storage, handling, and processing costs incurred with respect to the long-term contract activities of the taxpayer. (See section 263A and the regulations thereunder for definitions of storage, handling, and processing costs.) Moreover, in the case of a cost-plus long-term contract or a Federal long-term contract, any cost not otherwise allocated to the contract under the general rule of the preceding sentence shall be allocated to the contract if the cost is identified by the taxpayer (or a related person) as being attributable to such contract, pursuant to the contract or any Federal, State, or local law or regulation. If, under a Federal or a cost-plus contract, the costs identified under the contract include a charge for the time value of money, that amount shall be treated as allocable to the contract without regard to whether the property produced is "qualified" property (as defined in Notice 88-99) with respect to which interest is required to be capitalized under section 460(c)(3).

The following costs are not subject to the rules of section 460 and are not allocable to long-term contracts: independent research and development expenses (as defined in section 460(c)(5)); expenses for unsuccessful bids and proposals; and marketing, selling and advertising expenses. Therefore, such costs are not taken into account in determining degree of contract completion under the percentage of completion method, and no portion of such costs is required to be capitalized under the percentage of completion-capitalized cost method by a taxpayer using the completed contract method as its normal method of accounting.

The use, direct or indirect, of the practical capacity concept to account for the costs required to be allocated to long-term contracts is not permitted. The practical capacity concept is defined as any concept, method, procedure, or formula (such as the practical capacity concept described in section 1.471-11(d)(4) of the regulations) whereunder fixed costs are not capitalized or allocated to a contract because of the relationship between the actual production at the taxpayer's production facility and the "practical capacity" of such facility. For this purpose, the practical capacity of a facility shall include either the practical capacity or theoretical capacity of the facility (as defined in section 1.471-11(d)(4) of the regulations), or any other similar determination of productive or operating capacity.

Q-40: What methods are available in accounting for the indirect costs required to be allocated to long-term contracts?

A-40: The indirect costs required to be allocated to a long-term contract must be allocated to particular contracts using either a specific identification (or "tracing") method, the standard cost method, or a method using burden rates (such as ratios based on direct costs, hours, or other items, or similar formulas), so long as the method employed for such allocation reasonably allocates indirect costs among long-term contracts. The method used by the taxpayer to allocate a particular cost must be applied consistently with respect to all long-term contracts of the taxpayer. An allocation method will not be considered to be reasonable if the method does not result in the allocation (and, to the extent applicable, the capitalization) of all costs that directly benefit or are incurred by reason of the performance of the taxpayer's long-term contract activities. The taxpayer shall account for each long-term contract separately and, except as provided, both the direct and indirect costs incurred during the taxable year attributable to long-term contract activities shall be allocated to particular long-term contracts for the taxable year such costs are incurred. See Q&A-35 for special rules relating to when a cost is allocable to a contract.

## **X. TREATMENT OF CERTAIN CONSTRUCTION CONTRACTS**

Q-41: What is a "residential construction contract" for purposes of section 460?

A-41: The term "residential construction contract" means any contract if 80 percent or more of the total estimated contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of (i) dwelling units, and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units. All costs that are attributable to the building, construction, reconstruction, or rehabilitation under the contract of such dwelling units and improvements and that are allocable to the contract, including costs of materials and raw land, are taken into account towards meeting the 80-percent test. In the case of a contract to construct a mixed-use building (e.g., a building expected to contain both apartments and offices), the portion of costs that is attributable to construction of dwelling units (and

improvements directly related to such dwelling units) is equal to the sum of (i) all costs that are attributable solely to the dwelling units (and directly related improvements), and (ii) a pro rata portion of all costs other than costs solely attributable to the dwelling units (and directly related improvements) or solely attributable to other uses of the building (and directly related improvements). The pro rata apportionment shall be based on the relative amount of space in the building expected to be used for dwelling units. Thus, for example, if 50 percent of the total space in a mixed-use building is expected to be used for apartments, then 50 percent of the cost of land would be considered attributable to dwelling units. However, all of the expected cost of appliances to be installed only in the apartments would be considered attributable to dwelling units, because this cost is attributable solely to dwelling units.

For purposes of this Q&A-41 and for purposes of Q&A-43, the term dwelling unit has the same meaning as in section 167(k)(3)(C). Thus, a dwelling unit is a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment more than one-half of the units of which are used on a transient basis.

Q-42: Which long-term contracts are exempt under section 460(e) from the requirements of section 460?

A-42: Section 460(e) provides that, except for the interest capitalization requirement of section 460(c)(3), the rules of section 460 do not apply to (1) any home construction contract entered into after June 20, 1988, and (2) any other construction contract entered into by a taxpayer (i) who estimates (at the time such contract is entered into) that such contract will be completed within the 2-year period beginning on the commencement date of such contract, and (ii) whose average annual gross receipts for the 3 taxable years preceding the year in which such contract is entered into do not exceed \$10 million.

Thus, except for the interest capitalization requirements of section 460(c)(3), the law in effect before the enactment of section 460 applies to any contract described in clause (2) of the preceding paragraph, regardless of whether the contract involves the construction of a home or of commercial property. In the case of a home construction contract that is not described in clause (2) of the preceding paragraph (i.e., a contract that is not expected to be completed within two years of the commencement date, or a contract entered into by a taxpayer whose average annual gross receipts exceed \$10 million), the provisions of section 263A and the regulations thereunder apply, except that the interest capitalization requirements specifically provided in section 460(c)(3) also apply. For purposes of clause (2) of the preceding paragraph, a construction contract is any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property. Whether a particular contract is a construction contract under this definition is to be determined by applying the rules set forth in section 1.451-3(b)(3)(ii) of the regulations and Q&A-4.

Q-43: What is a "home construction contract" for purposes of section 460(e)?

A-43: For purposes of section 460(e) the term "home construction contract" means any construction contract if 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 building, construction, reconstruction, or rehabilitation of (i) dwelling units (within the meaning of section 167(k)) contained in buildings (with each townhouse or rowhouse treated as a separate building) containing four or fewer units, and (ii) improvements to real property directly related to such dwelling units and located at the site of such dwelling units. All costs attributable to the building, construction, reconstruction, or rehabilitation under the contract of such dwelling units and improvements, and allocable to the contract, including costs of materials and land, are taken into account towards meeting the 80-percent test. For the treatment of a mixed-use building, see Q&A 41.

Q-44: For purposes of the 80-percent tests of Q&A-41 and Q&A-43, can costs that a developer expects to incur to construct, build, or install roads, sewers, and other common features not located on the sites of dwelling units ("off-site work") be treated as attributable to dwelling units that the developer is constructing under contract?

A-44: Yes. Assume, for example, that a developer enters into a contract for the construction and sale of a house. The costs of off-site work properly allocable to this contract are treated as attributable to the construction of the house for purposes of the 80-percent test.

Q-45: What rules apply in determining the gross receipts that are to be taken into account in applying section 460(e)(1)(B)?

A-45: For purposes of applying section 460(e), the taxpayer must take into account the gross receipts of (i) all trades or businesses (regardless of the nature of such trades or businesses) under common control with the taxpayer (within the meaning of section 52(b)), and (ii) all members of any controlled group of corporations of which the taxpayer is a member. For purposes of this determination, the term "controlled group of corporations" has the meaning given to such term by section 1563(a), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1), and the determination shall be made without regard to paragraphs (a)(4) and (e)(3)(c) of section 1563.

Persons are treated as members of controlled groups within the meaning of section 1563(a), regardless of whether such persons would be treated as "component members" of such group under section 1563(b). (See section 1.52-1(c) of the regulations.) Thus, for example, the gross receipts of a franchised corporation or a foreign corporation that is treated as an excluded member for purposes of section 1563(b) would be included for purposes of the aggregation rules of the gross receipts test under section 460(e) if the corporation and the taxpayer are members of the same controlled group under section 1563(a).

With respect to the group of persons ("members") the gross receipts of which are included in the calculation of the taxpayer's gross receipts for a taxable year, the gross receipts of the

taxpayer are determined by aggregating the gross receipts of all members of the group, excluding gross receipts attributable to transactions occurring between such members. Moreover, in determining the gross receipts of any member of the group for a taxable year of less than 12 months, the gross receipts shall be annualized by (i) multiplying the gross receipts for the short period by 12, and (ii) dividing the result by the number of months in the short period.

In addition, in determining the gross receipts of the group for the three taxable years preceding the taxable year in which the contract is entered into, the gross receipts of all persons (or their predecessors) who are members of the group as of the first day of the taxable year in which the contract is entered into are included in such determination, regardless of whether such persons were members of the group for any of the three preceding taxable years. Similarly, the gross receipts of persons that were members of the group for any or all of the three preceding taxable years, but who (including their successors) are not members of the group as of the first day of the taxable year in which the contract is entered into, are not included for purposes of determining the taxpayer's average gross receipts.

*Example (1).* Assume that a parent corporation P has continuously owned 100 percent of the stock of another corporation (S1) since 1983, and that P and S1 are calendar year taxpayers. S1 enters into a long-term contract in March of 1987. In addition, P acquired 100 percent of the stock of another calendar year corporation (S2) as of the beginning of business on January 1, 1987.

In determining whether S1's long-term contract is subject to the provisions of section 460, the gross receipts of P, S1, and S2 for 1984, 1985, and 1986 shall be aggregated, excluding the gross receipts attributable to transactions occurring between the three corporations. The gross receipts of S2 are taken into account because it was a member of the group on January 1, 1987.

*Example (2).* Assume that a parent corporation (P) has continually owned 100 percent of the stock of two other corporations, (S1) and (S2), since 1983, and that the three corporations are calendar year taxpayers. S1 enters into a long-term contract in April of 1987. On December 31, 1986, P sells all of its stock in S2. In determining whether S1's long-term contract is subject to the provisions of section 460 for the taxable year beginning January 1, 1987, only the gross receipts of P and S1 for 1984, 1985, and 1986 shall be aggregated, excluding the gross receipts attributable to transactions occurring between the two corporations. The gross receipts of S2 are not taken into account because it was not a member of the group on January 1, 1987. Similarly, gross receipts attributable to transactions between S1 and S2 are not excluded.

In addition to the rules set forth above, the rules of section 1.451-3(b)(3)(iii) of the regulations (to the extent not inconsistent with the rules set forth above) relating to the determination, aggregation and attribution of gross receipts apply for purposes of section 460(e).

Q-46: Does the exception provided by section 460(e) apply for purposes of the alternative minimum tax?

A-46: Section 56(a)(3) provides, in general, that the percentage of completion method of accounting (as modified by section 460) shall be used in determining the alternative minimum taxable income ("AMTI") of a taxpayer for all long-term contracts entered into on or after March

1, 1986, for taxable years beginning after December 31, 1986. This general rule does not apply, however, to any home construction contract that both (i) is entered into after June 21, 1988, and (ii) meets the requirements of section 460(e)(1)(B) (i.e., the taxpayer estimates that such contract will be completed within the 2-year period beginning on the contract commencement date, and the taxpayer's average annual gross receipts for the three taxable years preceding the taxable year in which such contract is entered into do not exceed \$10 million). Therefore, except for such home construction contracts, the requirement to use the percentage of completion method under section 56(a)(3) applies to all long-term contracts of the taxpayer, even if the contracts are exempted under section 460(e)(1) from the requirement to use the percentage of completion method or percentage of completion-capitalized cost method for regular tax purposes.

Under section 56(a)(3), as amended by section 1007(b)(1) of the 1988 Act, however, the percentage of contract completion for any contract described in section 460(e)(1) shall be determined using the simplified cost-to-cost method. (See Q&A-22 for a discussion of the simplified cost-to-cost method.)

Whether or not a contract is described in section 460(e)(1), a taxpayer may elect, as provided in Notice 87-61, solely for purposes of determining percentage of completion for purposes of the alternative minimum tax, to use either (1) the methods of accounting and costs applied in computing regular tax, or (2) the methods of accounting and costs used in computing alternative minimum taxable income. See Notice 87-61 for procedures for making this election.

## **XI. CHANGES IN METHODS OF ACCOUNTING**

Q-47: If, as a result of the amendment of section 460 by the 1988 Act, a taxpayer wishes to change from the percentage of completion-capitalized cost method to the percentage of completion method, in what circumstances may the taxpayer do so without obtaining the consent of the Commissioner?

A-47: For purposes of section 460 of the Code, any taxpayer using a method of accounting other than the percentage of completion method as its normal method of accounting for long-term contracts (e.g., a taxpayer using the completed contract, cash or an accrual method of accounting) may automatically change its method of accounting to the percentage of completion method (including, if elected, the simplified cost-to-cost method) for --

1) all items under all long-term contracts entered into by the taxpayer after June 20, 1988;  
or

2) all items under all long-term contracts entered into by the taxpayer after October 13, 1987; or



3) all items under all long-term contracts entered into by the taxpayer after February 28, 1986.

The effect of alternative (2), regarding contracts entered into after October 13, 1987, is to extend the time period set forth in Notice 88-66 within which taxpayers may elect to use the percentage of completion method for all such contracts. The effect of alternative (3), regarding contracts entered into after February 28, 1986, is to extend the period, initially set forth in Notice 87-61, within which taxpayers may elect to use the percentage of completion method for all such contracts. Thus, for example, a taxpayer may use the percentage of completion-capitalized cost method for all contracts entered into after February 28, 1986 and before June 21, 1988, and may, under the terms of this notice, automatically (i.e., without requesting the consent of the Commissioner) change its method of accounting to the percentage of completion method for all long-term contracts entered into after June 20, 1988. Alternatively, a taxpayer may, under the terms of this notice, use the percentage of completion-capitalized cost method for all contracts entered into after February 28, 1986, and before October 14, 1987, and may, under the terms of this notice, automatically change its method of accounting to the percentage of completion method for all items under all contracts entered into after October 13, 1987. In addition, a taxpayer may, under the terms of this notice, use the percentage of completion method for all items under all long-term contracts entered into after February 28, 1986.

This automatic change in method of accounting for long-term contracts is conditioned on the filing of an amended return for any affected tax year for which a Federal income tax return has been filed (subject to the applicable statute of limitations). The period for filing amended returns for taxpayers changing their method of accounting to the percentage of completion method is provided in Q&A-49 of this notice. Any taxpayer changing its method under this Q&A-47 must follow the notification procedure in Q&A-49.

Any automatic change to a method of accounting permitted under this Q&A-47 shall be effectuated by using a "cut-off" method with respect to contracts entered into after February 28, 1986, or October 13, 1987, or June 20, 1988, as the case may be. Thus, there is no change in the accounting method used with respect to any contract entered into before the applicable effective date, and the taxpayer shall not compute a section 481(a) adjustment with respect to its use of the new method of accounting.

Any change in method of accounting to the percentage of completion method other than a change for --

1) all items under all long-term contracts entered into by the taxpayer after February 28, 1986, or

2) all items under all long-term contracts entered into by the taxpayer after October 13, 1987, or

3) all items under all long-term contracts entered into by the taxpayer after June 20, 1988,

will constitute a change in method of accounting that requires the consent of the Commissioner. For example, if a calendar year taxpayer wishes to change from the percentage of completion-capitalized cost method to the percentage of completion method for its taxable year beginning on January 1, 1989, such taxpayer is required to obtain the consent of the Commissioner with respect to such change in method of accounting. Moreover, in such a situation, any change in method of accounting approved by the Commissioner (and any resulting section 481(a) adjustment) shall not consist, in whole or in part, of a change in method of accounting required to initially comply with section 460. Therefore, any resulting adjustment computed pursuant to section 481(a) shall relate only to a change from one proper method under section 460 to another proper method under section 460. See Q&A-13 for rules regarding taxpayers that had not complied with section 460 prior to requesting a change in their method of accounting for long-term contracts.

Q-48: What procedures should taxpayers follow to effectuate (1) the change in the percentage of completion-capitalized cost method of accounting from the 70/30 method to the 90/10 method required by the 1988 Act, and (2) the change in method of accounting for home construction contracts pursuant to the 1988 Act?

A-48: These changes shall be effectuated by using a "cut-off" method with respect to contracts entered into after June 20, 1988, i.e., the taxpayer shall not change its method of accounting for contracts entered into before June 21, 1988, and no adjustment under section 481(a) of the Code shall be computed. Taxpayers making these changes shall follow the notification procedures in Q&A-49 of this notice.

Q-49: What notification and filing procedures should be followed by taxpayers changing methods of accounting under either Q&A-47 or Q&A-48 of this notice?

A-49: Any taxpayer described in Q&A-47 or Q&A-48 of this notice shall complete and file a statement notifying the Internal Revenue Service of its use of the various methods of accounting (including the simplified cost-to-cost method) permitted under this notice with the taxpayer's Federal income tax return for the first taxable year ending after June 20, 1988, for which the taxpayer is required to account under section 460 for long-term contracts. The taxpayer shall type or legibly print the following language at the top of the statement required to be filed: "NOTIFICATION PROCEDURES UNDER SECTION XI OF NOTICE 89-15." Any amended return filed by a taxpayer for the purpose, in whole or in part, of changing the taxpayer's method of accounting under Q&A-47 must be filed on or before August 14, 1989. The taxpayer shall type or legibly print the following language at the top of each amended return: "NOTIFICATION PROCEDURES UNDER SECTION XI OF NOTICE 89-15."

Notwithstanding the requirements of the preceding paragraph, if a taxpayer has (i) filed a Federal income tax return on which the statement described in the preceding paragraph was

required to be included, (ii) failed to file the statement described in the preceding paragraph with such return, and (iii) otherwise properly used the method of accounting as required or allowed under this notice (including Q&A-47 and Q&A-48), the taxpayer may file a statement indicating the use of its method of accounting under the following procedures. This statement must be attached to the taxpayer's first Federal income tax return filed after May 15, 1989, for which the taxpayer is required to account under section 460 for long-term contracts. (A taxpayer, at its option, may attach the statement with any return filed before May 16, 1989.) The taxpayer shall type or legibly print the following language at the top of the statement required to be filed: "NOTIFICATION PROCEDURES UNDER SECTION XI OF NOTICE 89-15."

## **PROCEDURAL INFORMATION**

This notice serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied upon to the same extent as a revenue ruling or a revenue procedure. It is expected that provisions of this notice will be included in forthcoming regulations to be issued under section 460. The Commissioner invites comments concerning the issues addressed in this notice, and other issues arising under section 460.

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For further information regarding this notice, contact Paulette C. Galanko at (202) 566-3731 or Carol Conjura at (202) 566-3024 (neither is a toll-free call).

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## GLOSSARY

### - A -

**ADVANCE PAYMENTS** -- Payments generally made to a prime contractor prior to the performance of any work under a contract. These payments help the contractor cover developmental and preliminary costs incurred prior to commencement of work.

**ADVANCES ON CONTRACTS** -- A current liability 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 the purpose of clearly reflecting 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 his or her bid was accepted.

### - B -

**BACK CHARGES** -- Billings between parties, such as from owners to general contractors or general contractors to subcontractors, covering expenses which, according to the contract, should have been incurred by the party to whom billed.

**BACKFILL** -- 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 expected to be received from them.

**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 to be charged 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 contractor's bid is accepted 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 in excess of 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 provisions for bonuses are stipulated in the bonus clause of the contract and are in contrast to 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 of 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 buyer is offered 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.

- C -

**CERTIFICATE OF OCCUPANCY** -- Written authorization issued by a local government stating that the structure is ready and fit for occupancy.

**CERTIFICATE FOR PAYMENT** -- Statements prepared by an architect to inform the owner of the amount due a contractor as a result of 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 may be initiated by either the owner or the contractor.

**CLAIMS** -- Amounts in excess of 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 has been 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** -- Also called a settlement statement. Detailed cash accounting of a real estate transaction. It is usually prepared by an escrow officer, broker, or attorney.

**CLUSTER DEVELOPMENT** -- Subdivision development in which detached houses are built 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** -- One of the two generally accepted methods of accounting for long-term contracts under which all contract income and all contract costs are deferred until the year in which the contract is finally completed and accepted.

**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 to be performed and the terms of payment.

**CONSTRUCTION CONTRACTOR** -- A person or entity who 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 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 (C.P.M.)** -- A method of scheduling construction activities according to sequence and interdependence. The sequence of activities that allows the project to be completed in the shortest time is called the critical path.



**- D-**

**DELAYED BILLINGS** -- Billings from a contractor for which he or she was entitled to payment in previous billing periods.

**DESIGN-CONSTRUCT CONTRACT (OR DESIGN-BUILD CONTRACT)** -- A single contract in which the contractor agrees to provide the design, procurement, and construction services necessary to complete a project.

**DESIGN-MANAGE CONTRACT** -- A contract in which construction is performed by a number of independent contractors in a manner similar to the professional construction management concept.

**DEVELOPER** -- Person or entity who 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** -- 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 are currently available to a contractor under a contract with a fixed payment schedule.

**- E -**

**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 upward adjustments to be made in the contract price of certain items or elements of work when conditions affecting their cost change.

**ESTIMATES** -- These are estimated costs of a construction project. A project has three types of estimates during the evolution of the project. Conceptual estimates are generally made in the early phases of a project for the owner to consider whether the project is economically feasible. Detailed estimates are made after the design has been approved. These require a careful tabulation of all the quantities for a project or portion of a project (quantity takeoff or quantity survey). A definitive estimate is made after the initial approximate estimates become more defined and accurate as additional information is developed. Definitive estimates forecast the final project cost with little margin for error.

- F -

**FACTORY-BUILT HOUSES** -- Houses whose shells are factory-built 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 it has been completed according to contract requirements. Final acceptance usually precedes the date when the owner makes the final payment. The procedures to determine final acceptance will be specified in the contract.

**FINAL INSPECTION** -- The final review or inspection of a project performed by an architect, engineer, or construction manager in order to certify that work has been completed according to the contract requirements, after which the final certificate for payment may be issued.

**FINANCIAL ENGINEERING** -- The providing of assistance by the contractor to the client in arranging for the long-term financing of the project. This is an emerging feature in some large contracts which requires the contractor to submit a financial package with his or her bid.

**FIXED-PRICE CONTRACT (OR LUMP-SUM 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 higher relative values are assigned to work to be completed 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 than it otherwise would have been. See "Unbalanced Bid."

- G -

**GENERAL CONTRACTOR** -- A contractor who contracts with an owner to be responsible for all of the construction work necessary to complete a project, even though subcontractors may be used to perform part of the work.

**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 referred to as a "performance bond" or "completion bond." If it guarantees payment of obligations, it is a "payment bond."

- H -

**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).

- I -

**INDIRECT COST** -- Generally, overhead expenses of the contractor that are not directly attributable to a particular construction project.

**IMPROVEMENT BOND** -- Bond issued by a public agency to finance the construction of improvements such as highways and streets.

**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.

- J -

**JOB COSTS** -- Costs that can be allocated to specific jobs of a contractor (such as material, labor, and job overhead costs).

**JOB OVERHEAD COSTS** -- See "Overhead Costs."

**JOINT VENTURE** -- 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.

- K -

**KICKBACKS** -- Payments made without any legal obligation, usually to individuals in return for their influence in obtaining a contract.

- L -

**LABOR AND MATERIAL PAYMENT BOND** -- A type of guaranty bond which guarantees the owner that all costs of labor, material, and supplies incurred by the contractor in connection with a project will be paid.

**LABOR AND MATERIAL RELEASE** -- Document signed by laborers and material men 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** -- Legal claim against specific property of the owner to secure payment of amounts due to material suppliers or contractors, who are engaged in the construction of a project.

**LIQUIDATED DAMAGES** -- Amounts stipulated in the contract, usually as a fixed amount per day, that the contractor is obligated to pay the owner as compensation for damages suffered as a result 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 is not completed within the taxable year in which it is entered.

**LOT BOOK** -- Records maintained by a title company of recorded transactions affecting a particular property.

**LUMP-SUM CONTRACT** -- See "Fixed-Price Contract."

- M -

**MAINTENANCE BOND** -- A bond guaranteeing the owner that, for a specified time following the completion of a project (warranty period), any defects in workmanship or materials will be rectified. A one-year maintenance bond is normally included in the performance 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. Clear title to the property cannot be obtained until the claim is settled.

- N -

**NEGOTIATED BID** -- A bid proposal from a specific contractor (selected on the basis of reputation, past performance, quality of work, expertise, or other reasons) in which the terms and conditions are negotiated between the owner and contractor, as opposed to the competitive bidding process under which the lowest bid is sought from various qualified contractors.

- O -

**OFFSITE COSTS** -- Expenditures incurred for the improvement of raw land that are not related 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 can be allocated to a specific job, but they cannot be allocated to specific items of work within that job. "Operating overhead costs" are indirect costs of operating a construction business that cannot be allocated 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.

- P -

**PAYMENT BOND** -- A bond guaranteeing payment of the contractor's obligations incurred in connection with 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 METHOD** -- One of the two generally accepted methods of accounting 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. It is usually combined 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 amounts of the billings are determined 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 to be completed or corrected by the contractor.

- Q -

**QUANTITY TAKE-OFF (OR QUANTITY SURVEY)** -- A detailed compilation of the quantity of each elementary work item that is called for on the project. These are used in making project cost estimates.

- R -

**RETAINAGE** -- Specified amount usually withheld from progress billings pending satisfactory completion and final acceptance of the project.

- S -

**SEVERING (OR SEGMENTING)** -- The process of treating one agreement as two or more contracts for the purpose of clearly reflecting 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 all major work has been completed. 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).

- T -

**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, time (and sometimes material) is charged at marked-up rates.

**TURNKEY JOB** -- A project on which the contractor is responsible to deliver a completed and operational facility.

- U -

**UNBALANCED BID** -- A bid under which the contract price is disproportionately allocated 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, revenue and cost of sales are recorded



as units of work are delivered. This is most suitable to production-type contracts where many units of a product are produced 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.