APPEALS
INDUSTRY SPECIALIZATION PROGRAM
SETTLEMENT GUIDELINES

INDUSTRY/SPECIALTY AREA: Construction/Real Estate

ISSUE: Advance Payments From Construction Service Contracts (Revised)

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APPEALS SETTLEMENT GUIDELINES
CONSTRUCTION/REAL ESTATE INDUSTRY

ADVANCE PAYMENTS FROM CONSTRUCTION SERVICE CONTRACTS
(Revised)

ISSUE

Whether an accrual basis taxpayer must report advance payments[1] received from construction services contracts in gross income in the year of receipt.

NOTE: *This issue replaces the coordinated issue "Advances for Personal Services" previously coordinated by the Construction/ Real Estate industry. Revision date in Examination Division was October 19, 1996. The purpose of the revision is to narrow the issue to specific situations involving the Construction business.*

EXAMINATION DIVISION POSITION

BACKGROUND & FACTS

Two types of contracts frequently found in the construction industry are construction contracts and construction service contracts (design, engineering and construction management). For financial reporting purposes, revenue from both categories of contracts is usually accounted for under a percentage-of-completion method or, in very limited circumstances, under the completed contract method. For tax purposes, however, a taxpayer generally must use the accrual method of accounting under I.R.C. §446 for reporting gross income from construction services contracts. On the other hand, a construction contractor that enters into a construction contract that will not be completed before the end of the taxable year in which it is entered (and whose average annual gross receipts for the 3 taxable years preceding the year in which such contract is entered into exceeds $10 million) generally must report gross income from such contract under the percentage-of-

[1] Although the Examination Coordinated Issue Paper frames the issue by discussing "advance payments," this terminology is a misnomer; the paper is actually referring to "advance receipts" that constitute unearned income for services to be rendered by the taxpayer in the future.

completion method (PCM) described in IRC §460.

What is the difference between a construction contract and a construction services contract? For tax purposes, a long-term contract (for actual construction) is defined under IRC §460(f) 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." If the contract fits within this definition, then the income is recognized ratably as costs of actual construction are incurred. Based upon this definition of long-term contracts, the percentage of completion method would not be available to taxpayers performing construction services contracts, since these contracts involve design, engineering and management services and not actual construction.

Construction services contracts normally provide for the taxpayer to be compensated on either a cost plus a percentage fee basis or cost plus a fixed fee basis. These contracts entitle the taxpayer to be compensated for:

(1) certain defined costs incurred in performing the agreed services (primarily labor & overhead), and,

(2) a fee for those services, based on either a percentage of the costs or a set amount.

Most construction services contracts provide for the client to advance funds to the taxpayer based on the amount of costs the taxpayer estimates it will incur in the next subsequent period, usually the next month. The contracts also provide that such advanced funds must be applied to the taxpayer's costs incurred on the contract, and that any excess determined at the time the contract is either completed or terminated must be returned to the client. Similarly, excess fee payments, if any, must be returned to the client at contract completion or earlier termination.

The "advance payment" issue arises with respect to construction service contractors because the taxpayer (contractor) will not generally be including advance cash receipts (cash receipts related to work to be performed in future years) in income in the year of receipt. Instead, for example, the amount of gross income in a given year from a fixed fee contract will generally be calculated with reference to the number of man hours worked during the year in relation to total estimated man-hours for the entire contract.

If the percentage of completion method is used, the amount of advance payments received during the years is irrelevant in the computation of gross income. This is because, under the percentage of completion method, the ratio of costs incurred to total estimated costs is the basis for determining annual gross income. Although for financial accounting purposes the percentage-of-completion method is acceptable under generally accepted accounting principles for determining gross income from a construction services contract, it cannot be used for tax purposes. Therefore, advance payments of fee income received from construction services contracts must be recognized in the year of receipt, except to the extent that deferral is permitted under Rev. Proc. 71-21, 1971-2 C.B. 549, discussed below.

CONCLUSION REACHED BY EXAMINATION DIVISION

Taxpayers must include advance payments received from construction services contracts in gross income in the year of receipt except to the extent Rev. Proc. 71-21 allows a deferral.

DISCUSSION

BACKGROUND

As noted above, the issue to be addressed is the proper tax treatment of advance payments received under construction services contracts. A taxpayer using the percentage of completion method for financial and tax purposes may be reporting income earned but not received, and excluding from income amounts received but not earned.

AICPA Statement of Position 81-1 at paragraph 6 states:

> In practice, methods are sometimes found that allocate contract cost and revenues to accounting periods on (a) the basis of cash receipts and payments or (b) the basis of contract billing and cost incurred. Those practices are not generally accepted methods of accounting for

> financial reporting purposes. However, those methods are appropriate for other purposes, such as the measurement of income for income tax purposes, for which the timing of cash transactions is a controlling factor. Recording the amounts billed or billable on a contract during a period as contract revenue of the period, and the cost incurred on the contract as expenses of the period, is not acceptable for financial reporting purposes because the amounts billed or billable on a contract during a period are determined by contract terms and do not necessarily measure performance on the contract. Only by coincidence might those unacceptable methods produce results that approximate the results of the generally accepted method of accounting for contracts that are appropriate in the circumstances.

AICPA SOP 81-1 will, in most instances, produce results that differ from the accounting required for Federal Income Tax.

<u>LAW</u>

IRC §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.

IRC §451. General Rule for Taxable Year of Inclusion.

(a) General Rule.-The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Treas. Reg. §1.451-1. General Rule for Taxable Year of Inclusion.

(a) General Rule. . . .Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. . . .

Rev. Rul. 80-308, 1980-2 C.B. 162 @ p. 163:

All the events that fix the right to receive income occur when

(1) the required performance takes place, or
(2) payment is due, or
(3) payment is made, whichever happens first.

See Schlude v. Commissioner, 372 U.S. 128 (1963), Ct. D. 1879, 1963-1 C.B. 99 and Rev. Rul. 79-195, 1979-1 C.B. 177.

The Commissioner has consistently required the inclusion of prepayments in income in the year received, citing the claim of right doctrine. **Revenue Ruling 60-85, 1960-1 C.B. 181 @ p. 182** concludes:

> . . .the Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income, ... regardless of whether the period of proration is definite or indefinite, unless a different treatment is specifically provided in the Internal Revenue Code of 1939 or 1954 or the regulations thereunder.

Rev. Proc. 71-21, 1971-2 C.B. 549, provides certain limited exceptions for accrual basis taxpayers "... in certain specified and limited circumstances to defer the inclusion in gross income for Federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year."

Cases For the Government. Support for the proposition that advance payments received are reportable as gross income in the year received is found in the oft-cited trilogy of decisions by the Supreme Court: Automobile Club of Michigan v. Comm., 353 U.S. 180 (1957); American Automobile Association v. U.S., 367 U.S. 687 (1961); and, Schlude v. Comm., 372 U.S. 128 (1963). In each of these cases, prepaid fees or dues were found to be income in the year received where the taxpayer had complete control over and use of the funds received. Subsequent decisions which followed the conclusions reached in the above cases include RCA Corp., 664 F2d 881 (CA2, 1981), [81-2 USTC 9783], Cert. den. 102 SCt 2958, and Handy Andy T.V. and Appliances, Inc., 47 TCM 478, TC Memo 1983-713. RCA Corp. is particularly thorough in its discussion of tax accounting principles vs. generally accepted accounting principles.

Cases For the Taxpayer. The Seventh Circuit took the lead in finding a perceived opening in the Supreme Court's rulings against deferral of reporting prepaid income in Artnell Company, 400 F2d 981 (7th Cir. 1968), rev'g & rem'g 48 TC 411. The Court ruled "there must be situations where the deferral technique so clearly reflects income that the court will find an abuse of discretion if the Commissioner rejects it." On remand, the Tax Court found that the taxpayer's method more clearly reflected income than the Commissioner's did since it did a far better job of matching revenue and related expenses. TC Memo 1970-85.

In Collegiate Cap and Gown Company, Transferee, 37 TCM 960 (1978), the Tax Court was constrained to follow the Artnell Company decision because of the Golsen Rule, i.e., the case was appealable to the Seventh Circuit. The Court found that "at least to that extent, Cap & Gown's accounting method more clearly matched income and related expenses than did the accounting method utilized by the baseball team in Artnell." The opening (in the above-cited Supreme Court decisions) seized upon by the Seventh Circuit is articulated in Artnell as follows:

> ...the Commissioner did not abuse his discretion in rejecting a deferral of income where the time and extent of performance of future services were uncertain...

Likewise, the Tax Court in Collegiate Cap & Gown stated:

> ... the objection of the Supreme Court was not to the deferral of prepaid income **per se,** but to the uncertainty as to when the prepaid income would be reported by each of the taxpayers...

In Boise Cascade Corp., 530 F2d 1367 (Ct. Cls., 1976), [76-1 USTC 9203], Cert denied Taxpayer on different issue 429 US 867, the Claims Court held that since the time of performance (and, by inference, the proper time for accrual of the income) was adequately fixed and definite, deferral of reporting was proper.

Deposits Distinguished. In Indianapolis Power & Light Co., SCt 88-1319 [90-1 USTC 50,007], aff'g CA-7, 857 F2d 1161 (1988), [88-2 USTC 9529], aff'g Tax Court, 88 TC 964, the Supreme Court held that customer deposits are not advance payments for electricity and therefore do not constitute taxable income to IPL upon receipt. In the process of reaching this decision, the court discussed the differences between advance payments, deposits and loans in rather thorough detail:

> We begin with the common ground. IPL acknowledges that these customer deposits are taxable as income upon receipt if they constitute *advance payments* for electricity to be supplied. (footnotes omitted}
>
> The Commissioner's advance payment analogy seems to us to rest upon a misconception of the value of an advance payment to its recipient. An advance payment, like the deposits at issue here, concededly protects the seller against the risk that it would be unable to collect money owed it after it has furnished goods or services. But an advance payment does much more: it protects against the risk that the purchaser will back out of the deal before the seller performs. From the moment an advance payment is made, the seller is assured that, so long as it fulfills its contractual obligation, the money is its to keep. . .

Of perhaps greatest value to the IRS position regarding advance payments is the court's seeming confirmation of the premise that advance payments are income in the year of receipt, absent unusual circumstances.

ANALYSIS

IRC §446(b) provides the Commissioner the statutory authority to change the taxpayer's method of computing taxable income when the taxpayer's method does not clearly reflect income. The term "clearly reflect income," becomes the focus of the dispute and it is obviously a term of art rather than exactitude. At page 39,615 of CCH's Standard Federal Tax Reports, the issue is described in this manner:

> Many taxpayers have contended that advance payments received for services to be performed should be deferred for income tax purposes, as they are for financial

statement purposes under commercial accrual accounting rules, until later performance of the services. If an accounting method used on a taxpayer's books does not clearly reflect taxable income, however, the law gives the IRS the power to use a method which it thinks does do so. The IRS's position is that the deferral of prepayments under commercial accounting rules does not clearly reflect taxable income because the seller has already received payment. He has taxable income in hand even though the services have not been performed.

In RCA Corp., supra, pp. 88604 and 88606, the Second Circuit drew the line more sharply:

> ... As the Supreme Court has recognized, these two systems of accounting have "vastly different objectives":
>
> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. {quoted from Thor Power Tool Co., 439 US 522, 542 (1979), [79-1 USTC 9139]}
>
> ... Tax accounting therefore tends to compute taxable income on the basis of the taxpayer's present ability to pay the tax as manifested by his current cash flow, without regard to deductions that may later accrue.

While the decision in RCA Corp. would seem to indicate that the court accepts the Commissioner's discretion as the last word in the correctness of accounting methods, there is the opposite line of cases exemplified by Artnell, Boise Cascade, and <u>Collegiate Cap & Gown</u>, supra. From <u>Artnell</u>:

> Has the Supreme Court left an opening for a decision that under the facts of a particular case, the extent and time of future performance are **so** certain, and related items properly accounted for with such clarity, that a system of accounting involving deferral of prepaid income is found clearly to reflect income, and the Commissioner's rejection deemed an abuse of discretion? Or has it decided that the Commissioner has complete and unreviewable discretion to reject deferral of prepaid income where Congress has made no provision? . . {emphasis added}

The Seventh Circuit in <u>Artnell</u>, supra, found that the Supreme Court **must** have intended to restrict the Commissioner's discretion, and that an abuse of discretion could be found when the taxpayer's method of accounting "will so clearly reflect income."

While each of the courts described its reasoning somewhat differently, it would appear that a "time certain" for performance of the services was an important factor (perhaps <u>the</u> important factor) when findings were made in the taxpayer's favor. That is, there appears to have been a continuum from "fixed event, time certain" to "possible performance, time indefinite." In <u>Artnell</u>, supra, the Chicago White Sox ticketholders paid in advance, but the date and performance of the games were fairly certain. By contrast, the auto towing or repair in <u>American Automobile Association,</u> supra, or dance lessons in <u>Schlude</u>, supra, were uncertain as to time and sometimes were never performed. Between these extremes lie <u>RCA Corp.</u>, supra, (statistical sampling as to what services could be expected to be performed), <u>Boise Cascade</u>, supra, (engineering estimates and contractual obligations as to dates of performances) and numerous other cases, mostly cited above.

Rev. Proc. 71-21, supra, modified Service position somewhat and has as its express purpose "to reconcile the tax and financial accounting treatment of such payments in a large proportion of these cases without permitting **extended** deferral in the time of including such payments in gross income for Federal income tax purposes." (Emphasis added).

Deferral is limited under Rev. Proc. 71-21 to the succeeding taxable year:

> ...if the inclusion in gross income of payments received is properly deferred under the preceding sentence and for any reason a portion of such services is not performed by the end of the next succeeding taxable year, the amount allocable to the services not so performed must be included in gross income in such next succeeding year, regardless of when (if ever) such services are performed.
>
> ...a payment received by an accrual method taxpayer pursuant to an agreement for the performance by him of services must be included in his gross income in the taxable year of receipt if under the terms of the agreement as it exists at the end of such year:
>
> (a) Any portion of the services is to be performed by him after the end of the taxable year immediately succeeding the year of receipt; or
>
> (b) Any portion of the services is to be performed by him at an unspecified future date which may be after the end of the taxable year immediately succeeding the year of receipt.

Prepaid rent and prepaid interest are not covered by the Revenue Procedure; it also has no application to guaranty or warranty contracts. Subject to these and a number of additional constraints, Rev. Proc. 71-21 states that "[T]he deferral of the inclusion in gross income of amounts in accordance with the foregoing principles will be treated as an acceptable method of accounting under section 446 of the Code as long as the method is consistently used by the taxpayer."

A taxpayer wishing to change its method from including advance payments in income in the year of receipt, to deferring advance payments on contracts that qualify under Rev. Proc. 71-21, may do so by filing Form 3115 and obtaining the Commissioner's consent. If the terms of any contract provide for services to be rendered beyond two taxable years, the contract will not qualify for deferral and any advance payments received must be included in income in the year of receipt.

The effect of Rev. Proc. 71-21 will be to exclude the "large proportion" of prepayments from adjustments required to prepare the tax return, just as stated in the text of the Revenue Procedure. That is, services for most prepayments _will_ be performed in the succeeding taxable year. However, this should not be construed as the adoption of commercial accrual accounting in its entirety; such deferral is carefully limited by the Revenue Procedure. The _RCA Corp._ Court squarely considered this question:

> . . . While the Commissioner has permitted certain forms of accrual accounting in Rev. Proc. 71-21, supra, and Rev. Rul. 71-209, supra, that does not necessarily mean, as RCA asserts, that the Commissioner has conceded the correctness of RCA's position in this litigation. As we have emphasized above, the Commissioner possesses considerable discretion in these matters, . . .

SETTLEMENT GUIDELINES

1. The focus of contention is likely to be whether a particular contract calls for construction in addition to services; i.e., construction contract vs. construction services contract. Many contracts encompass both construction services as well as actual construction (dual-purpose contracts). The general rule is that advance payments received, which relate to construction services that enable the taxpayer to perform actual construction of the same subject matter, do not have to be included in income in the year of receipt, because gross income from this type of contract can be accounted for under the percentage of completion method. For example, advance payments associated with the taxpayer's architectural design services related to Building A do not have to be included in income in the year of receipt if the taxpayer is also involved in the actual construction of Building A. If this is the case, advance payments of fee income should be credited to unearned income upon receipt of the cash. This unearned income is then recognized when appropriate under the percentage of completion method.

2. If, however, the advance payments received are unrelated

to construction services that enable the taxpayer to perform actual construction of the same subject matter (e.g., where the advance payments are made with respect to the design of Building B and the only construction required of the taxpayer relates to ancillary structures which facilitate construction of Building B, such as parking facilities for laborers), these advance payments will have to be included in income in the year of receipt, except to the extent that these receipts can be deferred under Rev. Proc. 71-21.

3. Resolution of the issue will normally be on a factual basis. Adequate documentation (contracts) for the advance payments at issue should be reviewed. In distinguishing between construction contracts and construction services contracts, particular attention should be given to the actual contractual obligations set forth as opposed to the labels or terminology used. Taxpayers may attempt to label service contracts as construction contracts in an attempt to qualify the contract for percentage of completion method tax treatment.

With respect to whether an advance payment received actually represents unearned income, particular attention should be given to the contract’s terms as to the disposition of the advance payments in the case of termination or non-performance. Unearned advance payments for services typically must be returned to the client in the event of termination or non-performance. The absence of such a provision may be indicative that the payment is already earned and not contingent upon some future service obligation. If already earned the payment would not be eligible for deferral under Rev. Proc. 71-21.

Another important factual determination is the contract’s estimated completion date. In the case of construction service contracts, this effects the contract’s eligibility for deferral under Rev. Proc. 71-21 (e.g. it must be anticipated that all services will be performed by the end of the next succeeding taxable year). In this regard, it should be determined whether the contract is one of a series of contracts with the same customer, especially whether a succeeding contract depends on completion of the current contract. Multiple contracts may, in substance, be a single contract, rendering the advance payment ineligible for deferral under Rev. Proc. 71-21 (if services are anticipated to extend beyond the end of the next succeeding taxable year).

4. If an accrual basis taxpayer has consistently deferred the reporting of income from advance payments **and** none of the contracts extend beyond the next succeeding taxable year, Rev. Proc. 71-21, Sec. 3.14, should be applied and no adjustment to the tax return is required. If the taxpayer changed to such method, then the Commissioner's permission was required. If the taxpayer defers reporting the income for all advance payments, whether or not the applicable contract extends beyond the next succeeding taxable year or indefinitely, that is an unacceptable accounting method. If the taxpayer has:

   - failed to obtain the Commissioner's approval for a change in accounting method, or

   - deferred the reporting of income for all advance payments, some of which extend beyond the next succeeding taxable year, or,

   - inconsistently reported income from advance payments,

   then the adjustments are negotiable, based on the strengths and weaknesses of the government's and taxpayer's positions.

It should be noted that a change to the time a taxpayer consistently reports income or deducts expenses is a change to the taxpayer's method of accounting, subject to the provisions of IRC §§ 446 and 481. Thus, a change from reporting income from a construction services contract using a long-term contract method, such as the percentage-of-completion method, to reporting income from these contracts using, for instance, an overall accrual method, could potentially be a change in accounting method. Although this issue is not addressed in the Examination Coordinated Issue paper, it may be raised in the revenue agent's report. Any change of accounting method concerns can be addressed when you contact the Appeals ISP coordinator.