APPEALS
INDUSTRY SPECIALIZATION PROGRAM
SETTLEMENT GUIDELINES

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ISSUE: Construction Management Contracts

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CONSTRUCTION/REAL ESTATE INDUSTRY

CONSTRUCTION MANAGEMENT CONTRACTS

STATEMENT OF ISSUE

Whether a contract is a construction contract subject to long-term contract accounting under I.R.C. §460, or a construction management contract that must be accounted for under some other permissible method of accounting under the Internal Revenue Code.

If a particular contract is determined to be a long-term contract as defined in IRC §460, then long-term contract accounting (generally the percentage-of-completion method {PCM}) is used to account for revenues & costs. If not, then an acceptable method (usually accrual), as defined in I.R.C. §446, must be used. The difference produced by these differing accounting methods will have greatest impact on the recipient of advance ("upfront") payments made at the beginning of the contract. For tax purposes, the construction contractor who provides goods and services will report only an appropriate portion of such advance(s) as the construction progresses. The construction manager, who provides primarily services, will generally be required to report such advances as taxable income in the year received.

EXAMINATION DIVISION'S POSITION

FACTS

The Examination Coordinated Issue Paper provides a typical scenario in the industry to illustrate the issue.

A taxpayer (construction manager) executes a contract with an owner to provide construction management services in connection with a large construction project. The construction management services the taxpayer is required to perform involve the management of the construction site and all activities thereon. This includes preparing a construction plan, scheduling contractors' work performance, scheduling analysis and control, cost estimating and budgeting, and controlling costs. The taxpayer is also

responsible for the solicitation of bids and selection of contractors that will perform the actual construction work on the project, subject to the owner's approval. It also includes supervision and management of construction of all structures into an acceptable configuration. The contract also provides for the taxpayer to construct fencing for security purposes around the construction site and build roads to allow contractors access to the project.

The contract further requires the taxpayer to monitor, supervise and coordinate the general contractors (or subcontractors) so that the actual construction work will be performed in a timely and efficient manner. In its dealings with the contractors on the project, the taxpayer performs its services as the agent of the owner. Orders, contracts, and any other obligations that the taxpayer incurs with the owner's concurrence are to be in the owner's name, "By Taxpayer, Agent." All orders and contracts placed by the taxpayer are to contain provisions recognizing the taxpayer as the agent of the owner.

Although the taxpayer may stop work for quality reasons, only the owner may expand the scope of the construction services under the contract. The taxpayer may not expand the scope of the services performed under the contract without first advising the owner of such need, and the probable cost and schedule impact. Moreover, the taxpayer may not expand the scope of the services to be performed without the owner's written authorization. The owner has the overall responsibility for the construction of the project, and bears the risks of construction defects. The taxpayer assumes complete responsibility for the performance of its services under the contract. However, the taxpayer is not liable for construction defects, except for the fences and roads.

The taxpayer's compensation is based on the reimbursement of the salaries of its employees for the time allocable to the project, plus a percentage of such salaries as an allowance for overhead and administrative costs, and for profit (cost-plus contract). The taxpayer may also earn performance and milestone incentives if certain goals in the performance of its services are met. Finally, the taxpayer receives a fixed fee in the first year of the contract.

The issue is whether this taxpayer should report all revenues from the contract, including the fixed fee, using the percentage-of-completion method of long-term contract

accounting under the provisions of IRC §460.

CONCLUSION REACHED BY EXAMINATION DIVISION

To distinguish between a construction contract and a construction management contract requires a determination as to whether the activities performed are in the nature of personal services or are those of a general contractor. Although no one factor is determinative, analysis of the contract indicates that the taxpayer was acting as an agent for the owner and had no control over the actual construction. The taxpayer was not subject to the risks or liabilities generally associated with the business of "building or constructing", nor was the taxpayer liable for construction defects. Thus, the contract constitutes a construction management contract rather than a contract to build or construct, and income and expenses attributable to it may not be accounted for under the Percentage-of-Completion Method.

Although the fence and road construction qualifies as a construction activity for purposes of IRC §460(f)(1), this activity is, nevertheless, unrelated to the subject matter of the contract, which is to manage the construction of the project. Thus, although income and expenses attributable to the construction of the fences and roads may be accounted for under IRC §460 (if otherwise qualified), the service income may not be accounted for under IRC §460.

DISCUSSION

BACKGROUND

Traditional general contractors, or Master Builders as they were called, were individuals or families who hired tradespeople, purchased materials, and undertook the construction process with their own resources and crews.[1]

The construction manager is an agent of the owner and may be engaged in lieu of or in addition to a general

[1] Carmichael, Douglas R.; Griffith, J. Clifford; Roberts, Everett A.; Guide to Construction Contractors, Vol. 1, 6th Ed (May, 1994), Practitioners Publishing Company, Ft. Worth, p. 115.02.

contractor. As the owner's agent the construction manager coordinates the construction project but has no contractual relationship with [contractors or] subcontractors and, generally does not perform any of the construction work on the project.[2]

Construction management represents a sort of hybrid which evolved beginning perhaps in the 1950's or 1960's in response to the market conditions. Huge construction projects (atomic power plants, for example) put the contractor at great risk if the traditional bid methods were used; there were many unknowns and inflationary pressures spiraled costs upward. Project owners, on the other hand, simply did not have the expertise to build their own plant, office building or dam. Construction managers provided the construction expertise to owners without such major risk of loss.

The distinction between a construction contract and a construction management contract is best illustrated by a comparison of the activities to be performed pursuant to each type of contract. The distinction is based on an analysis of each contract and on the rights and obligations of the parties to the contract. Many construction firms are simultaneously working in both types of engagements; the distinction is contract-specific rather than attaching to a particular taxpayer. And, finally, analysis of a particular contract may be made all the more complex if some construction activities are required of a taxpayer within the construction management contract.

CONSTRUCTION CONTRACTS

A construction contract requires that the taxpayer perform actual construction activity, either itself or through subcontractors; i.e., a contractor is building or making something.

The term "long-term contract" means 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. I.R.C. §460(f) and Reg. 1.451-3(b)(1)(i).

A construction contractor is generally responsible for the final product and must correct mistakes in construction or

[2] Ibid, p. 115.01.

defects in the building or product. This contractor is at-risk financially for the project/contract; i.e., a contract may be unprofitable, even to the extent of large losses.

CONSTRUCTION MANAGEMENT CONTRACTS

A construction management ("CM") contract generally requires the performance of personal services, and does not put the CM firm at-risk for defects in the materials nor mistakes in the construction. The construction manager is generally the **agent** of the project owner and, as such, coordinates the construction project for the owner but has no contractual relationship with the contractors or subcontractors. The construction management firm will probably also be an engineering or architectural firm and:

- may provide engineering and design services;
- may negotiate with contractors or subcontractors & suppliers on the owner's behalf;
- will oversee and coordinate all construction activity on the project; and,
- may actually perform some construction functions.

To reiterate, the determination whether a particular contract is a construction contract or a construction management contract is a matter of facts & circumstances, case by case.

"MIXED" CONTRACTS

In many instances, firms will provide both construction management services, such as architectural and engineering services, in addition to performing actual construction activities. The degree to which a contract may qualify as a long-term contract is a matter of facts & circumstances. For example, a taxpayer may enter into a single contract to design and construct a building. In general, income and expenses attributable to engineering or other similar services that enable the taxpayer to construct the subject matter of a long-term contract must be accounted for as part of a long-term contract; see General Counsel Memorandum 39803, 11/16/89, pp. 9 & 10. This follows since the services are functionally

related to, directly benefit, and are performed by reason of the taxpayer's building, installation, or construction obligation under the same contract. In this example, the design services are directly related to the subject matter of the taxpayer's construction activity, and the income and expenses attributable to the design services must be accounted for with the income and expenses attributable to the construction activity.

In a second example, the contract might require a firm to provide primarily CM services, but also to build ancillary structures which facilitate construction of the primary subject matter of the contract. For instance, a CM firm may enter into a contract to provide architectural and engineering services, to coordinate bidding among several prime contractors for the construction of a power plant, and to coordinate on-site construction activities, but not to perform any construction of the plant. Since this contract is primarily CM services and not actual construction, the firm appropriately uses the accrual method of accounting to report its management services income. Pursuant to the same contract, however, the CM firm agrees to build ancillary structures such as parking facilities for construction laborers, install fencing for security purposes during construction of the project, erect and coordinate the use of construction cranes for the various contractors, and build roads to allow the contractors access to the project. It would be extremely unusual that the construction manager would be the contractor or subcontractor for a major portion of the actual construction; this could create a conflict-of-interest, i.e., the same firm would be supervising construction as agent of the owner and constructing some major portion of the project.

A contract that provides for the performance of services, but does not provide for a qualifying long-term contract activity, may not be bootstrapped into IRC §460 simply by adding an ancillary construction obligation mostly unrelated to the service obligations. In the second example, the architectural, engineering, and CM services directly relate to the construction of the plant, not to the ancillary structures which facilitate construction of the plant. Although income and expenses attributable to the ancillary construction activities might qualify for IRC §460 accounting, the primary services under the CM contract are not sufficiently related to the ancillary construction to qualify for IRC §460 treatment. In such a case, the income and expenses attributable to the

services should be accounted for under the accounting method normally used by the company, which in this example is the accrual method. The income and expenses attributable to the ancillary construction activities, and any services directly related to that construction, may be accounted for under IRC §460, if the length of time for such construction extends into the next taxable year (and all other qualifying standards are met).

For additional examples, see GCM 39803, supra, and Notice 89-15, supra.

LAW AND ANALYSIS

A contractor performing pursuant to a long-term contract (as defined for tax purposes) generally must account for the income from that contract under the PCM. In general, taxpayers must use PCM to account for income earned from long-term contracts entered into on or after July 11, 1989, in accordance with IRC §460(a). Long-term contract accounting methods were initially justified for construction contracts, in large part, by the difficulty in determining the net profitability of a construction project due to fluctuating and unforeseen costs. See Sam W. Emerson Co. v. Commissioner, 37 T.C. 1063, 1068 (1962). Rev. Rul. 70-67, 1970-1 C.B. 117, indicates that one of the primary reasons long-term contract accounting methods are provided for long-term construction contracts is because of changes in the price of materials to be used, losses and increased costs due to strikes, penalties for delay, and unexpected difficulties in laying foundations. These "builder's risks" may make it difficult for a contractor in the construction business to estimate with any certainty the amount of gain or loss derived from a particular construction project until the project is completed. While the completed-contract method of reporting income is no longer generally available for long-term contracts, the rationale remains applicable.

A contract to provide only services that are not "building, installation, construction, nor manufacturing" is not a long-term contract because such a contract does not call for the taxpayer to "build, install, construct, or manufacture" anything. Rev. Rul. 82-134, 1982-2 C.B. 88 (engineering and construction management services); Rev. Rul. 80-18, 1980-1 C.B. 103 (engineering services); Rev. Rul. 70-67, 1970-1 C.B. 117 (architectural services). These Revenue Rulings stand for

the proposition that contracts which do not require a taxpayer to build, install, or construct anything, even if the services provided are functionally related to building, installing, or constructing activities, do not qualify for one of the long-term contract accounting methods. Especially relevant is Rev. Rul 82-134 which specifically discusses construction management services.

In United States v. Howard, 655 F. Supp. 392, 400 (N.D. Ga. 1987), aff'd, 855 F.2d 832 (11th Cir. 1988), the District Court decision contains an especially clear & extensive discussion of the distinction between personal services and construction (even though the primary issue of the case was something else entirely):

> Besides the fact that "consulting contracts" are not included in the definition of the term "long-term contract" as that term is defined in the applicable regulation, consistently-applied revenue rulings indicate that taxpayers who earn income pursuant to **personal services contracts**, such as the Consulting Agreement in this case may not utilize the completed contract method of accounting. This is the case even though the services that the taxpayer performs may be "functionally related to activities which may be the subject of long-term contracts. . ." Rev. Rul. 80-18. [Emphasis added].

The court gave appropriate weight to revenue rulings of the Commissioner which had clearly and consistently held that personal services contracts cannot be long-term contracts for income tax purposes. See Notice 89-15, 1989-1 C.B. 634, for additional, extensive discussion of most aspects of Long-Term Contracts.

The receipt of an advance payment on a long-term construction contract should have no effect on the amount of gross income the contractor includes in income for any particular taxable year under PCM. The gross income for such year is based on the product of the total expected revenue from the entire contract and the percentage of completion determined under an estimated "cost to cost" ratio, less previous years gross income from the contract. Discrepancies in estimates are corrected after the contract is completed under the "look back" provisions of IRC §460. Accordingly, the receipt of an advance payment for construction work not yet performed is not included in income in the year of receipt by reason of the

receipt.

However, an accrual basis taxpayer generally must include advance payments for services in gross income in the taxable year of receipt. See Schlude v. Commissioner, 372 U.S.128 (1963); American Automobile Ass'n v. United States, 367 U.S. 687 (1961); Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); Angelus Funeral Home v. Commissioner, 47 T.C. 391 (1967), aff'd, 407 F.2d 210 (9th Cir.), cert. denied, 396 U.S 824 (1969). Thus, advance payments received for a construction management contract should be included in gross income when received. A limited exception is provided for advance payments when all services under the contract are required to be performed before the end of the taxable year following the year of receipt. Rev. Proc. 71-21, 1971-2 C.B. 549.

SETTLEMENT GUIDELINES

This issue should have relevance in the first year (advance payments) or last year (retainage or issue as to when a contract is completed) of a contract. Otherwise, as the Examination ISP Coordinated Issue Paper notes, ". . .the use of either the accrual method or a percentage of completion method could yield substantially similar results when applied to the same service contract for the same year."

A taxpayer seeking to defer income may attempt to use the percentage of completion method under IRC §460 with respect to a contract by classifying that contract as a construction contract, rather than a construction management contract. In order to be successful in this argument, the taxpayer will have to be able to qualify its activities as relating to the manufacture, building, installation, or construction of property. IRC §460(f)(1). The factual issues will generally center on:

- ♦ whether the contract requires the taxpayer to construct anything; and,

- ♦ whether the contract subjects the taxpayer to a contractor's normal risk-of-loss.

GCM 39803 put to rest the Service's effort to "carve out" design, engineering, and other service facets of a long-term construction contract to be accounted for separately. It was

concluded that, so long as the services were an integral part of the construction contract, income & expenses generated thereby could be accounted for as part of the construction contract. Here, we have essentially the "flip side" of this issue; a services contract with incidental construction required. Will the Service permit the taxpayer to "carve out" a portion of the income from the construction management contract and report such portion using the percentage-of-completion method? The answer is Yes, but within narrow guidelines. The taxpayer must show:

- that the separate construction activities qualify as long-term contract activities;

- that the taxpayer has allocated a reasonable amount of revenue to the construction portion of the contract versus the construction management portion; and,

- that the taxpayer has utilized proper costing techniques in determining the annual percentage of completion for the construction portion of the contract.

Settlement will be case-by-case. Fortunately, there is usually an adequate factual basis to separate income/costs from the construction management portion of the contract versus the construction portion. General Counsel Memorandum 39803, supra, Notice 89-15, supra, and Reg. 1.451-3 provide a number of examples with recommended solutions which might provide guidance.

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 management 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.