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## The home construction contract: what's in a name?

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William Shakespeare in *Romeo and Juliet* penned the phrase; "What's in a name? That which we call a rose by any other name would smell as sweet." Shakespeare would try to convince us that what really matters is what something is, not what it is called. What's in a name in the world of tax statutes and regulations? Shakespeare would likely be amused or very frustrated. How something is named, labeled, or defined can be of critical importance in the tax world.

Defining a home construction contract in layman's terms may seem as easy as it might to Shakespeare. In the tax world this has not always been the case, but there is hope for a sweet-smelling outcome. On August 4, 2008, the Internal Revenue Service (IRS) issued proposed regulation to provide guidance to taxpayers in the home construction industry regarding accounting for long-term construction contracts that qualify for home construction contracts under §460(e) of the Internal Revenue Code (Code). Proposed regulations were also issued to provide guidance on various other matters regarding long-term contracts. This article will focus on those proposed regulations that provide guidance about §460(e).

### Home construction contracts

Many readers are likely familiar with the general requirement imposed by §460 on contractors. In general, §460(a) requires a contractor to use the percentage of completion method (PCM) to determine taxable income from any long-term construction contract. A long-term contract is one that straddles any taxable year end of the taxpayer. One important exception to this general rule is in regards to home construction contracts. Section 460(e) exempts home construction contracts from the PCM.

Being exempt from the mechanics of the PCM of accounting for long-term contracts is a good thing. If exempt under §460(e), a contractor can use exempt methods such as the completed contract method (CCM). This should generally result in a tax deferral for the contractor. In addition, home construction contracts are exempt from the application of the look-back provisions and the requirement to use the PCM for alternative minimum tax purposes.

Section 460(e)(6)A) of the Code defines a home construction contract as any construction contract where 80 percent or more of the estimated contract costs are reasonably expected to be attributable to the construction of (i) dwelling units contained in buildings containing four or fewer dwelling units and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units. The 80 percent test is applied in the year that the contract is entered into. For purposes of (i) above, each townhouse or rowhouse shall be treated as a separate building.

**Shakespeare and the IRS might disagree: the Service sometimes thinks a name is of critical importance.**

Home construction contracts and residential construction contracts are not the same item under the Code and Regulations. The distinction between home construction contracts and residential construction contracts has been very important. Shakespeare might protest that a residential construction contract should be the same as a home construction contract. His protest would be a failing one. Regs §1.460-3(c) defines a residential construction contract as a home construction contract except that the building or buildings being constructed contain more than four dwelling units. Shakespeare would indeed protest. Residential construction contracts typically apply to apartments and condominiums with greater than four units per building. Why is the distinction so important under the current regulations? It is important because residential construction contracts do not receive the same favorable treatment afforded home construction contracts.

The proposed regulations expand the types of contracts eligible for the home construction contract exemption. Tax advisors, taxpayers, and the construction industry have generally viewed the expanded definition very favorably. The regulations when finalized would permit a greater number of players in the home construction industry to be exempt from the PCM. The potential winners include land developers, condominium developers, and related subcontractors. Many feel the expansion is really a clarification and that these players in the home construction process already qualify for exemption from the PCM under §460(e). However, the IRS recently disagreed via an Industry Director's Directive dated September 15, 2009.

## Improvements to real property

Recall that under §460(e)(6)(A), improvements to real property directly related to qualifying dwelling units and located on the site of such dwelling units can qualify as construction costs attributable to home construction. A point of contention in past years was whether or not a residential developer or contractor that installed infrastructure would have improvements to real property attributable to a home construction contract. Advisors had suggested that many contracts entered into under this scenario should qualify as home construction contracts. Regs. §1.460-3(b)(2)(i) of the proposed regulations expand the scope of the home construction contract exemption by providing that a contract for the construction of common improvements is considered a contract for the construction of improvements to real property directly related to the dwelling units located on the site:

*Improvements to real property directly related to, and located on the site of, dwelling units consists of improvements to land on which dwelling units are constructed, **and common improvements as defined in paragraph (b)(2)(iv) of this section.***

Further, under Regs. §1.460-3(b)(2)(iv)(B) of the proposed regulations, even if the contract is not for the construction of any dwelling units, such a contract would be a home construction contract:

*A common improvement is an improvement that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land containing dwelling units (or the land on which dwelling units are to be constructed) and that benefits the dwelling units (or the land on which dwelling units are to be constructed). In general, **a common improvement does not solely benefit any particular dwelling unit or any particular lot on which a dwelling unit is constructed.***

Under the proposed regulations, a land developer or subcontractor installing infrastructure or common improvements may have a contract that qualifies for exemption from PCM under §460(e). Common improvements include sidewalks, sewers, roads, and clubhouses.

Some commentators believe there is still room for improvement. The proposed regulations refer to improvements to real property directly related to and located on the site. Should the term “site” be further clarified? Commentators feel that additional examples in the proposed regulations could be used to help clarify what is intended by the term site. The IRS has in the past taken positions that indicate a general tendency to view the term “site” more narrowly than do taxpayers. Without additional language or effective use of examples, there is some concern that there still may be confusion regarding what “site” is meant to be.

### **Townhouses, rowhouses, and condominiums**

Under §460(e)(6)(A), the definition of home construction contract is tied very much with the definition of a dwelling unit. Section 168(e)(2)(A)(ii)(I) defines the term “dwelling unit” to mean a house or apartment used to provide living accommodations in a building or structure. Section 460(e)(6) states that each townhouse or rowhouse shall be treated as a separate building, regardless of the number of units contained in the structure. This meant that each townhouse or rowhouse structure would meet the requirements under §460(e) to be treated as a home construction contract. This has not been the case for condominiums. In the case of condominiums, if there were more than four units in the structure, those related contracts would not qualify as home construction contracts. They would be residential construction contracts. On the surface, this result may seem a bit wacky. After all, condominium units share many common characteristics with townhouses and rowhouses. However, as we have learned, what’s in a name can be very important.

Regs. §1.460-3(b)(2)(iii) of the proposed regulations expand what is considered a townhouse or a rowhouse for purposes of the home construction contract exemption to include an individual condominium unit, stating:

*For purposes of determining whether a long-term construction contract is a home construction contract under paragraph (b)(2) of this section, each townhouse or rowhouse is a separate building. **For this purpose, the term townhouse and rowhouse includes an individual condominium unit.***

This has the effect of allowing each individual condominium unit to be treated as a separate building for purposes of determining whether the related contract qualifies as a home construction contract. Commentators are concerned about the potential conflict between this part of the proposed regulations and the “four or fewer dwelling units” language contained in §460(e). To avoid any future misunderstanding and confusion, commentators have suggested that additional clarity be added to state that a condominium unit qualifies as a home construction contract no matter what the structural configuration.

## To be, or not to be

The preamble to the regulations states specifically that these regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the Federal Register:

***Taxpayers may not change or otherwise use a method of accounting in reliance upon the rules contained in these new proposed regulations until the rules are published as final regulations in the Federal Register.***

In other words, the proposed regulations tell taxpayers and their advisors how the definition of a home construction contract is likely to be expanded and clarified. The preamble to the regulations states that the proposed regulations cannot be relied on until made final and so formally published. At this point, the final regulations cannot be published in the Federal Register any sooner than some point in 2009 and, in fact, it is currently doubtful that any action will be taken to finalize the proposed regulations in 2009. For calendar year end taxpayers, this means the regulations may not take effect until perhaps 2011. This has left taxpayers and advisors a bit frustrated.

The IRS, in May 2009, also updated the Construction Industry Audit Technique Guide (ATG). The ATG discussed the proposed regulations in brief. The ATG is not an official pronouncement of the law or the position of the IRS and cannot be used, cited, or relied upon as such. Regarding the proposed regulations, the ATG stated, in language similar to that in the preamble to the regulations, that the proposed regulations had not been finalized and cautioned readers to look for the issuance of subsequent guidance. An IRS Industry Director's Directive followed on September 15, 2009 that further stated the proposed regulations cannot be cited or relied on as authority. This directive also communicated the IRS's position that the proposed regulations are not a clarification of current law, but an expansion of current law. This communicates to readers the IRS's intent to continue to follow past precedents in dealing with issues on audit until after the proposed regulations are made final.

## Conclusion

What would William Shakespeare say about the Code and regulations definition of construction contracts regarding homes, townhouses, rowhouses, condominiums, common improvements, and improvements to real property? Would he feel that his phrase "That which we call a rose by any other name would smell as sweet" would apply? Perhaps Shakespeare would have a bit of fun with our dilemma. He might also recognize that things are moving in a positive direction, though perhaps not quickly enough for many taxpayers.

Taxpayers and their advisors are still looking for some absolute answers. Nonetheless the IRS and Treasury should be commended for their efforts as commentators at the public hearings have stated. Certainly, it seems that taxpayers and the IRS are closer to finding common ground regarding the definition of a home construction contract and how it affects the various contractors in the development and construction process. We now anxiously wait for the proposed regulations to become final so the positive changes can be put to good use.

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