THE IRS TARGETS THE CONSTRUCTION INDUSTRY

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The Internal Revenue Service has turned its attention to the construction industry in a recently issued field directive that addresses accounting for long-term contracts. According to Keith M. Jones, IRS Industry Director of Natural Resources and Construction, and author of the directive, "The misuse of the completed contract method is a growing trend within the construction industry . . ."

The IRS gives five scenarios in the directive as examples of improper treatment:

(1) A land developer enters into a sales/construction contract to provide improved lots. The taxpayer sells the lots and is contractually obligated to provide a future common improvement (e.g., clubhouse, pool, roads, etc.). The taxpayer treats the contract as a home construction contract and defers income recognition until the future common improvement is completed.

(2) The taxpayer is a subcontractor hired by the land developer to construct roadways, sidewalks, utilities, grading, or other common improvements within a residential community. The taxpayer treats the contract as a home construction contract, thus deferring the progress payments until the entire contract is completed.

(3) The taxpayer establishes two partnerships to separate land development from home construction. The land developer enters into one contract for the homebuilder to build all of the homes in the development. The homebuilder defers the income on the homes it builds until the entire contract is completed. The land developer may defer the lot sales, which is the same as in Situation (1).

(4) A homebuilder adopts the project-by-project basis provided in Rev Proc 92-29, 1992-1 CB 748 (dealing with the use of the alternative cost method), to determine when completion occurs. None of the home sales are recognized until the entire development (project) is done.

(5) The land developer/homebuilder is required to provide a future common improvement to a development. As the homes are sold, the developer/homebuilder's position is that the home is not 95% complete because the allocable portion of the future common improvement keeps the completion factor for that particular home less than 95%.

A long-term contract is defined as a contract entered into for the building, installation, construction, or manufacturing of property that is not completed with the same tax year. A contract is deemed to be completed at the earlier of: (1) the date the subject property is used by the consumer for its intended purpose and at least 95% of total allocable costs have been incurred; or (2) when there is final completion and acceptance.

Generally, long-term contracts are required to be accounted to use the percentage-of-completion method (PCM) for tax purposes. Exceptions to this rule include home construction contracts and small construction contracts.

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Home construction contracts are currently defined as contracts where 80% or more of the estimated total costs are reasonably expected to be incurred in the construction, reconstruction or rehabilitation of dwelling units in buildings where there are four or fewer dwelling units and to improvements of the real property directly related to those units. (In a private letter ruling, the IRS ruled that a land sale contract, i.e. the land developer is not performing the construction activities; do not qualify as home construction contracts.) Since ambiguities in this definition have left room for broad interpretations, a team from the IRS's Industry Issue Resolution Program is working on clarifications.

Small construction contracts are contracts that will be completed within two years by a taxpayer with average annual gross receipts of $10 million or less for the three-year period preceding the tax year into which the contract was entered. Since the average annual gross receipts test is recalculated annually, the taxpayer may qualify for the exemption in one year but not the next.

The completed contract method is generally preferred since it defers the recognition of income and expense until completion of the contract, and the accounting is relatively simple. Under the PCM, the taxpayer is required to report an allocation of the income and expenses of a contract based on costs incurred by the end of the tax year as compared to total estimated costs. That means that tax is calculated on the current progress of a contract regardless of how much, if anything was billed to the customer. In addition, the Internal Revenue Code also requires the taxpayer to go back after a contract is completed and recalculate the actual percentage completed in the prior tax year since estimates are used in the original calculation. While the computation does not result in any additional tax (or reduction of tax), interest is computed on the difference to the benefit of the IRS or the taxpayer.

To complicate this issue further, the PCM may apply to non-long-term contracts under certain circumstances. If a non-long-term contract incident to a long-term contract is performed by the same party or for a related party, the long-term contract rules are applicable to both contracts. For example, a construction company is owned by the same parties that own an architecture and engineering firm. The firm is contracted to design an office building, and the construction company is separately contracted to build the office building. Since one contract is incident to the other, and the companies are related, if the construction contract falls subject to the PCM, the design contract will also.

The IRS plans to identify possible offenders and aggressively attack this issue going forward. Taxpayers in the industry should be proactive in identifying their potential exposure by reviewing their accounting methods with a tax professional.

As one of the leading accounting and consulting firms for the construction industry, Cowan, Gunteski & Co., P.A. provides clients with advice and counsel on how Federal and state tax laws could impact your business. Our goal is to position your construction company to take advantage of all legitimate strategies to minimize your tax obligation. Contact Dawn Greenberg, CPA – Tax Manager – Construction Services Group at 732-349-6880 extension 118 or dgreenberg@cowangunteski.com to discuss your particular situation.

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