INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

September 27, 2005

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-146459-04/CC:LM:RFPH:JAX

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Partnership Sub =

Corporation Sub =

Partnership A =

ISSUE:

Whether the land sale contracts between Taxpayer and Partnership A are “home construction contracts” as described in section 460(e)(6) of the Code.

CONCLUSION(S):

The land sale contracts are not “home construction contracts” as described in section 460(e)(6), because the Taxpayer is not performing construction contract activities under section 460(e)(4) with respect to dwelling units as required by section 460(e)(6)(A).

FACTS:

Taxpayer is a land development corporation. In the years , , and , Taxpayer developed six very extensive planned communities. Taxpayer developed these communities through Corporation Sub and Partnership Sub, Taxpayer's wholly owned subsidiaries. Corporation Sub and Partnership Sub are the partners in Partnership A. In six separate contracts, Taxpayer contracted to sell residential building lots in the six communities to Partnership A. Each of the six contracts provided, in addition to the sale of the real estate, that Taxpayer would provide paved roads, curbs, gutters, and utilities (up to the perimeter of the lots) to service the lots. In addition, three of the contracts provided that Taxpayer would provide common amenities and recreational facilities for the use of the community homeowners. Pursuant to the development contracts, Taxpayer also graded, cleared, and installed utilities on the lots.

Taxpayer does not build houses or dwelling units in the communities. Partnership A and its subcontractors build the dwelling units in the communities.

Examination concedes that Taxpayer's contracts are long-term "construction contracts" eligible for the Percentage of Completion Method (PCM) of accounting under section 460(e)(4). However, the Taxpayer reported its income from its land sale contracts under the more favorable Completed Contract Method (CCM), on the theory that its construction contracts qualify for the "home construction contract" exception to the PCM under section 460(e)(6)(A).

LAW AND ANALYSIS:

Statutory Provisions

Section 460(a) generally requires the use of the PCM of accounting for long-term contracts. Section 460(e)(6)(A) excepts "any home construction contract" from the general rule requiring use of the PCM of accounting. A taxpayer performing construction services pursuant to a "home construction contract," defined in section 460(e)(6)(A), may report income from that construction activity under the CCM of accounting.

Section 460(e)(4) defines "construction contract" as "any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property."

Section 460(e)(6)(A) defines "home construction contract" as 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 activities referred to in paragraph (4) with respect to-

> (i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 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.

For purposes of § 460(e)(6)(A), a “dwelling unit” is defined at Section 168(e)(2)(A)(ii) as "a house or apartment used to provide living accommodations in a building or structure... ."

Section 1.48-1(e)(1) of the Income Tax Regulations defines a building as “any structure or edifice enclosing a space within its walls, and usually covered by a roof…”

We think that the statutory language is clear. The plain intent of the statute is to provide the more favorable CCM of accounting to only taxpayers actually building homes. Hence the term home construction contract. Section 460(e)(6)(A)(i) limits “home” to certain types of “dwelling units.” That limitation is thoroughly consistent with reading Congressional intent to limit the exception to taxpayers building houses for home buyers, or consumers who dwell in the houses. Section 460(e)(6)(A)(ii) similarly limits the CCM of accounting to improvements “related to such dwelling units and located on the site of such dwelling units.”

The statutory language does not contain a specific exception to PCM treatment for land sales. Absent a specific exception or liberalization, a developer’s construction contracts related to general land sales are defined in section 460(e)(4) and are subject to the general rule (PCM treatment) of section 460(a).

We think that Congress clearly limited the favorable CCM treatment to taxpayers actually producing homes, i.e. houses used as consumer dwellings. It would be anomalous to allow the exception that Taxpayer urges: Taxpayer seeks to defer reporting all its income from land sales and development activities until Partnership A and its subcontractors complete the last house in very large communities. Some of the communities contain several hundred houses (dwelling units) and could take a decade or more to complete. That deferral is far longer than the CCM deferral permitted for individual home builders. Congress did not specifically except Taxpayer’s sales and development activities, nor do we think Congress intended to except those activities without saying so as the Taxpayer contends. In the absence of clearer Congressional direction, we interpret the statute literally and the tax benefit narrowly.

Published Guidance

The Service first issued a notice then regulations interpreting “home construction contract” under section 460(e)(6). The notice covers part of the period at issue in this case, and the regulations cover the rest of the period. The notice and the regulations are consistent on the issue and compel the same (adverse) conclusion.

Notice 89-15, Contracts Entered into before January 11, 2001

Notice 89-15, 1989-1 C.B. 634, elaborates on home construction contracts defined in section 460(e)(6). At page 644, the notice states:

> 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) [now section 168(e)(2)(A)(ii)]) 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.
>
> 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.

The answer to Question 44 indicates ("assumes") that one type of a developer's off-site costs for community improvements qualify for CCM treatment: only the costs of off-site work properly allocable to a "contract for the construction and sale of a house." The notice does not treat general sales and development costs, not incurred under a "contract for the construction and sale of a house", as attributable to a home construction contract for purposes of the 80 percent test of section 460(e)(6).

Regulations, Contracts Entered into on or after January 11, 2001

Regulations under section 460 superseded Notice 89-15. For contracts entered into on or after January 11, 2001 the regulations provide:

§ 1.460-3 Long-term construction contracts.

(a) In general. Section 460 generally requires a taxpayer to determine the income from a long-term construction contract using the percentage-of-completion method described in § 1.460-4(b) (PCM). A contract not completed in the contracting year is a long-term construction contract if it involves the building, construction, reconstruction, or rehabilitation of real property; the installation of an integral component to real property; or the improvement of real property (collectively referred to as construction). Real property means land, buildings, and inherently permanent structures, as defined in § 1.263A-8(c)(3), such as roadways, dams, and bridges. Real property does not include vessels, offshore drilling platforms, or unsevered natural products of land. An integral component to real property includes property not produced at the site of the real property but intended to be permanently affixed to the real property, such as elevators and central heating and cooling systems. Thus, for example, a contract to install an elevator in a building is a construction contract because a building is real property, but a contract to install an elevator in a ship is not a construction contract because a ship is not real property.

(b) Exempt construction contracts--(1) In general. The general requirement to use the PCM and the cost allocation rules described in § 1.460-5(b) or (c) does not apply to any long-term construction contract described in this paragraph (b) (exempt construction contract). Exempt construction contract means any—

(i) Home construction contract; and

(ii) Other construction contract that a taxpayer estimates (when entering into the contract) will be completed within 2 years of the contract commencement date, provided the taxpayer satisfies the $10,000,000 gross receipts test described in paragraph (b)(3) of this section.

(2) Home construction contract--(i) In general. A long-term construction contract is a home construction contract if a taxpayer (including a subcontractor working for a general contractor) reasonably expects to attribute 80 percent or more of the estimated total allocable contract costs (including the cost of land, materials, and services), determined as of the close of the contracting year, to the construction of—

(A) Dwelling units, as defined in section 168(e)(2)(A)(ii)(I), contained in buildings containing 4 or fewer dwelling units (including buildings with 4 or fewer dwelling units that also have commercial units); and

(B) Improvements to real property directly related to, and located at the site of, the dwelling units.

(ii) Townhouses and rowhouses. Each townhouse or rowhouse is a separate building.

(iii) Common improvements. A taxpayer includes in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units.

These regulations clearly contemplate that only the party building or producing the house has an eligible "home construction contract." Treas. Reg. § 1.460-3(b)(ii) characterizes the "allocable contract costs" as "including the cost of land, materials, and services…" That is, in a home construction contract, the builder accounts for the cost of the land in calculating the builder's income under the CCM of accounting. The selling developer derives income from the builder's payments for land and development services (builder's costs). The selling developer realizes this income pursuant to its sale contract with the builder, not from the builder's "home construction contract" with the consumer. The developer should use PCM to account for its land sales income under the general rule of section 460(a).

Because the Taxpayer is not performing construction contract activities with respect to dwelling units, the Taxpayer's contracts are not "home construction contracts" defined in section 460(e)(6)(A) eligible for the CCM of accounting. Rather, the Taxpayer's contracts are construction contracts within the meaning of section 460(e)(4). The exception to PCM accounting provided by section 460(e)(6) does not apply to Taxpayer's contracts.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.