

Home Construction Contractors Benefit From Tax Rule Change

JANUARY 20, 2009

BE IN A POSITION OF STRENGTH

Construction Contract Accounting Treatment Update

New proposed regulations issued by the IRS will expand the types of contracts that qualify for the home construction contract exception to the general requirement that contractors use the percentage of completion method to account for long-term contracts. The proposed regulations also discuss the determination of the completion date for the completed contract method and the rules for change in accounting method for long term construction contracts.

Internal Revenue Code Section 460 provides the rules that must be used by contractors to account for long term contracts. IRC Section 460(e) provides that, for certain home construction contracts, an exempt method such as the completed contract may be used. IRC Section 460(e)(6)(A) defines a home construction contract as “a construction contract where 80% or more of the estimated total contract costs are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of dwelling units contained in buildings containing four or fewer dwelling units, and to improvements to real property directly related to the dwelling units.”

The Change

Proposed Regulations § 1.460-3(b)(2) expands the types of contracts that are eligible for the home construction contract exemption by providing that contracts for common improvements and improvements to real property directly related to and on the site of dwelling units are considered home construction contracts even if the contract is not related to any one individual dwelling unit.

The proposed regulations go on to define each townhouse or rowhouse in a complex as a separate building regardless of the number of townhouses or rowhouses physically attached to each other. The proposed regulations expand the definition of a home construction contract to include an individual condominium unit. This allows each unit to be treated as a separate building for purposes of determining whether the underlying contract qualifies as a home construction contract.

**HOME CONSTRUCTION
CONTRACTORS BENEFIT
FROM NEW TAX RULES**

Questions or comments?

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The completed contract method (CCM) as it is currently defined under the regulations leads to many controversies between the IRS and taxpayers, since the date a contract is completed is based mostly on a facts and circumstances test. This may result in income realized from the completion of a home construction contract not being recognized in the proper period and deferral of tax that is due on that income. The IRS states that they are aware of and are currently looking into solutions for these issues. In the near future, it plans on issuing proposed regulations to further define when a home construction contract is considered complete.

For contracts that do not qualify for the home construction contract exemption, Internal Revenue Code Section 460 defines the acceptable methods of accounting for long term contracts. Allowable methods are: the percentage-of-completion method (PCM); the exempt-contract percentage-of-completion method (EPCM); the 10-percent method or special alternative minimum taxable income (AMTI) method (if properly elected); or a similar method approved by the Internal Revenue Commissioner.

The regulations as they are currently written state that a taxpayer-initiated change in method of accounting will be permitted only on a cut-off basis (that is, for contracts entered into during or after the year of change). For example, a contractor who submits a change in accounting method for the 2008 tax year would still have to account for their long term contracts entered into during 2007 and prior under the old method of accounting. Only those contracts entered into during 2008 and later would be accounted for under the new method.

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The proposed regulations would continue this cut-off treatment for changes from one permissible percentage of completion method to another permissible percentage of completion method and from a permissible cost allocation method that complies with the allocation rules of Treasury Regulation 1.460-5 to another permissible cost allocation method. All other taxpayer-initiated changes in accounting method under IRC Section 460 would be made with an IRC 481(a) adjustment.

These proposed regulations are not currently applicable and only apply to taxable years in which they are finalized by the Department of Treasury.

Questions or comments?

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If you should have any questions, contact the WS+B tax department

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