CAN COMPLETED CONTRACT ACCOUNTING METHOD BE USED BY LOT DEVELOPERS WHO DO NOT BUILD HOMES?

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An analysis of the relevant elements of Section 460(e) and other pertinent material indicates the Service is incorrect in its position that a residential lot developer can be a party to a "home construction contract" only if the developer is a homebuilder or a subcontractor, and that a lot developer is neither.

In TAM 200552012, the IRS interpreted the meaning of "home construction contracts" for purposes of Section 460(e). It concluded that a residential lot developer's contract to develop residential lots—but not construct dwelling units—was not a "home construction contract." Consequently, the taxpayer in the TAM was required to use the percentage of completion method (PCM) and not the more favorable completed contract method (CCM). Your authors respectfully disagree with this interpretation, and believe that a contract of a residential land developer to develop lots and provide the infrastructure, common improvements, and amenities of a residential subdivision should qualify as a "home construction contract."

THE LONG-TERM CONTRACT RULES

Section 460(a) generally provides that a taxpayer entering into a long-term contract must use the PCM to determine the taxable income from that contract. The PCM requires that income from the long-term contract be reported proportionately over the life of the contract as contract costs are incurred. For example, if a taxpayer incurs approximately 20% of the contract costs by year-end, then 20% of the total contract price must be recognized and included in the taxpayer's income for that year. An exception in Section 460(e)(1)(A), however, allows taxpayers to use the CCM rather than the PCM for certain "home construction contracts."[1] One purpose for this exception is to encourage the development of homes in the U.S.

Eligible taxpayers generally prefer the CCM because it allows them to defer the recognition of income earned on a contract until the contract has been completed for tax purposes. For example, if a taxpayer enters into a three-year contract and incurs costs in each year, under the CCM the taxpayer will recognize income and most deductions only in year 3 when the contract is completed. Deferring the recognition of income until the end of a contract is usually preferable because it allows the taxpayer not only to defer the recognition of income but also to avoid the possibility of paying tax on a contract that initially appears profitable but later proves to be unprofitable.

In Rev. Rul. 70-67, 1970-1 CB 117, the IRS acknowledged the importance of the CCM: "One of the reasons why permission to report on a completed contract basis is given in the case of building, installation, and construction contracts is the fact that there are changes in the price of articles to be used, losses and increased cost due to strikes, weather, etc., penalties for delay, and unexpected difficulties in laying foundations which makes it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any

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certainty whether he has derived a gain or sustained a loss until a particular contract is completed."

In recent guidance, the IRS has taken the position that the CCM home construction contract exception in Section 460(e)(1)(A) applies to builders of dwelling units and their subcontractors, but not to residential lot developers who do not actually construct the dwelling units. With today's skilled labor forces, a homebuilder or general contractor often will do very little of the actual construction work; virtually all of it typically is performed by specialty contractors. Apparently in the Service's view a lot developer is not a subcontractor of the homebuilder or general contractor.

The IRS position is that the CCM home construction contract exception applies to builders of dwelling units and their subcontractors, but not to residential lot developers.

For purposes of this article, a "subcontractor" is a specialty contractor that enters into a contract with a homebuilder or a general contractor to improve real estate that is related to the home sold to the ultimate homeowner. A "lot developer" is a specialty contractor that usually enters into a contract with one or more general contractors or homeowners to deliver residential lots, infrastructure, and common area improvements, all of which are related to the homes to be occupied by the ultimate homeowners. A lot developer typically will purchase a large tract of land and enter into a long-term contract with the general contractor to clear and grade the land, install water and sewer lines, build roads, make common area improvements such as a pool, clubhouse, trails and golf courses, and then deliver individual undeveloped building lots to one or more homebuilders or individual lot purchasers. A contract to deliver a single developed lot to an individual also can be a long-term construction contract. In that situation, the lot developer will not have completed its contract until all roads, water and sewer lines, and amenities are installed. The individual lot purchaser will then contact a homebuilder to build the home. Thus, a lot developer should be classified as one type of subcontractor.

The Service has issued written guidance regarding Section 460(e)(1)(A) in several forms, each of which will be discussed in greater detail below. In addition, in IR-2005-81, 8/10/05, the IRS announced that the Industry Issue Resolution (IIR) program would address a request submitted to clarify the definition of "home construction contracts," primarily relating to income derived from residential real estate development that qualifies for the CCM.[2]

THE TAM

In TAM 200552012, the taxpayer was a land development corporation that developed extensively planned communities. The communities were developed through two wholly owned subsidiaries, Corporation Sub and Partnership Sub. Corporation Sub and Partnership Sub were partners in Partnership A.

In each of six planned communities, the taxpayer contracted to sell developed residential lots to Partnership A. Each contract provided that, in addition to the sale of developed lots, the taxpayer would provide paved roads, curbs, gutters, and utilities (up to the perimeter of the lots) to service the lots. In three of the contracts, the taxpayer contracted to provide common amenities and recreational facilities for use by the community homeowners. Partnership A and its subcontractors, not the taxpayer, built the dwelling units in the communities.

The TAM presents a fairly common fact pattern, although in most instances the taxpayer, as the lot developer, will not be related to the homebuilder. In the TAM, the Service took the position that only a taxpayer who actually builds dwelling units is entitled to use the CCM. Because the taxpayer in the ruling was a lot developer and did not actually build dwelling units, IRS found the taxpayer was not entitled to use the CCM.

After restating the statutory language, the Service declared in the TAM that the statutory language is "clear" and that the "plain intent of the statute" is to provide the more favorable CCM only to taxpayers actually building dwelling units (homebuilders) and to subcontractors of those homebuilders. Nevertheless, numerous IRS publications on the meaning of "home construction contract" and the fact that this issue was selected for the IIR program indicate that the Service is struggling with its interpretation of the statute. Thus, the authors believe that the Service is being disingenuous when it claims that the statute is clear in its requirement that a taxpayer be a homebuilder or a subcontractor to qualify for the CCM.

It seems that the IRS is asserting that the language is clear in the hope that a court will not examine the legislative history, which is favorable to taxpayers. As a general rule, if the relevant statutory language is plain and unambiguous, courts generally look no further than the statute.[3] If, however, the statutory language is not clear, courts may consider legislative history.[4] As discussed below, the legislative history is favorable for a residential lot developer claiming the CCM, because the legislative history indicates that the CCM is not limited to homebuilders. Furthermore, it is a "well-settled" rule that "[t]axing statutes must be con-

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1 A second, "de minimis" exception is found in Section 460(e)(1)(B), relating to construction by a contractor with less than $10 million of annual revenue.

2 The IIR program provides guidance on issues common to many taxpayers that are frequently disputed, material, and create a significant burden for taxpayers.

3 See, e.g., American Bankers Ins. Group, 408 F.3d 1328, 95 AFTR2d 2005-2291 (CA-11, 2005) ("[C]onstruing a statute ... requires the court to 'begin[] with the statutory text, and end[] there as well if the text is unambiguous'") (citation omitted).

4 Sale v. Johnson, 129 S.E.2d 465 (N.Car., 1963) ("where the meaning of a statute is doubtful, the history of legislation on the general subject dealt with ... may be considered in connection with the object, purpose, and language of the statute, in order to arrive at its true meaning") (citation omitted).

strued most strictly against the taxing authority and most favorably for the taxpayer."[5]

THE STATUTE

In analyzing the TAM, it is important to start with Section 460(e) and its legislative history. To understand the definition of "home construction contract" in Section 460(e)(6)(A), one must first understand Section 460(e)(4), since the former refers to the latter.

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." This definition is broad and inclusive. For instance, one of the activities listed in Section 460(e)(4) is "improvements," a term that is broader than the building of a structure. Moreover, all of the activities apply to "real property," which, as defined in Regs. 1.263A-8(c)(1) through (3), includes land, buildings, and inherently permanent structures. Therefore, one example of a construction contract would be a contract between a homebuilder and a lot developer obligating the latter to deliver developed lots to the homebuilder so that homes could be constructed on them. Reg. 1.460-1(b)(2) specifically provides that a contract for the sale of property can be a long-term construction contract.

In *Foothill Ranch Company Partnership*, 110 TC 94 (1998), the Service conceded prior to trial that a contract for the sale of land by a lot developer, which required the lot developer to provide infrastructure and common improvements, was a long-term construction contract, and therefore the lot developer was permitted to use the PCM.[6] The decision in *Foothill Ranch* was based in part on Notice 89-15, 1989-1 CB 634. In Q&A-4 of the Notice, the Service provided that a contract for the sale of land may be a long-term contract if the "building, installation, or construction of the subject matter of the contract is necessary in order for the taxpayer's contractual obligations to be fulfilled."

The definition of 'construction contract' in the Code is broad and inclusive.

Furthermore, in TAM 200552012 the IRS conceded that the taxpayer's contracts to sell residential building lots were long-term "construction contracts" eligible to use the PCM. Reg. 1.460-1(b)(2)(ii), which was promulgated as a result of the Service's loss in *Foothill Ranch*, provides that a contract is a "construction contract" if the contract includes the provision of land by the taxpayer and the estimated total allocable contract costs (including the cost of land) attributable to the taxpayer's construction activities are more than 10% of the contract's total contract price.[7] In an unnumbered Field Service Advisory dated 5/8/97 (1997 WL 33106664), the Service indicated that contracts for sale of land in which the seller is required to provide infrastructure and/or common improvements in the future are construction contracts. Indeed, the Service has given the term "construction contract" a broad meaning that encompasses future development and a contract to sell land, as long as a minimal level of construction activities occurs.

Parsing the Language

Keeping the definition of "construction contract" in mind, we can now break down Section 460(e)(6)(A) into its component parts to determine whether a "home construction contract" requires a taxpayer to be either a homebuilder or a subcontractor (but not solely a lot developer). Section 460(e)(6)(A) defines a "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 [Section 460(e)(4), which defines "construction contract," as set forth above] *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." (Emphasis added.)

While this language appears to be both broad and expansive, it is important to analyze each element to determine if, in fact, "home construction contract" applies only to homebuilders and subcontractors other than lot developers—who do not actually construct dwelling units.

The first element in the statutory definition is the word "any," which ought to be self-explanatory and certainly is all-inclusive. The second element is the term "construction contract," to which (as discussed above) the Service has given a broad meaning that encompasses future development and a contract to sell land, as long as

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[5] Ex parte Uniroyal Tire Co., 779 So.2d 227 (Ala., 2000) (citations omitted); see also OfficeMax, Inc., 428 F.3d 583, 96 AFTR2d 2005-6824 (CA-6, 2005) (referring to the "'traditional canon that construes revenue-raising laws against their drafter'") (citations omitted).

[6] For many years, the Service took the position that residential lot developers were not entitled to use even the PCM because a contract to improve real estate and deliver buildable lots was not a long-term construction contract, but instead was a sale of land. For example, in Foothill Ranch Co. Partnership, 110 TC 94 (1998), the taxpayer was a residential lot developer that sued to recover litigation costs that it incurred in defending the Service's denial of the taxpayer's use of the PCM before the IRS conceded the case prior to trial. The standard for awarding reasonable litigation costs to a taxpayer is that the taxpayer must (1) show that the Service's position is not substantially justified, (2) substantially prevail in the controversy, and (3) meet the net worth requirement. The lot developer in Foothill Ranch satisfied each element and thus was awarded reasonable litigation costs. This case, together with the Service's interpretation of the statute, demonstrates the Service's aggressive position that denies certain accounting methods to lot developers. This article offers several arguments and supporting evidence that should help establish that the denial of the CCM for residential lot developers is not justified.

[7] The decision in Foothill Ranch, *supra* note 6, did not require any minimum level of construction activities.

the taxpayer incurs a minimal level of construction activities.

"Reasonably expected" and "attributable to," when read together, allow taxpayers to apply the 80% test to contract costs as long as it is "reasonably expected" that 80% of the contract costs will be "attributable to" activities referred to in Section 460(e)(4). These two elements illustrate the broad nature of the statute. Furthermore, "activities" refers to the activities under a "construction contract," as defined in Section 460(e)(4). As previously discussed, Section 460(e)(4) covers a broad range of activities, including the building, construction of, or the installation of any integral component to, or improvement of, real property (including land).

Neither phrase compels the contract between the lot developer and the homebuilder to make site improvements to also require the lot developer to build the actual units.

The next element, "with respect to," should permit the actual dwelling units to be constructed when the costs referred to in Section 460(e)(4) are incurred, or at some time in the future. The "with respect to" requirement should be compared with the "directly related to" requirement later in the definition. Each of the phrases seems to be saying that the improvements to real property, whether described in Section 460(e)(4) or Section 460(e)(6)(A)(ii), must be somehow connected to dwelling units.[8] Each phrase seems to allow the dwelling to be built concurrently with the other construction contracts or at some future time. Neither phrase compels the contract between the lot developer and the homebuilder to make site improvements to also require the lot developer to build the actual dwelling units in order for the contract to be a "home construction contract." Clearly, improvements to the land, such as infrastructure improvements for a subdivision of homes, as well as common area improvements and amenities for a subdivision of homes, are "directly related to" the homes themselves. The statute requires only that the improvements to real property are "directly related to" the dwelling units, not to the *construction* of the dwelling units.[9]

The next element is the word "and." This seemingly uncontroversial word may be the most important element of the statute, because the linchpin of the Service's argument in the TAM that a lot developer is not eligible for the CCM is that "and" should be given its conjunctive meaning ("both"). Since the lot developer in the TAM failed to satisfy the "dwelling units" requirement (because the lot developer did not construct homes), use of the CCM was denied. In contrast, the authors submit that "and" should be given its disjunctive meaning ("either," "or"), and therefore a lot developer should only need to satisfy either element—dwelling units (in Section 460(e)(6)(A)(i)) or improvements (in Section 460(e)(6)(A)(ii))—in order to qualify.

The primary definition of "and" given in dictionaries is the conjunctive one, although *Webster's Third New International Dictionary* (2002) provides this alternative definition: "reference to either or both of two alternatives ... espe[cially] in legal language when also plainly intended to mean 'or.'"[10]

Legal usage guides and treatises confirm that, ordinarily, "and" and "or" are not interchangeable. Nevertheless, these language authorities acknowledge that the terms are often misused when drafting statutes. Consequently, many courts readily interchange these words when they deem it necessary or appropriate: "[S]ince the popular use of the words 'or' and 'and' is loose and frequently inaccurate, the courts may and should change 'and' to 'or,' and vice versa, whenever such conversion is required, inter alia, to effectuate the obvious intention of the Legislature and to accomplish the purpose or object of the statute."[11] One court described this "universal test" based on "[h]undreds of cases": "The words 'and' and 'or' when used in a statute are convertible, as the sense may require. A substitution of one for the other is frequently resorted to in the interpretation of statutes, when the evident intention of the lawmaker requires it."[12] An important part of this determination often includes a look at the associated legislative history.[13]

Based on the foregoing, the authors submit that "and" in Section 460(e)(6)(A) should be read disjunctively to mean "or." It would make no sense for "and" to mean the conjunctive, because the statute then would require homebuilders who only build the actual dwelling units to also construct all the improvements to the

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8 Notice 89-15, 1989-1 CB 634, uses an analogous phrase, "attributable to."

9 For purposes of Section 460(e)(6)(A), a "dwelling unit," as defined in Section 168(e)(2)(A)(ii)(I), is "a house or apartment used to provide living accommodations in a building or structure." Reg. 1.48-1(e)(1) defines a building as "any structure or edifice enclosing a space within its walls, and usually covered by a roof."

10 A humorous story was employed in a recent dissenting opinion to illustrate how "and" can be used in the disjunctive sense: "A host separately asked two prospective guests what they liked to drink. One said, 'I like bourbon and water.' The other said, 'I like beer and wine.' When the second guest arrived at the event, the host served the guest a glass of beer mixed with wine. 'What's that awful drink?' said the guest, to which the host answered, 'You said you liked beer and wine.' Replied the guest: 'Pfui! You know what I meant. Quit playing word games and get me something I can drink.'" OfficeMax, Inc., 428 F.3d 583, 96 AFTR2d 2005-6824 (CA-6, 2005) (Rogers, J., dissenting).

11 Duncan v. Wiseman Baking Co., 357 S.W.2d 694 (Ky. Ct. App., 1962); see also, e.g., OfficeMax, Inc., *supra* note 10 (noting that "there is more to 'and' than meets the eye" and cautioning that the case did not "simply turn on the intuition that 'and' means 'and,' 'or' means 'or,' and never the twain shall meet"); Barron v. CNA Ins. Co., 678 So.2d 735 (Ala., 1996) (affirming that "this court is at liberty in ascertaining the intent of the legislature to construe the disjunctive conjunction 'or' and the conjunctive conjunction 'and' interchangeably") (citation omitted); Dunn v. Mississippi State Dept. of Health, 708 So.2d 67 (noting that "courts may change ['and' and 'or'] as necessary to effectuate the intention of the legislature and to accomplish the purpose or object of the statute"); Baker's Supermarkets, Inc. v. State, 540 N.W.2d 574 (Neb., 1995) ("The words are so frequently interchanged that in construing a civil statute, 'or' may be read as 'and' where a strict reading would lead to an absurd or unreasonable result and defeat the intent of the statute").

12 Peacock v. Lubbock Compress Co., 252 F.2d 892 (CA-5, 1958).

13 See also Sale v. Johnson, *supra* note 4.

real property directly related to such dwelling units in order to qualify for the CCM. Certainly the IRS is not requiring stand-alone homebuilders to also be lot developers to qualify for the CCM. If the Service is not requiring the actual homebuilder to also make improvements to the real property to qualify for the CCM under Section 460(e)(6)(A)(ii), then the Service likewise should not require lot developers to build dwelling units under Section 460(e)(6)(A)(i). Because the literal language of the statute leads to this questionable and unlikely conclusion, a review of its legislative history is appropriate.

The term "improvements to real property" includes any improvements other than the dwelling units. This is the second time that the statute deems improvements to real property to be construction activities included within the meaning of "home construction contract." While the statute's double reference to improvements to land may contribute to the Service's difficulty in interpreting the statute, it also seems to support the position that Congress was so serious about including land improvement activities in "home construction contract" that it was included twice, i.e., in Sections 460(e)(4) and (e)(6)(A)(ii).

Finally, what exactly is the "site" of the dwelling units? The statute uses the phrase "on the site," while the Regulations use the phrase "at the site." The term "site" in the land development and construction industry often refers to an entire area of development and/or construction, not individual parcels or one home out of a planned subdivision.

This detailed analysis of the statutory language does not suggest a requirement that a taxpayer who is a party to a home construction contract actually be a homebuilder. The statutory terms dictate a broad and inclusive approach to the definition of "home construction contracts" that should include residential lot developers. Nevertheless, in the interest of thoroughness, the authors next examine other relevant authority to try to identify any prerequisite that a residential lot developer must also actually build the dwelling units in order to be a party to a "home construction contract."

Legislative History

When attempting to clarify ambiguities in a statute, it is generally helpful, and sometimes essential, to refer to the legislative history to determine congressional intent. With respect to Section 460(e)(6)(A), the legislative history is particularly instructive. The Conference Report states that "a contract is a home construction contract if 80 percent or more of the estimated total costs to be incurred under the contract are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, or improvements to real property directly related to and located on the site of, dwelling units in a building with four or fewer dwelling units."[14] Nowhere does the report indicate that a taxpayer who is a party to a "home construction contract" must build the dwelling units.

Thus, the legislative history supports the broad language of the statute, only requiring improvements to real property to be directly related to and on the site of dwelling units. In fact, it is more than reasonable to say that developing and otherwise preparing land for homebuilders is directly related to and located on the site of the dwelling units that will be built on the same land. Homebuilders cannot build functional homes until the infrastructure is in place, and the "site" should include the entire development site.

TREASURY AND IRS INTERPRETATIONS

In TAM 200552012, as discussed above, the IRS cites the Regulations as support for its position that the CCM applies only to homebuilders. Other IRS pronouncements also have an effect on the interpretation of the home construction contract exception.

The Regulations. Although the words used in the Regulations differ from those in the statute, as will be shown below they do not clarify whether a residential lot developer is entitled to use the CCM and do not support the Service's position.

For instance, under Reg. 1.460-3(b)(2)(i), a "home construction contract" is generally described as a contract that the taxpayer (including a subcontractor of a homebuilder or 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) ... to the *construction of* (A) [d]welling units ... and (B) [i]mprovements to real property directly related to, and located at the site of, the dwelling units." (Emphasis added.)

Unlike the statute, which uses the phrase "with respect to" dwelling units, this Regulation refers only to "construction of" dwelling units. As discussed above, the term "construction contract" has a broad and expansive definition, including contracts for the improvement of real property. It seems reasonable to interpret "construction of" as used in Reg. 1.460-3(b)(2)(i) as including the same wide array of activities encompassed by Section 460(e)(4).

Reg. 1.460-3(b)(2)(iii) provides that a "taxpayer includes in the cost of the dwelling units their allocable share of the cost [of] common improvements ... *that benefit the dwelling units* and that the taxpayer is ... required ... to construct *within the tract or tracts of land that contain the dwelling units.*" (Emphasis added.) The Regulation gives as examples of common improvements sewers, roads, and clubhouses. It does not provide that the taxpayer also must construct the dwelling units.

As discussed below, Notice 89-15 makes it clear that improvements such as water, sewer, and common area improvements are "attributable to" the construction of the dwelling unit to which these improvements are properly allocable. Furthermore, if Regs. 1.460-3(b)(2)(iii) and 1.460-3(b)(2)(i) are read together, a reasonable interpretation is that the cost of construction of dwelling units includes a taxpayer's cost for common improvements related to those dwelling units. In other words, constructing common improvements for dwelling units (whether built

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[14] H. Rep't No. 100-1104, 100th Cong., 2d Sess. 118 (1988).

currently or in the future) is a standalone cost that falls within the home construction contract definition.

The Regulations under Section 460 repeatedly look to the totality of the situation behind the contract. For instance, under the definition of a "long-term contract" in Reg. 1.460-1(b)(2)(ii), the fact that a taxpayer is not to required to deliver the property constructed to the customer and the characterization of the agreement by the parties to the contract are both irrelevant. Nevertheless, in denying CCM to a lot developer the IRS focuses narrowly on the subject matter of a lot developer's contract with a homebuilder, and does not acknowledge that the lot developer's activities are part of a group of activities in constructing the infrastructure for dwelling units, the dwelling units themselves, and the common improvements.

Furthermore, the Regulations specifically provide that subcontractors of a homebuilder or general contractor are parties to a "home construction contract." If the IRS allows some subcontractors, but not other subcontractors (such as lot developers), to come within the "home construction contract" definition, it seems that the Service is ignoring that portion of the Regulations stating that the parties' characterization of their agreement is not relevant.

The Notice. In Notice 89-15, the IRS provided a series of questions and answers as a way to provide guidance on the interpretation of the statute. As noted above, in TAM 200552012 the Service cited the Notice as support for its conclusion that a residential lot developer is not a party to a "home construction contract."

Q&A-44 of the Notice raises the issue of whether, for purposes of the 80% test, costs that a developer incurs to construct or install common features not located on the sites of dwelling units may be treated as attributable to dwelling units that the developer is constructing under contract. The Service's answer confirms that these types of costs, if properly allocable to a contract for the construction and sale of a house, are treated as attributable to the construction of the house for purposes of the 80% test. This answer provides useful guidance that common real estate improvements, such as building or installing roads, sewers and other common features, are attributable to "construction contract" activities with respect to dwelling units or improvements to real property directly related to dwelling units and located at the site of dwelling units. Moreover, Q&A-44 does not state that a residential lot developer that incurs those same costs, but does not construct the actual dwelling unit, is not a party to a "home construction contract." On the contrary, a lot developer that is a subcontractor of a general contractor or homebuilder would be a party to a "home construction contract," as expressly provided in the Regulations.

In TAM 200552012, the Service used Q&A-44 to conclude that the taxpayer must actually build the dwelling units. Logically, however, the example in Q&A-44 should not limit other possible fact patterns, specifically including the situation where a residential lot developer is building lots "with respect to" dwelling units.

Field Service Advice. For many years, the Service has taken the position that taxpayers who are not homebuilders (in the sense of being general contractors), but who contract part of the dwelling unit to subcontractors, are entitled to use the CCM. In an unnumbered Field Service Advisory dated 8/19/93 (1993 WL 1468110), the IRS acknowledged that a subcontractor who built foundations for all of the homes in a particular subdivision was "in the business of home construction" as that term is defined in Section 460(e)(6).

The issue in this FSA was not whether the taxpayer was in the business of "home construction," but whether the contract for the home construction should be severed and treated as multiple contracts rather than one contract. The importance of this FSA is that the taxpayer only put in the foundations for the homes in a subdivision. The taxpayer did not build entire dwelling units and the taxpayer's activities were undertaken in reference to the entire subdivision, not individual lots of dwelling units.

If building one part (the foundation) of a dwelling unit pursuant to a contract with a general contractor is a sufficient connection to dwelling units, why is a contract to deliver developed lots so that dwelling units can be built on them, along with constructing common areas and amenities to attract people to buy homes, insufficient under Section 460(e)(6)? All of these components contribute to making dwelling units livable and attractive to buy and certainly should be considered "with respect to" dwelling units.

Non Docketed Service Advice Review. In 2003 IRS NSAR 20,006 (1/18/03; 2003 WL 22171910), the IRS took the position that a residential lot developer was not eligible for the CCM under Section 460(e)(6). The conclusion was somewhat surprising because the main discussion began with the following IRS concession: "We also want to dispel up front the common-sense notion that

Practice Notes

Site developers who prepare lots and then sell the property must be ready to face the Service's antagonism to their use of the completed contract method. They may have no choice but to litigate the issue, given the view expressed by the IRS in a recent TAM.

a home construction contract *must involve* the construction of a home" (emphasis added). The Service continued: "Thus, 'construction' of a home in the technical sense is not an absolute prerequisite for a contract to qualify as a home construction contract."

The NSAR involved a taxpayer who was a residential lot developer. As in TAM 200552012, the Service took the position that the taxpayer was not entitled to use the CCM because the taxpayer did not handle the "vertical" dwelling construction. The NSAR focused on the statutory language and took the position that under the statute a taxpayer can use the CCM only if the taxpayer constructs the dwelling units.

The IRS discussed the fact that Section 460(e)(6)(A) uses the word "and" rather than "or." The NSAR acknowledged that "or" is used in the legislative history but concluded that it is only proper to look to the legislative history for guidance if the statute itself is ambiguous. As set forth above, the authors believe that "and" in Section 460(e)(6)(A) should be used in the disjunctive sense, and one only needs to look to the legislative history to confirm this conclusion.

Oddly enough, the NSAR leaves out a discussion of "with respect to" in its summary of Section 460(e)(6). In the NSAR, the Service seemed to initially give the term an expansive meaning before severely narrowing it. The NSAR states: "if there are no construction activities *related to* dwelling units, then there are no improvements to real property related to 'such dwelling units.'" It appears the IRS concluded that "with respect to" means "related to."

This is extremely significant. "Related to" is a slight connection indeed. It would be more than reasonable for a taxpayer or a court to conclude that developing the land for a home subdivision or community and constructing the accompanying infrastructure and common areas and amenities thereto is related to the dwelling units themselves.

TREATMENT OF 'SUBCONTRACTORS'

In the Regulations and the Service's guidance, subcontractors of homebuilders are treated the same as homebuilders for purposes of determining which taxpayers are eligible for the tax treatment afforded to "home construction contracts." Nevertheless, the IRS is apparently stubbornly clinging to its contention that residential lot developers are not subcontractors of the homebuilders. The critical question is why is the Service making this distinction? Why are the subdivision of land and the construction of improvements to land for home construction treated differently than the construction of only the foundation of a home, which the IRS specifically approved in the 1993 FSA discussed above? Nothing in the statute appears to provide a reason for different treatment of a foundation contractor and a residential lot developer. In fact, it would seem that a residential lot developer is more susceptible to unforeseen costs and uncertainty in calculating gain on a particular contract until the contract is complete, due to the difficulty of estimating the cost associated with site development, as opposed to the construction of a dwelling unit.

Under the Service's interpretation of Section 460(e)(6)(A), it appears that if a homebuilder has title to land and hires a specialty contractor to improve the land, put in the infrastructure, common areas and amenities, and develop individual building lots, then the specialty contractor may use the CCM. In contrast, a residential lot developer is not eligible for the CCM if the residential lot developer takes title to the land, completes the same activities pursuant to a binding contract with a homebuilder or homeowner, and then transfers the developed lots to the homebuilder or homeowner pursuant to the contract. Yet Reg. 1.460-1(b)(2)(i) specifically provides that in determining whether a sale of property is a construction contract, it is irrelevant whether or not the customer has title to, control over, or bears the risk of loss from the property constructed by the taxpayer. It appears that the IRS is drawing the line on who is a subcontractor that can be a party to a "home construction contract" at ground level—allowing use of the CCM by a foundation specialty contractor, but not a residential lot developer that makes "horizontal" site improvements.

CONCLUSION

As evidenced by TAM 200552012, the Service is attempting to drastically and unreasonably limit the scope of Section 460(e)(6)(A). These limits are inconsistent with congressional intent to encourage home construction. Moreover, residential lot developers run the risk of incurring unexpected expenses at the end of a long-term contract in the same manner as homebuilders. In fact, one could argue that it is more difficult for a residential lot developer to estimate its profit before the end of the contract period, especially if the residential lot developer is installing the site's infrastructure and delivering lots for a large project.

A better interpretation of the statute is to allow all taxpayers to use the CCM if they make improvements to real estate related to dwelling units or build dwelling units. If a vertical contractor of dwelling units purchased property, subdivided lots, paved roads, built utilities, built common areas, built amenities, and did the vertical home construction, then all of the profit or loss could be deferred until completion of the contract. It seems more than reasonable to allow any contractor who constructs real property improvements related to dwelling units, whether a general contractor, a foundation subcontractor, or a residential lot developer, to enjoy the deferral that the statute provides. Perhaps the IRS then can focus its efforts on issues such as when long-term contracts should be severed, rather than attempting to prevent a residential lot developer from using the CCM. ■