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AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
Quality People. Quality Projects.

November 3, 2008

CC:PA:LPD:PR (REG-120844-07)
Room 5203
Internal Revenue Service
POB 7604 Ben Franklin Station
Washington, DC 20224

Re: Proposed Regulations Under §1.460 – Home Construction Contracts

Dear Sir:

In response to your Notice of Proposed Rulemaking filed August 1, 2008, I am submitting the comments set forth below on behalf of the Associated General Contractors of America (AGC).

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 33,000 firms, including 7,500 of America's leading general contractors, and over 12,500 specialty-contracting firms. Over 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's, commercial buildings, manufacturing and industrial facilities, public infrastructure, multi-family housing projects, site preparation/utilities installation, and more.

Under What Conditions Is Land Development A Home Construction Contract?

The proposed regulations clarify that "land improvements" related to dwelling units are home construction contracts with the addition of §1.460-3(b)(2)(ii).

Much of the debate regarding land development contract classification has focused on whether a site developer and its contractor/subcontractors can classify their contracts as home construction contracts when no home is currently under construction on the site. The proposed regulations do not clarify this conflict of interpretation. §1.460-3(b)(2)(ii) refers to improvements to land "on which dwelling units are constructed." Dwelling units typically are not constructed until the site is improved. Do the proposed regulations require that the dwelling unit be constructed (or under construction) prior to or concurrent with the land improvements? Or is the term "are constructed" intended to mean "to be constructed".

AGC's position is that when a contract is for the development of sites that by their design—including the nature of the improvements, zoning, and Planned Unit Development (PUD) Agreements—are clearly sites for the future construction of homes, then the contracts are home construction contracts.

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On the Site and Common Improvements

The proposed regulations change current regulations in defining the costs that are measured for purposes of the 80 percent test to include costs and improvements to be incurred from "at the site" to "on the site". AGC's comments on the original section 460 regulations suggested, and Treasury adopted, the recommendation to expand the eligible costs to include costs at the site. The reason for this is that home subdivision frequently require costs to be incurred (either under prudent business decisions or contractually under a PUD agreement) that are adjacent or in close proximity to the site but not physically on the site. For example, a land developer may acquire a large parcel of land but develop only one phase with the intention of selling individual lots. The developer may be required to build roads and lay utility lines that are not on the phase that is under construction. These costs to the extent that they are allocable to the phase should be included in the 80 percent test.

AGC recommends that the current "at the site" definition in §1.460-3(b)(2)(i)(B) be retained in the regulations and also used in new paragraph (b)(2)(ii).

Change in Accounting Methods

AGC supports the proposed departure from the cut-off method to one allowing a section 481(a) adjustment and amortization with the exceptions noted in the proposed regulations.

As an aside, the continuing efforts to expand categories of changes that are permitted under the non-consent terms of recently issued Revenue Procedure 2008-52 coupled with a section 481(a) adjustment from these proposed regulations should result in an increased overall compliance with the code and regulations by taxpayers due to ease and lowered compliance cost.

Under the proposed regulations, §1.460-4(g)(i) and (ii) either require or do not permit, respectively, a section 481(a) adjustment for certain percentage-of-completion (PCM) contract changes. Under current regulations, a taxpayer is required to report income from long-term contracts on the PCM using the cut-off method for the first year following the year its average annual gross receipts exceed $10,000,000. AGC suggests that the regulations clarify that a taxpayer transitioning above or below the section 460(e)(1)(B) thresholds is not a taxpayer-initiated change, is made on a cut-off method, no section 481(a) adjustment is required, and there is no Form 3115 filing requirement.

The proposed regulations have explicitly required both the PCM method and the cost allocations be considered together ("and") to determine if an accounting method change is eligible for section 481(a). It is not uncommon in practice for taxpayers using a permissible PCM method not to be in total conformity with the cost allocation requirements of §1.460-5 having one or

more category of expense that is not allocated to individual contracts. However, due to fact that these costs occur ratably over the life of the contract, the PCM taxable income is the same with or without the allocation. Taxpayers consider the cost-benefit in evaluating costs allocated. Additionally, some of the costs required to be allocated under §1.460-5 are not required to be allocated under GAAP.

Under the proposed regulations, a taxpayer could have a change from one permissible PCM method to another permissible PCM method that would qualify for a section 481(a) adjustment but for the fact that one or more costs under §1.460-5 are not allocated. If the facts show that the change in cost allocations taken alone would result in no (or a diminimis) section 481(a) adjustment, AGC recommends that the concurrent change to a permissible PCM method be allowed a section 481(a) adjustment and amortization.

Individual Lots

The "Supplementary Information: Improvements to Real Property" comments that accompanied the proposed regulations referred to "a land developer that is selling individual lots (and its contractors and subcontractors)". There is no reference to the act of selling individual lots as opposed to selling an entire subdivision of lots. Is there any inference in this material that bulk sales of lots by the land developer would taint the ability of the developer and its subcontractors to utilize the home construction contract classification? Alternatively, is this suggesting that to qualify the land must be subdivided into individual lots but could be sold in bulk?

Severance and Completion

As stated in current regulations, severing may be applied "to clearly reflect income [e.g., to prevent the unreasonable deferral (or acceleration) of income or the premature recognition (or deferral) of loss]."

AGC believes that the terms of a legally binding contract should be followed for income recognition and that only when the clear reflection of income standard is abused should severing be considered by either the taxpayer or the Commissioner.

In deliberation on rules relating to severing, consideration should be given to the various tiers of contractors and their privity to information.

Under the proposed regulations, it is possible that each of the entities other than the Home Buyer listed below will qualify for contract classification as home contracts:

Home Buyer – buys completed home from House Contractor
House Contractor – buys land from Site Developer, constructs home including contracting with House Subcontractors, and contracts with Home Buyer

House Subcontractor – constructs components of house under contract with House Contractor

Site Developer – acquires undeveloped land, completes entitlement, zoning, PUD approval, contracts with Site Contractor to construct improvements, and contracts with House Contractor to purchase sites (individually or in a pool of sites).

Site Contractor – constructs common improvements to land under contract with the Site Developer and may include contracts with Site Subcontractors.

Site Subcontractors – constructs components of common improvements under contract with the Site Contractor.

Only in the case of the House Contractor is it normal that each unit of property is independently priced and separately delivered and accepted. For example, a Site Contractor will enter into a contract for all of the grubbing, street, water, sewer, other utility, and club houses. No pricing is given for individual sites. While the Site Developer may sell an individual lot to a House Contractor, the Site Contractor may not be aware of the sale and may not have incurred all of the costs allocable to the individual site which will be performed by a Site Subcontractor. Any regulations regarding severance of contracts between unrelated parties should be carefully structured to avoid any cascading effect so that the revenue recognition event by an upper tier party requires a lower tier party to sever its contract and recognize income. It is not practical to expect a lower tier entity to have knowledge of the tax treatment another taxpayer is applying to their transaction and even if the lower tier party did know, the upper tier's recognition may be improper.

AGC believes that when under a contract for multiple lots or dwelling units a lot or dwelling unit is completed and payment in full has been received by the taxpayer for the specific unit or group of units, severing may be appropriate in situations where the deferral period is significant. The regulations should create a safe harbor for simplicity and consistency that severance will not be imposed unless the deferral is greater than a specific number of tax years beyond when the contract would be taxable if the contract were severed.

The receipt of payments that are progress payments under the contract, a typical industry practice, should not be a trigger for severance or completion.

Under pre-1986 Act code and regulations, a lot developer typically reported income as lots were closed and the allocable costs were deducted against each transaction. Under Revenue Procedure 92-29, developers that had allocable costs that would be incurred in the future are permitted to deduct those costs currently when the conditions of the Revenue Procedure are met. This resulted in an equitable taxation of profit.

If a contract is severed and thereby treated as complete while there are future costs to be incurred, it is not equitable to require the taxpayer to pay tax on the difference between the

contract price and costs currently deductible. Even if the contractor has received payment of the full contract price, the portion of the payment that represents the obligation for future costs constitute "trust funds" under most state laws. AGC suggests that regulations provide that when a contract is reported as completed on the CCM method and the taxpayer is contractually obligated to incur future allocable costs, the contract amount recognized to date is the total contract price reduced by future costs to be incurred. The remaining contract amount and its related costs would be reported under an acceptable method as the costs are incurred (accrual). Under this procedure, the taxpayer's taxable income in the completion year includes 100 percent of the gross profit on the contract.

Look-Back

You have requested comments regarding the look-back computation when taxpayer initiated changes result in section 481(a) adjustments.

AGC agrees that for purposes of look-back, the section 481(a) adjustment should be taken into account in the years and amounts that they are reported for regular tax computations.

AGC does not agree that a section 481(a) adjustment should be accelerated solely for the purpose of look-back in the year a contract completes. The intent of look-back is to compensate the government/taxpayer for errors in estimates – not for timing differences that are permitted under the law. If the regular tax computation permits a section 481(a) amortization, it should be consistently applied for look-back.

Additionally, any given section 481(a) adjustment for a contractor might allocate to hundreds of individual contracts. To allocate the adjustment and track it by contract would be costly and would likely be of little effect on the computation of look-back.

Mixed-Use Properties

The current regulations and the proposed regulations address the concept of mixed-use properties and the 80 percent cost allocation test for home construction contract classification. In today's construction world, our members are typically constructing mixed-use properties that contain elements that would qualify as home contracts, elements that would qualify as residential contracts, and elements that would qualify as other construction contracts under the Code.

To keep the income tax regulations in line with the business environment, the mixed-use property regulations should be expanded to identify circumstances under which a contract can be severed to apply proper methods of accounting for contracts that have multiple scope elements.

Effective/Applicability Date

The proposed date for application of the final regulations is tax years beginning after publishing in the *Federal Register*. With the current schedule, it is unlikely that this event will occur until some date in calendar 2009. This means that implementation will be delayed for most taxpayers until January 1, 2010.

The classification of home contracts has been an issue for many taxpayers since 1988. During the last 3 to 4 years, taxpayers have applied for changes in accounting methods for home construction contracts with the IRS National Office and their form 3115 have been held in a non-ruling state. These stale 3115's are now being denied. These taxpayers and others desire to change as quickly as possible and other taxpayers that have been previously using methods that are consistent with the proposed regulations desire to obtain audit protection for prior years. The uncertainty in tax revenue recognition may have financial statement impacts under FIN 48.

Accordingly, AGC suggests a process for earlier application of the rules. For instance, consider a transition under the proposed regulations whereby a taxpayer can elect to apply the home construction contract definition for any new contract entered into after the date published in the *Federal Register* using a cut-off method. Prior contracts would be required to follow prior accounting methods unless application for change is made for the first tax year beginning after the year the rules are published.

Alternatively, AGC suggests that application be permitted through filing a timely form 3115 after the date the final regulations are published in the *Federal Register*.

AGC appreciates the deliberation that has gone into this IIR project and the opportunity to comment on the proposed regulations.

Thank you for your consideration of these comments.

Sincerely,

Jeffrey D. Shoaf
Senior Executive Director
Government and Public Affairs