Tax Tip

Tax Accounting Dilemma Continues for Condo Developers

By Charles H. Egerton and Edward A. Waters

Prior to the enactment of the Tax Reform Act of 1986[1] (TRA '86), homebuilders and condominium developers who entered into contracts with customers to construct and deliver a completed home or a completed condo unit would report their income or loss with respect to each such home or condo unit sold one of two ways: under the general tax accounting rules set forth in Code Secs. 451 and 461[2] or under another permissible long-term contract accounting method, such as the completed contract method (CCM). Code Sec. 460, which was added as a revenue raiser in TRA '86, significantly altered the reporting rules for these and other similar construction contracts by requiring that taxable income from a long-term contract be reported on the percentage of completion method (PCM). A long-term contract is broadly defined under Code Sec. 460(f)(1) as any contract for the manufacture, building, installation or construction of property if such contract is not completed within the tax year in which such contract is entered into.

Under PCM accounting, the taxpayer/developer must report income from the construction contract (which, generally speaking, consists of the sale price, less total projected costs of construction) for each tax year during the construction period proportionately with the percentage of the construction actually completed in such tax year. In the parlance of Code Sec. 460, the taxpayer/developer includes in gross income for the tax year that portion of the total contract price that corresponds to the percentage of completion for such tax year. The total contract price is defined as the amount that a taxpayer reasonably expects to receive under a long-term contract, including holdbacks, retainages and cost reimbursements.[3] The percentage of completion is determined by comparing allocable contract costs actually incurred during the tax year with estimated total allocable contract costs.[4] For example, assume a condo developer ("Developer") enters into a contract to sell a condo unit to Buyer for $300,000 on January 1, 2015. By December 31, 2015, Developer has incurred $50,000 of allocable contract costs on Buyer's unit and estimates the total allocable contract costs on Buyer's unit to be $150,000. In this scenario, the ratio of actual costs to estimated costs, referred to in the regulations as the completion factor,[5] is 33-1/3 percent ($50,000/$150,000). Under PCM, Developer must report gross receipts of $100,000 ($300,000 × 33 1/3%) and gross income of $50,000 ($100,000 – $50,000) with respect to Buyer's unit. Unfortunately, Developer is unlikely to

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actually receive any of the sales price from Buyer, except for a deposit (or portion thereof) of varying magnitude, until the condo is complete. This means Developer must pay tax on income he has not yet received.

Until the Proposed Regulations are finalized, condo developers will continue to face the same uncertainty as they have since Code Sec. 460 was enacted in 1986.

As noted above, prior to the TRA '86, income and loss from the construction of homes and condos were reported either under CCM or on an accrual basis, with income and loss reported in the year when the contract improvements were completed and delivered. One reason for the enactment of Code Sec. 460 was to bring tax accounting in line with financial accounting. In October 1982, the Financial Accounting Standards Board (FASB) released Financial Accounting Standards (FAS) No. 66. Among other things, FAS No. 66 required taxpayers to report income from presales of condo units under PCM for financial accounting purposes. Therefore, the enactment of Code Sec. 460 was seemingly justified as necessary to bring tax reporting and financial reporting in line with one another for condo presales contracts. However, in March 2007, FASB revisited the issue of the use of PCM accounting for condo presales contracts in Emerging Issues Task Force (EITF) No. 06-8. EITF No. 06-8 required a buyer to make sizable payments over a condo's construction term in order for PCM accounting to be allowed. In the event such payments were not made, EITF No. 06-8 instructed condo sellers to account for income under the "deposit method," whereby income would only be reported once a sale was actually complete. Because the payments required by EITF No. 06-8 were not generally made by a condo buyer over the course of development, many condo developers switched from PCM to the deposit method for financial accounting purposes. As a result, beginning in 2007, the conformity of financial accounting and tax accounting desired by the enactment of Code Sec. 460 ceased to exist.

Congress amended Code Sec. 460 in 1988 to exclude homebuilders from having to use PCM accounting for home construction contracts (HCCs). An HCC is defined under Code Sec. 460(e)(6)(A) as any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the tax year in which the contract was entered into) are reasonably expected to be attributable to construction activities with respect to (1) dwelling units (as defined in Code Sec. 168(e)(2)(A)(ii)) contained in buildings containing four or fewer dwelling units and (2) improvements to real property directly related to such dwelling units and located on the site of such dwelling units. Importantly, the HCC exclusion, as enacted, did not apply to presale contracts for individual condo units. This meant that, as of 1988, homebuilders could begin to report income and loss from the construction of homes under CCM or the accrual method, while condo developers continued to be required to report income and loss from condo sales contracts under PCM.

Generally, in a presale contract between a condo developer and a buyer, the buyer puts down an initial deposit at the time the contract is executed and, in many (if not most) instances, the contract limits the penalty for the purchaser's default to forfeiture of the deposit. Historically, deposits have been anywhere between five percent and 20 percent of the total sales price. Recently, however, in areas such as south Florida, deposits have grown to be as high as 50 percent of the total sales price.[6] At least some portion of the deposit is typically required to be held in escrow,[7] but the balance of the sales price is not paid until closing. Despite the fact that many condo sales contracts call for significant deposits, buyers have, in the past (and particularly during the recent "Great Recession"), shown a willingness to forfeit these deposits and abandon deals with developers as condo values have plummeted.

The regularity with which buyers have abandoned their condo sales contracts has prompted some developers to treat their agreements with buyers not as a long-term contract, but as an option to purchase, especially if the purchaser's amount at risk is limited to the forfeiture of his deposit. Under this line of reasoning, treating an agreement as an option allows developers to avoid the imposition of PCM, as Code Sec. 460 applies only to long-term contracts. Note, however, that under Reg. §1.460-4(h), Ex. 5 ("Example 5"), a contract for the purchase of a condo unit was subjected to PCM even where the deposit was only two percent of the total purchase price. Example 5 leaves this line of reasoning open to serious question, especially when deposits are 20 percent or more of the total sales price.

On August 4, 2008, the IRS proposed amendments to the regulations promulgated under Code Sec. 460 (the "Proposed Regulations").[8] Among the changes made by the Proposed Regulations, Proposed Reg. §1.460-3(b)(2)(iii) provides "For purposes of determining whether a long-term construction contract is a home construction contract … each townhouse or rowhouse is a separate building. For this purpose, the term townhouse and rowhouse includes

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an individual condominium unit." The preamble to the Proposed Regulations explains that individual condominium units possess many of the characteristics generally associated with townhouses and rowhouses, such as private ownership, shared portions of their structures, residential housing and the economics of the underlying purchase transactions. The preamble continues by stating that the Proposed Regulations expand what is considered a townhouse or rowhouse (which are already covered by the home construction contract exemption) to include an individual condominium unit. This has the effect of allowing each condominium unit to be treated as a separate building for purposes of determining whether the underlying contract qualifies as a home construction contract. It is no coincidence that the Proposed Regulations were released during 2008, in the midst of the aforementioned Great Recession, to alleviate the financial woes confronting condo developers in a floundering economy.

The preamble states that the Proposed Regulations are to apply to tax years beginning on or after the date the final regulations are published in the Federal Register. Additionally, the final regulations are to provide rules applicable to taxpayers who seek to change a method of accounting to comply with the rules in the final regulations, and taxpayers may not change or otherwise use a method of accounting in reliance on the rules contained in the Proposed Regulations until the rules are published as final regulations in the Federal Register. Unfortunately for condo developers seeking to benefit from condo sales contracts being classified as home construction contracts, the Proposed Regulations have, to date, yet to be finalized. In the 2014–2015 IRS Priority Guidance Plan, released on August 26, 2014, and covering the plan year period from July 2014 through June 2015, the Proposed Regulations were listed as one of 22 tax accounting projects that the IRS actively intended to work on. Despite being listed in the Priority Guidance Plan, the Proposed Regulations were not finalized during the 2014–2015 plan year, and it remains uncertain when, if ever, the Proposed Regulations will be finalized.

Until the Proposed Regulations are finalized, condo developers are faced with a difficult decision as to how to account for taxable income on contracts for the sale of condo units during development of the condominium building. Despite the fact that the preamble to the Proposed Regulations explicitly states that the Proposed Regulations apply to tax years beginning on or after the date the final regulations are published in the Federal Register, some developers have apparently chosen to report income and losses under CCM or the accrual method, consistent with other HCCs.[9] There is an obvious risk associated with this approach, as the IRS could very well challenge the use of such methods for periods prior to finalization of the Proposed Regulations. Alternatively, a developer may opt to avoid imposition of PCM accounting by treating a condo sales agreement as an option rather than a long-term contract. However, with deposits rising as high as 50 percent of the total sales price in some parts of the country, this strategy seems riskier than ever. Further, the Proposed Regulations continue to contain Example 5, revised to include the sale of an apartment building rather than a condo unit. Nevertheless, the contract still contains the same two-percent deposit and is still classified as a long-term contract, which will continue to call into question the argument that a construction contract coupled with a small deposit should be regarded as an option agreement and not as a long-term contract that is subject to mandatory PCM reporting under Code Sec. 460. Finally, a condo developer may account for income and losses under PCM, with the unenviable result of paying tax on money it has not yet received. Until the Proposed Regulations are finalized, condo developers will continue to face the same uncertainty as they have since Code Sec. 460 was enacted in 1986.

ENDNOTES

1. Tax Reform Act of 1986 (P.L. 99-514).
2. All references to the "Code" are to the Internal Revenue Code of 1986, as amended, and all "Reg. §" references are to the Treasury regulations issued thereunder.
3. Reg. §1.460-4(b)(4)(i)(A).
4. Reg. §1.460-4(b)(1).
5. Reg. §1.460-4(b)(5)(i).
6. Nicholas Nehamas, *Tax Confusion Creates "Serious Financial Headache" for South Florida Condo Developers*, Miami Herald, June 17, 2015.
7. For example, in Florida, Fla. Stat. §718.202 requires a condo developer to pay into an escrow account all payments up to 10 percent of the sale price received by the developer from the buyer towards the sale price.
8. 73 FR 45180 (Aug. 4, 2008).
9. Nehamas, *supra* note 6.

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