INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 460.00-00, 460.04-01
CASE-MIS No.: TAM-106726-16

Director

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer:
State A:
Date 1
Date 2:
Date 3:

ISSUE:

Whether certain of Taxpayer’s contracts qualify for the completed contract method of accounting.

CONCLUSION:

Those of Taxpayer's long-term construction contracts requiring grading and soil compaction of the pad area necessary for the construction of foundations for houses qualify for the completed contract method of accounting.

FACTS:

Taxpayer, a C Corporation, actively participates in private sub-division housing projects in State A. It enters into contracts with both land developers and owners/homebuilders. These contracts require Taxpayer to make a variety of heavy construction improvements necessary for the development of a housing sub-division. In particular, these contracts require some or all of: clearing land; grading and compacting soil for construction of homes; installing lot improvements such as retaining walls and driveways; and constructing common improvements for the development, such as curbs, sidewalks, and gutters.

Taxpayer's grading activities include rough grading of the sub-division and fine grading of the "pad" area of an individual lot where the foundation of a house will be constructed. Further, state and county building codes in State A require the testing of soil in a sub-division, in some cases on a lot-by-lot basis. Taxpayer performs grading and soil compaction of the pad area to required densities and depths in accordance with engineering surveys that are completed in order to comply with these requirements. In some cases, clay or organic soil must be replaced with more stable soil. The specific grading and compaction of the pad area required are based on the structure that will be built on the lot and environmental factors such as water runoff. Taxpayer's work is

covered by home warranties, and Taxpayer represents that it has paid claims related to its work on pad areas. Taxpayer represents that its contracts generally do not exceed four years in duration.

For the tax year ending on Date 3, the Service granted consent to Taxpayer to use the completed contract method of accounting (CCM) to account for its contracts qualifying as home construction contracts within the meaning of § 460(e)(6)(A). Home construction contracts are exempted from required use of the percentage-of-completion method of accounting (PCM). I.R.C. § 460(e)(1)(A). Under PCM, contract price is reported as contract costs are incurred, based on the proportion of incurred to estimated total costs. § 460(b)(1)(A). A taxpayer can use an "exempt method," including CCM, to account for home construction contracts. Treas. Reg. § 1.460-4(c). Under CCM, contract price and costs are reported upon contract completion. Treas. Reg. § 1.460-4(d). In an audit of the tax year ending Date 2, the revenue agent examined several contracts that Taxpayer claimed were home construction contracts and thus eligible for CCM. Based on this review, the field office has requested revocation of the Date 1 letter of consent on the grounds that none of Taxpayer's contracts qualify as home construction contracts.

LAW AND ANALYSIS:

Section 460(a) generally requires use of PCM to account for long-term contracts, as defined in § 460(f). Section 460(e)(1)(A), however, exempts "any home construction contract" from the general rule. A taxpayer performing construction services pursuant to

a “home construction contract” may report income from that construction activity using CCM. Treas. Reg. § 1.460-4(c).

Under § 460(e)(4), a construction contract is “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 are reasonably expected to be attributable to construction activities with respect to “(i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.” We refer to this test as “the 80-percent test.”

For purposes of § 460(e)(6)(A), a “dwelling unit” is defined at § 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 . . . .”

For purposes of the 80-percent test, § 1.460-3(b)(2)(iii) of the regulations allows taxpayers to include in the costs of dwelling units their allocable share of the costs of common improvements that taxpayer is required to build, by contract or by law, on the tract of land containing the dwelling units.

The home construction contract exemption was recently interpreted in *Howard Hughes Co., L.L.C. v. Comm’r*, 805 F.3d 175 (5th Cir. 2015). The *Hughes* court found

that a land developer who incurred solely common improvement costs, but did not incur costs for the construction of dwelling units or for improvements within the individual lots on which dwelling units were to be situated, could not use CCM to account for its contracts. Because of its construction activities within individual lots, Taxpayer's case is not governed by *Howard Hughes Co*. Rather, we are required to determine whether Taxpayer performs construction activities with respect to dwelling units, within the meaning of § 460(e)(6)(A)(i). If it does, those contracts requiring such work qualify for CCM treatment. At least 80 percent of a contract's estimated costs would be attributable to the construction of dwelling units, because under the regulations a taxpayer constructing all or a portion of a dwelling unit can consider the allocable share of common improvement costs as part of the costs of constructing the dwelling units. Substantially all of a contracts' estimated costs would be qualifying costs for purposes of meeting the 80-percent test: costs for the construction of a portion of a dwelling unit; costs for the construction of improvements to real property on the site of such dwelling unit; and an allocable share of the costs of constructing common improvements.

We conclude that under the specific circumstances of this case, grading and soil compaction of the pad area necessary for the construction of foundations for houses are construction activities with respect to dwelling units per § 460(e)(6)(A)(i). Taxpayer's work is regulated by state and local building codes and is the subject of home warranties. The grading and soil compaction of the pad area necessary for the construction of the foundations are as essential to support of the houses as the

foundations themselves and should be considered construction of a portion of the dwelling units.

Further support for this conclusion is found in authorities addressing the issue of whether the cost of land preparation can be included in the basis of a building used in a trade or business or held for the production of income, and therefore depreciable. Courts have found and the Service has ruled that when grading (that is, land preparation) is so closely associated with a specific depreciable structure that the land preparation would be retired, abandoned, or replaced contemporaneously with that depreciable structure, the cost of the land preparation is depreciable and may be part of the cost basis of the structure. *Eastwood Mall, Inc. v. United States*, 95-1 U.S. Tax Cas. (CCH) P50,236 (N.D. Ohio 1995); Rev. Rul. 2001-60, 2001-2 C.B. 587; and Rev. Rul. 68-193, 1968-1 C.B. 79.

In all likelihood, replacement of a rental house and its foundation would require the contemporaneous physical destruction of the pad, so that the cost of the pad is part of the cost basis of the rental house. For purposes of § 460(e)(6)(A), the pad therefore may be considered part of the dwelling unit. Note that rough grading of the lot or clearing trees would not qualify as construction of a dwelling unit because those are non-depreciable improvements to land. Installation of retaining walls and driveways for a rental building would qualify as the construction of depreciable improvements to land, but not ones that are part of the dwelling unit itself.

CAVEATS:

Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusions in the memorandum. See § 13.03 of Rev. Proc. 2016-2, 2016-1 I.R.B. 102 (or any successor). A technical advice memorandum that modifies or revokes a letter ruling or another technical advice memorandum generally is not applied retroactively if the taxpayer can demonstrate that the criteria in § 13.02 of Rev. Proc. 2016-2 (or any successor), are satisfied. This technical advice memorandum is not to have retroactive effect, because the criteria for relief have been satisfied.

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