The Real Estate Roundtable

August 21, 2019

The Honorable Steven T. Mnuchin
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Dear Secretary Mnuchin:

Current tax accounting rules related to condominium development constrain new housing production, job growth, and economic activity. The Real Estate Roundtable, which represents the leading owners, developers, lenders, and managers of the nation's real estate, respectfully requests that the Treasury Department issue guidance providing relief from existing rules that unfairly accelerate the federal income tax liability on new condominium construction. The guidance would not reduce tax imposed on new condominium development, but rather align the timing of taxes with actual income.

Federal tax law provides special tax accounting rules for long-term contracts—*i.e.*, contracts for the manufacture, building, installation or construction of property that are not completed in the same taxable year they are entered into. I.R.C. §460(f). These statutory rules generally require developers of large condominium projects to use the percentage-of-completion method of accounting when pre-selling condominium units during the construction phase. Under percentage-of-completion, the developer includes a portion of the contract price in gross income annually as he or she incurs construction and other contract costs. Treas. Reg. §1.460-4(b)(1).

Under the completed contract method, in contrast, a developer would recognize the contract amount as income when the sale closed and the buyer took possession of the condominium unit. Treasury regulations provide a bright-line test to determine when a contract is completed.[1]

The completed contract method would provide a more accurate and clear reflection of income from condominium construction. Large condominium projects regularly take two or three years to complete, or even longer. In these cases, the developer will often market units to the public prior to completion and accept deposits from prospective buyers in order to secure construction financing. The buyer agrees to purchase the unit at a future date. During the construction period, the

[1] A contract is completed upon the earlier of: (a) use of the subject matter of the contract by the customer for its intended purpose and at least 95% of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer, or (b) final completion and acceptance of the subject matter of the contract. [Treas. Reg. §1.460-1(c)(3)](#).

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developer does not receive "draws" or "progress payments" from the buyer. The developer is not entitled to the balance of the purchase price or access to the original deposit until the condominium unit is delivered and the buyer closes. In the interim, the developer uses construction financing to pay for the expenses related to the condominium development. Typically, the lender will require that all dollars received upon sale of the condominium units first go towards paying down the construction financing, exacerbating the phantom income issue for the developer.

In addition, the developer retains title to the property until closing, bears all economic risk until closing, and finishes construction under the developer's own terms and direction. The deposit usually constitutes the sole amount at risk for the buyer, who is specifically limited to a refund of the deposit as "liquidated damages" in the event of a default by the developer. Such a default occurs where the developer, for whatever reason, fails to build or fails to convey the house on the date of closing. Similarly, under the terms of a typical contract, the deposit constitutes the only damages recoverable by the developer in the event of a default by the buyer.

Lastly, State law and contractual commitments typically restrict the developer's access to deposits, and until the transaction is completed and the buyer takes possession, there is no certainty that the developer will receive the proceeds from the sale.

All of these factors demonstrate how the percentage-of-completion method of accounting creates a mismatch of cash flow and tax liability. In order to pay tax on this phantom income, developers must have other revenue streams, or they must secure financing or capital from another source. This limits the amount of capital developers have to fund projects. Financial institutions will not finance tax payments through construction financing because tax payments are not considered a cost of the project. Failure to find the additional financing or capital needed to prepay tax on the phantom income threatens a taxpayer's ability to follow through with construction projects that strong underlying economic fundamentals would otherwise justify.

In short, the current tax accounting rules create artificial hurdles to high-density condominium construction, distort the economics of residential construction, and serve no discernible tax policy purpose. The pre-sale of condominium units should not trigger the recognition of income until the individual contracts are completed.

Adding insult to injury, the tax accounting rules requiring the percentage-of-completion method were designed to prevent the abusive deferral of income by defense and government contractors. Congress was concerned that large defense contractors were using the completed contract method of accounting to defer income recognition for long-term contracts under which substantial progress payments would be made prior to the completion of the contract.[2] At the time, a contemporaneous review and survey of firms by the General Accounting Office found that more than 94% of the income deferred under the completed contract method

[2] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (May 4, 1987), at 527:

> The Congress believed that the completed contract method of accounting for long-term contracts permitted an unwarranted deferral of the income of those contracts. The Congress noted that the Study of 1983 Effective Tax Rates on Selected Large U.S. Corporations by the Joint Committee on Taxation indicated that some corporations had large deferred taxes and low effective tax rates as a result of their use of the completed contract method for tax purposes. Annual reports for certain large defense contractors reflected negative tax rates due to net operating loss carryforwards generated through use of the completed contract method in prior years.

was attributable to manufacturing businesses and less than 6% related to construction companies.[3] The rules were not intended to apply to residential construction.[4]

The existing, discriminatory tax rule for condominium construction is particularly harmful in light of the significant and often measureable economic, environmental, and social benefits of high-density residential development. High-density development brings down the costs of infrastructure, as well as the costs of key public services: police, fire, and emergency medical assistance. The environmental benefits include reduced vehicle emissions and smaller ecological footprints that minimize encroachment on farms, forests, and other sensitive areas. In addition, research links high-density growth to greater labor productivity and economic innovation.[5]

Not surprisingly Congress sought to differentiate the treatment of residential construction contracts from the types of long-term defense, aerospace, and government contracts that were the subject of abuse. In 1988, Congress enacted an exception from percentage-of-completion for home construction contracts. I.R.C. §460(e)(5)(A). A long-term construction contract is a home construction contract if a taxpayer reasonably expects to attribute 80 percent or more of the contract costs to the construction of dwelling units contained in buildings containing four or fewer dwelling units and improvements to real property directly related to, and located at the site of, the dwelling units. Treas. Reg. §1.460-3(b)(2). For purposes of the exception, a townhouse or rowhouse is treated as a separate building.

Unfortunately, the current interpretation of the home construction exception does not extend to buildings with five or more condominium units. The Treasury Department can solve this problem, however, and provide a lift to homebuilding and the economy by simply finalizing a previously proposed regulation that regrettably fell off the Department's regulatory agenda in the last Administration. Pending, proposed Treasury regulations would modify what is considered a home construction contract and clarify that condominium construction qualifies for the completed contract method of accounting. Treas. Prop. Reg. §1.460-3(b)(2)(iii). The proposed regulation would effectively allow each condominium unit to be treated as a separate building for purposes of determining whether the underlying contract qualifies as a home construction contract. The Preamble to the proposed regulations properly acknowledged that, in certain circumstances, the terms condominium and townhouse are used interchangeably to describe similar structures, "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."[6] As demonstrated by the proposed rule, the Treasury Department has clear and ample authority to extend the home construction exception to all residential condominium development.

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[3] U.S. General Accounting Office, *Congress Should Further Restrict Use of the Completed Contract Method* (Jan. 1986); Thomas Edsall, *Tax Deferrals Boon to Key Defense Contractors*, WASH. POST (Mar. 27, 1982).

[4] "In both the 1986 Tax Reform Act and in the 1987 Budget Reconciliation Act, we legislated cutbacks in the completed contracts method of accounting. I think all of us believed that these cutbacks would primarily affect the long-term contracts of defense contractors, not contracts for the construction of homes." Statement of Sen. Dennis DeConcini, "Contracts for Residential Construction," 134 CONG. REC. 29,962 (Oct. 12, 1988).

[5] Amy Liu, *The Benefits of High Density Development* (Brookings Inst., 2005); Richard Florida, *Cities with Denser Cores Do Better*, THE ATLANTIC (Nov. 28, 2012).

[6] Dept. of Treasury, *Rules for Home Construction Contracts*, 73 FED. REG. 45,180 (Aug. 4, 2008)

For these reasons, we respectfully request that you use your regulatory authority to ensure that new condominium development, like other residential construction, qualifies for the completed contract method of accounting. We appreciate your consideration of this matter look forward to discussing it further with you or your staff in the days ahead.

Sincerely,

Jeffrey D. DeBoer
President and Chief Executive Officer

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