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Staff of the United States Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Re: Comments on Staff Discussion Draft on Cost Recovery and Accounting

On behalf of Leading Builders of America (“LBA”) and its members (see attached), we appreciate the opportunity to comment on the November 21, 2013, staff discussion draft relating to the cost recovery and accounting elements of tax reform (the “Discussion Draft”). The LBA members are all U.S. taxpayers and include many of the nation's largest production home builders. The members do business in 29 states and employ tens of thousands of individuals, directly or through subcontractors, who have just been through the worst home building market since the depression. The members are committed to increasing the construction of high-quality and affordable homes and thereby furthering the nation's economic recovery. They are concerned, however, that some of the proposals of the Discussion Draft would run counter to those objectives. In particular, and as described below, their concern relates to the proposed elimination of certain tax accounting methods currently available for use by home builders under the Internal Revenue Code.

As you know, current law provides that taxable income from long-term contracts, with certain exceptions, must be determined under the “percentage of completion method” (“PCM”). Code § 460(a). A “long-term contract” generally is any contract for the “manufacture, building, installation, or construction of property” if the contract spans two or more tax years. Treas. Reg. § 1.460-1(b)(1). Two exceptions to the use of PCM are available for home builders. One is that income from a “home construction contract” can be determined under the “completed contract method” (“CCM”). Code § 460(e)(1)(A); Treas. Reg. § 1.460-3(b)(2). The other exception allows income from a “residential construction contract” to be determined under the “percentage of completion/capitalized cost method” (“PCCM”). Code § 460(e)(5); Treas. Reg. 1.460-3(c). Each of these methods is described below.

“Home construction contracts” and “residential construction contracts” are similar with one principal difference. Under both types of contracts, as they are defined in the Code, 80 percent or more of the contract costs must be attributable to dwelling units and improvements

directly related to dwelling units. Code § 460(e)(6). The key distinction between the two is that a “home construction contract” involves the construction of buildings containing four or fewer dwelling units, while a “residential construction contract” involves the construction of buildings containing more than four dwelling units. *Id.*

The three methods of tax accounting at issue can be generally described as follows:

- Under PCM, a taxpayer must include in income for any taxable year an amount equal to (1) the estimated total profit on the contract multiplied by (2) the percentage of the contract completed during the taxable year. The percentage of a contract completed during a taxable year is determined by comparing the costs incurred with respect to the contract during the year with the estimated total contract costs.
- In contrast, CCM does not require the taxpayer to recognize income on the contract until the contract’s “completion year.” The “completion year” is the earlier of (1) the taxable year in which final completion and acceptance of the subject matter of the contract occurs, and (2) the taxable year in which use of the subject matter of the contract by the customer for its intended purpose (other than for testing) occurs and in which it can be determined that at least 95 percent of the total allocable contract costs have been incurred. Treas. Reg. § 1.460-1(b)(6).
- PCCM for residential construction contracts is a hybrid approach under which 70 percent of the items under the contract are taken into account using PCM and the remaining 30 percent are taken into account under another permissible method (including CCM).

The Discussion Draft would require the use of PCM by home builders as a result of the proposed elimination of both (1) the use of CCM for home construction contracts, and (2) the use of PCCM for residential construction contracts. No other exception to the general rule requiring use of PCM would be available for either a home construction contract or a residential construction contract. Thus, under the Discussion Draft, the income from these types of contracts, which are the core of the business of home builders, would be taxed pursuant to PCM.

We respectfully urge the Senate Finance Committee to make no changes to current law regarding the use of CCM for home construction contracts or PCCM for residential construction contracts. As discussed below, requiring the use of PCM by home builders would be distortive, inconsistent with financial statement income recognition, unfair and burdensome in application, and damaging to the home construction industry and the housing market in general. The following are the principal considerations that support maintaining current law:

- Contracts entered into by home builders typically provide for only a small deposit at the outset with the balance coming only after the construction is complete and the home sale actually closes. Deposits are typically less than 5 to 10 percent of the total home purchase price.

- In certain locations, deposits must be held in escrow, with the home builder having limited or no access to the funds. Thus, the deposits cannot be used by the home builder to pay construction costs related to the contract. They also would not be available to pay the up-front income taxes that would be due under PCM.
- Production home builders, unlike many long-term contractors, especially in the commercial construction and defense contractor segments, do *not* receive progress payments during the performance of a contract. Home builders must therefore fund 100 percent of the construction costs themselves with very little cash advanced by the prospective home buyer.
- The retention or, alternatively, the refund of deposits submitted by prospective home buyers is typically contingent on various factors. The most common “contingency” relates to whether the buyer receives financing approval for the ultimate purchase of the home. Whether these contingencies are triggered is entirely out of the control of the home builder, but when triggered the contingencies typically result in the refund of the deposit to the prospective buyer. As a result, the use of PCM by a home builder could well require inclusion of income for tax purposes that the home builder *never* actually receives from a particular buyer. It should be noted that many contracts cancel at some point in the process. During the recent market downturn some communities had cancellation rates as high as 30 percent. More recently, builders have seen rates of cancellation in the 15 percent range.
- Land generally represents the single largest cost associated with a home sale (normally 20 percent or more of the home construction costs), and is generally incurred by the home builder prior to any agreement with the home buyer. Typically, then, PCM would require immediate recognition at the commencement of the contract of over 20 percent of the contract profit, notwithstanding that only a nominal – or even trivial – deposit may have been made with numerous contingencies outstanding.
- During the construction period, title and risk of loss both remain with the home builder. Again, the home builder bears significant responsibilities – and the costs associated with those responsibilities – with no assurance of corresponding income. With a nominal deposit it is very easy for a buyer to either cancel or “walk away,” leaving the builder with a large investment and little or no cash.
- In these circumstances – where responsibilities and costs are assumed by the home builder and only nominal funds are advanced by the prospective home buyer – the added burden of paying near-term income taxes would exacerbate a home builder’s cash-flow problems. The home builder typically would have to fund this additional up-front tax cost by either (1) using a portion the builder’s existing working capital (thereby reducing the number of additional projects it is able to undertake), or (2) borrowing. The latter

option would be particularly damaging for home builders given the lack of construction financing available from commercial banks.

- If home builders must increase their borrowing – and borrowing costs – to pay the tax, the prices of homes will inevitably increase. The housing market today is improving and is expected to return to “normal” levels by 2017 or 2018, but the pace of the recovery has slowed recently as home prices have risen faster than incomes. Additional upward pressure on home prices will further reduce affordability and slow down the housing sector's rate of recovery – and the economy along with it.
- It is important to recognize that financial reporting rules (i.e., GAAP) require the home-building industry to use CCM for its contracts. This, notably, is not the case for most other long-term contractors, who typically are required to use PCM. The distinction is based on several of the considerations noted above. Since, in the case of the home builder, title does not pass during construction, deposits are small and subject to contingencies, progress payments are not received, and contracts often are cancelled, GAAP does not permit the recording of contract income until the construction is substantially complete and the home sale has closed. Tax accounting rules, of course, need not always follow GAAP. Here, however, where the policy considerations associated with both are so similar, there is every reason for the tax code to reflect financial accounting principles.
- The administrative requirements to implement PCM are dramatically more burdensome than those associated with CCM or even PCCM. It is fairly typical for a large production home builder to have several thousand active contracts at the end of a year. Since, as just noted, home builders use CCM for book purposes, a requirement to use PCM for tax purposes would be exceedingly burdensome. Home builders would be required to perform, in addition to the complicated CCM income calculations currently required of them by GAAP, even more complicated PCM computations for all “unclosed” contracts in progress (even for those noted above that may never result in the actual sale of a home). Moreover, home builders do not currently have the systems necessary to implement PCM. The additional costs for such systems, as well as for the manpower needed to operate them, would add to the overhead of the home builder – which again would lead to higher home prices.
- The prospect of PCM being imposed on a home builder could lead to unwanted changes in business practices that serve no useful purpose other than that of avoiding a draconian tax provision. Purchase agreements could become “reservations,” and contracts could be revised to take the form of options to buy a home rather than home construction contracts. These changes would add to the uncertainty of the housing market with potential harmful overall consequences.

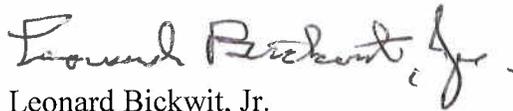
Most of these arguments have been raised before – and accepted by the Congress – with respect to earlier proposals regarding accounting for long-term contracts. In this regard, it is important to understand the sequence of events that led to the current home-builder exemptions from PCM. The *Tax Reform Act of 1986* and the *Revenue Act of 1987* each sought to tighten the tax accounting rules for long-term contracts in order to prevent perceived abuses of extended deferral, especially with respect to the defense industry. At the time, home builders largely believed these changes would not impact them, since their agreements with customers were viewed as sales contracts, not construction contracts. Shortly thereafter, however, the IRS released Notice 88-66, which characterized a typical home sale contract for a yet-to-be-built home as a home construction contract that would have to be accounted for under PCM. In response, the home building industry raised essentially all of the concerns discussed above regarding PCM's adverse impact on home builders in particular and the market for homes generally. Congress recognized the need to provide relief and included in the *Technical and Miscellaneous Revenue Act of 1988* the current exemptions from PCM for home construction and residential construction contracts.

The same reasons that prompted Congress to act at that time continue to be applicable today. The justifications for exempting home builders from PCM are every bit as forceful now as they were in 1988. The Congress should therefore recognize that fact, reach the same conclusion it did 25 years ago, and continue in effect the current home builder exemptions from PCM. The record simply does not provide a reason to change course.

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We appreciate the opportunity to comment on tax issues of great importance to the home building industry and to the economy as a whole. If you have further questions, please contact either of us using the above contact information.

Respectfully submitted,



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George A. Hani

Attachment



LEADING BUILDERS OF AMERICA
2014 MEMBERS

Ashton Woods Homes

Beazer Homes

Brookfield Residential Properties

David Weekley Homes

The Drees Companies

D.R. Horton

Hovnanian Enterprises

KBHome

Lennar Corporation

M.D.C. Holdings

Meritage Homes

M/I Homes

Perry Homes

PulteGroup, Inc.

Ryland Group

Shea Homes

Standard Pacific Homes

Taylor Morrison Homes

Toll Brothers, Inc.

Weyerhaeuser Real Estate Company

Woodside Homes