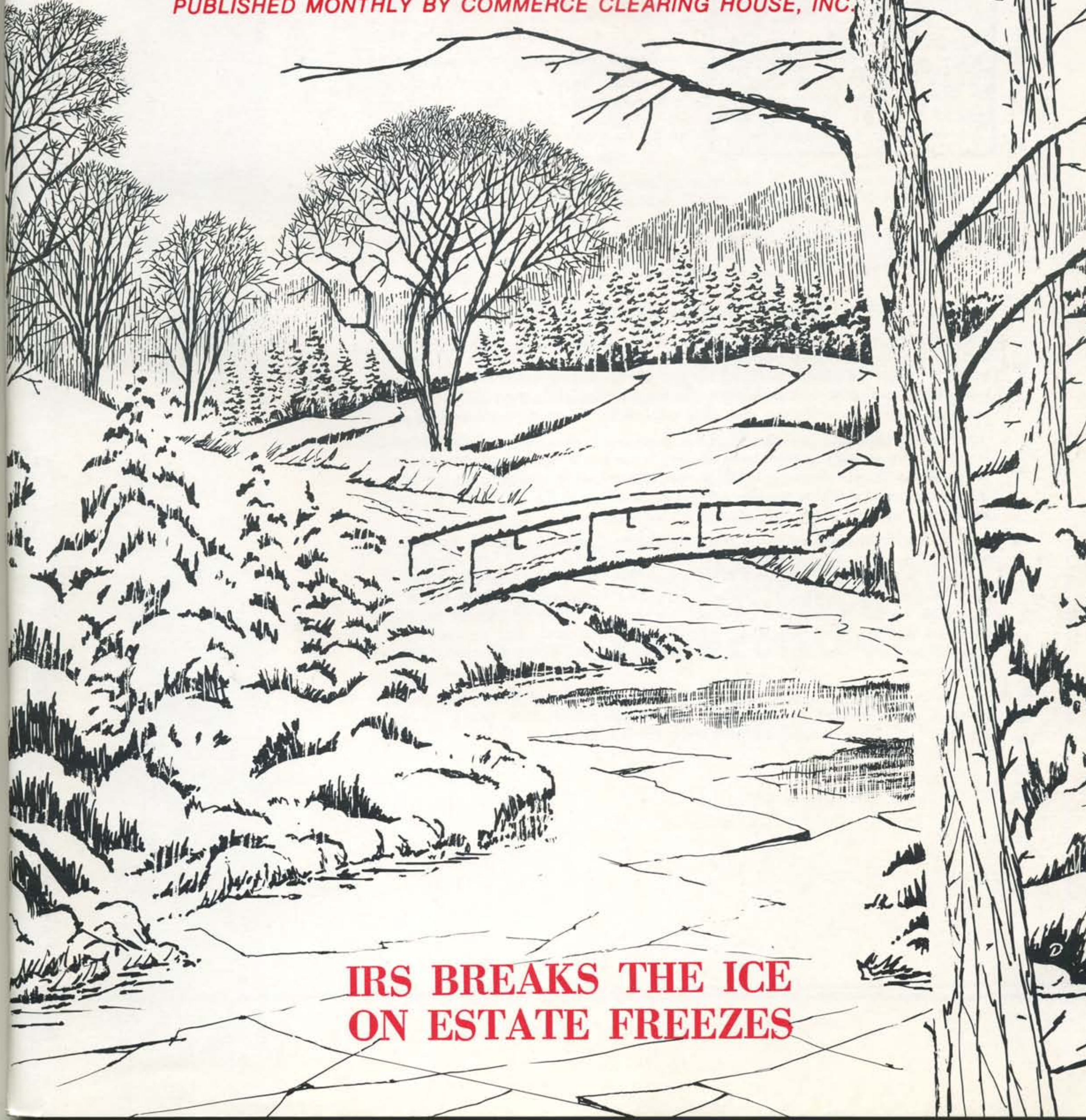
JANUARY 1990

taxes

THE TAX MAGAZINE

PUBLISHED MONTHLY BY COMMERCE CLEARING HOUSE, INC.



IRS BREAKS THE ICE ON ESTATE FREEZES

TAXES ®
The TAX MAGAZINE

CONTENTS

JANUARY 1990 • VOL. 68 NO. 1

Thus Spake the Commissioner: Advance Notice 89-99 and the Scope of the Section 2036(c) Estate Freeze Ban **3**

Long-awaited guidelines regarding estate freezes have finally been issued by the IRS. *Hamlin C. King* explores the impact that Notice 89-99 will have on estate planning.

IRC Section 460: Long-Term Construction Contract Issues **30**

Sheldon D. Pollack analyzes the new long-term contract accounting rules under Section 460, their application to construction contracts typically used by residential real estate developers, and the impact of Notice 89-15 on taxpayers who, prior to 1989, had treated their long-term construction contracts as not subject to Section 460.

Determining Valid Legal Authority in Advising Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties: The Impact of IMPACT **40**

Updating an earlier *TAXES* article, *Sheldon I. Banoff* considers what constitutes good legal authority in avoiding penalties on tax returns in light of the Improved Penalty Administration and Compliance Tax Act of 1989.

Unwrapping the ESOP Package **62**

Arthur H. Kroll and *Andrew L. Oringer* discuss, among other issues, the use of proceeds from the sale of suspense account stock to extinguish ESOP debt.

Avoiding Controlled Group Status: Growing Motivations and Challenges **70**

Joseph R. Oliver focuses on ways in which multiple corporations may avoid single-entity status.

Uniform Capitalization and the Oil and Gas Industry: The Challenge of Compliance **79**

The application of the UNICAP rules to oil and gas producers, including special problems that result under the rules, is explored by *Patrick Hennessee* and *Stephanie Bone*.

Assignment of Income: Gifts of Stock and Dividend Income **87**

Janet A. Meade examines the effect of a recent court of appeals decision allowing a taxpayer to avoid recognition of income on gifts of stock taking place between the dividend declaration date and the date of record.

Tax Pointer—New Standard Mileage Rate Rule Favors Taxpayers **94**

DEPARTMENTS:

Tax Notes **2**

In Washington **29**

International Journal **39**

State Taxes **69**

Tax Meetings **95**

This magazine is published to promote sound thought in economic, legal and accounting principles relating to all federal and state taxation. To this end, it contains signed articles on tax subjects of current interest and reports by the CCH Tax Law Editors on recent federal and state tax matters.

The editorial policy is to allow frank discussion of tax issues. On this basis contributions are invited. Responsibility is not assumed for the contents of the articles or for the opinions expressed therein.

Editor
Maureen K. Schwartz

Washington Editor
Paul B. Alligood

Business Manager
James A. Merchant

Circulation Manager
Donald B. Izban

Production
Barbara A. Wrobel

TAXES—The Tax Magazine (ISSN 0040-0181) is published monthly by Commerce Clearing House, Inc., 4025 W. Peterson Ave., Chicago, IL 60646. Second-class postage paid at Chicago, Illinois. **POSTMASTER:** SEND ADDRESS CHANGES TO TAXES—*The Tax Magazine*, 4025 W. PETERSON AVE., CHICAGO, ILLINOIS 60646. *Subscription rate:* $90, 1 year: $10 single copy. January 1990, Vol. 68, No. 1. Change of address should be received at least 30 days before the date of the issue with which it is to take effect.

© 1989, Commerce Clearing House, Inc. All rights reserved. Printed in U.S.A.

IRC Section 460: Long-Term Construction Contract Issues

By SHELDON D. POLLACK

The author considers whether the new long-term contract accounting rules prescribed under Section 460 apply to certain types of contracts typically used by residential real estate developers and discusses the impact of Notice 89-15, relating to the adoption of accounting methods under Section 460 by taxpayers who formerly treated long-term construction contracts as not subject to Section 460 prior to 1989.

Sheldon D. Pollack is an attorney with the Philadelphia law firm of Ballard, Spahr, Andrews & Ingersoll.

© 1989, Sheldon D. Pollack

Background

This article considers the issue of whether the new long-term contract accounting rules prescribed under Section 460 of the Internal Revenue Code of 1986 (the "Code") apply to certain types of contracts typically used by residential real estate developers. In addition, this article discusses the impact of the IRS's newly announced position concerning the adoption of the tax accounting methods mandated under Section 460 by taxpayers who formerly treated these types of contracts as not subject to Section 460 in taxable years prior to 1989.

History of Long-Term Contract Accounting. Under Section 460(f)(1), a long-term contract is a building, installation, construction or manufacturing contract which is not completed within the taxable year in which it is entered into. For taxpayer's engaged in businesses in which long-term contracts are typically employed, it has been long recognized that problems inevitably arise as to the bunching of income, and the mismatching of expense deductions with the income earned under the contract. To alleviate this problem and provide for a more accurate matching of income with related expenses, taxpayers traditionally have been allowed to use a more favorable tax accounting method (the completed contract method) under the authority of judicial doctrines

enunciated soon after the enactment of the earliest federal income tax. These judicial doctrines provided for use of the completed contract method under certain prescribed circumstances by qualified taxpayers. In 1956, Treasury proposed Regulation § 1.451-3(d) (adopted in 1957, amended 1987), which codifies most of these established judicial doctrines.[1]

Since the use of a cash or accrual method may create a bunching of income and a mismatching of expenses with related income, qualified taxpayers were permitted to use the completed contract method (or the percentage of completion method) at their own discretion. However, once a particular method is adopted, it must be adhered to consistently and cannot be changed without the consent of the Commissioner.[2]

Where a taxpayer who is engaged in the business of construction or building receives substantial progress payments which would be taken into income under a cash or accrual method, the taxpayer generally would find it advantageous to adopt the completed contract method in order to defer the recognition of income. In such a case, profit (or loss) on the contract would be deferred until the contract is completed since the deduction of related expenses and the taking into income of the contract price are deferred until the year of completion. Typically, large defense contractors used the completed contract method to defer income recognition for long-term contracts under which substantial progress payments would be made prior to the completion of the contract. Conversely, a typical residential homebuilder who receives only minimal (perhaps contingent, and therefore, refundable) deposits on its long-term contracts would have found it more advantageous to use the accrual method. This is because there was no substantial income to accrue under their contracts prior to settlement, while expenses likely would be deductible prior to closing. Apparently, use of the accrual method was the norm in the homebuilding industry prior to 1986.

In 1986, pursuant to the Tax Reform Act of 1986 ("TRA"), Congress chose to limit the tax deferral attained by use of the accrual or completed contract methods by requiring that taxpayers use only the percentage of completion method or (as a compromise) the hybrid percentage of completion/capitalized cost method.[3] Under this hybrid method, the taxpayer was required to report 40 percent of income derived from long-term construction contracts under the percentage of completion method, with the balance reported under the taxpayer's "normal" method of accounting (be it the accrual or completed contract method). In subsequent legislation in 1987 and 1988, for taxpayers using the hybrid method, Congress increased the portion of income that must be reported under the percentage of completion method from the initial 40 percent to 70 percent, and then to 90 percent. Finally, the Omnibus Budget Reconciliation Act of 1989 (passed by Congress on November 22, 1989) repealed altogether the hybrid method, leaving the percentage of completion method as the only generally permitted method for reporting income derived from long-term construction contracts. Apparently, Congress has decided that any use of those methods formerly permitted was an abusive situation because they provided an inaccurate reflection of the taxpayer's income. The most direct discussion and extensive explanation of that abuse which Congress specifically intended to rectify in enacting Section 460 is found in the Report of the Staff of the Joint Committee on Taxation (the "Blue Book"):

> The Congress believed that the completed contract method of accounting for long-term contracts permitted an unwarranted deferral of the income from 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.[4]

The Joint Committee Report suggests that the perceived abuse was the use of the completed contract method by "certain large defense contractors" who deferred taxation on significant amounts of income of which they already had

[1] See Mertens, *Law of Federal Income Taxation* § 12.136 (1985) ("To alleviate the problem of the bunching of income for contractors predominantly engaged in long-term contracts, relief is provided in the regulations. The methods of relief for spreading the effects of the income under long-term contracts are the completed contract method and the percentage of completion method.").

[2] Reg. § 1.451-3(f).

[3] See IRC Sec. 460(a) and (b).

[4] *General Explanation of the Tax Reform Act of 1986,* Staff of the Joint Committee on Taxation (the "Blue Book") at p. 527.

the use, benefit, and possession. Nonetheless, as this statute was worded it applies to *all* taxpayers with long-term construction contracts. Therefore, Section 460 also restricts the use of the accrual or completed contract methods by homebuilders who typically do not receive progress payments. While it has been suggested that the statute was not intended to restrict the accounting practices of small homebuilders using the accrual method, a literal reading of the provision clearly indicates that it is applicable to all taxpayers who have long-term construction contracts.

Typical Developer Contracts. Consider the type of contract which is generally employed where a developer owns a tract of land and builds individual homes upon subdivided lots. Customers who wish to purchase a home select an available lot, choose a home design from several available models, and execute a contract under which they agree to buy such lot and house at a future date. In turn, the developer agrees to sell the house to the buyer on the future date. Under the specific terms of the typical contract (which is often designated as an "Agreement of Sale"), the developer retains title in the property until closing, bears all economic risk until closing, and finishes construction under his own terms and direction. There are no "progress payments" made prior to closing, and usually there is only a minimal down payment made by the buyer. In the absence of special payments made in regard to upgrading materials or custom-built features, the standard practice often is that the down payment not exceed 5 percent of the total sale price. This down payment 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. Likewise, under the terms of the typical contract the down payment deposit constitutes the only damages recoverable by the developer in the event of a default on the part of the buyer.

Due to these features of the typical contract used by real estate developers, many tax practitioners took the position after the enactment of Section 460 that the developer was not promising to construct a house for the buyer, and thus that such contracts are not "construction contracts." Under the specific terms of these agreements, the developer does not have a legally enforceable right to the stated "sale price," nor does the buyer have an enforceable right to the house (i. e., the right to specific performance enforceable in action in contract).

IRS Authority and Prior Reporting Positions. Based upon this type of analysis, and under the authority outstanding at the time, many tax practitioners concluded that there was a strong position for taxable years 1986 and 1987 holding that contracts with such features as those described above are *not* "construction contracts" subject to Section 460 for purposes of either the regular income tax or the alternative minimum tax. Such analysis of the rights established between the parties to these contracts supported the position that they should be treated as agreements of sale, rather than as "construction contracts" within the meaning of Section 460.

Later, the tax community realized that the IRS seemingly took a contrary position. The IRS's position was first revealed in an example given in Notice 88-66 (issued in June 1988, and thus applicable authority for 1988, but not necessarily any prior year). Ostensibly, Notice 88-66 provided procedural guidance as to the application of Section 460 and the adoption of the required methods of accounting. However, the example given in the notice also suggested that under certain facts and circumstances, purported "agreements of sale" must be treated as long-term construction contracts. Yet the paucity of facts provided in the example made it impossible to determine with any certainty whether the agreements under review had features similar to those found in the typical contract used by developers (i. e., whether under the agreement there was a binding legal obligation to build a house). The IRS's position was obliquely presented in Notice 88-66; it was neither developed nor reasoned. Furthermore, no authority at all was cited in support of its apparent view that any contract executed within the context of the sale of a house which is not yet completely constructed, is subject to the new Section 460 accounting rules.

In addition to the position implied in Notice 88-66, conversations in 1988 with attorneys for the Legislation and Regulations Division of the IRS indicated that it was the IRS's position that the crucial factor was whether the house under contract was not yet completely constructed as of the date upon which the contract was entered into. The parties' characterization of the contract as an "agreement of sale," as

well as the underlying rights of the parties under the contract, was viewed as irrelevant by the IRS in determining whether the contract is or is not properly treated as a "construction contract." However, no authority was offered to support this conclusion.

IRS Notice 89-15

On January 12, 1989, the IRS issued Notice 89-15, providing additional analysis and guidance as to the IRS's construction of Section 460 as well as the amendments made to the statute by the Technical and Miscellaneous Revenue Act ("TAMRA") of 1988. It came as no surprise that the IRS reiterated and amplified its position (previously only implied in Notice 88-66) that contracts for the sale of a house not yet completed are always subject to Section 460 accounting rules as construction contracts:

> Q-4: Is a contract considered to be for the ". . . construction of property," even though the contract provides that the contractor is to retain title to, control over, and risk of loss with respect to the property until it is completed and accepted by the customer, and even though the parties characterize the contract as a contract for the sale of property?
>
> A-4: Such a contract is considered to be for the ". . . construction of property," if the . . . construction of the subject matter of the contract is necessary in order for the taxpayer's contractual obligations to be fulfilled, and if the . . . construction has not been completed at the time that the contract is entered into. It is not relevant whether the customer has title to, control over, or risk of loss with respect to the property. Moreover, it is not relevant whether the parties characterize their agreement as a contract for the sale of property.[5]

Examples (1) and (2) of Notice 89-15 illustrate this position under facts which appear at first glance to be comparable to those present in the case described above of the typical residential home developer; however, as will be argued below, the terms of the contracts in these examples in fact may be distinguishable in significant ways from those present in the contracts typically used by developers.

Notice 88-18 states the additional principle that where a taxpayer has "failed to comply with Section 460" in prior taxable years, it must change its method of accounting for long-term contracts to conform to Section 460. The IRS announced that it will grant consent to such a change in its accounting method *only* if: (1) the applicable statute of limitations will permit the assessment and recovery of all income not taken into account by the failure to comply with Section 460, and (2) the taxpayer files amended returns for all such taxable years. Where the statute of limitations is closed as to a year in which the taxpayer failed to report income and expenses under Section 460, consent to change its method of accounting will only be granted under the conditions imposed by Section 481. Under that statute, consent will be granted only pursuant to an "adjustment" (i. e., payment of tax liability) as is required in order to avoid the omission of any income from any prior tax return (including taxable years now closed by the statute of limitations). Where the taxpayer has "voluntarily" requested a change in accounting method, the Section 481 adjustment may be spread out over future tax years, whereas if the IRS requires a change in method (such as would result from an audit), then the adjustment is recognized in the entirety in the year of the change in method. Obviously, this new procedure imposes a cost (i. e., tax liability) upon a taxpayer who failed to conform to Section 460 as to accounting for its construction contracts and now attempts to adopt the proper method of accounting. This cost will correct for any prior improper tax benefits attained by the taxpayer by use of an erroneous method of accounting.

Analysis of Notice 89-15

Contractual Obligation. The specific language of Notice 89-15 provides that a requisite feature of a "construction contract" is that the construction of the house under contract must be a necessary condition of the fulfillment of the taxpayer's contractual obligation. The above analysis emphasized that in the typical developer contract the seller is *not* legally obligated to build a house for the buyer. Since under the terms of such an agreement the seller can choose not to build or convey the house, with the sole consequence being a refund of the buyer's minimal down payment, it could be argued that such an agreement should not be characterized as a construction contract. Indeed, under this type of agreement there may be no "binding contract"

[5] IRS Notice 89-15, Q&A (4); see also Examples 1–5.

at all created by the parties to the extent that either can walk away with only minimal economic consequences.

There is authority elsewhere in the Code and regulations holding that there is no "binding contract" where damages are limited as liquidated damages in an amount equal to less than 5 percent of the total contract price.[6] Thus, if this standard was to be applied to the question at hand, where the down payment is less than 5 percent of the sale price, there would be no binding contract. In the absence of a binding contract, the long-term contract accounting rules simply would not apply. In addition, Notice 89-15 can be viewed as actually supporting such a position to the extent that its finding of a construction contract directly and expressly relies upon the presence of a binding contractual obligation to construct the subject matter of the contract, a legal obligation that is absent (in substance, although not necessarily in form) in the contracts considered here.

The above argument also is consistent with prior law enunciated under Reg. § 1.451-3(c), concerning the recognition of the "gross contract price" into income under the percentage of completion method, as well as the IRS's current consideration of this principle as stated in Q&As 27 and 28 in Notice 89-15. These authorities address the issue of what amounts must be taken into consideration in computing "gross revenue" under the contract for purposes of applying the percentage of completion method as to each year under the contract. According to these authorities, the "total contract price" (for purposes of determining the amount that must be taken into income for a particular year under the contract) includes all amounts that the builder is "entitled to receive under the contract," assuming that all reasonably predictable events will occur. Under this standard, even if the developer's contracts were to be treated as construction contracts subject to Section 460, there is *no amount* that would be taken into consideration in computing "gross contract revenues" since the developer has no legally enforceable right to any portion of the stated sale price. Indeed, the developer is not "entitled to receive" the stated sale price from the customer under *any* rule of law.[7] Furthermore, even the down payment would not be included in the "gross contract revenues" to the extent that an accrual basis taxpayer would not accrue into income such down payment at the time of execution of the contract given the various contingencies to which it is subject. Thus, even if there was found to be a binding contract (due, perhaps, to a down payment in excess of 5 percent of the sales price) no amount would be taken into income under the percentage of completion method given the absence of an accruable gross contract price.

Under these principles, there simply is no binding, legally enforceable "construction" contract under the agreements at issue here. Nor does the application of the percentage of completion method make any conceptual sense where either party can walk away from the contract. On the other hand, it must be recognized that under the express terms of such contracts the developer is agreeing to sell a house, the construction of which is necessary in order to fulfill such legally enforceable promise. Despite the liquidated damages provisions which effectively dilute and negate the impact of this obligation in the event of a default by the developer, the IRS will likely persist in arguing (and a court might very well agree) that these contracts fall under the broad definition of a construction contract as set forth in Notice 89-15, Q&A-4.

Option. In light of the underlying economic substance of these contracts, one possible alternate characterization is that they should be viewed as "options" purchased by the buyer. Indeed, from the economic perspective of the buyer, these contracts amount to something even less than an option. Since the seller can refuse to close with no economic cost to him other than being bound to refund the down payment, the buyer of these options is not even guaranteed the possible up-side appreciation that might occur during the period between execution of the agreement and closing. Technically, the buyer's "call" cannot be enforced against the seller since a refund of the price paid for the option is his only remedy available.

---

[6] See, e. g., Temp. Reg. § 1.469-11T(c)(7)(i) ("A contract shall be treated as a written binding contract of a person for purposes of this Section if and only if the contract is enforceable against such person under the applicable State law and does not limit damages to a specified amount (e. g., by use of a liquidated damages provision). For purposes of the preceding sentence, a contractual provision that limits damages to an amount equal to five percent or more of the total contract price is not treated as limiting damages.").

[7] See Notice 89-15, A-27 (the amount included in gross contract revenue equals "[a]ll amounts that the taxpayer is or will be entitled to receive from the customer under the contract, or any other rule of law (including, for example, the contract law rule of quantum merit, or other quasi-contractual remedies). . . .").

If these contracts can be successfully characterized as options, there is some authority for excluding them from the long-term contract rules. Legislative history to the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") located in the House Committee Report indicates that it was anticipated that Treasury would prescribe regulations at a future date directed at any abuses that may arise where "options, or other similar arrangements" are used to avoid the application of the long-term contract rules. The committee suggested that such an abusive situation would arise where "considering the amount paid or required to be paid by the purchaser to the taxpayer prior to the exercise of the option and the amount of costs incurred by the taxpayer in producing the property prior to the exercise of the option, it is likely that the purchaser will exercise the option." Although there is no guidance as to how this standard will be applied, it seems safe to assume that where an option is purchased for an amount equal to only 5 percent of the total contract sale price such should not be sufficient to justify treating the option-holder as economically "likely" to exercise the option. Furthermore, given the limited economic benefits that attach to such an option in regard to up-side appreciation, it is difficult to imagine why this case should be treated any more harshly than one involving a genuine option in which the optionee actually can benefit from any possible future economic appreciation by paying in the additional 95 percent of the contract price by exercising the option. However, despite this analysis of the underlying economic substance of these contracts, their form is ostensibly that of a contract for the sale of a house, the construction of which is necessary in order to fulfill such agreement. Therefore, it must be stressed again that the IRS will likely continue to argue that these contracts are construction contracts, and not options.

Amended Returns? The IRS's new procedure for granting approval for a change in accounting method creates significant difficulties for taxpayers who, based upon arguments similar to those presented here, previously did not report contracts as long-term construction contracts, but now wish to abandon their prior position and thereafter account for their contracts under Section 460. Of course, to the extent that the contracts in fact are *not* construction contracts, the taxpayer never "failed" to comply with Section 460 in prior taxable years. Likewise, there would be no need to currently change the taxpayer's method of accounting for this type of contract or to file amended tax returns for prior taxable years (i. e., 1986, 1987 and 1988) if the contracts are not construction contracts. This new procedure is only applicable where genuine "construction contracts" (as defined under the principles in effect since Reg. § 1.452-3 and undisturbed by the enactment of Section 460 or its amendments) were not properly accounted for in 1986, 1987 and 1988 under Section 460, and the taxpayer thereafter wished to change to the proper method of accounting for such contracts. This simply is not the case to the extent that the taxpayer can successfully argue that its contracts are not, and never were, construction contracts subject to Section 460.

Of course, should a taxpayer take such a position and ever be forced to litigate this point with the IRS and lose, then at that time a "Section 481 adjustment" would be required as a condition for granting permission by the Commissioner to change to the proper accounting method. Section 481 was added to the 1954 Code (with no comparable provision under the 1939 Code) to provide a mechanism whereby adjustments are made to a taxpayer's income when computing taxable income under a method of accounting different from that under which taxable income for the preceding year was computed. This statute requires that there shall be taken into account in computing taxable income for the year of change those adjustments that are necessary (solely by reason of the change) in order to prevent amounts from being duplicated or omitted.[8]

If it ever transpires that the IRS successfully challenges the taxpayer's treatment of this type of contract, and a Section 481 adjustment is required in a future tax year, the cost imposed at that time would be greater (beyond interest charges) than a current change in accounting method adopting Section 460. At such a time as challenged by the IRS, the statutorily provided option to "spread" the Section 481 adjustment over future taxable years would be unavailable. In addition, penalties will be asserted to the extent that the IRS persists in its recently announced position that there was no substantial authority for treating these types of contracts

[8] See Mertens, *Law of Federal Income Taxation* § 12.15 (1988) ("The general intent. . . is that no income or deduction shall be omitted or duplicated as a result of the accounting method"); see also Bauernfeind, *Income Taxation: Accounting Methods and Periods* Chapters 33–35 (1988).

as not subject to Section 460.[9] Only adequate disclosure on such a tax return would allow the taxpayer to avoid penalties for this treatment of the contracts after 1988.

The difficulty presented by the procedure established in Notice 89-15 (regarding the filing of amended returns as a prerequisite for a change in accounting method) arises when a taxpayer decides to abandon an admittedly erroneous treatment of these contracts. At such time, for instance in taxable year 1989, the taxpayer will be viewed by the IRS as changing its current method of accounting for these contracts. Under Section 446(e), such a change in accounting method requires the consent of the Commissioner, or in lieu of such individually granted consent, the Commissioner may issue a broad statement granting consent (often granted with conditional requirements) to a general class of taxpayers.[10] This procedural consent is granted in Notice 89-15 upon the condition of filing amended returns or making a Section 481 adjustment, if one is necessitated by the closing of a prior taxable year.

Requiring the filing of amended returns as a precondition for the granting of permission to conform to a statutorily provided method of accounting is a unique procedural policy. Indeed, to the extent that a taxpayer now wishes to comply with the statutory provisions of Section 460, he is essentially being *required* to file amended returns. However, the extent to which the IRS has the authority to require the filing of amended returns in any context is uncertain. Admittedly, certain regulatory provisions provide for and anticipate the filing of amended returns.[11] Yet, as has been stated by the U. S. Supreme Court, none of these provisions "requires the filing of such a return."[12] It is questionable, and certainly open to challenge, whether in a procedural announcement the IRS can effectively require a taxpayer to file amended returns as a precondition for permission to comply with requirements imposed upon the taxpayer by a congressional statute. One would surely expect to see this issue litigated in future cases and controversies.

Home Construction Contracts. Pursuant to an exemption provided by TAMRA for "home construction contracts" within the meaning of Section 460(e)(6)(A), qualified contracts are exempt from the Section 460 accounting rules for contracts entered into after June 21, 1988, for the purposes of computing regular income tax. Thus, it would not be necessary to change methods of accounting for these contracts to the extent that they are "home construction contracts" exempt under Section 460(e)(1)(A), and the taxpayer is subject to regular income tax. However, this exception does not apply to accounting for long-term construction contracts for purposes of computing the alternative minimum tax ("AMT").[13] Under the AMT, the percentage of completion method is required in accounting for long-term home construction contracts. Therefore, if the taxpayer were to concede the IRS's position in 1989 that these contracts are construction contracts, and hence subject to Section 460, he still would need to change at that time to the percentage of completion method when computing AMT, regardless of whether the contracts are exempt as home construction contracts.

The IRS's position in the event of a subsequent change to conform with Section 460 for purposes of computing AMT again will be that consent is required at that time for such a change in accounting method, even though changing from an erroneous method to a correct method. In their view, such a treatment of these contracts in 1986 through 1988 was an "erroneous" accounting method, but one which the taxpayer cannot change from without the Commissioner's consent. While such a reading of Section 446(e) that consent is required to change from an erroneous method to a correct method was initially challenged by taxpayers, the IRS's view was later upheld by courts that considered this construction of the statute and the Commissioner's authority to issue regulations conforming to this position.[14] The IRS's view would be that consent is required to change to the percentage of

[9] See Comments by IRS attorneys, Federal Bar Association's 13th Annual Tax Law Conference (March 17, 1989), reported in *Tax Notes Today,* March 20, 1989 (89 TNT 62-6).

[10] See Reg. § 1.446-1(e)(3)(ii) ("the Commissioner may prescribe administrative procedures, subject to such limitations, terms, and conditions as he deems necessary to obtain his consent, to permit taxpayers to change their accounting practices or methods to an acceptable treatment consistent with applicable regulations").

[11] E. g. Reg. §§ 301.6211-1(a), 301.6402-3(a), 1.6091-2(e), 1.451-1(a), and 1.461-1(a)(3)(i).

[12] *Badaracco v. Commissioner,* 84-1 USTC ¶ 9150, 464 U. S. 386 (1984).

[13] IRC Sec. 56(a)(3) (1986 Code).

[14] See *Witte v. Commissioner,* 75-1 USTC ¶ 9477, 513 F.2d 391 (CA-D. C.) rev'g CCH Dec. 31,609(M), 31 TCM 1137 (1972) (taxpayer's proposed change in method of erroneously reporting gain on sale of real estate from the cost recovery to completed contract method constituted change requiring consent of Commissioner under Section 446(e) in order to avoid distortion of income to detriment of government); see also Reg. § 1.446-1(e)(2)(i).

completion method for computing the AMT, and a Section 481 adjustment would be imposed as a condition for granting such consent. In addition, failure to obtain consent for a change in accounting method could result in penalties being asserted for the year of change (if it were still an open year), given the clear regulatory and judicial authority upholding this requirement.

To summarize, the taxpayer who previously treated this type of contract as not subject to Section 460 has the following limited options: continue for taxable year 1989 and thereafter to report these contracts under its current accounting method (i. e., as not subject to Section 460), even for AMT, thereby incurring exposure to penalties beginning with taxable year 1989 for such a reporting position in the absence of adequate disclosure; or request the Commissioner's consent to change accounting methods (incurring a Section 481 adjustment or complying with the procedures of Notice 89-15 by filing amended returns).

Adoption vs. Change of Accounting Method. An alternative argument is that in these circumstances the taxpayer is merely "adopting" a new accounting method for which the Commissioner's consent is not required, rather than "changing" from a current method. Such a position would need to have been taken in 1988 and applied consistently to all home construction contracts entered into after the June 21, 1988 effective date of the exception for home construction contracts. This position is based upon the premise that a taxpayer need not obtain the Commissioner's consent to adopt a new statutorily prescribed method of accounting for special items (i. e., the newly designated category of "home construction contracts"). The requirement in Reg. § 1.446-1(e)(2)(i) holding that consent is required to change accounting methods contains the following qualification: "Except as otherwise expressly provided in chapter 1 of the Code. . . ." Elsewhere, Reg. § 1.446-1(c)(iii) describes "permissible" methods of accounting, and therein contains language describing "chapter 1 of the Code" as including the Section 481 rules relating to long-term contract methods. Section 460 also would be included in this category of statutorily prescribed methods the adoption of which are apparently excluded from requiring the Commissioner's consent under Section 446(e). In other words, it could be argued that Section 460 imposes an altogether new accounting method for home construction contracts entered into after June 21, 1988, and thus no permission is required to adopt and conform to such a statutorily mandated method of accounting.

Crucial to this argument is the assumption that Section 460 simply did not apply to these contracts prior to the June 21, 1988 effective date of the exception for home construction contracts. This premise rests upon the fact that Congress and the tax committees made no inference as to the applicability of Section 460 to these contracts from the period of February 28, 1986 to June 20, 1988 (the "interim period"). TAMRA simply declared that after the June 21, 1988 effective date, home construction contracts will henceforth be exempt from Section 460 for regular tax purposes and subject to the percentage of completion method for AMT purposes. Congress simply did not speak to the applicability of Section 460 to these contracts during the interim period.

The obvious difficulty with this argument is that if it were claimed that such contracts are now covered by the exception for home construction contract, then implicitly they must be long-term construction contracts. In effect, to claim that the contracts are now under the exception is to concede that they were previously subject to Section 460 between February 28, 1986 and the June 21, 1988 effective date. Such an implicit concession may lead a court to the conclusion that the taxpayer had knowingly changed from an erroneous accounting method to a permissible method without obtaining the Commissioner's consent. The appropriate response would be that the post–June 21, 1988 method is a newly mandated required method which can be "adopted" regardless of whatever method the taxpayer was previously reporting under, without obtaining permission of the Commissioner.

Of course, even if the taxpayer successfully litigates this issue relating to its method of accounting, deficiencies could still be asserted for taxable years 1986–1988 (if still open) unless the taxpayer also successfully litigates the underlying substantive issue concerning whether these contracts were in fact "construction contracts" subject to Section 460 from February 28, 1986 to June 21, 1988. This would be the more difficult position to sustain.

Conclusions

There is a strong argument to the effect that agreements for the sale of property which contain the legal provisions described above are not "construction contracts" subject to Section 460. Notwithstanding the issuance of Notice 89-15, there was a strong argument even for taxable year 1988 for *not* accounting for such contracts as long-term construction contracts under IRC Section 460. However, given the position taken in Notice 89-15, there no longer is authority for continuing such treatment of these contracts in 1989 and thereafter.

However, changing accounting methods to conform to Section 460 in 1989 will raise additional issues unless amended returns are also filed for prior open years. There is an argument that as to qualified "home construction contracts" entered into after June 21, 1988, applying the percentage of completion method for purposes of computing AMT on a 1988 tax return constitutes the "adoption" of a required method, rather than a "change" from an erroneous method to a permissible method. This argument would likely support the adoption of the percentage of completion method in 1988 for contracts entered into after the effective date of Section 460(e)(1)(A) without obtaining permission of the Commissioner. Nonetheless, if challenged by the IRS, the taxpayer would also need to successfully litigate the underlying substantive issue as to whether these contracts were construction contracts subject to Section 460 from 1986 to 1988. Absent such a successful defense, the IRS could still recover tax liability and interest (and perhaps penalties) for prior "open" taxable years, for the failure to previously treat these contracts as construction contracts subject to Section 460. ●

GAO Recommends Repeal of Section 809

Mutual life insurance companies should be allowed to deduct all policyholder dividends in determining corporate taxable income, the General Accounting Office recommended in a report to the House Ways and Means Committee. The GAO suggested that "this alternative is consistent with the 'prepayment' approach which holds that mutuals have already paid a tax on the earnings distributed as dividends since the excess premiums that were the source of these earnings were initially included in company income."

According to the GAO, the intent of Section 809 is to equalize the percentage of the total income taxes between the mutual life and stock life insurance companies by making the definitions of the types of life insurance income more similar. By isolating the earnings component of mutuals' policyholder dividends, it was hoped that mutual companies would pay taxes on earnings distributions just as stock companies do.

Section 809 requires the calculation of an imputed earnings rate for the mutual companies based on the average earnings rate of stock life insurance companies. The imputed rate represents the return on equity that is assumed to have been earned by the average mutual company and is used to calculate a differential earnings rate for all mutuals.

The GAO's concerns, however, focused on the fact that the tax is regressive both year-to-year and company-to-company. When mutual companies do well, the average mutual earnings rate is high and the differential earnings rate is low, causing subsequent low tax rates. If a company has a bad year, however, the extra taxes comprise a larger proportion of total taxes. The GAO concluded that this result occurs because of the way the differential earnings rate is calculated and applied to all firms regardless of their earnings that year.—CCH STANDARD FEDERAL TAX REPORTS, No. 51, November 29, 1989.