UHY LLP
Certified Public Accountants

CONSTRUCTION INSIDER

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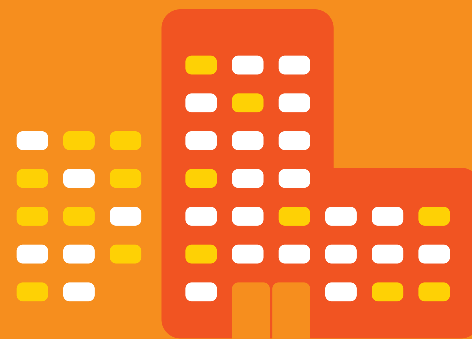

In This Issue:

IRS WON'T BACK DOWN ON "SUBJECT MATTER" ARGUMENT FOR COMPLETED CONTRACT METHOD OF RESIDENTIAL COMMUNITY DEVELOPER

Generally, a taxpayer who receives income from a contract in a year other than the year the contract was entered into must use the percentage of completion method. This method calls for the taxpayer to recognize income over the life of the contract based on the percentage of costs incurred compared to the estimated total costs of the contract. Exceptions exists for certain construction contracts that are either: (1) a home construction contract; or (2) a construction contract estimated to be completed within 2 years (but only for taxpayers that have average gross receipts for the 3 preceding taxable years that do not exceed $10,000,000).

If a taxpayer qualifies for one of the exceptions, a permissible method of accounting for long-term contracts is the completed contract method. Under the completed contract method, a taxpayer accounts for the entire long-term contract (both income and expense) in the year the contract is completed.

A contract is considered completed under Regulation §1.460-1(c)(3) when either: (1) "[u]se of the subject matter of the contract by the customer" and the taxpayer has incurred at least 95 percent of the total costs of the contract; or (2) completion and acceptance of the subject matter of the contract. It was the date of completion for a contract that lead to the following case.

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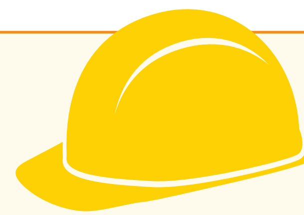

SAVE THE DATE!

UHY LLP's Construction Outlook will be held on Tuesday, November 7, 2017.

Contact Nicole Turner at nturner@uhy-us.com or 586 840 3639 to save your seat.

We hope to see you in November!

IRS WON'T BACK DOWN ON "SUBJECT MATTER" ARGUMENT FOR COMPLETED CONTRACT METHOD OF RESIDENTIAL COMMUNITY DEVELOPER, CONT.

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Shea Homes case

Shea Homes, Inc., through itself and other related entities, develops large residential communities. These communities include homes, infrastructure and numerous common amenities such as golf courses, restaurants and other recreational activity spaces. The taxpayer used the percentage of completion method because their developments were considered home construction contracts.

The issue of the case was on what date were the contracts "complete" for purposes of revenue recognition. Shea Homes argued that the contract was complete when they incurred 95 percent of the costs of the entire development. The IRS countered, asserting that the completion and acceptance test should apply. It was the IRS's position that the contract was completed and accepted when each individual house closed escrow (not when the entire development was completed). This was a narrow reading of the subject matter of the contract, while the taxpayer's was a more broad interpretation (and of course, more taxpayer friendly).

The Tax Court ruled in favor of the taxpayer. They held that the contracts were more than just purchase and sale agreements and the contracts included the costs of common improvements to the community. Potential buyers were buying into the community and paying more for the amenities offered, not just buying the houses and land upon which they were built.

The IRS appealed the decision to the Ninth Circuit Court of Appeals. The Court of Appeals again ruled in favor of the taxpayer finding the Tax Court did not err in their reasoning.

Action on decision

Even after losing in both the Tax Court and the Court of Appeals, the IRS still believes their interpretation is correct. In Action on Decision 2017-03, the IRS stated they will not follow this decision in circuits other than the Ninth Circuit and will only follow this decision in the Ninth Circuit if the cases cannot be differentiated. Therefore, the official position of the IRS is that for large, residential developments on the completed contract method, the subject matter of the contracts do not include the costs of the entire development. Each house will be considered separately for purposes of when to recognize the income and expenses of the contact.

Conclusion

While the courts ruled in favor of the taxpayer, they did caution other taxpayers who might consider this an opportunity to perpetually and unreasonably defer income. The Tax Court stated that their decision on what constituted the subject matter of the contract was based on a facts and circumstances test. Those facts and circumstances in the Shea Homes case provided a favorable ruling for the taxpayer, but each case will be different.

With the IRS's official position to not follow the holding of the Shea Homes case, any taxpayer similarly situated should anticipate the IRS to contest the method of revenue recognition. It is imperative that extra care is taken to address all of the issues before the IRS comes knocking at your door.

SINKHOLES: A NATURAL PHENOMENON OR CITIES' NEGLIGENCE?

About 50 miles off the coast of Belize lies the Great Blue Hole, a tourist destination that attracts thousands of visitors each year for its mystical beauty and unsurpassed wonderment. Very few things demonstrate the old real estate adage that value is derived from three things: location, location, location. This is because ultimately, the Great Blue Hole is a sinkhole. Yet as sinkholes pop up in cities and neighborhoods, which they have been doing more frequently in recent years, they are viewed much differently.

During the first quarter of 2017, there have been countless reports of sinkholes appearing across the US. The geology of some states, such as Florida and Texas, makes sinkholes more likely to occur than elsewhere.

However, according to a review performed by the Associated Press, approximately 39 significant sinkholes that have occurred, throughout the US, since early December 2016 are the result of cities with failing infrastructure. One such sinkhole, the size of a football field, wreaked havoc on Christmas Eve in the city of Fraser, Michigan, causing three houses and a section of road to be swallowed. The cause of this sinkhole was not nature's beauty, but rather neglected drain and sewer pipes.

Scientists that study natural sinkholes believe that holes created from failing infrastructure are becoming a bigger problem, yet there is no government agency to keep track of these sinkholes from man-made causes. According to a report last year from the American Society of Civil Engineers, public spending is running far short of what is needed to replace water and wastewater systems that will be outdated by 2025.

In the United States, most water lines are at least 50 years old, according to the American Water Works Association. In fact, the lines in use in Washington, D.C. were installed during the Civil War. Old and obsolete cast iron and asbestos cement lines are being replaced with more durable iron or plastic. Maintaining current service lines will cost, at a minimum, $1 trillion over the next 25 years.

In August 2014, a sinkhole more than 30 feet deep opened up in the city of Fraser, Michigan, taking nearly 10 months to repair and costing roughly $55 million. The latest sinkhole in the city is estimated to cost between $70 and $75 million. A local construction company has been awarded the $32.7 million contract to repair the collapsed sewer system.

CAN MICHIGAN BUILD LONGER LASTING ROADS?

As we embark on our daily commute, I am sure we have all asked ourselves, "Is there not a way we can build better roads?" The answer may be in the pilot program the Michigan Department of Transportation (MDOT) is implementing in 2017 and 2018.

A typical Michigan road is built to last approximately 20 years, and has 24 inches of sand and gravel beneath the surface. The purpose of the sand and gravel is to build a stable base and to resist frost in the winter months. The new roads that will be built during the pilot program will have a greater depth of sand and gravel (upwards of 36 inches) and will have a useful life of 30 to 50 years. MDOT plans to build four stretches of road during the program in Genesee and Kent counties. Two roads will be made with concrete and two roads will be made with asphalt. MDOT will monitor the pilot roads over the next several years to determine the cost effectiveness and durability of the new designs.

Of course, with longer lasting roads the state incurs additional costs. The pilot projects will be put out for a competitive bid so the actual costs will not be known until the contracts are signed. However, MDOT estimates that the cost of a 30 year road will be 50 percent to 100 percent more than the cost of current roads. The cost of a 50 year road will be up as much as 85 percent to 150 percent when compared to roads that are being built now.

How will the state pay for these additional costs? In November 2015, Governor Rick Snyder signed a roads fund package to address the needs of Michigan's crumbling infrastructure. The bills hike fuel taxes and registration fees for vehicles that took effect in January 2017. Also, $600 million will be taken from the states' general fund. However, the $600 million will not be fully funded until 2021. A requirement of the bills is for MDOT to investigate longer lasting roads so the state will not have to combat the same issues in the future. The first $100 million of new revenue created annually from the bills will be put into a "lockbox" intended to be used to build the pilot roads.

Although not everyone agrees that the Governor and MDOT are taking the correct course of action, one thing we can all agree on is that something has to be done to replace, repair, and maintain Michigan roads.

"MDOT estimates that the cost of a 30 year road will be 50 percent to 100 percent more than the cost of current roads."

CONSTRUCTION INDUSTRY INSIGHT

UHY LLP's National Construction Practice is comprised of the country's foremost experts in regards to audit and assurance, tax planning and compliance, and business advisory services for the construction industry. We work with a wide range of key industry segments including general contractors, underground contractors, underwater construction, tunnel, and bridge and heavy highway contractors.

As active members of various national, state and local construction associations, state housing councils and specialty trade groups, our team keeps alert to industry trends and opportunities. Our professionals are leaders in the industry and take the steps necessary to ensure our client's future success by identifying and addressing new accounting requirements and regulations. You can depend on us to anticipate major industry issues that might impact your company and help you structure workable solutions.

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