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## Condo Developers Get a Break To Be Spared From “Percentage of Completion” Rule

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It is commonplace for condominium developers to “sell” units in a condominium building to buyers before the construction of the building is complete. These contracts typically feature a relatively small upfront payment, with the bulk of the purchase price to be paid upon delivery of the condominium unit as completed to specifications. Under current law, it appears that, at least in some cases, the developers must recognize income prior to closing on condominium sales. However, a recently proposed regulation would eliminate this burden.

Section 460 of the Internal Revenue Code (the “Code”), subject to certain specific exceptions, requires income earned with respect to “long-term contracts” to be reported on the percentage of completion method. For this purpose, a “long-term contract” is defined as “any contract for the manufacture, building, installation, or construction of property” that is not completed within the taxable year in which the taxpayer entered into the contract. Where a condominium developer receives a down payment, enters into an agreement to sell a unit to a buyer upon completion, and completes construction of the unit in a taxable year subsequent to the year

in which the developer and buyer entered into the contract, in many cases there is a strong concern that all of the income payable to the developer under the contract of sale is required to be reported under the percentage of completion method.

In a nutshell, the percentage of completion method requires the developer to determine the estimated profit from the contract and report the estimated profit each year based on the ratio of the actual costs incurred to total estimated costs. In other words, if the developer completed a substantial portion of the construction required under a contract for the sale of a condominium unit in a given year, the developer would be forced to include a substantial portion of the total estimated profit from the contract in that year, even though the developer may have received only a small down payment or no payment from the buyer in that year. If, on the other hand, condominium developers were not required to report income using the percentage of completion method, they could typically report income only upon the closing of each unit.

Condominium developers typically face cash flow challenges. Even in those rare cases where the developer is allowed to use the buyer’s deposit, the developer is making monthly progress payments to the building contractor,

and the construction lender will generally require much more developer equity in the project than what will be covered by the buyer deposits. When the sales begin to close, the lender must be repaid before the developer can keep any sales proceeds, a situation which frequently causes developers severe cash flow problems. Further, buyers are generally not liable beyond the down payment on the pre-sale of the condominium. In today’s climate, the rising incidence of buyer default has amplified cash flow problems for developers.

The percentage of completion method can further exacerbate the strain on developers’ liquidity by causing developers to report income and pay tax prior to the receiving sales proceeds. For example, assume that in 2007, a developer enters into multiple pre-sales of units in a condominium building to be constructed. The developer takes a 10 percent down payment from the various buyers in 2007, but does not complete construction of the units until 2009, at which time the buyers remit the 90 percent balance at closing. If the developer completes 40 percent of the construction in 2007 and 40% in 2008, the developer will be required to include 40 percent of the expected profits from the sales in each of those years despite the fact that the developer has only received 10 percent of the proceeds (which amount, in any event, may not be avail-

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able to fund the tax liability). As a result, the condominium developer may need to obtain additional financing to cover the negative cash flow generated by the percentage of completion tax liability. Given today's credit markets, this effect of the percentage of completion method is particularly onerous.

Certain types of long-term contracts, such as "home construction contracts" are excepted from percentage of completion treatment. A "construction contract" includes any contract for the "building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvement of, real property." A "home construction contract" is a construction contract pursuant to which 80 percent or more of the estimated total contract costs are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of dwelling units contained in buildings containing four or fewer dwelling units. For this purpose, each townhouse or rowhouse is considered to be a separate building. Thus, if a developer entered into contracts to sell each of ten connected rowhouses to be constructed, each contract would be generally exempt from the percentage of completion method. Conversely, if a condominium developer entered into contracts to sell each of ten units in a to-be-constructed condominium building, the project would not have qualified for the home construction contract exception to the percentage of completion method, because the condominium building contains more than four dwelling units. Condominium developers could not typically qualify for the home construction contract exemption because condominium developments generally have too many units.

Roberts & Holland LLP led an effort to ask Treasury to exempt condominium developers from the percentage of completion method. We called attention to the fact that the percentage of completion method was originally intended to apply to contractors rather than developers and informed Treasury of the onerous burden placed on devel-

opers complying with the method. Perhaps in light of the recent financial troubles befalling the real estate development industry, Treasury was especially receptive to this real estate industry's prayer for relief.

On August 3, 2008, Treasury issued proposed rules amending certain provisions of the percentage of completion rules, including the rules governing the tax reporting of income for home construction contracts. These proposed rules provide significant relief to condominium developers from mandatory percentage of completion income reporting. The proposed regulations provide that "the term townhouse and rowhouse . . . includes an individual condominium unit." This fix ensures that each contract for the sale of a condominium unit will qualify for the home construction contract exception to percentage of completion treatment (so long as at least 80 percent of the total contract costs are attributable to the building, construction, reconstruction, or rehabilitation of such unit).

In addition to expanding the home construction contract exception to clearly include contracts for the construction of condominium units, the proposed regulations also expand the exception to include contracts entered into by land developers in the home construction industry. The proposed rules expand the scope of the home construction percentage of completion exception by providing that a contract for the construction of common improvements, such as sidewalks or roads, is considered a contract for the construction of improvements to real property directly related to the dwelling units and located on the site of such dwelling units, even if the contract does not involve the actual construction of any dwelling unit. Accordingly, under the proposed regulations, a developer that sells individual lots may have a long-term construction contract that qualifies for the home construction contract exemption even though the developer constructs no homes on those lots.

The proposed regulations (including the expansion of the home construc-

tion contract exemption for condominium developers would apply to tax years beginning on or after the date they are finalized. The Preamble to the proposed regulations warns that taxpayers may not rely upon the regulations in reporting their income until the proposed rules are published as final regulations. Treasury has not scheduled a hearing on the proposed regulations until December, 2008, so it is unlikely that the regulations will be finalized in 2008. At the earliest, the regulations could be finalized in 2009, making them effective for the 2010 tax year. Accordingly, despite the current economic crisis of condominium developers, the relief intended for condominium developers may not come until 2010 or later. The Assistant Secretary of the Treasury for Tax Policy, Eric Solomon, has made it clear in various public forums that Treasury will take the current state of the economy into account in the issuance of regulations. On behalf of condominium developers, some practitioners have urged Treasury to make the change to exempt condominium sales from the percentage of completion method available for all taxable years currently open. Despite the fact that the public hearing on the proposed regulations is not scheduled until December of this year, we fervently hope Treasury offers immediate relief to condominium developers. Treasury could remedy the situation by issuing guidance stating that until the regulations are finalized, taxpayers may choose to report sales of condominium units consistent with the proposed regulations.

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