2009 INCOME TAX UPDATE

STEVEN R. GLOVER, CPA, J.D., LL.M.

STEVEN R. GLOVER, CPA, J.D., LL.M. is a tax principal of Miller Cooper & Co., a Deerfield, Illinois CPA firm specializing in the construction and real estate industry. Mr. Glover is a frequent contributor to Construction Accounting and Taxation and is on its Board of Advisors and Contributors. He can be reached at 847/205-5000 or at sglover@millercooper.com. This article is distributed with the understanding that Miller Cooper & Co., Ltd. is not rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use.

A challenging economic climate calls for close scrutiny of tax developments.

The IRS updated during the year its guidance on a few areas specific to the construction industry. And these developments will be addressed in this article. The industry and its business owners continue to face financial difficulties and the second part of this article focuses on those difficulties. The areas addressed are reminders to owners and practitioners of how to minimize income tax liabilities when structuring their business affairs. The topics discussed include owner leasing arrangements, tax basis for S corporation shareholder loans and a new debt cancellation income provision.

"Super" completed contract method

In March 2007 the IRS Director for the construction industry issued a memorandum [1] regarding taxpayers' use and abuse of the complete contract method (CCM). He stated his concern that the misuse of the CCM is a growing trend, citing examples where taxpayers are improperly using the CCM because the contractor was not involved in building a home; rather:

- The road builder constructed a road through a housing subdivision; or
- The contractor built the subdivision's club house.

Then, in August 2008 the IRS proposed regulations [2] expanding the scope of the home construction contract by providing that:

> *A contract for the construction of common improvements is considered a contract for the construction or improvement to real property directly related to the dwelling unit(s) and located on the site of such dwelling unit(s), even if the contract is not for the construction of any dwelling unit.* [3]

The proposed regulations have yet to be finalized. However, in September 2009 the IRS Director issued a second memorandum [4] on the use of the CCM, reconciling the two conflicting positions. This memorandum updates and supersedes his first memorandum. The Director reminded practitioners that the proposed regulations are not effective until they are published as final in the *Federal Register* and thus, cannot be relied upon for tax years beginning prior to the date of publication. Since the regulations have not been finalized, his conclusions in the first memorandum, as restated in the second

memorandum, are still the correct analyses even though the conclusions would be different when the regulations are finalized.

Calculating look-back interest

The IRS granted [5] the taxpayer permission to revoke a previously elected method of calculating look-back interest and to elect a new method. The taxpayer is an S corporation shareholder. The S corporation entered into long- term contracts and accounted for them using the percentage-of-completion method. The taxpayer elected under Reg. §1.460-6(d)(4)(ii)(B) to use the simplified marginal impact method (SMIM) to compute the amount of look-back interest. The taxpayer wanted to change to the "actual method" provided in Reg. §1.460-6(c)(3). The IRS granted its consent and informed the taxpayer that if he wanted to re-elect the SMIM within the next six years, he must obtain the Commissioner's prior consent.

Construction industry audit guide

The IRS audit guide is a valuable resource, providing definitions and a broad over view of the income tax issues that are specific to the construction industry. [6] The guide was updated in May 2009 and is available on the IRS website. [7]

Capitalizing costs of selling manufactured homes

In a Ninth Circuit decision, [8] the court held that a business selling manufactured homes needed to capitalize into inventory certain costs, rather than immediately expensing them. In that case, the taxpayer bought and sold manufactured homes. In general, the home was constructed at the factory and transported directly to the purchaser's home site. Because of economic conditions, the taxpayer restructured its business model, entering into agreements with independent salespersons. It would purchase from the manufacturer a number of model homes and place them on retail sales lots that the taxpayer leased. The homes were on display to the public and potential retail customers and once a customer decided to purchase a home, several sales contracts were then drawn—between the taxpayer and the manufacturer; the salesperson and the taxpayer; and the customer and the sales-person. The manufacturer shipped the home directly to the customer's home site for installation and occupancy.

The taxpayer claimed on its income tax return ordinary and necessary business expenses of $243,350 for sales lot lease payments and $22,387 for miscellaneous expenses consisting of:

- $16,184 for shipping homes from closed sales lots to other sales lots;
- $3,423 to avoid a sheriff's seizure;
- $2,500 for repairs on a model manufactured home; and
- $280 for cleaning a water-damaged carpet in a model home.

On audit, the IRS determined that the above costs were not currently deductible as ordinary and necessary business expenses, but instead should be included under IRC 263 in the taxpayer's inventory costs. The taxpayer argued that:

- The costs in question qualified as marketing, selling, or distribution costs of property held for resale that are excepted from inventory; and alternatively

- The taxpayer's leased sales lots should be treated as "on-site" storage facilities, and thus the various expenses should be treated as onsite storage costs that are exempt from inventory capitalization. The taxpayer argued that by virtue of its ownership and placement of the homes onto the sales lots, it participated directly in the sales to the customer.

The IRS contended that the costs in question did not constitute deductible marketing, selling, or distribution costs, and that the lot lease payments did not constitute "onsite" storage costs because the taxpayer sells a home to the salesperson, not the homeowner (retail customer). However, the court concluded that although the taxpayer participates in the home sale to the retail homeowner, the former does not sell the home directly to the homeowner. Therefore, all the listed cost must be subjected to the inventory capitalization rules.

Shareholder equipment rental arrangement upheld

It is not unusual in the construction industry for a business to lease its assets from its owners, be it for lack of credit, asset protect ion and/or to strip earnings out of a C corporation as lease payments rather than as compensation or dividends. In the following case [9] the court upheld the lease terms, despite the IRS's argument that the lease payments were excessive and therefore not deductible.

The taxpayer was a mechanical contractor operating as a C corporation. As with many contractors, it incurred extensive expenditures for materials inventory, new tools, equipment and facilities expansion. The taxpayer also had additional equipment needs arising from its entry into high-tech construction that could not be met with its cash flow or credit. Management decided against entering into long-term leases or equipment financing for two reasons: (1) they considered it imprudent to bind the company to any new long-term obligations considering the risks the company faced with its business expansion plans; and (2) management believed the company lacked the financial resources to assume additional long-term debt. The company's owners decided to buy the equipment and lease it to the company. The rent was paid pursuant to written agreements containing the following terms:

- Five-year contract term; [10]
- Hourly rate rental;
- Lessee had exclusive use of the equipment throughout the term but was generally obligated to pay only for "actual usage;"
- At term's end, the equipment reverted to the shareholder lessor;
- Lessee was liable for "normal" maintenance while the lessor was liable for "extraordinary" maintenance;
- Rental rate was renegotiable annually.

The company and its shareholders generally established rental rates on the basis of their industry expertise and prior experience with third-party rental companies. The IRS claimed that rental deductions were excessive, and the excess were dividend payments, not deductible ordinary and necessary expenses. Its determinations were based upon the report of an IRS valuation engineer who concluded that a fair market rent would be an amount that would produce a 30-percent return on equity for the lessor.

The court addressed the issue in two steps. First it found that the taxpayer had valid business reasons for renting from its owners rather than purchasing or entering long-term leases for the construction equipment:

- Its management determined that additional long-term debt or comparable commitments under long-term leases were imprudent for purposes of entering an untested line of business;
- Short-term rentals were not feasible because of the shortages and other uncertainties that had arisen in the short-term general construction equipment rental market; and
- The financial risk of owning equipment that was not currently used for projects was borne by the owners, not dissimilar to the transfer of risk to a shareholder who provides a guaranty for his corporation's debt.

The court's second question was whether the rental payments were "required." [11] Since the parties were related, the court asked whether the amounts were reasonable, i.e., not more than the taxpayer would have paid to a third-party lessor. In support of its argument the IRS contended that the taxpayer had a "five-year leasehold interest" in the equipment and that arm's-length payments for that interest would equal the approximate fair market value of payments under a five-year bank loan, capital lease, or true lease. Moreover, it argued that five-year lease terms were not available in the third-party rental market. Based on the lease terms, the rent paid exceeded the fair market value of a five-year leasehold interest in the equipment and was excessive.

However, the court found that the payments were reasonable. The taxpayer had proven that it lacked financial wherewithal or creditworthiness to obtain a long-term lease on its own. The court also discarded the IRS's argument that the taxpayer could have obtained third-party financing had its owner given its personal guaranties for taxpayer indebtedness or long-term leases. The court held that such arrangements would not have been arm's-length unless the shareholders were compensated for this assumption of risk; meaning that the arm's-length rental rates in these circumstances would be set at some level above what would be paid for a five-year leasehold interest in order to compensate the shareholders for the risk they assumed in the transaction.

Shareholder tax basis; circularity

As business losses continue to mount, a basic income tax principal of pass-through entities is that an owner may currently use losses distributed to him to the extent he has tax basis in the entity. In a recent case, [12] the court decided that what appeared to be a transaction that created basis in the pass-through entity lacked economic substance; thus, no basis was created.

The issue was whether the taxpayers had made an "economic outlay" for annual loans to the S corporation to create basis in indebtedness. [13] Two individuals each owned a 50-percent interest in a partnership (P) and an S corporation (S). P borrowed money from a bank to acquire and construct real estate. Pursuant to the loan agreement, the proceeds could be used in limited circumstances to make further loans between P, S and the two owners. Each year, P loaned money to the partners, who loaned money to S. S then paid rent to P.

The accounting and documentation of the loans did not help the share-holders' cause. The monies were deposited in the owners' personal accounts and both their receiving and lending of funds occurred within a short time of each other. Each loan was evidenced by a note, and most notes had a stated interest rate among the loan terms. Each year, P recorded interest income and the partners recorded interest expense. As for the loans to S, S did not deduct accrued interest and the shareholders did not report the accrued interest income. Only a small portion of the principal was ever repaid to the S

shareholders. The owners also reclassified the accrued interest owed by S to paid-in-capital.

The court held that the owners' loans to S did not create income tax basis. The court's reasoning was for a shareholder to create basis in an S corporation, the former must prove that:

- The indebtedness flows directly to the S corporation from the shareholder; and
- The shareholder makes an actual economic outlay that renders him poorer in a material sense.

The court agreed that the owners met the first test, but did not agree that the second test was met. The court cited *Oren v. Commissioner* [14] for the proposition that transactions involving a brief, circular flow of funds (beginning and ending with the original lender) designed solely to generate bases in an S corporation have no economic substance and therefore do not evidence the required economic outlay. In this situation there was the same circular flow of cash beginning and ending with P. The fact that the funds were coming from a related lender did not automatically invalidate the transaction as long as there were other factors clearly establishing the economic validity of the transaction. But in this case, the court was not persuaded that the owners would ever have to repay the loans from P. They made no economic outlay because they were merely a conduit through which the money flowed and there was no real expectation that they would repay P. The fact that only one repayment was ever made in 16 years further indicated the loans' lack of substance. Viewed in its entirety, the transaction lacked economic substance since the money wound up right where it started. The fact that purely paper debts to two parties (S and the owners) were accumulating was not enough to give the transaction substance. Furthermore, since the owners exercised complete control over both P and S, neither of the entities would act in a manner adverse to the owners' interests so as to cause the latter to be required to repay the loans. In this case, the owners were not primarily liable on the bank loan to P.

The court distinguished this case's "circular flow of funds" from other cases concerned with "back-to-back loans." In the latter situation, courts have upheld the basis creation arrangement where the parties record the transactions as loans and actually make repayments according to the debt instrument. [15]

Back-to-back loans; shareholder S corp basis

In another case, the tax court [16] denied the S corporation shareholders basis for their alleged loans upon which they claimed losses. In this case, an S corporation borrowed money from a bank, and the two shareholders co-signed the loan and guaranteed its payment. The corporation received the funds and was listed as the borrower. Furthermore, the interest expense paid to the bank was reported on the corporate income tax return. The court agreed that the shareholders did co-sign and guarantee the bank note. However, neither shareholder was required to make any payment s with respect to that note. The court held that absent any discernible economic outlay, the shareholders' actions did not give rise to "indebtedness of the S corporation to the shareholder" under IRC §1366(d)(1)(B).

In yet another loan transaction, a C corporation owned by the same shareholders loaned money to the S corporation. Subsequent to the loan, the S corporation reclassified the loan payable to the shareholders rather than from the C corporation. The court found no evidence that at the time of the loan it was intended that the proceeds were coming directly from the shareholders. Standing by itself, this adjustment of a journal entry

several years after the actual transaction was insufficient to reclassify the source of a loan, again proving that the existence of economic outlay is the prevailing factor in creating income tax basis.

New debt cancellation provision

In general, a debtor who is relieved of repaying its obligation recognizes taxable income. [17] The tax code provides relief in certain circumstances, primarily when the debtor is bankrupt or insolvent. [18] Recent legislation expanded such relief to other situations.

For certain debt cancellation occurring after December 31, 2008 and before January, 2011, a taxpayer may irrevocably elect [19] to *defer* reporting the income in the year of discharge, and ratably report it over a five-year period beginning with:

- In the case of a cancellation in 2009, the fifth taxable year following the taxable year in which the cancellation occurs; and
- In the case of a cancellation in 2010, the fourth taxable year following the taxable year in which the cancellation occurs.

A taxpayer electing this provision would not be able to use the IRC §§108(a)(1) (A), (B), (C), and (D) rules whereby the taxpayer may be able to avoid recognizing taxable income, but has to reduce income tax attributes. [20] The election is made at the entity level. [21]

The type of debt cancellation that qualifies for this treatment is phrased as an "acquisition of an applicable debt instrument." Such acquisition includes an acquisition of the debt instrument for cash, the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument),

and the exchange of the debt instrument for corporate stock or a partnership interest, and the contribution of the debt instrument to capital . Such term also includes the complete forgiveness of the indebtedness by the debt holder. In essence, the definition is very broad and taxpayer-friendly.

For example, a creditor forgives in 2009 the taxpayer's $100,000 loan. Under prior law, unless another IRC §108 section provided otherwise, the taxpayer would report in 2009 $100,000 of taxable income. Under § IRC 108(i), the taxpayer could elect to recognize $20,000 of taxable income annually beginning in 2014 and ending in 2018.

The normal five-year spread will be accelerated upon the occurrence of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a Title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances. In the case of a pass-through entity, the acceleration clause also applies to the sale or exchange or redemption of an interest in such entity.

LMSB-04-0207-012, Impacted IRM 4.51.5, March 13, 2007; Refer to Glover, "2007 Income Tax Update," 17 *Construction Accounting and Taxation* No. 6, 5 (Nov./Dec. 2007).

REG-120844-07, August 4, 2008. See Glover, "2008 Income Tax Update," 18 *Construction Accounting and Taxation* No. 6, 5 (Nov./Dec. 2008).

The definition of a common improvement is an improvement that the taxpayer is contractually obligated or required by law to construct within the tract or tracts of land containing the dwelling units and that benefits the dwelling units. In general, a common improvement does not solely benefit any particular dwelling unit or any particular lot on which a dwelling unit is constructed. Examples include land clearing and grading, sidewalks, sewers, roads and clubhouses. Thus the road and club house examples would be classified as home construction contracts.

LMSB-04-0209-006, Impacted IRM 4.51.2 (Sept. 15, 2009).

Letter Ruling 200903076 (Oct. 8, 2008).

This Industry Guide is intended for examiners conducting audits in the construction industry and as information for taxpayers and practitioners associated with the construction industry. Review of this guide is recommended prior to initiating an audit. Users of this guide may need to augment these guidelines by researching specific tax issues and new tax law.

www.irs.gov. Search for "Construction Industry Audit Technique Guide."

Load, Inc v. Commissioner, 2009-1 USTC ¶50, 194, 554 F3d 785 (9th Cir. 2009), aff'g 93 TCM 969 (2007).

Yearout Mechanical & Engineering, Inc. v. Commissioner, T.C. Memo 2008-217 (Sept. 24, 2008).

The five-year lease term was designed to ensure petitioner's unrestricted access to the equipment without regard to the claims of creditors or the shareholder lessors' former spouses.

IRC §162(a)(3).

Kerzner v. Comm'r, TCM 2009-76 (April 6, 2009).

IRC § 1366(d)(1).

T.C. Memo 2002-172, affd. 2004-1 USTC 50,165, 357 F.3d 854 (8th Cir. 2004). The court found that the economic positions of the parties had not changed and the disbursement of loan proceeds was the equivalent of offsetting bookkeeping entries.

Ruckriegel v. Comm'r, T.C. Memo 2006-78; Yates v. Comm'r, T.C. Memo 2001-280; Culnen v. Comm'r, T.C. Memo 2000-139.

Donald L. and Evelyn Russell v. Commissioner, T.C. Memo 2008-246 (Oct. 30, 2008).

IRC §61(a)(12); Reg. §1.61-12(a).

IRC §§108(a)(1)(A), (B) .

IRC §108(i).

There may be situations whereby the taxpayer does not qualify for permanent avoidance of the cancellation of indebtedness income (for example not bankrupt or insolvent); or the taxpayer does not want to reduce its tax attributes.

This differs from the IRC §108(a) rules in the case of a partnership where the testing is done at the partner level. The Code section provides special rules for partnerships.

© 2009 Thomson Reuters/RIA. All rights reserved.

"2009 Income Tax Update" by Steven R. Glover was published in Construction Accounting and Taxation, November/December 2009. Copyright 2009 by Thomson Reuters/RIA.