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Will the IRS Follow the New Revenue Recognition Policies for Condominium Developers?

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Currently, the sale of real estate condominiums under development has been reported one of two ways under FASB ASC 360-20 Accounting for Gains on Real Estate Sales. The most commonly used methods are the percentage of completion method and the deposit method. The percentage of completion method recognizes income pro-rated over the time of the development, based on the percentage of the costs completed to date over the expected total project costs. When these factors are not present, the developer uses the deposit method, under which, no gain is recognized until the contract is completed and control passes to the buyer. The deposit method is also used when the seller has merely offered an option to buy the property or the seller guarantees a return of the buyer's investment for a limited time.

The ideology at the Internal Revenue Service is currently in alignment with the FASB's. For tax purposes, real estate developers follow a similar methodology to recognizing revenue by using the percentage of completion method or the completed contract method. The Internal Revenue Service requires condominium development projects to utilize the rules for long-term construction contracts, unless the development falls into one of the few exemptions available such as single family homes, townhouses and buildings containing four or fewer units. If the project falls into one of these categories the completed contract method can be used. However, developers of most condominium projects will need to use the percentage of completion method for contracts once they have taken significant deposits on those contracts during construction.

This places a burden on developers. Since they are required to use the percentage of completion method, they have to recognize taxable income over the construction period and incur the tax on that income.

The developers are generally required to place the deposits they receive in escrow until the final closing on the contract, since they do not have access to the deposits from those contracts to pay the tax. The developers are therefore forced to utilize their own equity to pay taxes on calculated profits for which they have received no economic benefit at the time.

> "The new standards go in effect for public companies for annual reporting periods beginning after December 15, 2017 (December 2018 calendar year end)."

Developers such as the Related Companies L.P. are trying to change this way of thinking. They are reaching out to their competitors to join in a comment letter to the IRS to change the rules governing the recognition of revenue on long term contracts. And they will have the support of another authoritative body to help strengthen their case.

The FASB, under new guidance issued in ASU No. 2014-09, will dramatically change how revenue should be recognized. The sales of real estate to customers in the ordinary course of business (timeshares condominiums, homebuilding, etc.) fall under the new rules, eliminating the use of percentage of completion. The developer can no longer recognize revenue until they satisfy a performance obligation. A developer satisfies a performance obligation when it transfers a promised good or service to the customer or when the customer obtains control of that good or service.

The performance obligation can be satisfied over time if the following conditions are met:

- The customer benefits as performance occurs.
- The developer's performance creates or enhances an asset that the customer controls, while the asset is being created or enhanced.
- The developer's performance does not create an asset with an alternative use to the developer and the developer has an enforceable right to payment for performance completed to date.

If these conditions are not met, the developer will not be able to recognize revenue over time, but will have to wait until the point in time that control is transferred to the buyer.

These changes in revenue recognition for reporting purposes could have a dramatic effect on the reporting of public companies, such as Toll Brothers Inc. Recognizing the majority of their revenue on a project at a point in time as opposed to over a period of time may lead to additional financial reporting requirements with the Security and Exchange Commission.
Revenue recognition can also be delayed by multiple performance obligations that need to be satisfied before the total sale can be recognized. Examples of this include a building or project being completed in phases that leave the buyer unable to access certain amenities included in the rights of the unit holder, even though they have taken control of their individual unit. Since contracts for each development project can be unique based on the specifics of the project itself and the local jurisdiction, the new rules need to be reviewed on a project by project basis and, in some cases, a contract by contract basis, to determine the proper revenue recognition procedures.

The new standards go in effect for public companies for annual reporting periods beginning after December 15, 2017 (December 2018 calendar year end). Early adoption is permitted, but not before the original effective date of December 15, 2016. The rules go into effect for nonpublic companies beginning after

December 15, 2018 (December 2019 calendar year), with early adoption available after December 15, 2016. Under IFRS, the standards are effective beginning on or after January 1, 2017, with early adoption permitted. Whether the IRS will look into making changes to the tax reporting rules remains to be seen.

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