



October 21, 2016

Planned Community Developers Score Significant Court of Appeals Win

CONSTRUCTION, REAL ESTATE, TAX
BY

Planned community developers scored a significant win in August when the United States Court of Appeals for the Ninth Circuit upheld a U.S. Tax Court decision permitting a developer to delay income recognition on individual home sales until the entire development was substantially complete.

Under traditional tax regulations, the IRS requires taxpayers to report income in the year in which it is earned. However, when a contract extends over two tax years, the contract is deemed a "long-term" contract, and income is generally required to be recognized based on a percentage of completion of the contract. Home construction contracts, though, are exempt from the "percentage-of-completion" method of accounting and can utilize, among other accounting methods, an accounting method known as the "completed-contract method ("CCM") (permitting the taxpayer to delay the reporting of income until the contract has been "completed").

In the recent case of *Shea Homes, Inc. v. Comm'r*, Nos. 14-72161, 14-72162, 14-72163, 2016 U.S. App. LEXIS 15570 (9th Cir. Aug. 24, 2016), the Tax Court and Ninth Circuit had the occasion to examine when a long-term contract is deemed complete under CCM pursuant to 26 CFR § 1.460-1(c)(3)(A), Income Tax Regs, with respect to a planned community development. 26 CFR § 1.460-1(c)(3) indicates that, in general, "a taxpayer's contract is completed upon the earlier of - (A) Use of the subject matter of the contract by the customer for its intended purpose (other than for testing) and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or (B) Final completion and acceptance of the subject matter of the contract." (Emphasis added.)

The taxpayer, Shea Homes, is one of the largest private homebuilders and developers in the country, with planned communities ranging in size from 100 homes to more than 1,000 homes. Shea Homes markets itself as selling more than just the "bricks and sticks" of a home and sells lifestyle, amenities, and community. As such, Shea Homes contended that their contracts with the home buyers include not only the building of the homes, but common area amenities, roads, and community. Therefore, by extension, the contract is not complete "until the last road is paved and the final bond is released," and income was not required to be recognized until and could be deferred until the entire community and contract was complete pursuant to 26 CFR § 1.460-1(c)(3). The IRS countered that the contracts were not for the community, but for the individual homes. The IRS argued that income should be recognized for each home when the individual home meets the "use and 95% test" (arguably upon the close of escrow on each home).

In the end, the Tax Court held, and the Ninth Circuit agreed, that the taxpayer's interpretation was correct. The Courts agreed that the taxpayer was selling not merely the home, but the development in its entirety, including amenities and common improvements. And because the contract was for the entire development, the contract was not complete until the project reached completion or at least 95% of the total allocable contract costs for the entire development had been incurred. Therefore, the taxpayer's deferral of income was proper.

While the Ninth Circuit's decision will come as a welcome clarification to planned community developers, the Court cautioned taxpayers that "a determination of the subject matter of the contract is based on all the facts and circumstances." This means that developers will have to look at the entirety of their developments when assessing the point at which the contracts for sale will draw to completion. The court went on to caution that developers should not expect to be able keep their developments in an incomplete state in an effort to indefinitely defer tax recognition.

Additionally, the Court left open the important juxtaposed question of whether a development that has completed all common areas/amenities and some homes, but is planning future home development, could be deemed complete despite the future home construction.

However, while these questions remain open, the holding in *Shea Homes* should be seen as nothing short of a major win for community home builders and an important clarification of the law.

For similar articles, visit our [Our Thoughts On](#) blog. For more information, [contact Schneider Downs](#).

You've heard our thoughts... We'd like to hear yours

The Schneider Downs Our Thoughts On blog exists to create a dialogue on issues that are important to organizations and individuals. While we enjoy sharing our ideas and insights, we're especially interested in what you may have to say. If you have a question or a comment about this article – or any article from the Our Thoughts On blog – we hope you'll share it with us. After all, a dialogue is an exchange of ideas, and we'd like to hear from you. Email us at contactSD@schneiderdowns.com.

Material discussed is meant for informational purposes only, and it is not to be construed as investment, tax, or legal advice. Please note that individual situations can vary. Therefore, this information should be relied upon when coordinated with individual professional advice.

© 2024 Schneider Downs. All rights-reserved. All content on this site is property of Schneider Downs unless otherwise noted and should not be used without [written permission](#).