TAXATION OF LONG-TERM CONTRACTS: LITTLE PIGS, THE IRS, AND THE COMPLETED-CONTRACT METHOD

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Little pigs get fed. Big pigs get slaughtered.

Most litigators are familiar with this truism, which is a pithy way of explaining that overreaching is dangerous. A recent Tax Court case shows this principle in operation; the IRS overreached in a real estate developer's tax case, and it wound up with a determination on income recognition that it almost certainly regrets. *Shea Homes, Inc. v. Comm'r*, Nos. 14-72161, 14-72162, 14-72163, 2015 U.S. App. LEXIS 15570 (9th Cir. August 24, 2016), *aff'g,* 142 T.C. 60 (2014).

Income is taxable under the Internal Revenue Code in the year that it is received, unless the taxpayer's accounting method calls for a different result. *See* I.R.C. § 451(a). To keep taxpayers from manipulating the time when they receive income, the Code grants the IRS authority to make adjustments if the taxpayer's method of accounting does not properly reflect her income. I.R.C. § 446(b). There are also special rules; for example, long-term contracts are governed by Section 460 of the Code, which subjects most of them to the percentage of completion method of accounting. I.R.C. § 460(a), (b). Home construction contracts are a prominent exception to this requirement. I.R.C. § 460(e)(1)(A).

Shea Homes involved contracts for the construction of homes. The taxpayers elected to use the completed-contract method, which is permitted under the relevant regulations. *See* Treas. Reg. § 1.460-4(c)(1). There was no dispute in *Shea Homes* that this method was permissible. 2015 U.S. App. LEXIS 15570 at *6. The key question dividing the parties was when the contract was complete; this is governed by a regulation providing that a contract is completed either upon "[u]se of the subject matter of the contract by the customer for its intended purpose" if "at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred." Treas. Reg. § 1.460-1(c)(3)(i)(A). Alternatively, a contract is complete upon "completion and acceptance of the subject matter of the contract." Treas. Reg. § 1.460-1(c)(3)(i)(B). Whichever test is satisfied first controls. Treas. Reg. § 1.460-1(c)(3)(i).

The taxpayers in *Shea Homes* were developers and builders of planned communities; their projects ranged from 100 homes to over 1,000. 2015 U.S. App. LEXIS 15570 at *6. The Tax Court found that the taxpayers "pride themselves on providing their customers with more than just the 'bricks and sticks' of a home and emphasize the features and lifestyle of the community." *Id.* at *4 (citations omitted). In applying the completed-contract method, the taxpayers treated the subject matter of the contract as the completion of *the entire development*. Consequently, they first recognized income from a development in the year when they had incurred at least 95% of their budgeted costs for *all* of the homes and associated amenities. *Id.* at *7. Because this accounting method deferred significant amounts of income, the IRS issued deficiency notices; these administrative determinations treated each individual house and lot as the subject matter of the contract. *Id.* at *9.

In the Tax Court, the IRS stuck to this position. As far as it was concerned, once a house and a lot were sold there was a completed contract. *Id.* Common improvements such as public areas, club houses and other common facilities could be ignored as "secondary items." *See* Treas. Reg. § 1.460-1(c)(3)(ii) (providing that "secondary items" are to be ignored in determining when a contract is complete).

As the Tax Court found, the amenities that the taxpayers offered in their developments were significant:

- One development had "a 30,000-square-foot clubhouse with a ballroom, a center for higher learning, a studio for creative arts, a cafe, a kitchen, a catering kitchen, a grand living room, offices, mail offices, locker rooms, studios, an indoor pool, an outdoor pool, cabanas, an indoor running track, a fitness center, a meditation garden, and a spa," 142 T.C. at 77;
- Another development featured "a 3.5-mile trail system, a restaurant, a spa, pools, a basketball gymnasium, a multipurpose building, a tennis court, parks, open spaces for wildlife, playgrounds, and a country club," *id.*;
- A third offered "a 21,000-square-foot recreation center featuring an indoor gymnasium, a fitness center, aerobics, meeting, and locker rooms, an outdoor pool with interactive water features, a 52-acre central park that includes multiuse athletic fields, trails, playgrounds, picnic facilities, and an amphitheater, 10 miles of walking, running and biking trails, 8 acres of lakes, 150 acres of parks, and 170 acres of open space." *Id.* at 78.

While these amenities were plainly designed to attract customers to the taxpayers' developments and to permit them to price their homes at a premium, the government apparently never considered whether there was some reasonable alternative to its position that only the sales of the homes and the lots mattered. In Tax Court, it lost badly: "In a careful and detailed opinion, the Tax Court concluded that on the evidence before it all aspects of the planned community development were understood by the Taxpayers and their buyers to be what was bargained for, and that the documents reflected that understanding." 2015 U.S. App. LEXIS 15570 at *10.

On appeal, the government attempted to moderate its position, acknowledging that the Tax Court was correct in determining that the subject matter of the contract was not just an individual house and lot. *Id.* at *11. The government also conceded that the taxpayers had a contractual obligation to build the common amenities and that those amenities should count for purposes of determining whether the contract was complete under the relevant regulation. *Id.* The IRS now argued that the Tax Court had improperly validated the taxpayers' inclusion of the budgeted costs *for other homes* in the determination of when the contract was complete. Specifically, the government argued that "the 95 percent test should be met when the Taxpayers incur 95 percent of the budgeted costs of the contracted-for house, lot and common amenities, but not the costs of the other houses." *Id.* at *12.

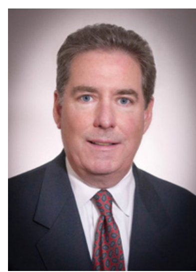
While sensible, this approach ran into an impermeable barrier, the standard of review. The government wanted the Ninth Circuit to treat the Tax Court's determination of whether the taxpayers' method of

accounting clearly reflected their income as a mixed question of law and fact, subject to *de novo* review. *Id.* at *12-*13. It refused.

Instead, the Court of Appeals observed that the IRS itself had previously told the Tax Court that the issue was factual, noting that the government "agreed that the Tax Court principally had to decide what the subject matter of the Taxpayers' home construction contracts was a matter of fact . . . ." *Id.* at *14. In the Ninth Circuit's view, the parties had a factual dispute over what was the "subject of the contract" for purposes of determining when it was complete. While the IRS "took the very crabbed view that the subject matter was limited to the house and the lot," the Tax Court made a specific factual determination that the subject of the contract was broader, embracing the entire development. *Id.* Faced with a challenge to a factual finding, the Ninth Circuit applied the clearly erroneous standard, and it readily concluded that the evidence in the record supported the Tax Court's findings. *Id.* at *14-*15. One judge concurred, indicating that he would dispose of the case solely on the basis that the IRS was arguing an issue that it had not preserved without touching upon the reasonableness of the taxpayer's position or the Tax Court's findings. *Id.* at *21-*24 (Rawlinson, J. concurring in the judgment)

The result leaves the IRS with a serious problem: *Shea Homes* provides a template for developers and builders to argue for the deferral of income for a long period of time. Even if such a position is challenged and the IRS prevails, *Shea Homes* would appear to support a solid argument that the taxpayer should not be penalized because there is a good faith basis to treat an entire development as the subject matter of a contract to apply the completed contract method. For its part, the Tax Court cautioned developers and builders against overreaching. 142 T.C. at 109 n.24 (cautioning taxpayers that "a determination of the subject matter of the contract is based on all the facts and circumstances). And the Ninth Circuit reiterated that caution. 2015 U.S. App. LEXIS 15570 at *21.

In other words, don't be a pig.



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