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Real Estate

Shea Homes Can Defer Income Until Community Complete

BNA Snapshot

- Developer can defer income, tax if buyers expect completed community
- Decision provides more confidence, but no bright line on completion



By [Erin McManus](#)

Aug. 24 — Planned community developer Shea Homes Inc. can defer income on sales of homes in a development until the project is nearly complete ([Shea Homes, Inc. v. Commissioner](#) , [2016 BL 274845](#), 9th Cir., No. 14-72161, 8/24/16).

A federal appeals court ruled Aug. 24 that Shea Homes can defer recognition of income from a development until 95 percent of that development or community is completed, because the homebuyers “understood and believed that the parties had contracted for the entire lifestyle of

the development and its amenities.”

Mark Hoenig, a tax partner at Weil, Gotshal & Manges LLP in New York, told Bloomberg BNA in a Aug. 24 e-mail that the decision strengthens “confidence in the rule that permits homebuilders to defer paying tax while common amenities are yet to be completed.”

Anson Asbury, a tax attorney at the Asbury Law Firm in Atlanta, told Bloomberg BNA Aug. 24 that “the ruling allows well-advised homebuilders to plan with greater confidence.”

‘Crabbed View.’

The Internal Revenue Service originally argued to the U.S. Tax Court that Shea Homes should be able to apply the contract completion method of accounting only to individual lots ([30 DTR K-4, 2/13/14](#)).

Judge Ferdinand F. Fernandez, writing for a panel of the U.S. Court of Appeals for the Ninth Circuit, said the IRS “took the very crabbed view that the subject matter was limited to the house and the lot.”

“We suspect that the Commissioner was satisfied that his position on those points would win the day and, therefore, that he need not concentrate his firepower on the overall planned community development aspect of the contracts. The resulting outcome was due to his misperception rather than a Tax Court mistake,” Fernandez said.

Open Question

Hoenig said the Tax Court opinion left open the question of just how far the rule could be taken.

“The Tax Court held favorably for the taxpayer homebuilder as relates to the ability to defer paying taxes under the completed contract method, even after receiving full payment for early homes built within a given development, by taking account of items not yet built but having (debatably) tenuous connection to the units actually sold, for example, homes not yet built but part of the development,” Hoenig added.

In his closing sentence, Fernandez quoted the Tax Court opinion, saying that the court would caution those taxpayers who might seek an almost unlimited deferral period that “a determination of the subject matter of the contract is based on all the

facts and circumstances.”

Hoenig said, “The Circuit Court opinion, while a happy result for homebuilders, does not advance the ball as relates to the question left open by the Tax Court regarding the construction of other homes within a given development.”

Disallowed Argument

When its initial approach proved unsuccessful, the IRS appealed with the “late-blooming argument” that the subject matter of the contract included the house, lot and common amenities, but didn't include the other houses in the community, Fernandez said.

Fernandez said Shea Homes' “promises gave buyers justifiable expectations regarding what would be promised to those who came later.”

Judge Carlos T. Bea joined Fernandez in the opinion. Judge Johnnie B. Rawlinson concurred solely on the basis that the IRS was bound by the arguments it made to the Tax Court.

Concurrence Favored IRS

Rawlinson said the fact remained “that a Taxpayer could readily manipulate the 95 percent completion test by deliberately incurring development costs of less than 95 percent and deferring the balance of the costs indefinitely, correspondingly deferring taxes indefinitely.”

Asbury said Rawlinson's comments didn't “differ too much from the IRS arguments rejected by the majority. By its very nature, the completed contract method calls for deferral. The practical reality that is being overlooked here is that homebuilders in fact do not defer the completion of these developments indefinitely. If they did, buyers would complain and it would almost certainly damage the builder's reputation.”

The Ninth Circuit recognized the Tax Court's approval of applying the 95 percent method on a phase-by-phase basis for a large development. This approach—actually accelerating income recognition on a relative basis—demonstrates that concerns about indefinite deferral are simply overblown,” Asbury said.

Andrew M. Weiner of the Department of Justice Tax Division argued the case for the IRS. Gregory G. Garre of Latham & Watkins LLP in Washington argued for Shea Homes.

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For More Information

Text of the [decision](#) is in TaxCore.