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Timing is Everything: Shea Homes, Inc. v. Commissioner

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NOTE

Timing is Everything: *Shea Homes, Inc. v. Commissioner*

Shea Homes, Inc. v. Commissioner, 142 T.C. 60 (2014).

NICK GRIEBEL*

I. INTRODUCTION

In 1986, the Internal Revenue Code (“Tax Code”) was comprehensively revised for the first time in over thirty years as part of the Tax Reform Act of 1986 (“Act”).¹ In enacting this comprehensive reform, Congress was guided by three overarching objectives: achieving fairness, improving efficiency, and striving for simplicity in the Tax Code.² Before 1986, high-income taxpayers found ways to lower their effective tax rates through many tax shelters and loopholes in the Tax Code.³ As a result, many of these wealthy taxpayers were paying lower tax rates than their less affluent, low-income counterparts.⁴ With this perceived unfairness in mind, Congress consciously closed loopholes and eliminated tax shelters within the Act.⁵ While critics still remain,

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1. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 16 U.S.C., 19 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 42 U.S.C., 46 U.S.C., and 49 U.S.C.).

2. Staff of Joint Comm. on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 6 (Comm. Print 1987), <http://www.jct.gov/jcs-10-87.pdf>.

3. *Id.* at 7–11.

4. *Id.* at 6.

5. *Id.* at 6–7. The Act provided restrictions on using passive losses to offset unrelated income. *Id.* at 6. It strengthened the minimum tax rate to prevent high-income taxpayers from eliminating tax liability through the excessive use of preferences. *Id.* The most commonly used itemized deductions were retained, but abusive deductions that benefited only a limited group were restricted. *Id.* at 7. Prior practices, such as assigning investment income to lower income family members, were restricted. *Id.* at 7–8. Deductions for IRA contributions were phased out for taxpayers enjoying other tax preferred retirement arrangements when those taxpayers earned more than a specified amount of income. *Id.* The standard deduction and personal exemptions were substantially increased, which resulted in tax relief to lower income taxpayers. *Id.* at 8. Families that were below the poverty level were completely relieved of tax liability, which resulted in no taxes for nearly six million taxpayers. *Id.* at 6. The practical results of these changes, along with many others, allowed the Act

the 1986 reform accomplished its goal of increasing fairness by ensuring that taxpayers with similar amounts of income paid similar amounts of taxes.⁶

With many traditional tax loopholes and shelters eliminated, two primary mechanisms for reducing taxes remain. The first of these methods involves manipulating the timing of income. The second, often referred to as the characterization of income, attempts to take advantage of lower capital gains rates, rather than ordinary income rates.⁷ *Shea Homes, Inc. v. Commissioner*⁸ is a perfect illustration of how the timing of income can be manipulated in order to achieve substantial tax benefits.

Shea Homes is a developer of massive residential neighborhoods that include hundreds of houses and elaborate amenities, such as clubhouses, pools, trails, spas, fitness centers, ballrooms, and parks.⁹ In *Shea Homes*, the taxpayers reported income from activities on the “completed contract” method of accounting.¹⁰ This accounting method provides that income shall be recognized whenever the contract is deemed complete, even if income is received before the contract is completed.¹¹ Shea Homes argued that its contracts were not completed upon the sale of each individual home in the neighborhood, but rather upon the completion of the entire neighborhood.¹² The Tax Court found in favor of the developer, allowing Shea Homes to defer nearly \$900 million dollars of income from the sale of individual homes to subsequent years.¹³

One of the overarching goals of tax policy is the concept of matching the receipt of income with the imposition of a tax on that income.¹⁴ If a tax is imposed before income is actually received, liquidity difficulties become self-evident because the taxpayer does not have the cash on hand to pay the tax. This issue has influenced how the Tax Code and accompanying regulations were written.¹⁵ Applying this policy to long-term contracts, the general rule is that taxpayers must use the “percentage of completion” method of accounting.¹⁶ Under this method, the taxpayer is required to recognize income as

to reduce the highest tax bracket from fifty percent to twenty-eight percent, however, the effective tax burden for the highest income groups remained “essentially unchanged.” *Id.* at 7.

6. *Id.* at 7. This is often referred to as horizontal equity. Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992).

7. The issue of manipulating the character of income is beyond the scope of this Note.

8. 142 T.C. 60 (2014).

9. *Id.* at 64–65, 77–79.

10. *Id.* at 61.

11. I.R.C. § 460(b)(1) (West 2014).

12. *Shea Homes, Inc.*, 142 T.C. at 88–89.

13. *Id.* at 66, 103–06.

14. Staff of Joint Comm. on Taxation, *supra* note 2, at 9.

15. *See id.*

16. I.R.C. § 460(a) (West 2014).

payments are received throughout the duration of the contract.¹⁷ This makes sense because it reflects the overarching tax policy of matching the receipt of income with the imposition of a tax. By definition, a long-term contract takes more than one year to finish;¹⁸ accordingly, if the taxpayer receives income and incurs expenses throughout the year, he should be required to include amounts received in income and deduct expenses incurred at the end of each year to appropriately reflect his economic position.

By contrast, a contract that qualifies as a home construction contract allows a taxpayer to account for income under the completed contract method of accounting.¹⁹ Under this method, the taxpayer does not have to include anything in income until the contract is complete.²⁰ This is logical because a homebuilder typically does not receive any income until the home has been constructed and the buyer pays for the house at closing and receives the keys.²¹ It would be unfair to impose a tax on the homebuilder in a year in which he did not yet receive any income from a potential buyer. So, why did the Tax Court allow *Shea Homes* to defer recognition of income until the entire subdivision was complete, rather than requiring the developer to include gain from the sale of each home in income? That question is the focus of this Note.

Part II of this Note introduces the parties, the facts, and the arguments of the case. Part III explains the law that underpins the holding. Part IV delves into the *Shea Homes* decision in greater detail. Finally, Part V criticizes the holding as inconsistent with tax policy and suggests why the Tax Court may have gotten it wrong in *Shea Homes*.

II. FACTS AND HOLDING

This Part will first discuss the parties, followed by the facts that led to the controversy. Next, this Part will cover the arguments and the holding of the Tax Court.

17. See generally *id.* § 460(b); *Tutor-Saliba Corp. v. Comm’r*, 115 T.C. 1 (2000).

18. I.R.C. § 460(f)(1). “The term ‘long-term contract’ means any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.” *Id.*

19. *Id.* § 460(e).

20. *Id.*

21. See *Home Construction Contracts*, IRS, <https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Home-Construction-Contracts> (last updated Oct. 5, 2015).

A. *The Parties*

The Shea family has been in the business of developing homes for nearly half a century.²² The Sheas' home development business functions through numerous entities.²³ The common parent company is Shea Homes, Inc. ("SHI").²⁴ Shea's subsidiary companies include Shea Homes, Limited Partnership ("SHLP") and Vistancia, LLC ("Vistancia").²⁵ SHI, SHLP, and Vistancia are developers and builders of large, planned communities that vary in size from 100 homes to over 1000 homes.²⁶ Shea Homes and its subsidiaries' business involves purchasing land and then designing, developing, and marketing homes within planned communities that include various features and common amenities.²⁷ During the years at issue, Shea Homes sold homes in approximately 114 developments in Arizona, California, and Colorado.²⁸ The principal source of revenue for Shea Homes was from the sale of its homes.²⁹

Respondent is the Commissioner of the Internal Revenue Service ("IRS").³⁰ For the years of 2004 and 2005, the IRS found roughly \$23.8 million in deficiencies with respect to SHI.³¹ With respect to SHLP, the IRS found roughly \$650 million in deficiencies for the years of 2003 through 2006.³² Finally, the IRS found roughly \$132 million in deficiencies with respect to Vistancia for the years of 2004 and 2005.³³

22. *Shea Homes, Inc. v. Comm'r*, 142 T.C. 60, 64 (2014).

23. *Id.*

24. *Id.*

25. *Id.* at 61–62.

26. *Id.* at 64.

27. *Id.* at 65.

SHI, SHLP, and Vistancia purchased land in various stages from completely raw to finished lots in developed communities. Their business involved the analysis and acquisition of land for development and the construction and marketing of homes and the design and/or construction of developments and homes on the land they acquired. The costs incurred in their home construction business included, by partial example: (1) acquisition of land; (2) financing; (3) municipal and other regulatory approvals of entitlements; (4) construction of infrastructure; (5) construction of amenities; (6) construction of homes; (7) marketing; (8) bonding; (9) site supervision and overhead; and (10) taxes. Their primary source of revenue from the home development business was from the sale of houses.

Id.

28. *Id.* at 64.

29. *Id.* at 65.

30. *Id.* at 60.

31. *Id.* at 63.

32. *Id.*

33. *Id.*

B. The Facts

One crucial aspect of Shea Homes's case was that the individual homes it sold were part of a larger community. These housing communities were extensively planned and very well developed.³⁴ All of the developments were set up to have their own homeowners association, which was to be governed by articles of incorporation and bylaws, as well as covenants, conditions, and restrictions ("CC & Rs").³⁵ Shea Homes's marketing strategy was focused at least as much on the community and lifestyle of the housing developments as on the sale of the individual homes.³⁶ For accounting purposes, Shea Homes generally estimated the costs on "a development-wide basis."³⁷ The costs were divided between direct costs and indirect costs.³⁸ Essentially, the direct costs included "costs incurred in the vertical construction of the homes," whereas the indirect costs included costs attributable to land development and common area costs, such as infrastructure and amenities.³⁹ In some instances, the indirect costs of a given development exceeded thirty percent of the total budgeted costs.⁴⁰

As discussed further below, the general rule for reporting income on long-term contracts is that taxpayers are to use the percentage of completion method of accounting, which requires that income be recognized throughout the duration of the contract.⁴¹ As an exception to this general rule, taxpayers are allowed to use the completed contract method of accounting for a contract that qualifies as both a home construction contract and a long-term contract.⁴² This alternative method of accounting is preferable because it allows for the potential deferral of income to a later date, when the contract is deemed completed. As was the case in *Shea Homes*, many home developers begin to sell houses and receive income well before the neighborhood, as a whole, is com-

34. *See generally id.*

35. *Id.* at 72.

36. *Id.* at 74. For example, the developments were usually laid out so that potential customers had to drive past various amenities and aesthetically appealing centerpieces in order to get to the tour center and sales office. *Id.* Before potential customers were able to tour the individual homes, they were first given a tour of the various features and amenities, such as golf courses, clubhouses, cafes, and amphitheaters. *Id.* The customers were even shown videos and given speeches that "emphasized the development's friendships, lifestyle, and community." *Id.* This tactic was used in order to "sell the dream" to potential customers before they were sold the home. *Id.*

37. *Id.* at 70.

38. *Id.* at 70, 76.

39. *Id.* at 75.

40. *Id.* at 76. *See also* Tony Nitti, *The Top Ten Tax Cases (And Rulings) of 2014: #8-A Big Break For Homebuilders*, FORBES (Nov. 11, 2014, 10:29 AM), <http://www.forbes.com/sites/anthonymitti/2014/11/03/the-top-ten-tax-cases-and-rulings-of-2014-8-a-big-break-for-home-builders/2/>.

41. I.R.C. § 460(a)–(b) (West 2014).

42. *Id.* § 460(e).

plete.⁴³ Shea Homes attempted to defer income from the sale of individual homes until the neighborhood in which these homes were located was completed.⁴⁴

C. *The Arguments*

The Commissioner maintained that Shea Homes had improperly reported income using the completed contract method.⁴⁵ The essence of the Commissioner's argument was that the subject matter of the sales contracts was the individual homes themselves, rather than the larger community that included the amenities and common improvements.⁴⁶ To support this argument, the IRS maintained that the sole document of the contract was the purchase and sale agreement, which only mentioned the home.⁴⁷ Additionally, the Commissioner noted that the integration clauses contained in each of the purchase and sale agreements stated, "[T]he agreement is the sole and entire agreement between the buyer and the seller."⁴⁸

The Commissioner argued, in the alternative, that the amenities and common improvements constituted "secondary items," which were excluded by statute from inclusion in the analysis of whether a contract qualifies as a long-term contract.⁴⁹ The Commissioner contended that only the home contracts that closed in escrow within a year, other than the year in which the contracts were entered into, could qualify as a long-term contract.⁵⁰ Because many of the homes sold by Shea Homes closed within the same year, if the Commissioner's interpretation was correct, those contracts could not qualify as long-term contracts. Therefore, Shea Homes would not be allowed the potential deferral of income under the completed contract method.⁵¹ Consequently, Shea Homes would have to recognize income from the sale of homes

43. *Shea Homes, Inc.*, 142 T.C. at 73.

44. *Id.* at 104.

45. *Id.* at 88.

46. *Id.*

47. *Id.* at 89.

48. *Id.* at 89–90.

49. *Id.*

The date a contract accounted for using the CCM is completed is determined without regard to whether one or more secondary items have been used or finally completed and accepted. If any secondary items are incomplete at the end of the taxable year in which the primary subject matter of a contract is completed, the taxpayer must separate the portion of the gross contract price and the allocable contract costs attributable to the incomplete secondary item(s) from the completed contract and account for them using a permissible method of accounting.

Id. at 105 (quoting Treas. Reg. § 1.460–1(c)(3)(ii) (2015)).

50. *Id.* at 88.

51. Nitti, *supra* note 40.

in the year that each home was sold – not the year that the neighborhood and community were completed as a whole.⁵²

Conversely, Shea Homes argued that the subject matter of the contracts included the common improvements and all other features of the entire development.⁵³ Shea Homes argued that the contract consisted of much more than merely the purchase and sale agreement, but also the documents referenced and incorporated into that agreement, such as “public reports, CC & Rs, publicly recorded plats and maps, public resolutions or conditions of approval, and homeowners association documents.”⁵⁴ If this interpretation was correct, Shea Homes would be allowed to consider the costs of constructing the entire development in its determination of when the contract was completed and if it qualified as a long-term contract.⁵⁵ Under Shea Homes’s theory, the contract was not deemed complete until the completion of the entire development as a whole, including completion of all common improvements.⁵⁶ Using this theory, Shea Homes attempted to defer almost \$900 million dollars of income to later years.⁵⁷

D. *The Holding*

The Tax Court held that the purchase and sale agreements were not limited to the contracts themselves, but also incorporated numerous other documents by way of reference.⁵⁸ The subject matter of the contracts at issue consisted of the houses, lots, improvements to the lots, and amenities and common improvements to the development.⁵⁹ According to the Tax Court, the common improvements and amenities of the developments were not secondary items.⁶⁰ Therefore, the taxpayers were allowed to include the cost of all the common improvements in determining not only whether the contract qualified as a home construction contract, but also whether it qualified as a

52. *Id.*

53. *Shea Homes, Inc.*, 142 T.C. at 88.

54. *Id.* at 89.

55. *Id.* at 88–89.

56. *Id.*

57. Nitti, *supra* note 40.

58. *Shea Homes, Inc.*, 142 T.C. at 106.

[W]e do not conclude that the purchase and sale agreement alone serves as the *exclusive* embodiment of the entire agreement between the parties. Buyers of homes from SHI, SHLP, and Vistancia are consciously purchasing more than the “bricks and sticks” of the home. The purchase and sale agreement specifically includes a checklist ensuring that the purchaser receives the related documents.

Id. at 90.

59. *Id.* at 106.

60. *Id.* at 105.

long-term contract.⁶¹ As a result of this holding, Shea Homes was permitted to recognize income based on their interpretation of the completed contract method of accounting, deferring nearly \$900 million of income to the year in which the amenities and common improvements were completed and the development sold.⁶²

III. LEGAL BACKGROUND

In order for Shea Homes to have deferred gain from the sale of individual homes until the entire development was completed, it needed to use the completed contract method of accounting.⁶³ This method of accounting is only available for a contract that qualifies as both a long-term contract and a home construction contract.⁶⁴ Contract integration is used to determine whether the subject matter of the home construction contracts encompassed the entire development or merely the home itself.⁶⁵ First, this Note discusses the requirements of long-term and home construction contracts, followed by methods of accounting and, finally, contract integration.

A. Long-Term Contracts

Section 460 of the Tax Code dictates the manner in which a taxpayer reports income for long-term contracts.⁶⁶ A long-term contract is “any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.”⁶⁷ Home construction contracts are a type of long-term contract.⁶⁸ In other words, in order for a contract to qualify as a home construction contract, it must first meet the requirements of a long-term contract. The contract is deemed completed if it satisfies the requirements of one of two possible tests.⁶⁹ These tests are the 95% completion test and the final completion and acceptance test.⁷⁰

The 95% completion test provides that a contract is completed when “[u]se of the subject matter of the contract by the customer for its intended purpose and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer.”⁷¹ The final

61. *Id.* at 109.

62. *Id.*

63. Nitti, *supra* note 40.

64. *Id.*

65. *Shea Homes, Inc.*, 142 T.C. at 90–92.

66. *Id.* at 85.

67. I.R.C. § 460(f)(1) (West 2014).

68. Nitti, *supra* note 40.

69. Treas. Reg. § 1.460–1(c)(3)(i) (2015).

70. *Id.*

71. *Id.* § 1.460–1(c)(3)(i)(A).

completion and acceptance test provides that the contract is completed upon final completion and acceptance of the subject matter of the contract.⁷² The taxpayer must consider all relevant facts and circumstances when determining whether final completion and acceptance has occurred.⁷³ However, “[A] taxpayer may not delay the completion of a contract for the principal purpose of deferring federal income tax.”⁷⁴

B. Method of Accounting

As a general rule, taxpayers must use the percentage of completion method of accounting for income earned on long-term contracts.⁷⁵ However, taxpayers engaged in home construction contracts are permitted to account for income using a different accounting procedure, the completed contract method.⁷⁶ A home construction contract is defined as:

any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to—

(i) dwelling units . . . contained in buildings containing 4 or fewer dwelling units . . . , and

72. *Id.* § 1.460-1(c)(3)(i)(B).

73. *Id.* § 1.460-1(c)(3)(iv).

74. *Id.* Secondary items, which are not defined in the statute, cannot be considered when determining what has been used or finally completed and accepted throughout the duration of the contract. *Id.* § 1.460-1(c)(3)(ii).

Secondary items. The date a contract accounted for using the CCM [completed contract method] is completed is determined without regard to whether one or more secondary items have been used or finally completed and accepted. If any secondary items are incomplete at the end of the taxable year in which the primary subject matter of a contract is completed, the taxpayer must separate the portion of the gross contract price and the allocable contract costs attributable to the incomplete secondary item(s) from the completed contract and account for them using a permissible method of accounting. A permissible method of accounting includes a long-term contract method of accounting only if a separate contract for the secondary item(s) would be a long-term contract, as defined in paragraph (b)(1) of this section.

Id.

75. Treas. Reg. § 1.460-3(a); I.R.C. § 460(a) (West 2014).

76. *Shea Homes, Inc. v. Comm’r*, 142 T.C. 60, 85-86 (2014).

(ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.⁷⁷

The regulations explicitly allow for the consideration of common improvements when determining whether a contract qualifies as a home construction contract.⁷⁸

The method of accounting a taxpayer employs must clearly reflect income.⁷⁹ The Commissioner has a vast amount of discretion in determining whether a method of accounting clearly reflects income.⁸⁰ If the method of accounting a taxpayer uses in fact clearly reflects income, the Commissioner is not allowed to change the method of accounting.⁸¹ This is true even if the Commissioner's proposed method represents income more clearly than the taxpayer's current method.⁸²

C. Contract Integration

Even though a contract may contain an integration clause, the decisive issue is “whether the parties intended their writing to serve as the exclusive embodiment of their agreement.”⁸³ Instruments that are simultaneous or contemporaneous are read together.⁸⁴ As noted by the *Shea Homes* court,

While no specific wording is required to incorporate another document, the incorporating reference must be clear and unequivocal and “must be called to the attention of the other party, he must consent thereto, and the terms of the incorporated document must be known or easily available to the contracting parties.”⁸⁵

77. I.R.C. § 460(e)(6)(A). The activities listed in § 460(e)(4) consist of “building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property.” *Id.* at § 460(e)(4).

78. Treas. Reg. § 1.460-3(b)(2)(iii) (“A taxpayer includes in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units.”).

79. I.R.C. § 446(b) (2012).

80. *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 532 (1979).

81. *Photo-Sonics, Inc. v. Comm’r*, 357 F.2d 656, 658 n.1 (9th Cir. 1966); *Keith v. Comm’r*, 115 T.C. 605, 617 (2000).

82. *Keith*, 115 T.C. at 617.

83. *Grey v. Am. Mgmt. Servs.*, 139 Cal. Rptr. 3d 210, 213 (Cal. Ct. App. 2012) (quoting *Masterson v. Sine*, 436 P.2d 561, 563 (Cal. 1968)).

84. *Pearll v. Williams*, 704 P.2d 1348, 1351 (Ariz. Ct. App. 1985).

85. *Shea Homes, Inc. v. Comm’r*, 142 T.C. 60, 93 (2014) (quoting *United Cal. Bank v. Prudential Ins. Co. of Am.*, 681 P.2d 390, 420 (Ariz. Ct. App. 1983)).

IV. INSTANT DECISION

The first issue that the Tax Court decided was whether the purchase and sale agreement contract was limited to the document itself because of the integration clause, or whether the contract was comprised of numerous other documents by way of reference and incorporation.⁸⁶ The answer was crucial in determining the subject matter of the contract.⁸⁷ Ultimately, the Tax Court held that the purchase and sale agreements encompassed numerous other documents, such as homeowners association documents, public reports,⁸⁸ CC & Rs,⁸⁹ conditions of approval, and publicly recorded maps.⁹⁰ Because the public reports and CC & Rs “referenced the need and obligation to complete common improvements,”⁹¹ the subject matter of the contracts did include the common improvements and was not merely limited to the homes themselves.⁹² Essentially, purchasers of the homes bargained for Shea Homes’s continuing obligation to complete the development as a whole, including the neighborhood and all of the amenities and common improvements.⁹³ The Tax Court stated:

Purchasers of homes in their developments were conscious of the elaborate amenities and would have understood that the price they paid for a home included the amenities of the development. If a purchaser did not want to live in one of the planned developments with its

86. *Id.* at 89–90.

87. Nitti, *supra* note 40.

88. “The purpose of a public report is to disclose to a homebuyer the rights and obligations imposed on or granted to the homebuyer as well as the seller with respect to a certain development.” *Shea Homes, Inc.*, 142 T.C. at 81.

89. *Id.* at 82–83.

These CC & Rs provided rights and restrictions with respect to the use and enjoyment of the purchased property. CC & Rs applied to the purchaser of property within the development and to all future interest holders of property in the development. The CC & Rs included a legal description of the land subject to the CC & Rs, including both residential lots and common areas . . .

Id. “The CC & Rs provided the authority for the homeowners association to administer the CC & Rs and manage the development, including the authority to assess members and to own and maintain common improvements.” *Id.* at 83. For each of the developments, the CC & Rs required Shea to “transfer title to the common improvements to [either] the developments’ respective homeowners associations . . . [or] the purchasers.” *Id.*

90. *Id.* at 93.

91. Nitti, *supra* note 40.

92. *Shea Homes, Inc.*, 142 T.C. at 103.

93. *Id.* at 91.

accompanying amenities, it is likely he or she could have paid much less for an otherwise comparable dwelling outside of a development and with no seller-provided amenities.⁹⁴

In addition to the contractual analysis, the Tax Court used the language of applicable statutes and regulations to determine whether the contracts included amenities.⁹⁵ Because the Commissioner did not argue that its interpretation of the statutes should be afforded any special deference, it was given none by the court.⁹⁶ The court interpreted the statute and regulations according to their “plain and ordinary meaning”⁹⁷ and attributed an “ordinary, contemporary, common meaning” to any words that were left undefined.⁹⁸ The subject matter of the contract was not defined by statute or regulation.⁹⁹

The regulations were also silent on whether common improvements should be used in determining when the contract was completed.¹⁰⁰ Under the two tests used to determine whether a contract qualifies as a long-term contract, the taxpayer is instructed to deem the contract complete either upon final completion and acceptance of the subject matter or when 95% of the total costs of the subject matter are incurred.¹⁰¹ As the court stated, “In one test, the taxpayer looks to allocable costs attributable to the subject matter of the contract; in the other test, all relevant facts and circumstances inform the subject matter of the contract.”¹⁰²

The court noted that the regulations allow for the consideration of common improvements when determining whether a contract qualifies as a home construction contract.¹⁰³ Additionally, the court gave weight to the fact that

94. *Id.*

95. *Id.* at 97–104. “[W]e look at the contract completion tests in section 1.460–1(c)(3), Income Tax Regs., in the context of the entire section 460 regulatory scheme, including section 1.460–3, Income Tax Regs., concerning long-term construction contracts, and, of course, the statute itself.” *Id.* at 100–01.

96. *Id.* at 100.

97. *Id.* (citing *Union Carbide Corp. v. Comm’r*, 110 T.C. 375, 384 (1998)).

98. *Id.* (quoting *Hewlett-Packard Co. & Consol. Subsidiaries v. Comm’r*, 139 T.C. 255, 264 (2012)).

99. *Id.*

100. *Id.* at 102.

101. *Id.* at 86.

102. *Id.* at 102. 95% Completion Test: “[T]he contract is completed upon ‘[u]se 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.’” *Id.* (quoting Treas. Reg. § 1.460–1(c)(3)(i)(A) (2015)). Final Completion and Acceptance Test: “[T]he contract is complete upon ‘[f]inal completion and acceptance of the subject matter of the contract.’” *Id.* (quoting Treas. Reg. § 1.460–1(c)(3)(i)(B)). But “to determine whether final completion and acceptance of the subject matter of a contract have occurred, a taxpayer must consider all relevant facts and circumstances.” *Id.* (quoting Treas. Reg. § 1.460–1(c)(3)(iv)(A)).

103. *Id.* at 98.

the regulations¹⁰⁴ “instruct taxpayers to ‘consider all relevant allocable contract costs . . . that are incident to or necessary for the long-term contract’, in determining the contract commencement and completion dates.”¹⁰⁵ In the realm of home construction contracts, the allocable contract costs comprise “the cost of any activity that is incident to or necessary for the taxpayer’s performance under a long-term contract,” including indirect costs.¹⁰⁶ Thus, the 95% completion test uses costs that are more than merely those associated with the house and lot, and the final completion and acceptance tests contemplate a subject matter that extends beyond just the house and lot.¹⁰⁷

The Tax Court ultimately held that the subject matter of the contracts did encompass the common improvements and amenities.¹⁰⁸ As a result, the contract was not deemed complete until the “the final bonds were released and the final road paved.”¹⁰⁹ Because the purchase and sale agreement contracts for the individual homes were not deemed complete until the entire development was complete, the contracts qualified as long-term contracts, and thus were also home construction contracts.¹¹⁰ Finally, because the contracts were home-construction contracts, Shea Homes was not required to use the percentage of completion method of accounting and was instead permitted to use the completed contract method, thus deferred nearly \$900 million of income until the contract was completed.¹¹¹

V. COMMENT

Shea Homes was a poorly analyzed and hastily drafted opinion that not only violated fundamental tax policy, but will ultimately result in the improper deferral of billions of dollars of taxes. At a time when the federal government is facing unprecedented fiscal deficits, the improper deferral of income can have devastating effects on the economy.

The regulations accompanying section 460 explicitly acknowledge that the subject matter of a home construction contract extends beyond the construction of a home. When determining whether a contract qualifies as a home construction contract, the taxpayer takes into account the total costs of dwelling units, improvements to the related real property at the site of the dwelling unit, and the “allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements.”

Id. (quoting Treas. Reg. § 1.460-3(b)(2)(iii)).

104. *Id.* at 102 (citing Treas. Reg. §§ 1.460-1(c)(1), (b)(3), 1.460-5(d)(1)).

105. *Id.* (quoting Treas. Reg. § 1.460-1(c)(1)).

106. *Id.* (quoting Treas. Reg. § 1.460-5(d)(1)).

107. *Id.* at 103.

108. *Id.* at 86-106.

109. *Id.* at 103.

110. *Id.* at 106.

111. *Id.* at 104.

A. Violation of Tax Policy

Recall that one fundamental principle of tax policy is to match the imposition of tax with the receipts of income to pay that tax so that a taxpayer does not have to liquidate assets in order to satisfy his tax liability.¹¹² *Shea Homes* violates this fundamental tenet of tax policy by allowing the taxpayer to defer the recognition of more than \$900 million of income until the completion of the entire housing community, despite having received the cash to pay those taxes years earlier. In *Shea Homes*, it would have been very easy, and much more practical, to use the percentage of completion method of accounting, whereby Shea Homes would recognize income on the sale of each individual home. Because Shea Homes received income and incurred expenses that were distinct and identifiable, as each home was constructed and sold, gain from the sale of each home could have been easily ascertained, and Shea Homes would have had the cash readily available to pay the resulting tax liability.

There are instances in which a sale should not result in the immediate imposition of a tax. For example, an installment sale is the quintessential illustration of the mechanics and justifications for deferring income until the taxpayer actually has the money to pay the tax: “An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.”¹¹³ Essentially, instead of paying in full for the purchase of an item up front, the buyer makes numerous payments over a duration that spans more than one year. In an installment sale, the seller is required to include the payments in income as he receives them over time, rather than including the total amount of gain at the time of sale in income.¹¹⁴ This makes sense because the seller does not receive the full purchase price in the year of the sale, and thus would not have the cash on hand to pay for the tax in full at the time of sale.¹¹⁵

112. This concept has also been referred to as the realization rule. Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355 (2004). The principle justifications for such a rule are:

- A realization rule is necessary because imposition of a tax on an increase in value without a disposition raises insuperable liquidity concerns[;]
- A realization rule is necessary because annual valuation of the taxpayer’s assets is administratively impossible[;]
- Since a complete mark-to-market system is not feasible, a rule of convenience, such as the realization rule, is necessary[; and]
- It is politically impossible to repeal the realization rule.

Id. at 359–60.

113. I.R.C. § 453(b)(1) (2012).

114. *Id.* § 453(c).

115. See *Delucchi v. Franchise Tax Bd.*, 88 Cal. Rptr. 3d 840, 843 (2009).

In order to analogize Shea Homes's position to that of an installment sale, the Commissioner could argue that if the item sold was the community, each home sale was an installment payment. Thus, even if Shea Homes's argument was accepted, it would nevertheless have to recognize gains as each home sale was completed.

The better tax treatment of the transaction, however, was to use the percentage of completion method of accounting. Even if one were to accept Shea Homes's argument – that the subject matter of its contracts encompassed the entire development, and final acceptance and completion did not occur until the final road was paved – the percentage of completion method could still have been employed. Shea Homes's expenses could have easily been allocated to the separate phases of construction. Shea Homes paid for the land, incurred expenses in building the houses, and then incurred expenses in completing the common improvements and amenities to complete the neighborhood. Each of these expenses could have been easily accounted for by increasing Shea Homes's basis in the development as a whole along the way. Each time Shea Homes incurred an expense, its cost basis in the property would have correspondingly increased.

The same is true with income. Shea Homes received income upon the sale of each individual home; the difference between the individual purchase price and the costs associated with the sale of that home would have been income to Shea Homes upon the sale of each home. After all amenities and common improvements were made, Shea Homes would have recognized gain equal to the difference between the sale price and its cost basis in the community. That basis would have been comprised of the sales price of each home and the costs of constructing all amenities and common improvements. Thus, Shea Homes's gain on the ultimate sale of the community would consist only of the increased value in the community resulting from the addition of all amenities. Because Shea Homes would not be taxed on the improvements until it ultimately sold the entire development, it would have the cash on hand to pay the tax, thereby furthering the tax policy of matching the receipt of income with the imposition of a tax.

B. Two-Pronged Solution to Shea Homes

To prevent repeating the improper result of the Tax Court's holding in *Shea Homes* in future cases, both a legislative and judicial response is necessary. First, future cases should limit the holding of *Shea Homes* to its particular facts. In addition, Congress should amend the Tax Code to require developers of planned communities to recognize income upon the sale of each

The installment method is a remedial device for dividing a capital gain into discrete taxable events, in order that all of the tax liability is not incurred in the taxable year of an asset's disposition before the seller has all of the sales proceeds in hand to pay the tax liability on it.

Id.

home in the development under the percentage of completion method of accounting. Each solution is outlined below.

1. Limiting *Shea Homes* to Its Facts

Since *Shea Homes*, the Tax Court has declined to follow its holding in at least one case by limiting *Shea Homes* to its particular facts. In *Howard Hughes v. Commissioner*, Petitioners were in the business of residential land development.¹¹⁶ Petitioners sold land in different manners with different types of contracts.¹¹⁷ Petitioners would sell land through: (1) bulk sales, (2) pad sales, (3) finished lot sales, or (4) custom lot sales.¹¹⁸ As the court stated:

In bulk sales, Ps develop raw land into villages and sell an entire village to a builder. Ps do not otherwise develop the sold village. In pad sales, Ps develop villages into parcels and sell the parcels to builders. Ps do not develop within the sold parcels. In finished lot sales, Ps develop parcels into lots and sell whole parcels of finished lots to builders. In custom lot sales, Ps sell individual lots to individual purchasers or custom home builders, who then construct homes.¹¹⁹

The Petitioners themselves did not construct any residential dwelling units on the land they sold.¹²⁰ However, Petitioners extensively constructed the infrastructure and common improvements within many of these contracts.¹²¹ As the Tax Court noted, “These improvements included rough grading, roadways, sidewalks, utility infrastructure such as water, sewer, gas, electricity, and telephone, storm water drainage, parks, trails, landscaping, entry features, signs, and perimeter walls.”¹²² The cost of these improvements exceeded ten percent of various total contract prices.¹²³

The land that Petitioners sold belonged to a massive, master-planned community called Summerlin.¹²⁴ This community contained roughly 22,500 acres, 40,000 homes, and 100,000 residents.¹²⁵ Petitioners expected approximately 220,000 residents to live in Summerlin when it was fully completed.¹²⁶ In addition, Summerlin “contains about 1.7 million square feet of developed retail space, 3.2 million square feet of developed office space, 3 hotels, and health and medical centers. It has 25 public and private schools, 5

116. Nos. 10539–11, 10565–11, 2014 WL 10077466, at *2 (T.C. June 2, 2014).

117. *Id.* at *1.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.* at *3.

122. *Id.* at *8.

123. *Id.*

124. *Id.* at *2.

125. *Id.*

126. *Id.*

higher learning institutions, 9 golf courses, parks, trails, and cultural facilities.”¹²⁷

Petitioners reported income from these contracts¹²⁸ using the completed contract method of accounting.¹²⁹ The Commissioner argued that the contracts at issue were not home construction contracts.¹³⁰ The Commissioner further argued that the contracts were not long-term construction contracts, and therefore would be ineligible for the long-term percentage of completion method of accounting.¹³¹

The court held that Petitioners’ argument failed because of the uncertainty as to whether homes or “qualifying dwelling units” would ever be built on the land they sold.¹³² The court noted that Petitioners “did not build homes on the land they sold, nor did qualifying dwelling units exist on the sold land at the time of the sales.”¹³³ The Petitioners were not even able to firmly establish that any homes would ever be built on the land at the time the time of sale.¹³⁴

The Tax Court ultimately held that none of the contracts at issue were home construction contracts.¹³⁵ Therefore, Petitioners were not allowed to report income from these contracts using the completed contract method of accounting.¹³⁶ The custom lot contracts and bulk sale agreements did qualify as long-term contracts; however, the Petitioners were still required to use the percentage of completion method of accounting instead of the completed contract method.¹³⁷ In its analysis, the Tax Court sketched a bright line to illuminate when a long-term contract would qualify as a home construction contract:

Our Opinion today draws a bright line. A taxpayer’s contract can qualify as a home construction contract only if the taxpayer builds, constructs, reconstructs, rehabilitates, or installs integral components to dwelling units or real property improvements directly related to and located on the site of such dwelling units. It is not enough for the taxpayer to merely pave the road leading to the home, though that may be necessary to the ultimate sale and use of a home. If we allow taxpayers who have construction costs that merely benefit a home that may or may not be built, to use the completed contract method of account-

127. *Id.*

128. These contracts consisted of the purchase and sale agreements. *Id.* at *8.

129. *Id.* at *1, *13.

130. *Id.* at *1.

131. *Id.*

132. *Id.* at *19.

133. *Id.*

134. *Id.*

135. *Id.* at *25.

136. *Id.*

137. *Id.*

ing, then there is no telling how attenuated the costs may be and how long deferral of income may last.¹³⁸

The Tax Court in *Howard Hughes* made sure to note that *Shea Homes* never stood for the principle that a home construction contract could consist of only common improvement costs.¹³⁹ Even though many of the contracts that Petitioners sold in *Howard Hughes* belonged to an extremely large master-planned community, just as in *Shea Homes*, and while these communities were extensively marketed based on the lifestyle of the neighborhood as a whole, just as in *Shea Homes*, the contracts simply did not include homes or qualified dwelling units.¹⁴⁰ Therefore, the land developers were not allowed to defer potentially massive amounts of income under the completed contract method of accounting.

There were other factors and circumstances that were crucial to *Shea Homes*'s success. *Shea Homes* marketed the homes it sold with an eye toward focusing on the community and lifestyle of the neighborhood as a whole, rather than just on an individual home. Many of the common improvements and amenities that were built within the neighborhood reinforced the concept that homebuyers were bargaining for more than just the individual home.¹⁴¹ In some cases, the cost of these common improvements exceeded twenty-seven percent of the total costs of development.¹⁴² This meant that the common improvements and amenities within the neighborhoods were substantial and not merely token. In *Shea Homes*'s case, some of the common improvements and amenities it built within various developments included a 30,000 square-foot clubhouse with ballroom, restaurants, pools, spas, fitness centers, basketball courts, tennis courts, soccer fields, trails, bike paths, amphitheaters, and parks, to name a few.¹⁴³

Additionally, supplementary documents, such as the public reports and CC & Rs, could be included in determining what comprised the purchase and sale agreements. In *Shea Homes*, these documents laid out the developer's obligations to construct the common improvements and amenities, and thus proved that customers were bargaining for more than the home alone.¹⁴⁴ The issue of whether ancillary documents can be incorporated into the purchase and sale agreement is an issue of state law, but many states allow for this integration.¹⁴⁵ Finally, the state law involved in *Shea Homes* also supported the concept that real estate included the costs of common improvements and amenities.¹⁴⁶

138. *Id.*

139. *Id.* at *24.

140. *Id.* at *19.

141. *Shea Homes, Inc. v. Comm'r*, 142 T.C. 60, 65 (2014).

142. *Id.* at 75–76.

143. *Id.* at 77.

144. *Id.* at 67.

145. *See id.* at 88–89.

146. *Id.* at 81.

Howard Hughes provides a glimpse of insight from the Tax Court that *Shea Homes* was wrongly decided. The decision illuminates one possible way to avoid the potentially disastrous repercussions of *Shea Homes*. Courts must decline to follow *Shea Homes* in future cases if the facts and circumstances of those cases do not parallel *Shea Homes* itself. The Tax Court in *Howard Hughes* appreciated this solution and exercised judicial restraint by declining to follow *Shea Homes*, even though many of the facts present were extremely similar to those in *Shea Homes*.¹⁴⁷ Despite this revelation, the possibility of judicial restraint is not enough of a solution to the devastating problems that *Shea Homes* creates. The Tax Code must also be amended.

2. Legislative Proposal

The purpose of the amended legislation must be to realign future holdings with the fundamental tax policy of matching a tax with the receipt of income. The language will need to level the playing field between massive home developers that essentially construct entire neighborhoods and the homes contained in them, like *Shea Homes*, and traditional homebuilders who build one house at a time. In order to do this, the amendment must retain the completed contract method of accounting for valid home construction contracts, where the subject matter of the contract is the actual home, and it must mandate the percentage of completion method of accounting for contracts that purport to have a subject matter of both the home and the development or neighborhood in which it is located. An example of the legislative proposal would read as follows:

I.R.C. § 460(e)(6)(C):

Notwithstanding (A), a taxpayer shall not defer gain from the sale of a qualified dwelling unit built, constructed, or rehabilitated by the taxpayer until the entire development, subdivision, or community is completed or accepted. Taxpayers who build, construct, rehabilitate or develop qualified dwelling units as well as the development, subdivision, or community in which the dwelling unit is located shall use the percentage of completion method of accounting if the purchase and sale contract for the dwelling unit has a subject matter that encompasses the development.

147. *Howard Hughes Co., LLC v. Comm’r*, Nos. 10539–11, 10565–11, 2014 WL 10077466, at *22 (T.C. June 2, 2014).

V. CONCLUSION

With the ink still drying on the Tax Court's opinion, the ramifications of *Shea Homes* have yet to be recognized. *Shea Homes* will have a devastating impact on the nation's economy for years to come if massive developers are allowed to defer income from the sale of individual homes until the development in which they belong is finally sold, *if ever*. The judicial restraint and legislative action this Note proposes should curtail the results of *Shea Homes* and bring the Tax Code one step closer to achieving horizontal equity among taxpayers that build single homes and those that build thousands of homes.