Haynsworth v. Commissioner, 68 T. C. 703 (1977)

When a reserve for estimated development costs is closed upon completion of a project, the unused portion of the reserve must be reported as ordinary income.

Summary

In Haynsworth v. Commissioner, the U. S. Tax Court ruled that when a partnership's reserve for estimated development costs was closed after all lots in a subdivision were sold, the excess of the reserve over actual costs incurred ($45,219. 77) was taxable as ordinary income to the partners. The partnership had deducted a proportionate part of these estimated costs as part of the basis for each lot sold over several years. The court held that the closing of the reserve triggered income recognition, even though the statute of limitations had run on the years in which the deductions were taken.

Facts

In 1959, a partnership acquired land for subdivision development and obtained an estimate of $404,406 for development costs. The partnership created a reserve for these costs and deducted a proportionate part as part of the cost basis for each lot sold. By November 1, 1972, when all remaining lots were sold and the partnership liquidated, the total development costs deducted exceeded actual costs by $45,219. 77. The partners reported this excess as part of the sales price for the final lots sold, treating it as capital gain. The IRS determined it should be taxed as ordinary income.

Procedural History

The IRS issued a notice of deficiency to the petitioners, Robert F. and Hazel Haynsworth, for the 1972 tax year, reclassifying the $45,219. 77 from capital gain to ordinary income. The Haynsworths petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court upheld the IRS's determination, ruling that the unused portion of the development cost reserve was ordinary income when the reserve was closed.

Issue(s)

1. Whether the closing of a reserve for estimated development costs, created to reduce taxable income in prior years, results in ordinary income to the extent the reserve exceeds actual development costs when the reserve is closed.

Holding

1. Yes, because when the reserve was closed upon completion of the subdivision project and liquidation of the partnership, the excess of the reserve over actual costs incurred ($45,219. 77) was released and became taxable as ordinary income to the

partners.

Court’s Reasoning

The court reasoned that the partnership’s method of accounting required the inclusion of estimated development costs in the basis of lots sold. When the reserve was closed, the excess of the reserve over actual costs represented a recovery of previously deducted amounts, which must be reported as income. The court cited several cases where the closing of a reserve or the release of a liability previously deducted resulted in income recognition in the year of the event, regardless of when the deductions were taken. The court rejected the taxpayers’ argument that the statute of limitations barred the IRS from correcting the basis of lots sold in prior years, holding that the closing of the reserve itself triggered income recognition in 1972.

Practical Implications

This decision has significant implications for real estate developers and partnerships using reserves for estimated development costs. It establishes that such reserves must be closely monitored and adjusted as necessary to reflect actual costs. When a project is completed and the reserve is closed, any excess over actual costs must be reported as ordinary income, even if the statute of limitations has run on the years in which the deductions were taken. This ruling may affect how developers structure their accounting for development projects, potentially leading to more frequent adjustments to reserves to avoid large income recognition events upon project completion. It also underscores the importance of accurate cost estimation and the potential tax consequences of overestimating development expenses.

