Foothill Ranch Co. Pshp. v. Commissioner, 110 T. C. 94 (1998)

The court clarified that a contract may be considered long-term under the percentage of completion method if construction is necessary to fulfill contractual obligations, even if it is not the primary subject matter of the contract.

Summary

Foothill Ranch Company Partnership (FRC) used the percentage of completion method (PCM) to report income from property sales, which the IRS challenged. The Tax Court held that FRC was entitled to use PCM as the construction obligations were necessary to fulfill the sales contracts, despite not being the primary focus. The court also ruled on the eligibility for litigation costs, stating that first-tier partners meeting net worth requirements could receive awards proportional to their partnership interest. The decision has implications for tax reporting under PCM and the allocation of litigation costs in partnership disputes.

Facts

In 1987, Laguna Niguel Properties purchased the Whiting Ranch and exchanged it for an interest in FRC. FRC entered into an agreement with Orange County in 1988 to build housing units and other improvements in exchange for construction permits. FRC also sold parcels to Lyon Communities, Inc. , and P. B. Partners, with FRC obligated to fulfill construction commitments. FRC used the PCM to report income from these transactions on its 1988 tax return. The IRS issued a Notice of Final Partnership Administrative Adjustment in 1995, challenging FRC's use of PCM, leading to the litigation.

Procedural History

FRC filed a petition in response to the IRS's notice. The IRS initially moved to dismiss for lack of jurisdiction due to an improper designation of the tax matters partner, but this was denied after FRC amended the petition. The parties settled the case without adjustments to FRC's reported income, and FRC moved for litigation costs.

Issue(s)

1. Whether the IRS's position that FRC was not entitled to use the PCM was substantially justified?
2. Whether first-tier partners meeting the net worth requirements are eligible to receive an award for litigation costs?
3. Whether a partner in a TEFRA partnership proceeding may receive an award for costs paid by the partnership?
4. Whether the amount sought by FRC for litigation costs was reasonable?

Holding

1. No, because the construction obligations were necessary to fulfill the sales contracts, making them long-term contracts under the PCM.
2. Yes, because first-tier partners meeting the net worth requirements of the Equal Access to Justice Act (EAJA) are eligible to receive an award.
3. Yes, but only to the extent such costs are allocable to that partner.
4. No, because the requested amount for litigation costs was adjusted to reflect a reasonable fee.

Court's Reasoning

The court reasoned that the construction obligations under FRC's sales agreements were necessary to fulfill the contracts, thus qualifying them as long-term contracts under IRC section 460. The IRS's position was not substantially justified as it incorrectly focused on construction not being the primary subject matter. The court also applied the EAJA and TEFRA rules, holding that first-tier partners could receive litigation cost awards based on their allocable share in the partnership. The court adjusted the litigation costs to reflect a reasonable fee based on statutory limits and cost of living adjustments, citing relevant case law and statutory provisions.

Practical Implications

This decision clarifies that the PCM can be used for contracts where construction is necessary to fulfill obligations, even if not the primary focus. It impacts how similar contracts are analyzed for tax purposes. For legal practitioners, it emphasizes the importance of understanding the scope of contractual obligations when advising on tax reporting methods. The ruling on litigation costs affects how costs are allocated in partnership disputes, potentially influencing settlement strategies and the financial considerations of pursuing litigation. Subsequent cases may reference this decision when addressing the application of PCM and the allocation of litigation costs in TEFRA partnership proceedings.

