Hutchinson v. Commissioner, 116 T. C. 172 (2001)

In Hutchinson v. Commissioner, the U. S. Tax Court ruled on the applicability of the alternative cost method under Rev. Proc. 92-29 for real estate developers. The court allowed the allocation of estimated construction costs for common improvements, like a golf course and clubhouse, to the bases of sold lots but disallowed the inclusion of future-period interest expense in these calculations. This decision clarified the scope of the alternative cost method, impacting how developers can allocate costs for tax purposes.

Parties

David C. Hutchinson et al. , as petitioners, were shareholders in Valley Ranch, Inc. (VRI), an Idaho corporation taxed under subchapter S of the Internal Revenue Code. The respondent was the Commissioner of Internal Revenue. The case was consolidated for trial, briefing, and opinion in the U. S. Tax Court.

Facts

In 1993, petitioners formed VRI and entered into an option to purchase a 526-acre parcel near Sun Valley, Idaho, to develop a golf course residential community. VRI agreed to construct an 18-hole golf course, driving range, practice greens, a clubhouse with various amenities, and transfer these to Valley Club, Inc. (VCI), a nonprofit membership corporation. VRI estimated total construction costs for the golf course at $13,390,624 and for the clubhouse at $3,707,662, plus additional costs for employee housing and finance costs totaling $23,334,881. VRI began selling residential lots and constructing the golf course and clubhouse in 1994, completing them in 1996. VRI used the alternative cost method to allocate these estimated costs to the bases of lots sold, aiming to reduce taxable gain.

Procedural History

The Commissioner initially disallowed VRI’s allocation of estimated costs to the lots sold, treating the residential development and golf course/clubhouse as separate projects. Before trial, the Commissioner conceded that these were integrated projects but argued that VRI retained a depreciable interest in the clubhouse, disqualifying its estimated construction costs from allocation under the alternative cost method. The Commissioner also challenged the inclusion of estimated future-period interest expense in these allocations. The case was submitted fully stipulated to the U. S. Tax Court, which then decided on the application of Rev. Proc. 92-29.

Issue(s)

Whether, under Rev. Proc. 92-29, a real estate developer may allocate to the bases of lots sold (1) estimated construction costs relating to common improvements like a golf course and clubhouse, and (2) estimated future-period interest expense relating to these common improvements.

Rule(s) of Law

Under Rev. Proc. 92-29, a real estate developer may allocate estimated future construction costs of common improvements to the bases of lots sold, subject to the limitation that such allocated costs in any year cannot exceed the cumulative actual construction costs incurred for the entire development. Common improvements must be those the developer is contractually obligated to construct, and the costs must not be recoverable through depreciation. Additionally, under section 263A(f) of the Internal Revenue Code, only interest expenses paid or incurred during the production period can be capitalized.

Holding

The U. S. Tax Court held that VRI could allocate $3,707,662 in estimated construction costs for the clubhouse to the bases of lots sold under the alternative cost method, as VRI did not retain a depreciable interest in the clubhouse. However, the court disallowed the allocation of $5,861,595 in estimated future-period interest expense to the bases of lots sold, as such expenses were not incurred during the production period and were thus not includable under the alternative cost method.

Reasoning

The court analyzed the ownership of the clubhouse during the transition period after its completion, concluding that VCI, not VRI, possessed the benefits and burdens of ownership, negating VRI's ability to recover the clubhouse costs through depreciation. The court emphasized that the alternative cost method under Rev. Proc. 92-29 allows allocation of estimated construction costs but only if the developer does not have a depreciable interest in the improvements. For the interest expense, the court applied section 263A(f), which limits interest capitalization to expenses paid or incurred during the production period. The court rejected VRI's argument for including estimated future-period interest, as it contravened the economic performance rule under section 461(h) and the specific provisions of Rev. Proc. 92-29.

Disposition

The U. S. Tax Court affirmed the allocation of estimated construction costs for the clubhouse under the alternative cost method but disallowed the allocation of estimated future-period interest expense. Decisions were to be entered under Rule 155.

Significance/Impact

Hutchinson v. Commissioner clarifies the scope of the alternative cost method under Rev. Proc. 92-29, allowing developers to allocate estimated construction costs of common improvements to the bases of lots sold provided these costs are not recoverable through depreciation. However, it restricts the inclusion of estimated future-period interest expense in these allocations, aligning with the economic performance rules of section 461(h) and the interest capitalization rules of section 263A(f). This decision has significant implications for how real estate developers calculate their taxable gains and manage their tax liabilities during the development process.

