Shea Homes, Inc. & Subsidiaries, et al. v. Commissioner, 142 T. C. 60 (2014)

In Shea Homes, Inc. v. Commissioner, the U. S. Tax Court ruled that home developers could use the completed contract method of accounting for their home construction projects, encompassing the entire development rather than just individual homes. The court's decision allows developers to defer income until the development or phase is nearly complete, impacting how income from long-term construction projects is reported and taxed. This ruling clarifies the scope of home construction contracts under tax law, affecting the accounting practices of developers nationwide.

Parties

Shea Homes, Inc. and its subsidiaries (Petitioners) were the taxpayers in this case, contesting the Commissioner of Internal Revenue's (Respondent) determination of tax deficiencies. Shea Homes, LP, and Vistancia, LLC were also involved as petitioners in consolidated cases. The Commissioner of Internal Revenue was the respondent seeking to change the taxpayers' accounting method.

Facts

Shea Homes, Inc. , along with Shea Homes, LP, and Vistancia, LLC, were involved in developing large planned residential communities in Colorado, California, and Arizona. They sold homes in 114 developments during the years in question. The companies used the completed contract method of accounting, deferring income until 95% of the total contract costs were incurred or the development or phase was completed and accepted. This method included costs related to the entire development, such as land acquisition, infrastructure, amenities, and marketing. The Commissioner argued that only the costs of the individual home and lot should be considered, leading to a dispute over the application of the completed contract method.

Procedural History

The Commissioner issued notices of deficiency to Shea Homes, Inc. for the 2004 and 2005 tax years and notices of final partnership administrative adjustments to Shea Homes, LP, and Vistancia, LLC for various tax years. The taxpayers timely petitioned the U. S. Tax Court for review. The cases were consolidated, and after a trial in Washington, D. C. , the court issued its opinion in favor of the taxpayers, affirming their use of the completed contract method of accounting.

Issue(s)

Whether the subject matter of the home construction contracts includes the entire development or is limited to the individual home and lot, and whether the taxpayers correctly applied the completed contract method of accounting under Section 460 of the Internal Revenue Code?

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Rule(s) of Law

Section 460 of the Internal Revenue Code governs the accounting for long-term contracts, typically requiring the percentage of completion method. However, Section 460(e) exempts home construction contracts, allowing the use of the completed contract method. The regulations define a home construction contract as one where 80% of estimated total contract costs are attributable to the construction of dwelling units and related improvements. The completed contract method deems a contract complete when either 95% of allocable contract costs are incurred and the subject matter is used for its intended purpose, or upon final completion and acceptance of the subject matter.

Holding

The U. S. Tax Court held that the subject matter of the contracts included not only the individual home and lot but also the larger development, including amenities and infrastructure. Consequently, the taxpayers were permitted to use their interpretation of the completed contract method, deferring income until 95% of the total allocable costs of the development were incurred or the development or phase was completed and accepted.

Reasoning

The court's reasoning focused on the nature of the contracts and the intent of the parties. It found that the contracts consisted of more than just the purchase and sale agreement, including public reports, covenants, conditions, and restrictions (CC&Rs), and other related documents. These documents collectively set forth the rights and obligations of the buyer and seller, indicating that the subject matter of the contracts encompassed the entire development. The court also considered the significant upfront costs borne by the developers and the difficulty in predicting profits until near the end of the project, supporting the use of the completed contract method. Additionally, the court rejected the Commissioner's argument that the contracts should be limited to the house and lot, finding that the common improvements were integral to the contracts and not secondary items. The court's interpretation of the regulations under Section 460 supported the inclusion of common improvement costs in determining the contract completion date.

Disposition

The U. S. Tax Court entered decisions in favor of the petitioners, allowing them to continue using the completed contract method of accounting as applied to their developments.

Significance/Impact

The Shea Homes decision is significant for the home construction industry, as it clarifies that the completed contract method can be applied to the entire

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development rather than just individual homes. This ruling impacts how developers account for income and expenses, allowing for longer deferral periods until the development or phase is nearly complete. The decision also underscores the importance of considering all relevant documents and the intent of the parties in determining the scope of a contract under tax law. Subsequent treatment by other courts and the IRS will likely be influenced by this ruling, affecting the tax planning and compliance strategies of home developers.

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