Shea Homes, Inc. v. Commissioner, 142 T. C. No. 3 (2014)

In Shea Homes, Inc. v. Commissioner, the U. S. Tax Court ruled in favor of the homebuilder, allowing them to use the completed contract method for accounting income from home sales in planned developments. The court determined that the subject matter of the home purchase contracts included the entire development, not just individual homes, thus permitting income deferral until 95% of the development's costs were incurred. This decision clarifies the scope of home construction contracts under tax law and has significant implications for how homebuilders account for income from large-scale projects.

Parties

Shea Homes, Inc. , and its subsidiaries, Shea Homes, LP, and Vistancia, LLC, were the petitioners in this case. They were represented by Gerald A. Kafka, Rita A. Cavanagh, Chad D. Nardiello, and Sean M. Akins. The respondent was the Commissioner of Internal Revenue, represented by Melissa D. Lang, Allan E. Lang, David Rakonitz, and Nicholas D. Doukas.

Facts

Shea Homes, Inc. , and its subsidiaries, Shea Homes, LP, and Vistancia, LLC, are home developers that build large, planned residential communities across multiple states. They reported income from home sales using the completed contract method of accounting, which allowed them to defer income until they met the 95% cost completion threshold for each development. The Commissioner challenged this method, asserting that the subject matter of the contracts consisted only of the homes and lots, not the broader development, and that income should be recognized upon the close of escrow for each home sale.

Shea Homes, Inc. , and its subsidiaries maintained detailed budgets and used Tract-PIE software to track costs and revenues for each development. They argued that the subject matter of their home purchase contracts included the entire development, including amenities and infrastructure, which influenced the cost calculations for the 95% completion test.

Procedural History

The case was heard in the U. S. Tax Court, with Shea Homes, Inc. , and its subsidiaries challenging the Commissioner's determination of tax deficiencies for the tax years 2004 and 2005. The court consolidated the cases involving Shea Homes, LP, and Vistancia, LLC, and reviewed the notices of final partnership administrative adjustments issued by the Commissioner for the tax years 2004, 2005, and 2006. The standard of review was de novo, as the court was tasked with determining whether the completed contract method of accounting was properly applied by the petitioners.

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Issue(s)

Whether the subject matter of the home purchase contracts between Shea Homes, Inc. , and its subsidiaries and homebuyers includes the entire development, thus permitting the use of the completed contract method of accounting for income recognition?

Rule(s) of Law

Under section 460 of the Internal Revenue Code, taxpayers who receive income from long-term contracts must generally use the percentage of completion method, but home construction contracts are exempted and may use the completed contract method. A contract is considered completed under the completed contract method when it meets either the use and 95% completion test or the final completion and acceptance test. The regulations under section 460 allow taxpayers to include the allocable share of costs for common improvements in determining if a contract qualifies as a home construction contract.

Holding

The U. S. Tax Court held that the subject matter of the home purchase contracts included the home, the lot, improvements to the lot, and the common improvements in the development. Consequently, Shea Homes, Inc. , and its subsidiaries were permitted to report income and losses from home sales using their interpretation of the completed contract method of accounting.

Reasoning

The court’s reasoning focused on the interpretation of the subject matter of the home purchase contracts. It rejected the Commissioner’s argument that the contracts were limited to the house and the lot, finding instead that the contracts encompassed the entire development or phase of the development, including amenities and infrastructure. This broader interpretation was supported by the inclusion of public reports, covenants, conditions, and restrictions (CC&Rs), and other documents provided to homebuyers, which indicated that the purchase included rights to use common areas and amenities.

The court also considered the practical implications of the homebuilders’ business model, which involved significant upfront costs for land acquisition, grading, utilities, and infrastructure before any home sales occurred. The completed contract method was deemed appropriate for matching these costs with the revenues from home sales over time.

The court addressed the Commissioner’s contention that common improvements should be treated as secondary items, separate from the primary subject matter of the contract. It found that the common improvements were integral to the home purchase contracts and not secondary items, as they were essential to the lifestyle

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and value proposition marketed to homebuyers.

Finally, the court concluded that the completed contract method, as applied by Shea Homes, Inc. , and its subsidiaries, clearly reflected income under section 446(b) of the Internal Revenue Code. The method was consistent with the legislative intent behind the home construction contract exception and allowed for a reasonable deferral of income given the nature of the homebuilding industry.

Disposition

The court entered decisions in favor of the petitioners, Shea Homes, Inc. , and its subsidiaries, allowing them to continue using the completed contract method of accounting for their home construction contracts.

Significance/Impact

The Shea Homes decision is significant for the homebuilding industry, as it clarifies the scope of home construction contracts under tax law. By recognizing that the subject matter of such contracts can include the entire development, the court affirmed the use of the completed contract method for large-scale projects, which can involve significant upfront costs and long-term planning. This ruling may influence how other homebuilders structure their contracts and account for income, potentially affecting tax planning and financial reporting practices industry-wide. The decision also underscores the importance of considering all contractual documents and the broader context of home sales in planned communities when applying tax accounting methods.

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