

ACTION ON DECISION

Subject: *Shea Homes, Inc. and Subs. v. Commissioner*,
834 F.3d 1061 (9th Cir. 2016), *aff'g* 142 T.C. 60 (2014)

Issue: Whether a contract for the construction and sale of a house in a residential development is completed for purposes of the completed contract method of accounting only after a taxpayer has incurred 95 percent of the estimated costs of constructing the entire development, including the cost of constructing houses that are the subjects of contracts with other buyers.

Discussion: Taxpayers constructed and sold houses in residential developments. Taxpayers also constructed common improvements. These improvements included infrastructure, such as sewers and roads, and amenities, such as parks and clubhouses. Taxpayers entered into separate purchase and sale agreements (home construction contracts) with individual buyers.

Taxpayers used the completed contract method (CCM) of accounting set forth in Treasury Regulation § 1.460-4(d) to account for the income and costs of their home construction contracts. Under CCM, gross contract price and allocable contract costs are taken into account upon contract completion. Contract completion occurs upon the earlier of (1) the customer's use of the subject matter of the contract and taxpayer having incurred 95 percent of the estimated allocable contract costs attributable to the subject matter (95-percent completion test), and (2) final completion and acceptance of the subject matter. Treas. Reg. § 1.460-1(c)(3)(i). The regulations also provide that completion is determined without regard to whether "secondary items" have been used or finally completed and accepted. Treas. Reg. § 1.460-1(c)(3)(ii). For purposes of determining when their home construction contracts were completed, Taxpayers treated an entire development or phase of a larger development as the subject matter of each individual home construction contract. Thus, in applying the 95-percent completion test to a contract, Taxpayers took into account the estimated costs of the entire development or phase, including the costs of constructing houses that were the subject matter of other contracts. Taxpayers deferred recognition of income from all house sales in a development or phase until they had incurred 95 percent of the estimated costs of the entire development or phase.

The Service challenged this treatment and asserted that income from Taxpayers' home construction contracts should be reported at the time of sale, because that is when there is final completion and acceptance of the subject matter of the contract, or, in the alternative, final completion and acceptance of all but uncompleted secondary items. The Tax Court rejected the Service's arguments (1) that the subject matter of an individual home construction contract consisted solely of a house and the lot on which the house was situated and (2) alternatively, that common improvements, although a

part of each contract's subject matter, were secondary items, so that a contract was completed upon the sale of a house, when the sole or primary subject matter of the contract had been finally completed and accepted. The court entered decisions for Taxpayers. The Service appealed to the Ninth Circuit Court of Appeals.

The Ninth Circuit Court of Appeals affirmed. The court's opinion states, "[T]he Tax Court determined that, as a matter of fact, the subject matter included the house, the lot, 'the development . . . and its common improvements and amenities.'" 834 F.3d at 1067 (quoting *Shea Homes*, 142 T.C. at 109). The court reviewed the Tax Court decision under a clearly erroneous standard and declined to reverse what it considered the Tax Court's factual finding that the subject matter of each home construction contract consisted of the entire development or phase in which a house was situated. Accordingly, the court held that Taxpayers' method of determining contract completion was proper.

The Service disagrees with the court's conclusion that the 95-percent completion test can properly be applied with reference to the costs of an entire development or phase. Contract completion and the 95-percent completion test apply on a contract-by-contract basis. The latter considers "the total allocable contract costs attributable to the subject matter [of the contract]." Treas. Reg. § 1.460-1(c)(3)(i)(A). The total costs of an entire development or phase cannot be the "allocable contract costs" of each individual home construction contract. Section 1.460-4(d)(1) of the regulations provides that "a taxpayer using the CCM . . . must take into account in the contract's completion year, . . . the gross contract price and all allocable contract costs incurred by the completion year." If the "allocable contract costs" of a contract are the entire cost of a development or phase, this same set of costs becomes deductible multiple times as each and every individual home construction contract is completed.

Further, the definition of contract completion in the regulations assumes that the subject matter of a contract can be used by a customer and that the customer can accept the subject matter. Treas. Reg. § 1.460-1(c)(3)(i)(B). The buyer of a house, the counterparty to each of Taxpayers' home construction contracts, has no right to use other houses in a development and has no authority to accept them.

Accordingly, the Service will not follow the Ninth Circuit Court of Appeal's opinion in *Shea Homes*. Although we disagree with the decision of the court, we recognize the precedential effect of the decision to cases appealable in the Ninth Circuit, and therefore will follow it with respect to cases within that circuit, if the opinion cannot be meaningfully distinguished. We do not, however, acquiesce to the opinion and will continue to litigate our position in cases in other circuits.

Recommendation: Nonacquiescence.

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