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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

"Recent developments are just like ancient history, except they happened less long ago."

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

The **Tax Increase Prevention Act of 2014**, Pub. L. No. 113-295, colloquially called the "Extenders Bill," was signed by the President on 12/19/14. The Tax Increase Prevention Act [hereinafter TIPA] retroactively extended through 12/31/14 a myriad of deductions, credits, and special benefit provisions that had expired at the end of 2013. It did not address extension of these provisions, or any other expired provisions, to 2015. This outline mentions some of the more important provisions that were extended but does not attempt comprehensively to list the extenders or to explain them in detail. TIPA also made miscellaneous technical corrections, none of which are discussed herein, and encompassed The Achieving a Better Life Experience (ABLE) Act of 2014.

I. ACCOUNTING

A. Accounting Methods

1. Accounting method changes related to the final tangible property regulations.

a. Accounting method changes are coming and the IRS wants to make it easy. Rev. Proc. 2014-16, 2014-9 I.R.B. 606 (2/24/14). This revenue procedure modifies the procedures for obtaining the automatic consent of the IRS for certain changes in methods of accounting for amounts paid to acquire, produce, or improve tangible property. In particular, it provides procedures for obtaining automatic consent to change to (1) a reasonable method described in Reg. § 1.263A-1(f)(4) for self-constructed assets, and (2) a permissible method under § 263A(b)(2) and Reg. § 1.263A-3(a)(1) for certain costs related to real property acquired through a foreclosure or similar transaction. Rev. Proc. 2011-14, 2011-4 I.R.B. 330, is modified and clarified, and Rev. Proc. 2012-19, 2012-14 I.R.B. 689, is modified and superseded.

b. The IRS hears the many pleas for relief and provides to small businesses a simplified method of making accounting method changes related to the final tangible property regulations. Rev. Proc. 2015-20, 2015-9 I.R.B. 694 (2/13/15). This revenue procedure permits small business taxpayers to make certain accounting method changes to comply with the final tangible property regulations (T.D. 9636, Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 78 F.R. 57686 (9/19/13) and T.D. 9689, Guidance Regarding Dispositions of Tangible Depreciable Property, 79 F.R. 48661 (8/18/14)) without filing Form 3115 and by taking into account a § 481(a) adjustment that takes into account only amounts paid or incurred, and dispositions, in taxable years beginning on or after 1/1/14. In effect, the revenue procedure permits eligible taxpayers to make changes on a cut-off basis. A taxpayer is a "small business taxpayer" for purposes of this simplified procedure if the taxpayer has one or more separate and distinct trades or businesses that has either total assets of less than $10 million as of the first day of the taxable year for which the change is effective or average annual gross receipts of $10 million or less for the prior three taxable years (as determined under Reg. § 1.263(a)-3(h)(3)).

- A taxpayer that uses the simplified procedure to make accounting method changes does not receive audit protection for prior years. Thus, for example, a taxpayer that fully deducted in prior years costs that are required by the tangible property regulations to be capitalized could, by applying the regulations on a cut-off basis, have the prior year deductions disallowed on audit. In contrast, making the change by filing Form 3115 with a corresponding § 481(a) adjustment would provide audit protection.
- A taxpayer that uses the simplified procedure and applies the tangible property regulations on a cut-off basis cannot make a late partial disposition election. This election allows taxpayers to deduct as a loss the remaining undepreciated basis of previously retired structural components.
- The revenue procedure is effective for taxable years beginning on or after 1/1/14. A transition rule permits an eligible taxpayer that previously filed a return for its first taxable year beginning on or after 1/1/14 with a Form 3115 to change to an accounting method specified in the revenue procedure to withdraw the Form 3115 by filing an amended return. The amended return must be filed by the due date (including extensions) of the taxpayer's return for its first taxable year beginning on or after 1/1/14.

2. Howard Hughes may have died nearly 40 years ago, but his successors are still trying to fly the Spruce Goose.

Howard Hughes Co., LLC v. Commissioner, 142 T.C. 355 (6/2/14), *amended and superseded by* 2014 WL 10077466 (6/2/14). The taxpayer was in the residential land development business. The taxpayer generally sold land through bulk sales, pad sales, finished lot sales, and custom lot sales. In bulk sales, it developed raw land into villages and sold an entire village to a builder. In pad sales, it developed villages into parcels and sold the parcels to builders. In finished lot sales, it developed parcels into lots and sold whole parcels of finished lots to builders. In custom lot sales, it sold individual lots to individual purchasers or custom home builders, who then constructed homes. The taxpayer never constructed any residential dwelling units on the land it sold. The taxpayer reported income from purchase and sale agreements under the § 460 completed contract method of accounting—generally when it had incurred 95 percent of the estimated costs allocable to each sales agreement. The IRS took the position that the land sales contracts were not home construction contracts within the meaning of § 460(e) and that the bulk sale and custom lot contracts were not long-term construction contracts eligible for the percentage of completion method of accounting under § 460. (The IRS conceded that the other contracts were long-term construction contracts.) The Tax Court (Judge Wherry) held that the bulk sale and custom lot contracts were long-term construction contracts under § 460(f)(1), and that the taxpayer could report gain or loss from those contracts on the appropriate long-term method of accounting to the extent it had not completed the contracts within a year of entering into them. The contracts included more than just the sale of lots. The costs incurred for a custom lot contract are not really different from the costs for the finished lot sales. The contracts included development of things such as water service, traffic signals, landscaping, and construction of parks, which did not necessarily occur prior to the closing. Completion of the contracts thus occurred upon final completion and acceptance of the improvements, the cost of which was allocable to the custom lot contracts. However, none of the contracts qualified as home construction contracts eligible for the completed contract reporting method under § 460(e). In relevant part, § 460(e)(6) defines a home construction contract as follows:

> (A) Home construction contract. -- The term "home construction contract" means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to —
>
> > (i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and
> >
> > (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

The taxpayer argued the costs met the "80 percent test" applied to determine whether the land sales contracts met the definition in § 460(e)(6). At the end of a long analysis of the statutory language, the regulations, and the legislative history, Judge Wherry concluded that the contracts did not qualify as home construction contracts. The taxpayer's costs were, if anything, common improvement costs. The taxpayer did not incur any costs with respect to any home's "structural, physical construction." The costs were not "costs for improvements 'located on' or 'located at' the site of the homes." Accordingly, the costs could not be included in testing whether 80 percent of their allocable contract costs are attributable to the dwelling units and real property improvements directly related to and located on the site of the yet to be constructed dwelling units.

> Our Opinion today draws a bright line. A taxpayer's contract can qualify as a home construction contract only if the taxpayer builds, constructs, reconstructs, rehabilitates, or installs integral components to dwelling units or real property improvements directly related to and located on the site of such dwelling units. It is not enough for the taxpayer to merely pave the road leading to the home, though that may be necessary to the ultimate sale and use of a home. If we allow taxpayers who have construction costs that merely benefit a home that may or may not be built, to use the completed contract method of accounting, then there is no telling how attenuated the costs may be and how long deferral of income may last.

a. **And spruce doesn't grow in the deep South; it's piney woods down there.** Howard Hughes Co., L.L.C. v. Commissioner, ___ F.3d ___ (5th Cir. 10/27/15). The Fifth Circuit, in an opinion by Judge King, affirmed the Tax Court's holding. "A plain reading of [§ 460(e)(6)(A)(i)] supports the Tax Court's holding. … [A] taxpayer seeking to use

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