RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

Bruce A. McGovern
Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, Texas 77002
Tele: 713-646-2920
e-mail: bmcgovern@stcl.edu

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Note: This outline was prepared jointly with Cassady V. ("Cass") Brewer, Associate Professor of Law, Georgia State University College of Law, Atlanta, GA, and Martin J. McMahon, Jr., James J. Freeland Eminent Scholar in Taxation and Professor of Law Emeritus, University of Florida Levin College of Law, Gainesville, FL.

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.

I. ACCOUNTING

A. Accounting Methods

1. The Tax Court sides with the taxpayer on application of the completed contact method of accounting to development of planned residential communities. Shea Homes Inc. v. Commissioner, 142 T.C. 60 (2/12/14). The taxpayer was a home builder using the completed contract method allowed by § 460(e) (which provides an exception to the percentage-of-completion method otherwise required); the taxpayer developed large, planned residential communities. The question was whether the subject matter of the contracts consisted only of the houses and the lots on which the houses are built, as argued by the IRS, or the home as well as the larger development, including amenities and other common improvements, as argued by the taxpayer. The contracts were home construction contracts under § 460(e)(6) because Reg. § 1.460-3(b)(2)(iii) provides the cost of the dwelling units includes "their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units." More specifically, the taxpayer's position was that the contracts were completed when they meet the test under Reg. § 1.460-1(c)(3)(i)(A) that the property was used by the customer for its intended purpose and 95 percent of the costs of the development had been incurred. Under this argument, final completion and acceptance pursuant to Reg. § 1.460-1(c)(3)(B) did not occur (excluding secondary items, if any, pursuant to Reg. § 1.460-1(c)(3)(B)(ii)) until the last road was paved and the final bond was released. The Tax Court (Judge Wherry), upheld the taxpayer's position. He rejected the IRS's argument that the common improvements were "secondary items." A key element in the holding was that the taxpayer was required by the contracts and by state law to complete common improvements, and that obligation was secured by "hefty performance bonds."

The decision might be narrower than it appears on its face. Footnote 24 of the opinion states as follows:

> We are cognizant that our Opinion today could lead taxpayers to believe that large developments may qualify for extremely long, almost unlimited deferral periods. We would caution those taxpayers a determination of the subject matter of the contract is based on all the facts and circumstances. If Vistancia, for example, attempted to apply the contract completion tests by looking at all contemplated phases, it is unlikely that the subject matter as contemplated by the contracting parties could be stretched that far. Further, sec. 1.460-1(c)(3)(iv)(A), Income Tax Regs., may prohibit taxpayers

from inserting language in their contracts that would unreasonably delay completion until such a super development is completed.

a. And the Ninth Circuit says the Tax Court was correct in holding that homebuyers value amenities. Shea Homes, Inc. v. Commissioner, 834 F.3d 1061 (9th Cir. 8/24/16). In an opinion by Judge Fernandez, the Ninth Circuit affirmed the Tax Court's decision on the ground that the only issue on which the Tax Court's decision rested was a question of fact—what was the subject matter of the taxpayers' home construction contracts, that is, what were the taxpayers obligated to provide to the buyers—and that the Tax Court's fact finding was not clearly erroneous. The IRS's argument in the Tax Court was limited to "a dispute about the subject matter content of the contracts" and the IRS "took the very crabbed view that the subject matter was limited to the house and the lot." The Tax Court, however, "determined that, as a matter of fact, the subject matter included the house, the lot, "'the development ... and its common improvements and amenities.'" The Court of Appeals observed that "[t]his was not a simple case of buyers purchasing homes and having no substantial interest in whether the development would be and remain the kind of development that they wished to live in for some time in the future," adding that "[e]ach person in the planned community would, indeed, have an interest in the use of other property in the development, and that would include not only the common amenities but also the use that others in the development made of their own properties." Thus, the IRS's argument that "a buyer's contract cannot encompass more than the house and lot or, as a fall-back position, more than the house, the lot, and the common improvements" was rejected.

b. The Ninth Circuit got it wrong, says the IRS. A.O.D. 2017-03, 2017-15 I.R.B. 1072 (4/12/17). The IRS has nonacquiesced in the Ninth Circuit's decision in *Shea Homes*. "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 IRS will follow the *Shea Homes* decision in cases appealable to the Ninth Circuit, but will continue to assert its positon in cases appealable to other U.S. Courts of Appeals.

2. It turns out that 6666, not 666, is the mark of the devil for the IRS. Burnett Ranches, Ltd. v. United States, 753 F.3d 143 (5th Cir. 5/22/14). Burnett Ranches, Ltd. operated two cattle and horse breeding operations and reported on the cash method. The principal owner, beneficial owner, and the manager, of Burnett Ranches, Anne Burnett Windfohr Marion, interposed an S corporation between herself and one of the two major ranch properties (6666, the Four Sixes) and had a direct interest in and was a beneficiary of a trust that held an interest in the other major ranch property (Dixon Creek). The IRS took the position that Burnett Ranches was a "farming syndicate" required by § 464 to use the accrual method of accounting. Speaking generally, § 464 requires farming partnerships to use the accrual method if they are a farming syndicate, which is generally defined as a partnership (or any other enterprise other than a corporation which is not an S corporation) engaged in the trade or business of farming if either (1) interests in the partnership or enterprise have been offered for sale in any securities offering or (2) more than 35 percent of losses are allocable to limited partners. But because it is targeted at late twentieth century tax shelters, it has a number of exceptions that cover "family farms." The taxpayer maintained that the exception in § 464(c)(2)(A) applied. This exception treats the following interests (among others) as not being held by a limited partner: "in the case of any individual who has actively participated (for a period of not less than 5 years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation. The government conceded that (1) Ms. Marion did "actively participate" in the management of Burnett Ranches' agricultural business for not less than five years previously, and (2) her interest in Burnett Ranches is "attributable to" her active participation, but argued that the interposition of the S corporation between the entity owning the ranch and Ms. Marion rendered the exception inapplicable. The District Court granted judgment in favor of the taxpayer, and, in an opinion by Judge Wiener, the Fifth Circuit affirmed. The court rejected the government's argument that the interest of the individual actively managing the farm or ranch had to be held by direct legal title for the exception to apply. Focusing on the language of § 464(h)(2)(A), which describes the excepted interest as "In the case of any individual who has actively participated (for a period of not less than five years) in the

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