RICHEY MAY & CO

Extreme income deferral mechanism for finished lot sales

For the past two months, we have laid out tax strategies that are potentially beneficial to landowners that plan to develop homes for retail sale. We have received a number of questions from land developers that follow a similar path, but who sell finished lots to homebuilders rather than building the homes for their own account (the question being, "What about us?"). On the ability to qualify pre-development land appreciation as capital gain the answer is the same – sell the asset to a qualifying related party before development activity occurs (or before you otherwise disqualify yourself from capital gain treatment). On the ability to defer tax gain on lot sales until the last dollars are spent, the answer is quite a bit less clear.

If you were looking for signs of dysfunction in our federal tax administration this area serves as a fine example. On its face, you would want to say that finished lot developers could not qualify for a "homebuilder" exception because, well, they are not building homes. However, the exception itself speaks to costs associated with dwelling units and improvements to real property at the site of the dwelling, plus common improvements that benefit the dwelling units (the latter two covering pretty much everything except the sticks and bricks). Further, the IRS (in 2008) issued proposed regulations in this area that would make clear that lot developers qualify for the homebuilder exception. All of this suggests that a position that a finished lot sale qualifies for the homebuilder exception would not only be reasonable, but the right answer.

Now to the dysfunction. A year after issuing proposed regulations that allow finished lot sales to qualify for the homebuilder exception, the IRS issued internal guidance to their auditors telling them the opposite. Further, in *The Howard Hughes Company* (yes, *that* Howard Hughes) *v. Commissioner* case, which concerned 2007 and 2008 tax years (case not final until 2014), the IRS won its case asserting that the lot developer did not qualify for the homebuilder exception. There is quite a bit of food for thought in the case, but ultimately the judge flatly stated that the homebuilder exception is only available to taxpayers that actually build homes.

Where does this leave us? If and until the proposed regulations are finalized (they can't be relied upon until they are), making the assertion that a lot developer can qualify for the homebuilder exception would be risky to say the least. However, the judge in the Howard Hughes case did suggest a possible way out. The judge points out that a subcontractor's work can qualify for the homebuilder exception if it is part of the cost for the home, the implication being that if the lot developer styled its relationship with the ultimate homebuilder as a subcontractor relationship (to provide finished lots and community improvements), the exception (and, therefore, the completed contract method of accounting) would be available.

Talk to your tax advisor about your situation and what kind of ammunition you have available to make the argument for the homebuilder exception work for you. To learn more about this tax planning opportunity, please contact Zane Dennis at zane@richeymay.com or 303-721-6131.