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A STUDY OF SELECTED ACCOUNTING AND INCOME TAX FACTORS

IN RESIDENTIAL LAND DEVELOPMENT

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TABLE OF CONTENTS

Chapter | Page

A STUDY OF SELECTED ACCOUNTING AND INCOME TAX FACTORS IN RESIDENTIAL LAND DEVELOPMENT

CHAPTER I

INTRODUCTION

The conversion of undeveloped land into residential homesites (including residential resort sites for purchase by individuals) is a rapidly expanding activity. The organizations participating in the function range in size from small firms owned by one or a few individuals to large publicly-owned corporations. To a significant degree, the participation of publicly-owned firms in the field is increasing in importance.

The residential land development activity may perhaps be considered a part of an over-all land development industry which includes the development of commercial, industrial, and other types of sites as well. As a matter of fact, some land development enterprises participate in a variety of different land development activities, often developing various types of sites in a single coordinated effort. However, a great many land development firms devote their sole, or at least their major, efforts to the development of residential sites.

The characteristics of residential, commercial, industrial, and other development operations tend to differ in many respects. For example, the number of individual units (lots) produced in a residential development project is generally much greater than the quantity of production units to be found in a commercial or industrial development venture. Furthermore, such factors as the following frequently differ from one type of land development activity to another: the means of promoting sales of completed sites, the terms of sales, the methods of financing the acquisition of raw land, the methods of financing site improvements, and the risks to be assumed by developers in undertaking projects.

Purpose and Emphasis of the Study

The emphasis in this study is on those factors related specifically to residential land development activities. Unless otherwise specified, the term "land development" is used throughout the study to mean residential land development. Of course, many of the factors discussed in the study may apply in some cases to other types of land development.

Among the problems presently facing firms in the residential land development industry are difficulties in formulating accounting rules and procedures for financial statement presentation and for income tax reporting. As a matter of fact, a great deal of controversy currently exists regarding the accounting practices utilized by land development firms in their periodic measurement of earnings.

A primary purpose of this study is to examine the income measurement procedures utilized in the land development industry with respect to factors pertinent to both financial reporting and income tax reporting. Various revenue reporting procedures, as well as numerous expense determination factors, are critically examined. Differences in practice between financial reporting and income tax reporting procedures are noted. Recommendations for improving the income measurement procedures in the industry are presented.

An additional purpose of the study is to analyze significant income tax factors related to planning the operations of land development firms. The success of land development enterprises, especially the smaller firms in the industry, is strongly affected by various income tax considerations. Many of these factors are evaluated from the standpoint of land development investors. In particular, special attention is devoted to income tax factors in selecting the entity form of small-scale land development enterprises.

For the purposes of this study, small-scale land development firms, as distinguished from the large-scale enterprises in the industry, are considered as those local or regional organizations undertaking land development projects of less than 500 acres in size. The designation is, of course, not precise.

In some instances, factors discussed in the study apply to both small-scale and large-scale development enterprises. In other cases, they primarily affect one or the other category of firms. Specific discussions throughout the study indicate the particular category of firms to which the material being discussed is most applicable.

Sources of Data

Data for the study was obtained primarily from the following sources: interviews with officials of selected land development and home building companies participating in residential land development projects; books, periodicals, and other publications in the areas of real estate, accounting, and finance; and various Federal income tax authorities. The major income tax sources consulted were the Internal Revenue Code of 1954 (as amended), the corresponding Treasury Department Regulations, other Federal Government publications (particularly Treasury Department pronouncements reprinted in the Internal Revenue Cumulative Bulletins), legal cases relating to Federal income tax matters, and numerous income tax services, texts, and journals.

Incidentally, references throughout the study to specific sections of the Internal Revenue Code and the Regulations [e.g., Section 751(a); Regulation 1.752-1(e)], unless otherwise indicated, are to the Internal Revenue Code of 1954 (as amended) and the corresponding Treasury Department Regulations. Likewise, references simply to "the Code" are understood to mean the Internal Revenue Code of 1954 (as amended).

Organization of the Study

The study is divided into six chapters. The initial chapter constitutes an introduction to the subject.

Chapter II discusses general features of residential land development operations and provides a background for the study as a whole. The chapter contains a brief history of residential land development in the United States, an analysis of problems in defining land development, discussions pertaining to the nature of land development projects and the characteristics of project developers, and comments regarding the impact of the Federal income tax on land developers.

Chapter III deals with revenue reporting procedures relating to land sales. For the most part, the chapter is devoted to an analysis of specific problems in reporting retail land sales in financial statements, particularly problems relating to the recognition of revenue. The chapter also contains brief discussions of two significant income tax reporting measures pertaining to sales of land, (1) using the "installment sales method" and (2) obtaining long-term capital gain treatment on certain sales of land. In general, the discussion throughout the chapter applies mainly to large-scale land development enterprises. However, the material pertaining to long-term capital gain treatment on certain land sales is also relevant to small-scale land development firms.

Chapter IV discusses significant expense determination factors in measuring the earnings of land development firms. The factors studied are pertinent to both large-scale and small-scale development enterprises. Both financial reporting and income tax reporting aspects are emphasized. Specific factors covered in the chapter are the following: the significance of joint costs in land development operations; cost allocation methods; the treatment of non-salable portions of a development tract; and procedures for handling land acquisition costs, interest and other carrying charges, and site improvement costs.

Chapter V is devoted to an analysis of income tax factors in selecting the entity form for residential land development firms. Primary emphasis in the chapter is directed toward small-scale development firms. Significant income tax advantages and disadvantages of operating land development enterprises as either corporate or noncorporate organizations are discussed. Certain related non-tax factors are also briefly reviewed.

The results of the study are summarized and concluded in Chapter VI.

CHAPTER II

GENERAL FEATURES OF RESIDENTIAL LAND DEVELOPMENT OPERATIONS

Introduction

The purpose of this chapter is to provide a general perspective for the study as a whole. Beginning with a brief account of the history of residential land development in the United States, the chapter continues with an analysis of the problems in defining land development. Following that is a discussion of the nature of residential land development projects along with the characteristics of project developers. Lastly, the impact of Federal income taxes on developers is presented.

Historical Background

The early growth of American cities was characterized by a gradual encroachment upon adjacent undeveloped land. Little by little, portions of adjoining land would become a part of the city. It was not until the last quarter of the nineteenth century that the practice of planning the urban development of rural land began to be commonly exercised. However, the advancement of this activity was quite slow and spasmodic until the 1920's.[1]

During the 1920's two types of land-use planning and development activity emerged. One such activity involved what has been called the "parasitical subdivision" and merely consisted of a subdivider's acquiring control over a small tract of land on the outskirts of a city, spending a minimum amount in marking the land into building sites, and then carrying out a short but intensive selling campaign.[2] Because the subdivision promoters often lacked interest in the installation of streets and other facilities for making the lots usable and also because there was usually no organization of lot owners, some of these subdivisions remained as idle land for years.[3]

The parasitical subdivision is the type of speculation in suburban lands that, according to one writer, "led to the creation of a great oversupply of subdivision lots in most metropolitan areas which was not absorbed until after World War II."[4] Likewise, another writer makes the following observation:

> . . . the vast land speculations of the 1920's showed the folly and ruinous expense to local governments of unrestricted subdivision. . . . The wastage of land was appalling. In 1929 of 375,000 registered lots in Cleveland, 175,000 were vacant. In 1934 there was said to be enough vacant platted land in the country to house 18 million people.[5]

The second type of land development activity which appeared during the 1920's has been labeled the "development project." The objective here was to create a complete community near, or perhaps adjacent to, a currently populated area. Such a project would cover a large tract of land containing from a few hundred acres to perhaps a few thousand acres. The idea underlying this operation was that the project would take years to complete and that the success of the venture would be dependent upon the building sites being used by homeowners and others. Although emphasis was still placed on selling lots, developers of such projects usually did everything possible to encourage purchasers of sites to make use of them.[6] These developers, according to Hoagland and Stone, "must be credited with some of the outstanding residential communities in the country."[7]

During the depression period of the 1930's and during the World War II years, the annual rate of residential construction was very low. Following this period, however, a high level of economic activity and increased marriage and birth rates brought about an unparalleled residential building boom. An important consequence of this activity was the substantial extension of home building into the undeveloped peripheral territory surrounding the metropolitan areas.[8]

Regarding this population growth and the residential construction consequences, Charles M. Haar states that "the 1950 Census showed that while the central cities gained 5.7 million (13 percent) over the preceding decade, the outlying suburbs increased by 9 million (35 percent)."[9] Haar continues further by pointing out that

> virtually the whole growth in the nation's population between 1950 and 1955 was accounted for by an expansion in the metropolitan areas, . . . central cities gained a further 2 million (less than 4 percent), while their suburbs added 9.6 million (nearly 28 percent) to their numbers.[10]

Data for subsequent periods tend to reflect this trend of growth in the development of outlying suburban areas. A recent Economic Report of the President states the following:

> The population of the 24 metropolitan areas of more than a million people in 1960 grew 14 percent between 1960 and 1970, as compared to 10 percent for the remainder of the country. Metropolitan areas with more than a million persons now contain 39 percent of the total population. At the same time, the population within metropolitan areas is shifting from the central city to the suburban fringe. Fifty-seven percent of the people in metropolitan areas of more than a million lived outside the central city in 1970, compared to 51 percent in 1960.[11]

The suburban residential growth today is not always caused by an increase in population. For example, the Economic Report states that "the distribution of populations within cities is also affected by changing cost factors. The lower the cost of transportation and the higher the value of spacious living, the more people will spread out around centers."[12]

Characteristic of the recent expansion of residential construction into previously undeveloped areas has been the particular emphasis on planned development activities. In addition to the "development project" originating in the 1920's, other approaches to planned land development have arisen. These include such activities as "development-construction projects," "planned unit residential developments," and the creation of entire "new towns" or "new cities."

"Development-construction projects" are in effect "development projects" in which the developer assumes the task of constructing homes on a large-scale basis in addition to the preparation of sites for construction. This activity has been described as follows:

> Bypassing high-priced and scattered building sites in development projects . . ., builders are acquiring raw land at wholesale prices; developing it according to a unified pattern; building houses in great numbers and by the use of whatever economies they can lay hands upon; equipping them with home appliances such as refrigerators, washing machines, stoves, and even television sets and air-conditioning units; and then using as many wholesale methods of finance and of sale of the entire package as have been developed to date.[13]

"Planned unit residential developments" represent a land development concept in which dwelling units are organized and constructed in a carefully coordinated manner giving consideration to the relationships of the units to each other and to commonly-shared facilities. Rather than consisting of one type of residential dwelling, such as single-family detached houses, the planned unit development may contain a variety of different housing types, e.g., garden apartments, multi-story apartments, townhouses, as well as single-family detached houses. Furthermore, such projects usually include planned recreational, community, and shopping facilities.[14]

Planned unit developments may range in size from a few acres to more than 1,000 acres. However, from the standpoint of size, emphasis is usually placed on the number of dwelling units rather than the number of acres. Zoning for such developments normally occurs on a density basis, i.e., control is exercised on the basis of average residential density over the whole area being developed rather than being applied according to individual lot size and setback specifications. In addition, the spatial arrangement of dwelling units within the planned unit project usually does not follow traditional subdivision layout patterns, namely, narrow, rectangular blocks and uniformly-sized lots. Instead, layout patterns such as cluster arrangements, which provide common open spaces, and curving, cul-de-sac, and loop streets may be used.[15]

The other significant approach to planned land development which is of fairly recent origin is the "new-town" or "new-city" development. This approach consists of the creation of an entire city on what was formerly an undeveloped site.

"New-town" or "new-city" developments are actually large-scale extensions of the planned unit development concept. The history of new-town developments in the United States can be traced to the early 1940's and is related to the acute need for housing facilities at major defense and military production locations during World War II. The wartime community developments were frequently owned by agencies of the federal government but were usually constructed by private building companies. Fairlington, Virginia, a suburb of Washington, D.C., is an example of such a community. This community was originally owned by the Federal government but, following World War II, was sold to private concerns.[16]

The current group of "new-town" developments are, for the most part, being undertaken by private interests. For example, a Business Week article in August of 1966 noted that some 70 young cities were under construction at that time and that "big business" is taking a hand in their development.[17] The following are a few of the new-town developments mentioned in the article, along with the principal developer and the projected population: Clear Lake City, Texas--Humble Oil and Refining Company--150,000; Columbia, Maryland--James W. Rouse--110,000; Litchfield Park, Arizona--Goodyear Tire and Rubber Company--75,000; New Orleans East, Louisiana--Clint Murchison, Jr., and others--175,000; Reston, Virginia--Robert E. Simon--75,000; and Valencia, California--California Land Company--200,000.[18]

In addition to Humble Oil and Refining Company and Goodyear Tire and Rubber Company, the article mentions a few of the other large corporations (Gulf Oil, General Electric, Alcoa, American Cement) that have become involved in the development of new towns.[19] A more recent article notes that two of the "Big Three" automakers are planning the construction of new towns. These firms are the Ford Motor Company and the Chrysler Corporation.[20] An interesting point to note is that many of the firms currently participating in these large-scale land ventures were formerly not noted for activity in this area.

The Business Week article implies that it is difficult to define the term "new towns." However, the article does remark that new towns

> differ from conventional large sub-divisions through presence of industry to provide jobs, a variety of income levels, a town center to provide community focus, and more controlled land use, especially dense concentration of houses in one area to allow for more community open space.[21]

The creation of new towns certainly appears to be an interesting aspect of current land development activities. The scope of such projects obviously encompasses more than just residential types of development. With respect to their residential development activities, firms participating in these large-scale ventures experience many of the accounting problems to be examined below.

Land Development Defined

The term "land development" is a very broad one, often receiving slightly varying usage by different sources. In practice, the term is frequently used interchangeably with the term "land subdivision," or simply "subdivision." From a professional or academic standpoint, however, most authorities try to distinguish between land subdividing and land developing. Frequently, though, the distinctions between the terms as proposed by the different authorities do not directly coincide with one another.

Frederick E. Case defines subdividing as "the process of dividing raw land into lots, installing streets and in other ways preparing the land for the construction of the improvements." Case then defines developing as "the process of adding improvements to the lots prepared by the subdivider." According to Case, improvements consist of such things as houses, garages, and landscaping. Also, he notes that the acts of subdividing and developing may be executed by the same business organization.[22]

On a similar note, Maurice A. Unger states that "a <u>subdivider</u> is one who buys undeveloped acreage, divides it into smaller parcels, and sells it." According to him, "a <u>developer</u> is one who advances the process a step further by building homes on the lots before selling them." Unger mentions, too, that the developer will sometimes build a controlled shopping center on the tract in addition to homes.[23]

A more restricted definition of subdividing is proposed by Ring and North when they make the following statement:

> Where subdividing is the owner's intent, he need not incur any additional expenses, other than those incident to purchase and survey of the land, to place the markers or stakes at intended plot boundaries and to submit a surveyor's "plat" of the proposed subdivision for city or county official's approval. The plat, as a rule, contains information concerning (1) the subdivision name; (2) block, lot, and street designations and dimensions; and (3) proposed easements, rights-of-way and land dedicated to public use. Once the plat is approved and signed by duly constituted municipal or county representatives, acceptance is made official by placing the plat on public records. It should be noted that the process of subdividing, as explained above, does not require any physical change in the land "per se." If the tract is in timber or pasture use, it remains that way. The "paper" subdivision merely gives notice of intent to change the area to urban or suburban site utilization as noted on the plat of record.[24]

From the foregoing it appears that Ring and North equate subdividing with the mere acquisition of "raw" land and with the preparation and submission of the plat to the appropriate governmental authority. In other words--as they later mention in their text--subdividing represents "the first step in the developing program."[25] On the other hand, land developing, according to these authors, occurs "whenever land improvements are carried out in accordance with subdivision plans, and expenditures are being made to provide essential site facilities."[26]

A completely different approach to the use of the term "subdivision" is presented by Husband and Anderson. These authors point out that the term "is used to cover projects that are sufficient in size to establish an identity and name in their own right."[27] From their elaboration on this point, it appears that the term "subdivision" is commonly used to identify any division of a large tract of land into smaller parts, regardless of the amount of development and improvement, or lack of such, made to the tract. Hence, a completely developed project--from the purchase of raw land to the construction of homes, public facilities, and shopping centers--would properly be called a subdivision.

It is apparent from the above discussion that a clear distinction between land subdivision and land development does not exist. In most instances, the differences in usage are based on the degree of change and improvement made to the undeveloped land.

<u>For the purposes of this study, land development will be considered as describing all activities from the acquisition</u>

of undeveloped land to the construction of structures on the land. This includes such activities as platting the land, grading and surfacing streets, installing curbs and gutters, grading sites, constructing parks and playgrounds, and constructing homes and shopping centers. However, the scope of the study will not include an analysis of the home building, or house construction, phase of the land development process.

Because the term "subdivision" is so frequently used interchangeably with the term "land development," this practice will be followed throughout the study. Unless otherwise specified, the two terms will be considered synonomous.

Nature of Residential Land Development Projects

A Manufacturing Process

The land development process actually represents a manufacturing activity in which a product is produced from raw materials. The basic raw material is, of course, the undeveloped land. As a result of the characteristics of this raw material, the finished product (the improved lot or site) possesses many unique features.

Unique Features of the Finished Product

Immobility is one of the most unusual features of the land development product. The improved lot or site simply cannot be moved. This fundamental characteristic profoundly affects the development process by causing the market for the product to be local in nature. Furthermore, this feature makes it necessary in most cases for the developer to first find the market for his product and then to find the undeveloped site (raw material), and not the reverse.[28]

Another unique feature of the land development product is the non-homogeneous nature of different development projects. Each development project ordinarily represents a different set of conditions. From the physical characteristics, such as topography and soil content, to the legal and financial aspects, each individual project may differ from all others. Therefore, each project must normally be individually planned and coordinated.

Another peculiarity of the land development product is its long life span. Improvements made to undeveloped land are extremely long in duration and drastically affect the physical characteristics of an entire community and the living conditions of its citizens for a long period of time. As a matter of fact, a project which proves to be an unsuccessful financial venture for the developer may result in an unsightly and unwanted scar on the community. Even a project which represents a financial success for the developer may in time be a liability to the community.

Incidentally, as a result of the importance of the land development process to a community, public interest in land development activities has brought about such land-use controls as zoning, subdivision regulations, and master planning. These controls have in the past been generally exercised on a local or a statewide basis. Today, however, there is an increasing trend toward the enforcement of these controls on a national level. For example, Federal controls are increasingly being exercised through Federal Housing Administration requirements for insuring land development loans, construction loans, and home purchase loans.

Long-term Nature of Projects

Residential land development projects are generally multi-year ventures, sometimes involving ten or more years for total completion. The period of time from the commencement of site improvement activities until the point at which the first improved lots are available for the construction of structures can also be quite long. In some cases, this period may exceed one year. Furthermore, in many cases, the "raw" land will be acquired and held for a number of years before the actual development of the site is begun.

The long-term nature of residential land development projects causes most of these ventures to be quite speculative in nature. The basic uncertainties inherent in long-run projections, combined with the immobility and tailor-made features of the projects create the risks present in these ventures.

Because of the long-term nature of development projects, land developers must exercise extreme care in their planning. For instance, overextension of their operations by initially acquiring too large a tract of land for development has caused developers to face financial difficulties in meeting property taxes and other carrying charges related to the land.[29]

Characteristics of Project Developers

The characteristics of the firms undertaking residential land development cannot be easily generalized. As previously mentioned, the companies participating in such activities vary in size from small firms owned by one or a few individuals to large publicly-owned corporations specializing in various types of real estate and finance activities, of which residential subdivision projects constitute only one aspect of their operations. However, there are some common, as well as contrasting, characteristics of the various organizations undertaking residential land development endeavors. Some of these characteristics will now be briefly discussed.

Form of Business Organization

The form of business organization, corporate or noncorporate, in which a land development enterprise operates is one of the significant considerations in land development. There are a number of alternative forms of organization in which a development firm may operate, e.g., individual proprietorship, general partnership, limited partnership, close corporation, publicly-held corporation, or joint venture. In selecting the form of business organization for a development firm, developers face numerous financing, income tax, and legal questions. Chapter V is devoted to an analysis of some of the pertinent income tax factors to be considered in selecting the form of organization for land development firms, particularly small-scale firms.

Geographical Extent of Operations

The extent to which land development organizations limit their operations to a specified geographical area or expand their operations on a statewide or nationwide basis is a significant characteristic of such firms. The smaller-scale development companies normally operate in a given geographical location. The large-scale development firms, on the other hand, are usually more diversified in the location of their activities and, at a given time, may have residential subdivision projects in process in many sections of the country. The relevant consideration to the large development firm is not the geographical location of a particular project but the importance of finding many locations for profitable development ventures.

Duration of Development Organization

Related to the issue of the extent of geographical operations of a development firm is the question of the length of existence of the firm. Large-scale, usually publicly-owned, development organizations are more likely to anticipate continuous unlimited existence than are smaller development firms. The larger firms have more flexibility in obtaining new locales for subdivision projects, and as current development projects are completed, they readily shift financial and other resources to new projects.

The discussion here, however, should not imply that all large-scale land development firms are statewide or nationwide in scope of operations nor that such firms always anticipate continuous existence. As a matter of fact, some relatively large land development enterprises have been formed to carry out single development projects, and these development firms often have no plans for subsequent development activities upon completion of the individual project currently in process.

Admittedly, however, the projects undertaken by these firms represent very large development ventures, such as the "new-town" projects mentioned above, which may have a development period ranging from 20 to 30 years or longer in duration. Incidentally, large development firms are sometimes organized as subsidiaries of much larger, non-development enterprises.

Small-scale development firms, which are usually local or regional in nature, often are limited in duration to the development period of a given development project. In many instances, the enterprise will be dissolved upon completion of the specific project. In other words, such firms may be organized to undertake a given development project, and once the project has been completed, the firm is liquidated. However, in some instances, smaller development firms will continue in existence as long as new projects can be undertaken within a limited geographical area. Even so, the owners of such enterprises will frequently dissolve the existing organization and will form new business entities to undertake additional ventures.

Diversity of Activities

Companies participating in residential land development operations have a varied range of activities. For example, some firms combine home building with their site development activities. Illustrative of this practice are the large-scale "development-construction" projects, discussed above.[30] Likewise, many small land development companies, undertaking smaller development ventures, sometimes combine home building and site improvement activities. As a matter of fact, in many instances, home building is the primary objective of these firms. Site improvement activities are simply performed in order to develop lots upon which the firm can construct its homes, either speculatively or on a custom-built basis. In other words, these firms are really home builders first and land developers second. To them, site improvement activities simply constitute a means of attaining their home building objective. Many small-to-medium-size subdivision projects have resulted from the efforts by an individual home builder or a group of home builders, acting collectively, to develop previously undeveloped land in order to obtain sites for homes.

There are also firms which are concerned solely with the acquisition of "raw" land and the installation of site improvements, exclusive of the construction of homes or other structures. These firms generally sell improved lots directly to builders or to potential home owners.

Some development firms have as their primary objective the acquisition of undeveloped land and the installation of site improvements; but, as a secondary measure, they participate to a limited extent in the home building process. Furthermore, there are organizations which actively participate in all of the following: acquisition and improvement of land; construction of homes; and the construction, ownership, and operation of shopping centers, multi-family rental units, and other income-producing facilities. These latter enterprises may be large national organizations, or they may be strictly local concerns.

Residential subdivision projects are sometimes organized and executed by real estate brokerage firms. In such instances, realtors will often form a separate business organization to facilitate the land acquisition and site improvement activities. As a matter of fact, a combining of real estate brokerage, home building, and land development activities appears to have some common application today.

Regardless of the diversity of activities or the type of ownership of a land development firm, the actual task of installing improvements to raw land is frequently carried out through contractual arrangements with firms specializing in the various types of construction work required. For instance, the grading and paving of streets in the subdivision may be executed by construction companies specializing in such work. Likewise, the installation of utility facilities may be performed by firms specializing in these activities. The land development enterprise itself, in many cases, maintains few construction facilities of its own. In other words, the development organization often represents a coordinating and financing institution in the process of land development.

Importance of Cash Planning

One characteristic of practically all land development firms is the need for careful cash planning. The significant emphasis on cash planning is apparently the result of the strain on cash resources caused by the long-term nature of land development ventures. As a matter of fact, some developers peruse their cash resources on a day-to-day basis.

Although maintaining an adequate supply of operating funds constitutes a major problem for most development firms, excessive cash resources has been mentioned as a reason why some major national corporations, particularly those involved in "new-town" projects, have entered the land development business on a large-scale basis. These large firms apparently have the funds which are so direly needed in the land development activity, and the housing market provides them a favorable investment outlet and contributes to a diversification of activities.[31]

Unlike many other long-term construction organizations, e.g., those in highway construction, bridge construction, building construction, or ship building, land development companies normally do not have parties to whom progress billings can be made and from whom cash advances can be received prior to completion of project work. Instead, the development enterprise must await the sale of lots before it can begin recouping its investment. In the meantime, however, the firm must be able to meet the debts arising from the performance of development activities, including the ordinarily large carrying charges (interest on borrowed funds, property taxes, etc.) inherent in this type of activity.

An interesting consequence of the critical cash situation in the land development field is that developers often adhere to the policy of using the cash generated from the sales of one section of a project to finance preparation of additional sections. The soundness of this policy is illustrated by the cases in which developers have not followed this practice. By instituting improvements on too large a portion of a tract too soon, they have found themselves faced with difficulties in meeting their financial obligations as they become due. Indeed, there is probably a natural tendency on the part of developers to overextend their development activities when they have experienced unusual success in earlier development activities. Nevertheless, developers must avoid overproducing their product.

Developers also try to avoid "freezing" substantial amounts of their liquid financial resources in the acquisition of raw land. Tying up too much cash in the land acquisition process can impair the ability of development firms to subsequently finance site improvement activities. Hence, developers usually seek various methods of acquiring raw land with as little immediate payment in cash as is possible. This practice often entails the use of such measures as options, deferred payment arrangements, and release clauses. Even when these methods are instituted, developers must still be cognizant of the large annual interest costs and other carrying charges which will occur as a result of the land acquisition. To summarize, developers normally analyze the effects on their cash position of various short-run and long-run operating decisions, to an extent probably as great, or greater, than most other manufacturing enterprises.

Impact of Federal Income Taxes

An unusual phenomenon in residential land development is the profound manner in which the activities of land development enterprises are affected by the Federal income tax. Firms in the land development field are, in general, forced to devote an abnormal amount of attention to the income tax consequences of their routine and long-range operating decisions.[32] In many respects, the income tax aspects of a developer's activities are related to the developer's cash planning problems. For example, a developer's ability to defer, or perhaps permanently reduce, Federal income taxes can be an important means for the developer to retain funds for current operating purposes. Of course, a permanent savings in tax dollars also increases the after-tax profitability of land development ventures and, therefore, may have a bearing on the ability of firms in the industry to attract investment capital.

The general significance of the Federal income tax on residential land development activities was the subject of a 1957 doctoral dissertation entitled "The Impact of the Federal Income Tax on Residential Real Estate Developers" by Donald E. Roark. As a result of his interviews with builders, developer-builders, professional tax consultants, and mortgage lending officers, Roark reached some interesting conclusions regarding the impact of Federal income taxes on developers.[33]

Roark concluded that Federal income tax considerations are so important in the operation of residential development firms "that a real estate developer cannot make a business move of any consequence without modifying his Federal income tax cost." Furthermore, Roark observed that the peculiarities of real estate and the law affecting real estate transactions causes the industry to be "subject to more areas of Federal income tax law than is true of most industries." He also noted that the "Federal income tax is one of the largest single costs" developers usually incur.

An interesting point made by Roark is that the risk already inherent in land development is further increased by the "complex, ambiguous, and unstable" nature of the Federal income tax law. As he states,

> When the nature and monetary amount of one of the principal factors to be considered, the Federal income tax, cannot be determined with reasonable certainty the element of risk assumed by the developer-taxpayer is greatly increased.

Although Roark found that residential developers have numerous opportunities under the Federal income tax law to effect tax reductions, he remarked that "very few of the real estate developers interviewed were making any constructive effort to manage their affairs so as to keep their Federal income taxes at a legal minimum." In fact, he found that most of the developers he interviewed were inclined "to emphasize and concentrate on their net profit before taxes and treat their Federal income tax as an uncontrollable cost." Furthermore, he discovered that when developers did attempt to use tax reducing methods, the methods they applied had a tendency to cause the firms to operate in "unnatural" ways. As an example, he mentioned the use of multiple corporations by builders and developers in order to gain income tax benefits when such a practice would otherwise result in unwise business policy.

In comparison, current developers and builders appear to be considerably more cognizant of the effects of the Federal income tax on their operations. Furthermore, modern developers seem more interested in instituting tax planning measures in order to minimize their income taxes.

Roark's analysis of specific income tax areas is limited to the following: spreading taxable income over more than one taxable year (using either the "installment sales method" of reporting income or the "deferred payment sales plan" of reporting income), converting ordinary income to long-term capital gain, and using multiple corporations. With the exception of the multiple corporations issue, the present study will briefly review the foregoing topics, in the light of current income tax provisions. Moreover, the current study will discuss in detail numerous other income tax matters relevant to land development organizations, e.g., cost allocation methods; accumulation and disposition of carrying charges, land acquisition costs, and site improvement costs; and considerations in selecting the form of business organization for development firms. The multiple corporations issue, incidentally, will not be reviewed in the study because its significance as a tax planning measure is gradually being eliminated as a result of the provisions of the Tax Reform Act of 1969.

Summary

The purpose of this chapter was to provide a general perspective for the study as a whole. An historical account of the residential land development activity in the United States revealed that economic prosperity combined with an expanding population has magnified the importance of the residential development activity in recent years. From a previously unplanned process, residential land development has evolved into a practice characterized by an emphasis on carefully planned and well coordinated conversion of undeveloped land into attractive and comfortable residential subdivisions.

Residential land development operations represent a manufacturing process resulting in a product possessing many unique features. Particularly significant are the following product features: immobility, non-homogeneity of development projects, and long life span. The long time period normally required for carrying out development projects causes these ventures to be speculative in nature. As a result, developers must exercise extreme care in their planning activities.

Some characteristics of land development organizations, such as the organizational forms of doing business, geographical extent of operations, duration of existence, and diversity of business activities, were discussed in the chapter. The critical importance to all development enterprises of the cautious management of cash resources was noted.

The chapter concluded with a general discussion of the impact of the Federal income tax on developer activities. Particular attention was given to the importance of exercising tax planning measures in order to minimize the effects of the income tax. Of special significance to the developer is the use of tax planning procedures as a means of deferring or reducing taxes and thereby conserving vital funds for current operating purposes.

FOOTNOTES

[1]Henry E. Hoagland and Leo D. Stone, Real Estate Finance (4th ed.; Homewood, Ill.: Richard D. Irwin, Inc., 1969), p. 420.

[2]Ibid.

[3]Ibid., p. 421.

[4]Richard U. Ratcliff, Real Estate Analysis (New York: McGraw-Hill Book Company, Inc., 1961), p. 276.

[5]John Delafons, Land-Use Controls in the United States (2nd ed.; Cambridge, Mass.: The M.I.T. Press, 1969), p. 28.

[6]Hoagland and Stone, Real Estate Finance, pp. 422-423.

[7]Ibid., p. 423.

[8]Charles M. Haar, Land-Use Planning: A Casebook on the Use, Misuse, and Re-use of Urban Land (Boston: Little, Brown and Company, 1959), p. 347.

[9]Ibid.

[10]Ibid.

[11]U.S., President, Economic Report of the President, Transmitted to the Congress February 1971 (Washington, D.C.: United States Government Printing Office, 1971), p. 111, 113.

[12]Ibid., p. 111.

[13]Hoagland and Stone, Real Estate Finance, p. 425.

[14]Urban Land Institute, The Community Builders Handbook (Anniversary Edition; Washington, D.C.: Urban Land Institute, 1968), pp. 99-105.

[15]Ibid.

[16]William H. Husband and Frank Ray Anderson, Real Estate (3rd ed.; Homewood, Ill.: Richard D. Irwin, Inc., 1960), pp. 272-273.

[17]"Where City Planners Come Down to Earth," Business Week, (August 20, 1966), p. 101.

[18]Ibid., p. 104.

[19]Ibid., p. 102.

[20]"Two Automakers Plan Construction of New Towns," Engineering News-Record, CLXXXIV (January 1, 1970), 21.

[21]"Where City Planners Come Down to Earth," p. 101.

[22]Frederick E. Case, Real Estate (Boston: Allyn and Bacon, Inc., 1962), pp. 465-466.

[23]Maurice A. Unger, Real Estate: Principles and Practices (Cincinnati: South-Western Publishing Company, 1969), p. 649.

[24]Alfred A. Ring and Nelson L. North, Real Estate: Principles and Practices (6th ed.; Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1967), pp. 388-389.

[25]Ibid., p. 392.

[26]Ibid., p. 389.

[27]Husband and Anderson, Real Estate, p. 270.

[28]This principle or advice is initially attributed to the late J. C. Nichols, a prominent land developer. See Urban Land Institute, The Community Builders Handbook, p. 5.

[29]Urban Land Institute, The Community Builders Handbook, p. 75.

[30]See p. 12 above.

[31]Hoagland and Stone, Real Estate Finance, p. 446.

[32]In states where state income taxes are in force, developers must also be cognizant of the effects of the state income tax on their operations. The scope of this study, however, will not cover the discussion of state income tax laws and regulations.

[33]Donald E. Roark, "The Impact of the Federal Income Tax on Residential Real Estate Developers" (unpublished D.B.A. dissertation, Indiana University, 1957). The following remarks regarding Roark's study are extracted from Chapter 10, the final chapter, of his study.

CHAPTER III

REVENUE REPORTING PROCEDURES RELATING TO LAND SALES

Introduction

Because of the long-term nature of land development projects, the interim measurement of earnings by developers can only be tentative. The actual profit or loss resulting from a land development undertaking must await the project's completion.[1] However, developers must measure their earnings periodically, at least annually, for such purposes as raising capital, distributing profits, and filing income tax returns. If it were not for this fact, then a venture type of accounting in which profits or losses are not determined until entire subdivisions or projects have been completed and all lots or sites have been sold would be the most practical accounting approach.[2]

In determining their profits on a periodic basis, one of the most difficult problems encountered by development firms is the proper reporting of revenues arising from retail sales of land. The present chapter is devoted to an analysis of selected aspects of the problem, particularly those related to the recognition of revenue.

The chapter contains a review of recent attention devoted to revenue reporting practices in land development accounting, a discussion of the fundamental methods of accounting for land sales, an evaluation of land sales transactions from an accounting standpoint, and a survey of proposed guidelines for recognizing revenue from land sales. The chapter also includes a brief discussion of some significant income tax reporting measures pertaining to sales of land.

For the most part, the revenue reporting information discussed in the chapter applies to large-scale, publicly-owned development organizations. These firms commonly undertake retail sales of land on an installment payment basis. The procedures discussed are less applicable to small-scale, non-public firms, because these latter enterprises usually sell improved lots on a cash basis, i.e., purchasers arrange financing elsewhere. However, the long-term capital gains discussion at the end of the chapter is relevant to the smaller firms.

Recent Attention to Revenue Reporting Practices in Land Development Accounting

Because the number of publicly-owned firms in the land development field has been increasing and large, publicly-owned non-development corporations have acquired interests in land development enterprises, considerable attention has been directed recently toward land development accounting practices for external financial reporting. In particular, the concern has centered on revenue reporting practices. As a matter of fact, the revenue accounting practices in the industry have been the subject of sharp criticism and much debate in recent years.

Recent Criticisms

One of the strongest critics of present-day land development accounting practices is Dr. Abraham J. Briloff, Professor of Accountancy, Baruch College of the City University of New York. In a February 2, 1970 article in Barron's, Professor Briloff attacks in an avid manner some of the accounting practices of publicly-owned land development companies.[3] Specifically, the criticisms rendered by Briloff are aimed at the revenue recognition practices and the related receivables valuation measures of the development companies.

Briloff's apparent objective for writing the article is to demonstrate that "the land companies are following a practice of income exaggeration."[4] Through the use of illustrations drawn from published sources of land development financial information, he develops a case in support of his claim.

In particular, Dr. Briloff takes issue with the commonly followed practice by publicly-owned land development companies of reflecting "as revenue the face amount of contracts entered into with customers in the year the contracts are written" without giving due consideration to "contingencies, risks, and time lags" which should impose "logical constraints and appropriate deliberate conservatism in the accounting for the income from those sales contracts."[5] In one illustration, for instance, he notes that a large development organization reports the full revenue (with the exception of a loss reserve) from a sales contract in the year the contract is written "although collection of the balance will run to as much as nine years for over 90% of the contract amount" and even though the firm is unable to make immediate delivery of the land. Furthermore, Briloff notes that the firm fails to charge the year of sale "with the very substantial costs which must be incurred in accounting for and collecting receivables over the years."[6] Briloff's concern, of course, is with revenue recognition as it relates to the matching process.

Briloff mentions in his article that the Securities and Exchange Commission (SEC) in 1962 established some rough guides or standards for the recognition of revenue on land sales. (These were enacted through the Commission's Accounting Series Release No. 95, Accounting for Real Estate Transactions Where Circumstances Indicate that Profits were not Earned at the time the Transactions were Recorded.)[7] Briloff appears puzzled, nonetheless, at the failure of the SEC to exercise these standards or to perhaps promulgate more rigid standards.

In summary, Briloff criticizes the land development companies for accelerating the period at which revenues from sales contracts are recognized in their external financial reports, and he criticizes the companies for their failure to properly reflect the costs of collecting balances from customers. In addition, he argues that, even assuming the acceptability of revenue recognition at the time a sales contract is executed, the developers do not properly value receivables because they fail to consider the factor of time and to discount the receivables to a present value.[8]

What is particularly significant about the Briloff article is the severe impact it had on the investing public. For example, in a regular feature section of the Wall Street Journal of July 28, 1971, the following statement is made in regard to the Briloff article in Barron's:

> Last year, the professor wrote a critical review of the accounting practices of land-development companies in Barron's. That article had a devastating effect. It sent the shares of many such concerns skidding, and the group has yet to fully recover.[9]

The Briloff criticisms were not without foundation. Prior to publication of the article, the American Institute of Certified Public Accountants (AICPA) had begun a study of land development accounting practices, with particular emphasis on revenue recognition principles. Furthermore, following the release of the Briloff article, other critical discussions of the accounting problems of land development companies appeared in financial publications.

For instance, the September 10, 1970 Wall Street Journal contains an article by Edward P. Foldessy which discusses the lack of uniformity in land development accounting practices as a result of the absence of standards for the recognition of revenue from land sales.[10] An interesting point noted in this article is that the problem is not solely limited to the United States. In Canada, as Foldessy reveals, the Ontario Securities Commission has established certain requirements--patterned after the SEC guidelines but more specific and stringent--that must be met in order for revenue from land sales to be recognized in financial statements.

The Foldessy article recognizes the AICPA study of land development accounting practices then in progress. But, as the article notes, the nonexistence of uniform standards in the United States at the time of its publication had caused at least one major accounting firm, Peat, Marwick, Mitchell and Company, to develop internal guidelines strengthening the requirements for the recognition of revenue from real estate transactions by its clients. Various provisions of the

Peat-Marwick guidelines are discussed in the article.

The AICPA Study

The American Institute of Certified Public Accountants recently completed a three-year study of accounting practices in the land development industry. The Institute's study deals principally with the revenue reporting problems existing in the industry, and particularly with the revenue recognition aspects. It represents an attempt by the accounting profession to find solutions to the inequitable land development income reporting practices so strongly criticized by Briloff and others.

In January, 1972, the AICPA Committee on Land Development Companies, the *ad hoc* committee established to review the land development accounting procedures, issued an exposure draft to AICPA members entitled "Accounting for Retail Land Developers." In this paper, the Committee expressed its position regarding certain financial reporting practices in the land development field. Significant revenue recognition guidelines contained in the Committee's exposure draft are analyzed in detail later in this chapter.[11] These guidelines are studied in relation to other proposed guidelines for recognizing revenue from land sales.

The Accounting Principles Board (APB) of the American

Institute of Certified Public Accountants reviewed the Committee on Land Development Companies' initial exposure draft and agreed, for the most part, with the Committee's proposed guides for retail land sales companies. For example, the May 5, 1972 issue of the Accounting Research Association Newsletter, a publication of the AICPA, states that the Accounting Principles Board

> concurred with the criteria in the draft to the effect that for seasoned companies a contract should be recorded as a sale when the cancellation and experience as to each type of sale (a) indicates that the buyers intent is to complete the contract and (b) provides a reasonable prediction of the percentage of contracts that will pay out to maturity. . . .[12]

On the other hand, this same issue of the Accounting Research Association Newsletter mentions that the Board

> decided that the guide should be revised to state that interest to be received on the gross receivables (face amount of contracts less collections and estimated cancellations) over the life of the contracts should be related to the net receivables (gross receivables less deferred sales) to determine the effective rate of return which would then be compared with the appropriate rate of interest in accordance with APB No. 21 to determine whether any imputation of interest is necessary. . . .[13]

Hence, the Accounting Principles Board desired certain revisions before it would grant final approval to the land development accounting committee's proposals.

In late 1972, the AICPA Committee on Land Development Companies submitted its revised proposals to the Accounting Principles Board for that body's final approval. Regarding this matter, the Accounting Research Association Newsletter of December 13, 1972 contains quotations from a statement issued by APB Chairman Philip L. Defliese on behalf of the Board. The following is an excerpt from Mr. Defliese's statement, as quoted in the publication:

> "At the conclusion of an intensive four day meeting Saturday, December 9, the Accounting Principles Board of the American Institute of Certified Public Accountants announced that it had reached a conclusion by a substantial majority, to approve the AICPA land sales committee's position paper on accounting for retail land sales, after making many modifications in conjunction with the committee. The thrust of the modifications is to delay the recognition of sales and to reduce the profit reported in the first year as compared with earlier drafts. The action is subject to final drafting and balloting.
>
> "The new draft will specify use of both accrual and installment accounting for retail land sales but will limit the use of an accrual method to only those situations where stringent criteria are met. Sales under either method will not be recognized until cash payments received aggregate ten percent of the contract price and the customer's cancellation privilege period has expired."[14]

Shortly after granting informal approval to the Committee's proposals (as modified), the APB gave its formal approval to the rules. According to the January 10, 1973 Wall Street Journal, Mr. Defliese stated, regarding the Accounting Principle Board's formal approval, that "the new requirements differ only by minor editing from those the board informally approved last month." The final version of the land development accounting rules are to be published shortly and are to apply to accounting periods ending December 31, 1972, or later.[15] The revenue accounting rules ultimately approved by the APB will be discussed later in this chapter.

An announcement issued by the Securities and Exchange Commission shortly before the APB meeting in December, 1972 threatened to delay indefinitely the final formulation of land development income reporting rules by the accounting profession. The SEC's communication, which was made public through a Wall Street Journal article of November 16, 1972, expressed the SEC's opposition to the proposals of the AICPA Committee on Land Development Companies.[16] The SEC, as a matter of fact, attacked the whole fabric of the Committee's proposals. The SEC's opinions unquestionably affected the Accounting Principle Board's ultimate conclusions regarding the proposals of the AICPA Committee on Land Development Companies. The Securities and Exchange Commission's views are quite significant and will now be briefly reviewed.

Current Views of the SEC

According to the November 16, 1972 article in the Wall Street Journal, the Securities and Exchange Commission's position regarding the proposals of the AICPA Committee on Land Development Companies was expressed in a letter sent by John C. Burton, Chief Accountant of the Securities and Exchange Commission, to the American Institute of Certified

Public Accountants.[17] The article remarks that

> The Securities and Exchange Commission has strongly criticized, and perhaps doomed, the accounting profession's proposed new rules for reporting the earnings of land development companies. In their place, the commission endorsed a method roundly opposed by the developers.

The SEC, as the article notes, favors the "installment" method of accounting for revenues, under which a firm recognizes revenue in its accounts as cash payments are received. This method also spreads over the cash collection period various costs incurred by a developer in purchasing, developing, and selling land.

The installment method, as a later discussion in this chapter notes, represents an exception to the general method of recognizing revenue at the time a transaction is completed. Accountants, in general, do not favor the use of the installment method in the preparation of external financial reports. On the other hand, the method is acceptable in income tax reporting and for tax purposes usually provides income tax savings in comparison with the general method of recognizing revenue. Some significant income tax factors pertaining to installment sales of land are discussed in the latter part of this chapter.

Frederick Andrews, author of the Wall Street Journal article discussing the SEC's opposition to the proposed accounting rules, states in the article that an immediate survey of the major land development companies revealed none which use the installment method in their financial reporting. In fact, Andrews mentions that "the industry has strongly resisted that method in its discussions with the institute committee, and, according to accounting sources, five of the committee's six members concurred in the companies' opposition."

"Accounting sources," according to Andrews, "generally predicted the immediate impact of the installment method, if adopted, would be to cut the land companies' reported earnings." For example, Abraham J. Briloff, as Andrews relates, expressed the feeling that the installment method "'will have a very serious negative effect on the industry's earnings, most seriously on the relatively new companies.'" Briloff, incidentally, is a member of the AICPA Committee on Land Development Companies.

Burton, the SEC chief accountant, interestingly enough, expressed the feeling that the installment method, while providing a lower income level for developers, might eventually have favorable effects on land development companies because it would tend to smooth out the income stream and provide a steady level of income. Furthermore, Burton expressed his opinion that the land development accounting committee's proposals if adopted as they were presently drafted "'wouldn't serve the interests of the investing public.'" As Andrews notes, among his reasons for making this statement, Burton felt that the proposals permit "'a significant degree of manipulation'" and would require firms to rely on "'arbitrary rules.'"

Although Burton favored the strict use of the installment method in accounting for the retail sales of land and avidly disapproved of the land development accounting committee's proposals, he apparently did offer his backing to these proposals if an overwhelming majority of the APB approved them. For example, the previously referred to statement by Philip Defliese regarding the Accounting Principles Board's December 9, 1972 informal approval of the land development accounting committee's proposals also contains the following comment:

> "Reached by telephone, John C. Burton, chief accountant of the SEC, expressed disappointment but affirmed his position, subject to review of the final draft, that he would recommend the Commission's acceptance of the paper if a solid two thirds majority of the APB endorsed it. . . ."[18]

At the present time, the Securities and Exchange Commission is withholding its final decision regarding the new accounting rules adopted by the Accounting Principles Board. The Commission is deferring its approval pending publication of the final text of the rules.[19]

In short, the discussion so far in this chapter has exposed the broad nature of the revenue recognition problems developers face. In the next few sections a more detailed study of these issues will be presented.

Fundamental Methods of Accounting for Land Sales

The general rules regarding the accounting for revenues are contained in chapter 1A of Accounting Research Bulletin No. 43, paragraph 1, and are reaffirmed in paragraph 12 of the Accounting Principles Board Opinion No. 10 and the related footnote. Paragraph 12 of Opinion No. 10 and the related footnote contain the following:

> 12. Chapter 1A of ARB No. 43, paragraph 1, states that "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." The Board reaffirms this statement; it believes that revenues should ordinarily be accounted for at the time a transaction is completed, with appropriate provision for uncollectible accounts. Accordingly, it concludes that, in the absence of the circumstances[8] referred to above, the installment method of recognizing revenue is not acceptable.
>
> [8]The Board recognizes that there are exceptional cases where receivables are collectible over an extended period of time and, because of the terms of the transactions or other conditions, there is no reasonable basis for estimating the degree of collectibility. When such circumstances exist, and as long as they exist, either the installment method or the cost recovery method of accounting may be used. (Under the cost recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time.)[20]

The foregoing citations provide three methods of accounting for revenues from sales transactions. These consist of the general rule of recognizing revenue at the time a transaction is completed and two exceptions, the installment method and the cost recovery method. According to Opinion No. 10, the general rule is to be followed unless conditions of the transaction warrant the use of one of the exception methods.

Opinion No. 10, however, is quite vague regarding the circumstances under which the exception methods should be used. Furthermore, the variety of conditions under which retail land sales transactions are executed complicate the task of selecting an appropriate revenue accounting method. Therefore, numerous attempts have been made to develop specific guidelines for applying the basic revenue accounting rules pertaining to retail land sales. Many of these guidelines will be analyzed later in this chapter.

Revenue recognition problems generally arise in retail land sales when the sales are made on credit terms and payments are spread over a long period of time. The uncertainties surrounding the collectibility of receivables create the chief difficulties in determining the accounting method which should be used in a particular sale of improved land. In addition, before the developer can even face the problem of determining the uncertainty of receivables collection and whether one of the exception methods should be used, he must first deal with the more basic problem of ascertaining whether a bona fide sale for accounting purposes has, in fact, taken place.

Evaluation of Land Sales Transactions from an Accounting Standpoint

What on the surface appears to be a bona fide sale, may in fact be an option, a deposit against a future purchase, a rental-purchase plan, or some other arrangement indicating a completed sale has not yet taken place. To identify the accounting characteristics of a sales transaction, the accountant must analyze numerous legal and financial aspects related to the transaction.

It is important that the accountant view the transaction from the standpoint of its business substance.[21] This involves an analysis of such commercial aspects of the transaction as the amount of money initially paid by the buyer, the schedule of debt payments, and the relationship of the value of the property to the selling price. Although the accountant will also study such legal factors as the transfer of title and the nature of the security supporting the purchase debt, the legal factors alone cannot be relied upon to signify that a sale for accounting purposes should be recorded. As one source reflects regarding the determination of a sale for accounting purposes:

> It is difficult to make a satisfactory generalization as to when a sale occurs, but in most cases which, by their terms, purport to be sales, a sale has occurred when the "rewards of ownership" have come to rest with the buyer, subject only to his meeting either a contractual or a purchase money mortgage obligation. (The retention or transfer of "risks of ownership" is more important to the

question of deferral of profit versus current recognition than to the question of whether a sale has occurred.)[22]

The possible legal and financial arrangements in sales of improved sites are practically infinite. There are, however, a few commonly occurring factors which are extremely important in evaluating a land sales transaction from an accounting standpoint.

Lack of Recourse to Buyer's General Credit

Land sales are frequently secured through purchase-money mortgages or similar security instruments whereby the purchaser does not have to pledge his general credit. In other words, if the purchaser fails to meet the obligations of his note or account, the seller has recourse to the mortgaged property only. The seller usually retains title to the land until final payment is made on the transaction.

Such security instruments tend to increase the risks attendant to the sales transaction. Because the purchaser generally stands to lose only his payments to date on the purchase, he is less reluctant to back out of the transaction than if his general credit is at stake.

However, the purchase-money mortgage in itself does not necessarily indicate that a high degree of risk prevails in a given transaction. In other words, the purchase-money mortgage must be considered in conjunction with other factors affecting the transaction, such as the amount of cash initially paid. The more cash paid by the purchaser, the greater is his incentive to complete the transaction.[23]

Failure to Investigate Credit of Buyers

The publicly-owned land development companies have been criticized for not carefully investigating the credit worthiness of their customers. This failure to make credit investigations of site purchasers apparently stems from the use of the purchase-money mortgage and the fact that the seller retains title to the land and can resume possession of the property upon default of payments by the purchaser.

At any rate, the failure to investigate the credit risks of purchasers increases the collection uncertainties surrounding the land sales transactions. From an accounting standpoint, the lack of adequate credit evaluation complicates the task of estimating the collection of accounts.

Unreasonably Small Down Payment and Small Monthly Payments

Probably the most questionable practice of land developers which causes accounting problems is the practice of receiving extremely small down payments on land sales and small monthly payments on the receivables. This practice often raises doubts regarding the ultimate collection of the full proceeds from the sale, particularly where the land has been purchased under a purchase-money mortgage or other arrangement whereby the seller has no recourse to the buyer's general credit. The likelihood that the buyer will rescind the purchase contract remains very high for a substantial part of the payment period, because during this time the buyer will not have a great deal of cash invested in the land.

The ability of land development companies to accurately project the uncollectibility of receivables from such sales and to provide reasonable allowances for future losses has not been very good. For instance, the writer of an article published in 1964 makes the following statement:

> The principal justification for considering contracts involving no transfer or very limited transfer of title and unrealistically small down payments as sales is that a large volume of small transactions diversifies the risk to the extent that experience can be used to provide assurance as to the percentage of contracts which will be completed and how much allowance for loss is necessary. *So far, however, it has not been convincingly demonstrated that such allowances can be accurately determined*. Within the past two years several publicly held real estate developers have had to make substantial increases in their original loss provisions which, in some cases, have seriously impaired their capital.[24] (Italics mine.)

More recently, Professor Briloff in his *Barron's* article notes the inability of developers at the present time to accurately estimate collection losses.[25]

Inability to Deliver Lots at Time of Sales Transaction

A great deal of criticism has been rendered land development companies for their practice of recognizing full revenue on land sales prior to the completion of required land improvements. According to Professor Briloff, land developers

> should be entitled to reflect the fruits of their labors only when, as, and if they fulfill their professed objective--namely, delivering homesites to their customers. At the very earliest, the revenues should be recognized when the entities have completed the improved site they have contracted to deliver.[26]

Whether or not all contracted site improvements must be completed before the transaction can be recorded as a sale and revenue be recognized might be subject to question. The important point is whether the purchaser can take possession of the site and begin to make use of it for his personal purposes. Where substantial improvements must still be undertaken by the developer before the purchaser can begin to make use of the site, the equitable accounting procedure would be to consider payments as deposits on the purchase until such time as sufficient improvements have been executed and the purchaser can begin to use the site.

Survey of Proposed Guidelines for Recognizing Revenue from Land Sales

Some of the problems in evaluating land sales transactions for accounting purposes have been reviewed. The study will now focus on various attempts to establish specific guidelines for the recognition of revenue from land sales.

Except for the Securities and Exchange Commission's Accounting Series Release No. 95, issued in 1962, and the accounting rules for retail land sales recently adopted by the Accounting Principles Board of the American Institute of Certified Public Accountants, the attempts to establish guidelines for the recognition of revenue from land sales have been isolated, individual efforts. Therefore, they have lacked uniform application throughout the industry.

SEC Accounting Series Release No. 95

Accounting Series Release No. 95, issued on December 28, 1962, was perhaps the first attempt to list specific factors affecting the current recognition of revenue arising from land sales. As the publication notes, the SEC had become aware of a number of cases involving real estate transactions in which gross profits "were taken into income under circumstances which indicate that they were not realized in the period in which the transactions were recorded." In some of the cases, circumstances revealed that "the sale of property is a mere fiction designed to create the illusion of profits or value as a basis for the sale of securities."

The following circumstances, as quoted from Release No. 95, tend to raise questions regarding the recognition of profit currently:

1. Evidence of financial weakness of the purchaser.
2. Substantial uncertainty as to amount of costs and expenses to be incurred.
3. Substantial uncertainty as to amount of proceeds to be realized because of form of consideration or method of settlement; e.g., non-recourse notes, non-interest-bearing notes, purchaser's stock, and notes with optional settlement provisions, all of indeterminable value.
4. Retention of effective control of the property by the seller.
5. Limitations and restrictions on the purchaser's profits and on the development or disposition of the property.
6. Simultaneous sale and repurchase by the same or affiliated interests.
7. Concurrent loans to purchasers.
8. Small or no down payment.
9. Simultaneous sale and leaseback of property.

The publication recognizes that any one circumstance by itself might not prohibit the current recognition of profit. Consequently, it states that "the degree of uncertainty may be accentuated by a combination of the foregoing factors." However, it goes no further than this in dealing with the issue of revenue recognition except to present, from SEC filings, seven cases in which the Commission found that it was inappropriate for firms to recognize revenue at the time of sale. Practically all of these cases deal with sales of land, either subdivided or not subdivided.

Affinito Guidelines

In an article in the Price Waterhouse Review published in 1963, Lilyan Affinito proposed "some basic guidelines for determining the method to be used for recognizing income on land sales." Her discussion dealt with both retail and wholesale sales of land by developers. Although her guidelines are quite general in nature, they do highlight the chief factors to be considered in selecting the proper method of recognizing revenue on land sales. The guidelines, as presented in the article, are as follows:

(1) To determine that a sale has been effected:

A. Has the seller given up control of the property?

B. Has delivery been made or will delivery be made in the near future? Does the company as a normal practice make delivery prior to the date specified in the sales agreement?

C. Is it possible to reasonably determine the amount of revenue that will be realized (and costs that will be incurred) on the transaction? Do the company's sales volume and gross profit percentages fluctuate considerably from reporting period to reporting period?

D. Is the down payment adequate and is the collection period of a reasonable short-term duration?

E. Is there any evidence that the seller has, concurrent with the transaction, loaned or advanced money to the purchaser?[27]

Affinito briefly discusses the application of her guidelines. She concludes that

> There is no <u>one</u> accounting method that can be advocated for recognizing income on instalment land sales. Accountants, therefore, must judge each transaction based on the facts of the individual situation.[28] (Italics in the original.)

Peat, Marwick, Mitchell and Company Guidelines

The Peat, Marwick, Mitchell and Company guidelines, which were mentioned in a Wall Street Journal article discussed above, are quite specific. According to the article,

> Peat-Marwick's new guidelines--an attempt to minimize the element of individual judgment--state that the seller may recognize income only if there is evidence that the purchaser is "substantially committed from a cash point of view." As indicators of a substantial commitment, the guidelines require that the seller has received at least 10% of the purchase price in cash at the closing, and that notes provide for annual payments of principal during the first five years of about an additional 10% to 15% of the purchase price.
>
> In a straight cash sale, of course, income can be recognized immediately. Similarly, in cases where the notes received are "clearly recoverable against the general assets of the purchaser" income can be recognized as in a cash transaction.[29]

The article also points out that the Peat-Marwick guidelines cover other revenue accounting areas, one of which pertains to interest rates on notes obtained in real estate transactions. Such notes often bear extremely low interest rates, with the interest actually being included in the face of the note.

The Peat-Marwick guidelines require that such notes bear interest at a reasonable rate or that interest be imputed to a reasonable rate. Although the guidelines recognize that a specific rate cannot be established, they do require that the rate not be less than rates the developer must pay in obtaining funds for its own use.[30]

Gillette, Hicks, and Nicholson Guidelines

In the Summer 1971 issue of The Arthur Young Journal (a special issue devoted to real estate and land development) appears an article by Charles G. Gillette, Ernest L. Hicks, and John W. Nicholson entitled "Guidelines for Recognition of Profit on Real Estate Sales." The guidelines presented in this article cover three classes of transactions: commercial transactions, home sales, and sales of homesites without buildings. The guidelines presented for the first two classes of transactions are more specific than for the third class--the one of concern in this study. Nevertheless, the guidelines provided for the third class of real estate transactions contain some elements beneficial to land developers.

The authors of the article feel that the guidelines for homesite sales cannot be as specific as for the sales of commercial real estate and homes because "the economics and risks involved in sales of homesites vary so greatly from one location to another."[31] The guidelines for homesite sales, which they state are to be considered "in addition to the financial aspects of the transaction," are as follows:

> Is the site presently usable in the expected manner, or is its use dependent upon major future development of the area (e.g., roads, utilities, or swamp drainage)?
>
> Has the buyer ever inspected his purchase?
>
> If not, does he have the right to get his money back upon such inspection?
>
> Has it been established by credit check that the buyer has the ability to pay?[32]

The "financial aspects of the transaction" presumably cover such factors as the amount of cash initially paid by the buyer, the timing of payments, and the financial position of the buyer.

Because of the more speculative nature of the purchase of homesites in relation to the purchase of homes or perhaps commercial real estate, Gillette, Hicks, and Nicholson feel that

> the financial terms required to qualify a sale of homesites for current recognition of profit should be considerably more favorable to the seller than those required to qualify a sale of homes. This generalization, however, should not be applied in cases where collection experience indicates otherwise.[33]

AICPA Guidelines

As noted above, the American Institute of Certified Public Accountants recently adopted rules regarding the recognition of revenue on retail land sales. The development of these rules or guidelines was begun in 1969 with the formation of the AICPA Committee on Land Development Companies.

Even before this group formally issued any recommendations or proposals on land development accounting, land development companies began to express concern regarding the impact on financial reports of probable changes in land development accounting procedures. For example, the Second Quarter Report for the six months ended June 30, 1971, of the General Development Corporation, a large land development organization, carries the following footnote appended to the Consolidated Statements of Income and Retained Earnings:

> As previously reported, the Accounting Principles Board of the American Institute of Certified Public Accountants is currently reviewing the accounting practices followed by the land development industry.
>
> Current indications are that the Board may recommend changes in accounting practices, which if adopted by the Institute could defer the recording of homesite sales and related profit and thus from an accounting viewpoint could have an adverse effect on the Company's financial Statements. Any such changes, however, should have no adverse effect on the Company's fundamental economic position, cash flow or historical growth trends.
>
> The Company is unable to predict at this time whether any changes in accounting practices applicable to the Company's business will be made, or what effect, if any, such changes will have on the Company's financial Statements. However, it is the Company's opinion that the accounting practices currently followed by the industry generally and the Company in particular present fairly the Company's financial condition and that no material changes in the Company's accounting practices are warranted.[34]

Similar comments were included in the footnotes to subsequent financial reports of this company.

The first formal proposals of the Committee on Land Development Companies were presented in the Committee's January 1972 exposure draft entitled "Accounting for Retail Land Developers." This draft contained specific quantitative standards for recognizing revenue on retail land sales.

The guidelines proposed by the Committee in its original exposure draft were revised in some respects before they were resubmitted in late 1972 to the Accounting Principles Board for that body's final approval. However, at that time, the guidelines still apparently contained many weaknesses. These infirmities were the obvious reason why the Securities and Exchange Commission so strongly opposed the Committee's proposed rules, as discussed above. The SEC, as the previous discussion notes, expressed support for the "installment method" of accounting for revenues. The Committee on Land Development Companies, as a matter of fact, had given only minor consideration to this method in its study.

Before adopting the revised guidelines finally submitted to it by the Committee on Land Development Companies, the Accounting Principles Board executed certain modifications to the proposed rules. The changes made by the APB were likely attempts to bring the Committee's proposals in line with the recent views of the SEC.

The revenue recognition proposals of the Committee on Land Development Companies will now be examined. The discussion will conclude with a brief analysis of the retail land sales accounting rules ultimately approved by the APB.

In its original exposure draft, the Committee on Land Development Companies acknowledged the fact that in retail land sales transactions there are exceptions to the general rule of recognizing revenue at the point of sale. In particular, the Committee noted the "installment sales method" as such an exception method. However, the group definitely favored the general rule for recognizing revenue in retail land sales. For example, the exposure draft contains the following statement:

> The Committee believes that, absent the conditions that would require the use of the installment method as described later, retail land development companies should record the sales contract at such time as the cancellation and collection experience of the company indicate that the buyer's apparent intent is to complete the contract.[35]

Regarding when the installment sales method would be permitted, the position paper contains the following comment:

> Where a company's collection experience cannot provide a reasonable prediction of the percentage of contracts that will pay out to maturity, with respect either to its entire operations or a portion thereof, the accounting for such sales should be based upon the <u>installment method</u>. (Italics mine.)[36]

Furthermore, regardless which method is used, the general revenue recognition method or the installment method, the exposure draft required that certain criteria be met before any revenue on a sales contract can be recognized. For example, the paper contained the following statement:

> Because of the element of uncertainty inherent in the application of historical data to current transactions, the Committee is of the opinion that at least 5% of the contract price (principal) must be collected before a contract can be included in the recording process.[37]

The Committee further elaborated with the following comment:

> Payments received on contracts which have not met the criteria for recording as sales (e.g. because less than 5% of the contract price (principal) has been received) should be recorded as contract deposits. (Italics mine.)[38]

The Committee's guidelines with respect to when revenue from retail land sales should be recognized in a development firm's accounts appeared to be clear. Where less than 5% of the contractual price has been received, no sale for the purposes of recording revenue is considered as having taken place. Where more than 5% has been received, the question then arises whether the general method of recognizing revenue or the installment sales method should be used. The answer is dependent on the firm's ability to determine the collectibility of sales contracts. It is in the area of determining collectibility of contracts that major difficulties regarding the Committee's guidelines begin to appear.

According to the position paper, the collectibility of current sales should be based on the presumption that a given developer possesses "a sufficient experience as to prior sales of the type of land being currently marketed" and that the collection period which has elapsed on these prior sales is adequate enough to establish the percentage of these sales that will be completely collected. The paper even goes so far as to state the following:

> Since different sales methods may result in differing cancellation and collection results, a further presumption is made that historical data as to such results is available with respect to telephone sales, broker sales, site visitation sales, etc.[39]

The foregoing presumptions, particularly the latter, appear to be subject to challenge. In other words, considerable doubt surrounds the question whether developers can be expected to possess the ability and necessary information to accurately determine the collectibility of receivables arising from land sales transactions. Past experience, as the present chapter has previously noted, does not reveal this ability.[40]

The "5% collection requirement" itself may be questioned on the grounds that it is obviously based on arbitrary considerations. As a matter of fact, this standard was later apparently considered not rigid enough, because in revisions of its original exposure draft and in the final rules adopted by the APB, the collection requirement on land sales transactions is established at 10% of the contractual price.[41] In sum, because of the many presumptions upon which they depend and because of their generally arbitrary nature, the Committee's proposals regarding when revenue on land sales should be recognized in developer accounts contained many weaknesses.

Incidentally, in addition to the highly-emphasized issue of timing in the recognition of revenue, the Committee on Land Development Companies also addressed itself to a number of other important revenue reporting issues, among which are the following: (1) computing the present value of receivables obtained on land sales, i.e., ascertaining imputed interest included in the consideration received by developers, (2) determining the revenue to be reported on the portions of a contract in which future development work is still to be performed, (3) establishing provisions for accounting for contract cancellations, and (4) developing quantitative criteria for deciding when contracts have been canceled. For the most part, these latter issues are simply subordinate problems connected to the basic question of when should revenue on land sales be recognized. The Committee's recommendations in its original exposure draft regarding these latter issues likewise contained many arbitrary rules.

The land development accounting rules ultimately adopted by the Accounting Principles Board, as mentioned earlier in this chapter, provide for the use of <u>both</u> the accrual (recognition of revenue at the point of sale) method and the installment accounting method in accounting for retail land sales. Notably, the final rules adopted by the APB devote significant attention to the installment method. According to the statement by Philip L. Defliese quoted in the Accounting Research Association Newsletter of December 13, 1972, the accrual method of accounting will only be permitted "'where stringent criteria are met.'" Furthermore, neither method will allow recognition of revenue "'until cash payments received aggregate ten percent of the contract price and the customer's cancellation privilege period has expired.'"[42]

Further comments by Mr. Defliese, as contained in the Accounting Research Association Newsletter of December 13, 1972, provide the following elaboration regarding the APB's final adoption of accounting rules for retail land sales companies:

> "The Board reaffirmed the position it took in APB Opinion No. 10 which permits use of the installment method only in cases when serious doubt of the collectibility of receivables exists. The SEC and Financial Analysts Federation both recommended use of the installment method in almost all cases involving typical sales in this industry.
>
> "Use of the accrual method will be required on a project by project basis if the following criteria are met:
>
> (1) The properties clearly will be useful for residential or recreational purposes when the payment period is completed.
> (2) The company's financial capabilities assure its ability to fund or bond the planned improvements.
> (3) The project's planned improvements must have progressed beyond preliminary stages and there is

evidence that the work will be completed according to plan.

(4) Collection experience of the project or related projects indicates that collectibility of receivable balances is reasonably predictable and that ninety percent of the contracts in force six months after sales are recorded will be collected in full.

"Until such time as collection experience of a project warrants use of the accrual method, contracts must be accounted for on the installment method which permits deferment of related selling costs. Until such time as the contract payments aggregate ten percent of contract price and promised performance becomes predictable, payments will be treated as deposits. The new accrual method requires (1) deferment of a portion of the contract price to cover cost and profit applicable to future development work; (2) discount of contract receivables to yield an interest rate equal to the retail installment credit rate which is currently about 12 percent."[43]

A close examination of the foregoing statements reveals that the final rules adopted by the Accounting Principles Board are still not conclusive as to the determination of periodic revenue on retail land sales. As a matter of fact, the extremely general nature of the criteria listed above will probably cause additional confusion among developers regarding the recognition of revenue on retail sales of land. Furthermore, the new rules actually do little to reduce the discretion exercised by developers in accounting for revenues. For example, in reference to item (4) of the accrual method criteria listed above, who is to determine when the collection experience of a project or projects "indicates that collectibility of receivable balances is reasonably predictable and that ninety percent of the contracts in force six months after sales are recorded will be collected in full."

About the only significant effect of the new rules will be to defer the recognition of revenue during the first year of a sale. The proposed criteria do little to alleviate the problem of estimating the collectibility of receivable balances. In other words, deferral of the revenue on land sales for a period of six months or so will still not eliminate the necessity of estimating the collectibility of these accounts once the full revenue on the sales has been recognized in the company's accounts. Furthermore, deferring the recognition of revenue does not reduce the difficulties in estimating the collectibility of the account balances.

Evaluation of Proposed Revenue Recognition Guidelines

The foregoing discussion of the various sets of proposed guidelines indicates that the revenue recognition problems pertaining to installment sales of land are extremely complicated. The sets of guidelines contain numerous similarities, but they also contain many differences in emphasis and coverage. Significantly, each set of rules or standards gives consideration to the amount of cash, or the down payment, received before total revenue on a sale is recognized. Most include evaluations of the financial position of the purchaser, relinquishment of control of the property by the seller, extent of completion of required site improvements, and extent of the commitment on the part of the purchaser, i.e., to what extent can the purchaser back out of the transaction.

No single set of guidelines appears to be all encompassing. Furthermore, all seem to allow considerable judgment in determining whether the revenue on a given transaction should be recognized currently. With the exception of the Peat, Marwick, Mitchell and Company guidelines and the recently-adopted AICPA guidelines, none of the guidelines presents specific, quantitative measures for judging when revenue on installment land sales should be recognized. Unfortunately, both the Peat-Marwick and the AICPA guidelines are based on discretionary factors and contain arbitrary rules.

The inherent weakness in all of the guidelines discussed above is that they all basically represent an attempt to provide a means of implementing the general method of recognizing revenue at the point of sale. None of the guidelines, including those adopted by the AICPA, attempts to support to any great extent the use of the installment sales method in recognizing revenue on long-term land sales transactions.

The writer's conclusion is that the most appropriate method of accounting for revenues arising from long-term installment sales of land is the <u>installment sales method</u>. The unique characteristics of retail land sales transactions seem to require this departure from the general method of recognizing revenue on sales. Under the installment method, the inequities in reporting revenues earned from retail sales of land appear most likely to be reduced.

The installment sales method is advantageous for the following reasons:

1) It eliminates the problem of establishing arbitrary standards regarding initial down payment and monthly cash payments.

2) It eliminates the need for estimating uncollectible contracts and establishing a reserve for contract cancellations.

3) It eliminates the need for using different methods of accounting for financial reporting and income tax reporting when the development firm uses the installment method for tax purposes.

4) It tends to smooth out the revenue flows and, therefore, reduce the possible erratic, cyclical nature of the net profits reported by land development companies.

Of course, certain accounting problems must still be faced even if the installment sales method is accepted as the basic method of accounting for revenues arising from retail land sales. For example, the following difficulties will still be encountered:

1) Selection of an appropriate rate to discount contract receivables to their present value, and

2) Determination whether a given transaction represents a bona fide sale, purchase option, contract deposit, etc.

Nevertheless, the difficulties in applying the installment method appear much less formidable than those in applying the general revenue recognition rules. Furthermore, the advantages of the installment method appear to outweigh the many disadvantages inherent in the application of the general revenue recognition method.

Income Tax Measures in Reporting Land Sales

A brief discussion of two special features pertinent to reporting land sales revenue for income tax purposes will now be presented. These two measures consist of (1) using the installment sales method in reporting land sales and (2) obtaining long-term capital gains treatment on certain land sales. The first measure involves a means by which taxable income can be spread over more than one taxable year. The second represents an attempt to obtain the lower long-term capital gains tax rate on income that might otherwise be taxed at the higher ordinary income tax rates.

Using the Installment Sales Method

Section 453(b) of the Internal Revenue Code explicitly allows the use of the "installment sales method" for reporting the gain on sales of real property as long as the payments received during the year of sale are not more than 30 percent of the selling price of the property. When the installment method is used, the seller is allowed to include the gain on sale in taxable income as cash collections are received on the contracts rather than having to report the total gain in the tax return of the year in which the transaction occurs.

Regulation 1.453-1(b) provides the rules for computing the amount of taxable gain to be reported in each year. As stated therein, the income to be reported in a given year is "that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when the property is paid for bears to the total contract price."

The advantage of the installment method of reporting land sales transactions for tax purposes is that the seller is allowed to report income and pay taxes on this income as cash is received on the sales contracts. If the total income is reported in the year of sale, then the developer may be faced with the task of paying out more cash in taxes during the year of sale than is collected from the purchaser during this year.[44]

Regulation 1.453-4 provides for the use of the installment method even though title to property sold is not conveyed to the purchaser until "all or a substantial portion of the selling price has been paid." Hence, land developers do not have to give up title to property in the year of sale in order to obtain use of the installment method of reporting for income tax purposes.

An important factor that must not be ignored in applying the installment sales method for income tax purposes is "imputed interest" on the installment sales contract. Section 483 of the Internal Revenue Code requires that interest be recognized on such transactions. If interest is not specified in the installment sales contract, then it will be imputed under the provisions of Section 483.

Under Regulation 1.483-1(d), no interest is imputed if interest of at least four percent is included in the sales agreement. If such interest is not provided, then interest will be imputed at a rate of five percent.

Of course, interest included in the sales agreement, whether specifically provided in the agreement or imputed, represents taxable ordinary income for the seller and a deductible expense for the buyer. Much more important, however, from the standpoint of the seller is that when interest is imputed each installment payment is discounted back to the time of the sale and, therefore, consists partly of sales price and partly of interest. The effect of discounting the installment payments is to reduce considerably the total sales price of the property. The consequence may be that the sales price is reduced to such an extent that the amount of cash received in the year of sale may exceed 30 percent of the reduced sales price. Hence, the installment method of reporting the sale for tax purposes may not be available to the seller. As a result, one source recommends that "the safest course to pursue is to provide for at least 4% interest in the sales contract and avoid the problem of imputed interest."[45]

Incidentally, when the development firm cannot qualify for use of the "installment sales method" of reporting long-term sales in income tax reporting, it may still qualify for another related method referred to as the "deferred payment sales method." The authority for this latter method is contained in Regulation 1.453-6. This method is less advantageous to the seller than the "installment sales method," but it does provide some tax relief in comparison with the recognition of total revenue at the point of sale.

Obtaining Long-Term Capital Gain Treatment

Land may be held primarily for sale to customers in the ordinary course of business or it may be held strictly for investment or speculative purposes. In the former case, it will be considered an ordinary asset with any gain arising upon its sale being subject to taxation at ordinary income tax rates. In the latter instance, it will usually be deemed a capital asset in which gain occurring upon its disposition may be subject to taxation at long-term capital gain rates under the provisions of Section 1221 of the Internal Revenue Code.

For the most part, land held for the purposes of subdivision and development is considered an ordinary asset specifically excluded from capital gain taxation by the provisions of Section 1221. However, the Internal Revenue Code does provide a limited exception to this rule, contained in Section 1237, which allows an individual to receive capital gain treatment on the subdivision and sale of land on a lot-by-lot basis if certain specific tests are met. Section 1237 allows an individual to receive capital gain treatment upon the sale of real estate acquired for investment purposes but which must be subdivided in order to facilitate its sale.

In brief, Section 1237 allows capital gain treatment where the taxpayer meets the following basic requirements:

(1) He has held the tract of land for at least five years, unless it was acquired by inheritance. In the latter instance, the holding period is six months.

(2) He has not held the property for sale to customers in prior years. Furthermore, during the year of sale, the taxpayer did not hold any other property for sale to customers.

(3) The taxpayer did not make substantial improvements to the property that would increase the value of the particular

lots sold.

The provisions of Section 1237 are, however, extremely limited in application. They generally apply only to individuals and only to those persons who undertake the subdivision of land and the sale of lots on a very limited basis, e.g., five lots or less from a tract per year. Hence, the provisions of Section 1237 do not apply to the organized land development enterprise operating with the express purpose of acquiring and developing land on a continuous, extensive basis.

Although land development enterprises do not come under the provisions of Section 1237, such firms may still qualify for capital gain treatment on the sale of certain parcels of land if they can prove that they specifically held the land for investment purposes and not primarily for sale to customers.

The fundamental question regarding the income tax treatment upon the sale of a specific parcel of land is whether the seller can be considered a "dealer" or an "investor" with respect to the particular parcel sold. Actually, the seller (whether an individual, partnership, or corporation) may be deemed a dealer in one instance and an investor in another.[46] The answer is not always clearly determinable.

In general, each case must be evaluated upon its own facts. As a result, the number of court cases pertaining to the dealer-investor question is extensive. To aid in determining when capital gain should be allowed in sales of real property, the courts have established certain criteria. For example, the Tax Court in one case listed the following factors to be considered in determining the primary purpose for which property is being held, i.e., whether the seller can be considered a dealer or an investor with respect to the property:

> (1) The purpose for which the property was initially acquired; (2) the purpose for which the property was subsequently held; (3) the extent to which improvements, if any, were made to the property by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and nature of the transactions involved; (6) the ordinary business of the taxpayer; (7) the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property; (8) the listing of property with brokers; and (9) the purpose for which the property was held at the time of sale.[47]

No single test is conclusive in determining the tax status of a given piece of property from the standpoint of the seller.[48] Instead, in each particular case, all of the factors must be evaluated as a whole. This, of course, makes the law regarding gain on sales of real property relatively indefinite.

A brief review of some pertinent judicial cases involving capital gain and the dealer-investor problem follows. In addition to this discussion, related capital gain taxation factors applicable to land developers are presented in Chapter V within the discussions of "collapsible partnerships," "collapsible corporations," and transfer of land to a corporation in a taxable transaction.

In 1955, the Supreme Court handed down a decision in Corn Products Refining Co.[49] which appeared to adversely affect the ability of real estate dealers, as well as other dealers, to receive capital gain taxation upon the sale of assets which are closely related to the dealer's day-to-day business activities. In general, the Corn Products case holds that any activity related to the day-to-day business of a taxpayer should be taxed as ordinary income. The decision is apparently intended to include the sale of assets which have been specifically held for long-run investment purposes. Fortunately, as the author of a recent article notes, the Government has never successfully applied the Corn Products doctrine in a real estate dealer case.[50]

A 1964 court decision rendered by the Ninth Circuit in Margolis[51] tended to add further detriment to a real estate professional's chances of obtaining capital gain treatment on the sale of parcels of land, even when this property has been held for long-term appreciation in value. The taxpayer in Margolis had participated in numerous real estate transactions of various types. With regard to the parcels in question, the taxpayer argued that they had been acquired for long-term appreciation. Nevertheless, the Court felt that the gain on their sale should be subject to taxation at ordinary rates. In support of its decision, the Court made the following statement:

> If the purpose of the acquisition and holding and the only manner in which benefit was to be realized from the property acquired was ultimate sale at a profit, its acquisition and holding by a dealer such as taxpayer must be considered to have been for sale to customers in the ordinary course of business.

Then, in 1966, the Supreme Court rendered a decision in Malat v. Riddell[52] which began to provide hope that real estate dealers could be allowed long-term capital gain treatment on the sale of certain parcels of land held strictly for long-range investment purposes. The major point dealt with in the Malat case involved the meaning of "primarily" as contained in the term "primarily held for sale to customers" in Section 1221 of the Internal Revenue Code.

Prior to Malat, many courts viewed "primarily" as meaning "substantially." Hence, if a substantial purpose for holding property was for later resale, the property was deemed to be property held for resale and therefore subject to ordinary taxation. But the Malat case established that "primarily" means "principally," or "of first importance." As a result, although one obvious motive for holding a piece of real property is resale, this motive may not be the principal motive. Therefore, property held by a real estate dealer will not necessarily be considered property held for resale in the regular course of business and subject to taxation at ordinary income tax rates.

The real importance of the Malat case is that it recognized the fact that a dealer in real estate could hold land both for investment purposes and also for resale to customers in the course of regular business operations.

Some interesting opinions have been rendered in post-Malat cases. For example, in Schueber,[53] the Seventh Circuit ruled that a real estate dealer can get capital gain treatment even if his investment goal is sale at a profit. Schueber was a licensed real estate broker who purchased an undeveloped tract of land which he felt would some day become quite valuable. After holding the land for fourteen years, he sold it at an enormous gain. The Internal Revenue Service and the Tax Court claimed that resale was Schueber's only reason for buying the land, and, therefore, the land was simply a long-term inventory item upon which gain would constitute ordinary income. The Seventh Circuit, however, allowed Schueber capital gain treatment on the grounds that the amount of gain on the sale of the land was too large to be considered profit on property held for resale in the day-to-day operation of a business.

Municipal Bond Corporation[54] is another interesting post-Malat case which has had a bearing on the dealer-investor question. In this case, the Eighth Circuit held that the sales of real property by the taxpayer (a corporation whose only business activity had consisted of buying, renting, and selling real estate) were subject to capital gain taxation. Although the taxpayer had been deemed a dealer in earlier transactions, the taxpayer was not acting in the capacity of a dealer with respect to the sales of the property in question in the case. The property had been held over a long period of time, and the sales came without the taxpayer exercising any effort on its part.

In Johnson v. United States,[55] a 1967 district court case in the state of New York, certain parcels of land sold by a real estate broker were deemed to be capital assets subject to capital gain treatment. The parcels in question were a part of a large tract of farmland purchased jointly by Johnson and another individual. The court found regarding the tract that when it was acquired Johnson did not intend to sell it in the foreseeable future. His intention was "to hold it as a long-term investment for himself or his daughter." The land was held intact for eight years during which time Johnson made no effort to sell it. Johnson's cotenant was the one who promoted the sales of the parcels and who dealt with the buyers. As a matter of fact, Johnson was reluctant to sell the land and was urged into selling it by his cotenant.

In Auda C. Brodnax,[56] the Tax Court allowed capital gain treatment on the sales of 28 plots of subdivided land to 15 individuals over a three-year period. The sales were unsolicited by the taxpayer and developed in an unplanned manner. Some were to relatives and friends. Others were originated by realty agents who approached the taxpayer with customers.

The land in question involved a 40-acre tract acquired by the taxpayer in anticipation of nearby freeway construction. The taxpayer was not a licensed real estate dealer nor had he ever held himself out to the public to be in the real estate business. The only improvements made to the land were an access road and a drainage ditch. Although a preliminary layout of the 40 acres was sketched, no recordable subdivision plat was filed on the property or submitted to a planning commission.

The Tax Court based its opinion in the case mainly on the purpose for which the property was held at the time of sale. The Court found that the taxpayer's "original intention in purchasing the property was to hold it in anticipation of the increase in value of the land upon the building of a freeway in the immediate vicinity." Furthermore, the Court felt that "this intention was never abandoned."

The preceding discussion reveals the possibility that dealers in real property may be allowed capital gain taxation upon the sale of certain parcels of land. The fundamental issue is whether a dealer can be considered an "investor" rather than a "dealer" with respect to the particular parcels sold.

Incidentally, when land which is subject to long-term capital gain taxation is held by a closely-held corporation and the stockholders of the corporation desire to sell the land and distribute the cash proceeds, the stockholders may find it advantageous to attempt a partial liquidation of the firm under the provisions of Section 346 of the Internal Revenue Code. If the partial liquidation procedure is allowed, the stockholders will be able to remove the cash from the business without having it subjected to double taxation, i.e., taxation at the corporate level upon the sale of the land and taxation as a dividend to the stockholders upon the distribution of the cash. Furthermore, where such land is owned by a corporation and the intent of the stockholders is to dissolve the corporate entity entirely, the stockholders may desire to liquidate the firm under the special liquidation provisions of either Section 333 or Section 337 of the Internal Revenue Code. Both of these liquidation measures provide avoidance of the double taxation feature. However, in order to utilize either of these means of liquidating a corporation, the corporation must generally not be subject to the "collapsible corporation" provisions of the Internal Revenue Code. Some of the provisions of Section 333 and Section 337 are briefly discussed in Chapter V, within the collapsible corporation discussion.[57]

Summary

The growth of publicly-owned enterprises operating in the land development field has intensified interest in land development accounting practices. In particular, concern currently centers on revenue reporting aspects. Certain revenue reporting problems involving land sales (especially those problems pertaining to the issue of when revenue on such sales should be recognized in a developer's accounts) were studied in the chapter. The analysis included a discussion of fundamental methods of accounting for land sales, an evaluation of land sales transactions from an accounting standpoint, and a comparative survey of various proposed guidelines for recognizing revenue arising from retail land sales.

The writer's conclusion is that the most appropriate method of recognizing revenue on retail land sales is the "installment sales method." Under this method, revenue is recognized as cash payments are received on sales contracts. Although the installment method is a departure from the general rule of recognizing revenue at the point of sale, the nature of retail homesite sales requires this exception. The particular advantages of the installment method in relation to the general revenue recognition method is that the former method (1) eliminates the problem of establishing arbitrary standards regarding initial down payment and monthly cash payments, (2) eliminates the need for estimating uncollectible contracts and establishing a reserve for contract cancellations, (3) eliminates the need for using different methods of accounting for financial reporting and income tax reporting when the development firm uses the installment method in its income tax reporting, and (4) tends to smooth out the revenue flows and, therefore, reduce the possible erratic, cyclical nature of the net profits reported by land development companies.

The chapter also included a brief discussion of two income tax features pertinent to reporting land sales revenue for income tax purposes. Regarding the first feature, using the installment sales method for income tax purposes, a few provisions of special note are the following: (1) payments received on an installment sale during the year of sale cannot be more than 30 percent of the selling price of the property sold, (2) title to the property sold need not be conveyed to the purchaser, and (3) interest may be imputed for the contract (the effect of which will alter the relationship between the amount of cash received in the year of sale and the sales price of the property and may cause the disallowance of the installment method for tax reporting).

The discussion with respect to the other income tax feature, obtaining long-term capital gain treatment on the sale of land, revealed that in some instances dealers in real property may be permitted taxation at capital gain rates on the sale of certain parcels of land. The chief issue here is whether the dealer can be considered an "investor" rather than a "dealer" with regard to the particular property sold.

FOOTNOTES

[1]Gardner M. Jones, "Some Problems in Accounting for Land Development," Management Accounting, IL (August, 1968), 27.

[2]LeRoy H. Cole, "Accounting Problems of Land Development Companies," The Arthur Young Journal, XII (October, 1964), 1.

[3]Abraham J. Briloff, "Castles of Sand? An Expert Questions the Accounting Practices of Land Development Companies," Barrons, L (February 2, 1970), 3ff. (Hereinafter referred to as "Castles of Sand.").

[4]*Ibid*., p. 3.

[5]*Ibid*.

[6]*Ibid*.

[7]Some of the provisions of the SEC's Accounting Series Release No. 95 will be discussed below. See p. 59 below.

[8]Briloff, "Castles of Sand," p. 8.

[9]Dan Dorfman, "Heard on the Street," Wall Street Journal, July 28, 1971, p. 21.

[10]Edward P. Foldessy, "Accountants Develop Stiffer Standards on Recognition of Income by Land Firms," Wall Street Journal, September 10, 1970, p. 4. (Hereinafter referred to as "Accountants Develop Standards.")

[11]See p. 64 below.

[12]American Institute of Certified Public Accountants, Accounting Research Association Newsletter, Vol. V, May 5, 1972, p. 2.

[13]*Ibid*. ("APB No. 21" refers to Accounting Principles Board Opinion No. 21, issued in August, 1971, which deals with accounting rules for handling interest on receivables and payables.)

[14]American Institute of Certified Public Accountants, Accounting Research Association Newsletter, Vol. V, December 13, 1972, p. 1.

15"Accounting Panel Votes to Approve New Rules for Land Developers," Wall Street Journal, January 10, 1973, p. 2. (Hereinafter referred to as "Accounting Panel Votes New Rules.")

16Frederick Andrews, "SEC Opposes Accounting Rules Proposed for Reporting Income of Land Developers," Wall Street Journal, November 16, 1972, p. 9. (Hereinafter referred to as "SEC Opposes Accounting Rules.")

17*Ibid.* The following discussion is extracted from this article.

18American Institute of Certified Public Accountants, Accounting Research Association Newsletter, Vol. V, December 13, 1972, p. 2.

19"Accounting Panel Votes New Rules," p. 2.

20American Institute of Certified Public Accountants, Accounting Principles Board Opinion No. 10, December, 1966, p. 149.

21C. G. Gillette, E. L. Hicks, and J. W. Nicholson, "Guidelines for Recognition of Profit on Real Estate Sales," The Arthur Young Journal, (Summer, 1971), p. 6. (Hereinafter referred to as "Guidelines.")

22*Ibid.*

23*Ibid.*, p. 8.

24Cole, "Accounting Problems of Land Development Companies," pp. 7-8.

25Briloff, "Castles of Sand," p. 16.

26*Ibid.*, p. 3.

27Lilyan Affinito, "Problems in Accounting for Land Sales of Developers," Price Waterhouse Review, VIII (Autumn, 1963), 23.

28*Ibid.*

29Foldessy, "Accountants Develop Standards," p. 4.

30*Ibid.*

[31]Gillette, Hicks, and Nicholson, "Guidelines," p. 12.

[32]*Ibid*.

[33]*Ibid*.

[34]General Development Corporation, Second Quarter Report, for the six months ended June 30, 1971, p. 10.

[35]American Institute of Certified Public Accountants, January 1972 Exposure Draft Issued by the AICPA Committee on Land Development Companies, *Accounting for Retail Land Developers* (New York: American Institute of Certified Public Accountants, 1972), p. 5.

[36]*Ibid*., p. 9.

[37]*Ibid*., p. 5.

[38]*Ibid*., p. 8.

[39]*Ibid*., p. 6.

[40]See p. 57 above.

[41]Andrews, "SEC Opposes Accounting Rules," p. 9, and American Institute of Certified Public Accountants, *Accounting Research Association Newsletter*, Vol. V, December 13, 1972, p. 1. See also *The Journal of Accountancy*, CXXXIV (December, 1972), p. 3, and *The Journal of Accountancy*, CXXXV (January, 1973), p. 3.

[42]American Institute of Certified Public Accountants, *Accounting Research Association Newsletter*, Vol. V, December 13, 1972, p. 1.

[43]*Ibid*., pp. 1-2.

[44]Paul E. Anderson, *Tax Planning of Real Estate* (6th ed.; Philadelphia: Joint Committee on Continuing Legal Education of the American Law Institute and the American Bar Association, 1970), p. 112.

[45]Irving Schreiber, ed., *How to Plan for Tax Savings in Real Estate Transactions* (Based on a Tax Conference of The Tax Institute of C. W. Post College, Long Island University) (Revised

ed.; Greenvale, N.Y.: The Macmillan Company by special arrangement with Panel Publishers, Inc., 1970), p. III-38.

[46]Malat v. Riddell, 383 U.S. 569, 66-1 USTC 9317 (1966); Municipal Bond Corporation v. Commissioner, 382 F.2d 184, 20 AFTR 2d 5393 (8th Cir. 1967); Schueber v. Commissioner, 371 F.2d 996, 19 AFTR 2d 639 (7th Cir. 1967); Johnson v. United States, 280 F. Supp. 412, 20 AFTR 2d 5873 (DC, N.Y.; 1967).

[47]Stanley H. Klarkowski, 24 CCH Tax Ct. Mem. 1827 (1965), affirmed 385 F.2d 398 (7th Cir. 1967).

[48]Stanley H. Klarkowski, 24 CCH Tax Ct. Mem. 1827 (1965), affirmed 385 F.2d 398 (7th Cir. 1967); Berry v. United States, 21 AFTR 2d 1413 (DC, Va.; 1968); Auda C. Brodnax, 29 CCH Tax Ct. Mem. 733 (1970).

[49]Corn Products Refining Co., 350 U.S. 46 (1955).

[50]Rondell B. Hanson, "When Will the Dealer in Real Estate Receive Capital Gains?" The Journal of Taxation, XXXII (January, 1970), 41.

[51]Margolis v. Commissioner, 337 F.2d 1001, 14 AFTR 2d 5667 (9th Cir. 1964).

[52]Malat v. Riddell, 383 U.S. 569, 66-1 USTC 9317 (1966).

[53]Schueber v. Commissioner, 371 F.2d 996, 19 AFTR 2d 639 (7th Cir. 1967).

[54]Municipal Bond Corporation v. Commissioner, 382 F.2d 184, 20 AFTR 2d 5393 (8th Cir. 1967).

[55]Johnson v. United States, 280 F. Supp. 412, 20 AFTR 2d 5873 (DC, N.Y.; 1967).

[56]Auda C. Brodnax, 29 CCH Tax Ct. Mem. 733 (1970).

[57]See p. 194 below.

CHAPTER IV

EXPENSE DETERMINATION FACTORS IN LAND DEVELOPMENT ACCOUNTING

Introduction

The income measurement task facing land developers is really two-sided. On the one hand, developers must cope with revenue reporting problems; on the other, they must deal with various expense determination factors. The expense determination aspects in land development accounting are probably as significant, if not more so, than the revenue reporting aspects. For the most part, the expense determination problems of developers constitute a cost accounting problem, i.e., the classification, accumulation, and allocation of land and improvement costs to the finished product, the improved lot or site.

The present chapter will discuss some of the more significant land development expense measurement problems. The discussion will cover both financial reporting and income tax reporting aspects. The factors to be discussed are pertinent to both large-scale and small-scale development enterprises.

Significance of Joint Costs in Expense Determination

The expense determination problems in the land development activity arise chiefly from the abundance of joint costs characteristic of the activity. The acquisition costs of undeveloped land as well as numerous site improvement costs must be allocated indirectly to individual lots or sites being developed.

The cost allocation process often consists of a series of allocation steps. For instance, land acquisition costs may first be allocated to broad sections of land within the whole project, and then allocations within the sections are made to individual lots or sites. Likewise, many site improvement costs, such as major streets or sewerage mains, benefiting the whole project or major portions of it, are allocated in a similar multiple-step allocation procedure.

Wherever possible, of course, land developers try to allocate site improvement costs directly to specific lots, sections, or tracts benefiting from the expenditures. For instance, the cost of installing a minor street may be allocated directly to the particular section of land benefiting from the street and then, in turn, the cost is allocated to the individual lots or sites existing within the section. Except for a few on-site improvement costs, discussed below, most site improvement costs are indirect with respect to individual lots and therefore must be allocated to lots on some discretionary basis. To account for such cost allocations, a system of subsidiary ledgers in which land and land improvement costs are accumulated by general sections of land and by individual lots or sites is frequently maintained by developers.

Incidentally, for accounting purposes land developers use a variety of account structures in classifying and accumulating individual land cost items and site improvement cost items prior to allocation of these costs to specific lots or sites. Illustrative of the types of accounts used by developers are the following land development accounts presented in THE Accounting System for ALL Builders, a publication prepared by the National Association of Home Builders' Business Management Committee in cooperation with the accounting firm of Touche, Ross and Company: Cost of Platted Lots (purchase price of the raw acreage and all costs incident to the purchase), Financing and Interest (related to the development of the raw land), Realty Taxes (related to the land being developed), Bonding Fees (for bonds insuring that development activities will be carried out), Land Planning, Engineering, Rough Grading, Street Grading, Street Paving, Curbs and Gutters, Sidewalks, Storm Sewers-Drainage, Sanitary Sewers, Water, Electricity, Gas, and Other (all additional costs related to the raw land development).[1]

Most developers, large and small, will generally provide at least a comparable degree of detail in the classification of their land development accounts. Of course, the more emphasis a developer places on accounting information for management control purposes, the greater will be the amount of detail maintained in the accounts. However, with the increased detail, particularly with respect to site improvement costs, comes the problem of deciding whether each of the cost items should be allocated separately to individual lots or whether all or a number of the items should be combined and allocated in one step.

Land acquisition costs must be allocated to broad sections of land at the beginning of the development period or at least during the year in which the first sales of lots or sites occur. This procedure is necessary for financial reporting, and it is also required in Federal income tax reporting. As a matter of fact, the Tax Court has held that in a subdivision the cost of the land must be allocated to individual lots as of the land acquisition date.[2]

Different uses to be made of the land in a development project create problems in the allocation of joint costs. For instance, some of the acquired land may be dedicated or contributed for community or civic purposes, e.g., schools, parks and playgrounds, and churches, rather than being developed for sale. Likewise, other non-salable portions of the land, such as those devoted to streets, right-of-ways, alleys, and drainage facilities, must be dealt with in allocating costs. In addition, some of the land may be developed into income-producing projects, such as shopping centers or golf courses, to be owned initially by the developer and perhaps to be sold at a later date. How to equitably account for the joint land and improvement costs related to these various items can be a difficult task with which the developer must cope. Many of these problems will be discussed below.

Cost Allocation Methods

Land developers use a variety of methods in allocating joint land and improvement costs to individual lots and sites. One researcher, Arjan T. Sadhwani, discovered that four such methods are frequently used by developers. These are as follows: (1) tentative selling price of each lot, (2) frontage feet of each lot, (3) number of lots in a subdivision, and (4) area of each lot.[3]

Sadhwani found in his survey of some medium and large-size development firms that the majority of companies use the "number of lots method" of allocating joint costs followed by the "tentative selling price method" and the "area of each lot method." A very small percentage of the firms he surveyed use the "frontage feet method."[4] Sadhwani discovered also that all four of the commonly-used allocation methods have been accepted for Federal income tax purposes.[5] In addition, he mentions in his work that many of the companies use more than one method in their operations, often allocating land cost using one method and allocating various site improvement costs using other allocation methods.[6]

In general, the land development enterprises interviewed in the present study use the same cost allocation methods that Sadhwani found in use in his study. One particular company interviewed in the present study used a combination of these methods in allocating the land acquisition costs of a venture to lots and to other sites. (This firm's land development venture, incidentally, consists of a variety of land development activities, including residential development projects.) To initially allocate land acquisition costs to various broad sections of the large tract of land it had acquired for development, the company used a relative market value approach. Further allocation of land costs to individual residential lots and to other site uses was then carried out through the use of the "number of lots" method for residential development sections and through a per acre basis for most of the other development areas.

Regarding the use of the "number of lots" method for allocating costs to individual lots in residential sections, the developer's spokesman stated that most of the lots within a given section of land were about the same size in area and dimensions and sold for approximately the same selling price. In cases where lots deviate from the standard dimensions or usual selling price, e.g., corner lots, the company did not feel that further refinements in the allocation of land costs were material enough to warrant the additional computational effort.

The allocation of joint costs in the land development field is obviously as difficult a chore, or perhaps more so, than the allocation of joint costs in other manufacturing enterprises. As Gardner M. Jones notes, the developer must "try to find some measure of benefit for each site and to allocate cost on the basis of that benefit pattern."[7] However, as he further states, "there is no adequate theoretical or practical way to do it."[8] Unfortunately, this is true. In most cases, developers, large and small, have had to rely on expedient measures. The smaller, non-public firms have concentrated mainly on allocation methods which are acceptable for income tax reporting. The publicly-owned land development companies, on the other hand, have had to find cost allocation procedures that are acceptable for both external financial reporting and income tax reporting.

In his evaluation of each of the four cost allocation methods frequently used by developers, Sadhwani reached the conclusion "that objective quantification in terms of complete freedom-from-bias is not attainable."[9] In other words, he found inherent weaknesses in each method. In particular, the "number of lots" method which he discovered was used by the greatest number of companies in his survey is, in his words, "the poorest basis of all" because "it fails to meet the standard of relevance", as prescribed in the American Accounting Association's <u>A Statement of Basic Accounting Theory</u> (1966).[10] The "number of lots" method is certainly the simplest approach to cost allocation, but it completely ignores differences in sales values or any other differences in benefits to be derived from different lots.

Sadhwani proposes that developers use a "weighted average cost" method in allocating joint land and improvement costs to lots. With his method, weights would be assigned to the following three variables: location factor, frontage feet, and area. Accordingly, he recognizes that quantitative and qualitative factors must both be given consideration in assigning weights.[11]

Sadhwani is very general in his discussion of the proposed weighted average allocation method, and he fails to provide any specific illustrations of its application. His idea, however, is a good one. Its basic weakness is that the measurement of the extremely important location factor variable, as well as the weights to be assigned to each of the three variables (including the location factor), must be based on qualitative judgment. To successfully use this cost allocation method, the developer must possess an ability to accurately evaluate the importance of the location factor and to assign a quantitative measure to it, and he must be able to realistically assign quantitative weights to each of the three variables. If the developer can acquire these skills, then the weighted average method will, most likely, be the best possible approach to the allocation of joint costs in the land development field. Incidentally, Sadhwani mentions regarding the location factor variable that "even selling price can be used as a surrogate measure for the location factor if no other measure is possible."[12]

From a Federal income tax reporting standpoint, developers are allowed considerable flexibility in the allocation of joint costs to individual lots and sites. For instance, Regulation 1.61-6, pertaining to gains derived from dealings in property, contains, in part, the following:

> When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of. (Italics mine.)

The Internal Revenue Code and the Treasury Department regulations, however, do not indicate what allocation methods are considered acceptable in apportioning costs. The developer must, therefore, use his own discretion in selecting allocation methods for income tax reporting. Of course, the burden of proving that the allocation methods used result in an equitable apportionment of costs rests with the developer. For the most part, the only guides the developer can obtain to aid him in the selection of cost allocation methods for income tax reporting must come from a review of the legal cases which have occurred with respect to this issue. A few of the allocation methods which have been adjudicated are discussed below.

The Tax Court held in Fairfield Plaza, Inc.[13] that relative values in existence during the year of purchase and applicable to various parts of a given tract of land were acceptable as a basis for allocating land acquisition costs to the parts of the tract. The Internal Revenue Service had argued in this particular case that the apportionment of land cost should be on the basis of square footage. Incidentally, in the same case, the Tax Court did accept the Internal Revenue Service's determination that site improvement costs be apportioned on the basis of square footage.

In Wellesley A. Ayling,[14] the Tax Court found that there was "no evidence that any particular part of the subdivided property was any more desirable for residential purposes than any other part at the time petitioners purchased the land." The Court, in this case, supported the Commissioner's position that allocation of the total basis of the unimproved land cost should be on a square foot basis.

Contrastingly, the Court found in Biscayne Bay Islands Co.[15] that the allocation of costs between a part of an island devoted to waterfront lots and an interior area not subdivided should not be on a proportionate area basis. According to the opinion of the Court, "The evidence makes it clear that the water front lots were far more desirable and valuable than the interior lots, the ratio, generally speaking, approximating three to one." The Commissioner had argued that the total cost of the property, including development costs, should be allocated proportionately on the basis of area. Incidentally, the cost of each waterfront lot was apparently computed on the "number of lots" basis, according to the information presented in the case.

Actually, the taxpayer in Biscayne Bay Islands Co. had contended that none of the land or development costs should be allocated to the interior area because this land had been set aside for thirteen years to be used by lot purchasers as a playground and recreational center. The area, in fact, was exempted as a public park from taxation by the city. Nevertheless, the Court held that "this area was not permanently and irrevocably dedicated to the public, but may later be sold by the petitioner." Therefore, the Court ruled that a portion of the land and development costs of the project should be allocated to this area.

Resale prices have also been considered in the allocation of total land costs to portions of a tract. In R. M. Clayton,[16] for instance, the taxpayer argued that the allocation of cost of a parcel of land fronting on two streets should be 90 percent of the cost to lots facing one street and 10 percent of the cost to those facing the other street. The Internal Revenue Service, however, contended that the allocation of cost to the two parts of the tract should be 65 percent and 35 percent based on the selling prices of lots on the two streets. The Tax Court ruled that the Commissioner's allocation was reasonable because it appeared that nothing had occurred between the date of purchase of the tract and the date when a portion of it was sold to materially change the relative values of the two frontages. Incidentally, in support of the use of resale prices as a basis for the allocation of costs to subdivided and developed lots, one tax source makes reference to an article appearing in a 1930 issue of the Internal Revenue News which suggests that tentative selling prices be used as the basis for allocating costs among lots.[17]

In situations where no evidence supporting a better allocation is available, allocation of land costs in relation to assessed values has been upheld. For example, in J.S. Cullinan,[18] the taxpayer argued that apportionment of land and improvement costs was not possible, and, therefore, no income should be reported until the entire cost of the project was recovered. The Court, however, disagreed with the taxpayer and sustained the Commissioner's allocation of costs which was based on values assessed by the city.

As a matter of fact, the Internal Revenue Service and the courts have been extremely consistent in refusing to find the allocation of costs impossible where real estate activities are involved.[19] The importance, of course, of having the allocation of costs ruled non-determinable is that a developer would then be permitted to use the "cost recovery method" of recognizing revenue on the sale of lots and could, therefore, defer any gain from lot sales until the full costs of the tract had been recovered.

The courts, themselves, as illustrated in Biscayne Bay Islands Co. and other court cases, have sometimes established the equitable apportionment of costs in the subdivision of land, based on the evidence presented in a case.[20] In fact, in one particular instance, the allocation of land costs to subdivided lots was actually determined by a jury.[21] In general, where the apportionment of cost has been performed by a court, the basis for cost allocation has usually been the relative values of the portions of a tract at the date of acquisition or at some later date, giving consideration to the relative desirability of the different portions of the tract.

In brief, the discussion of cost allocation methods reveals that from both a financial reporting standpoint and an income tax reporting standpoint, the land developer has a number of alternative allocation methods available to him. Selecting the most appropriate method to be used in a given situation, however, can be a difficult task. In spite of the difficulties involved in selecting a method, the land developer must nevertheless choose an allocation method and apply it in the allocation of costs to lots sold.

Non-salable Portions of a Development Project

The fact has been well established that for income tax purposes none of the land and improvement costs related to the development of a tract need be allocated to non-salable portions of the tract, i.e., portions dedicated to streets, alleys, parks and playgrounds, lakes, and for church, school, and other community uses.[22] In other words, all land and improvement costs pertaining to a development project can normally be allocated to the lots and sites which are actually marketable. Likewise, in their financial reporting practices, developers often follow the procedure of establishing a zero basis for non-salable parts of a development project and apportioning all related costs to salable units.

Non-salable portions of a development project may be considered analogous to "lost units" or waste occurring in other types of manufacturing activities. However, there is a slight difference between the "lost units" in the land development process and those occurring in other manufacturing endeavors. In other manufacturing enterprises, waste or non-salable units frequently are unavoidable and occur involuntarily, but in land development non-salable units often occur voluntarily at the option of the developer and, in fact, may enhance the value of the salable units. Such, for example, may be the case for the inclusion of parks, lakes, golf courses, or other recreational or scenic facilities in a development project.

The Internal Revenue Service and ultimately the courts have had to deal with a number of complicated circumstances involving the allocation of costs of non-salable portions of a tract to salable units. For example, in Country Club Estates, Inc.,[23] a land development company transferred land to an organization with the stipulation that the land "was to be used for a nonprofit country club and to be kept as such and not sold by the club." The Tax Court recognized in this case that the chief reason for the transfer of the land to the club by the petitioner (developer) "was to bring about the construction of a country club so as to induce people to buy nearby lots." The deed to the conveyed land provided "that the land is not to be levied upon and, in the event of bankruptcy, among other contingencies, *the land shall revert to the petitioner.*" (Italics mine.)

Even though there was the possibility that the land could revert back to the developer, the Tax Court ruled that the cost of the transferred land should be considered as part of the cost basis of the lots to be sold in the residential subdivision. As a matter of fact, Revenue Ruling 68-478 provides further that the cost of each lot in a residential subdivision not only includes a pro-rata portion of the cost of the land contributed to a nonprofit country club, but it also includes a pro-rata share of the expenditures made for the construction of golf courses, dams, lakes, and related recreational facilities.[24]

However, in the Biscayne Bay Island Co. case, previously discussed, a development organization was not allowed to allocate all land and improvement costs to salable lots. Instead, the firm was required to allocate a portion of total land and development costs to an interior area which was devoted to public recreational uses. As noted above, the Court held in this case that the land in question was not "permanently and irrevocably dedicated to the public, but may later be sold by the petitioner."[25] The Court apparently felt that the developer would eventually recover through sale the cost of the dedicated land.

In another interesting case, Sevier Terrace Realty Company,[26] in which land in a subdivision was donated for recreational uses, the Tax Court held that the cost of twelve lots conveyed by a developer to a recreation center, a "so-called non-profit corporation" in which membership was open to purchasers of subdivision lots, constituted a capital expenditure, and the cost of the contributed lots must be included in the cost basis of the remaining lots to be sold. The taxpayer had deducted the "alleged" fair market value of the contributed lots as an advertising expense in the tax return for the year the land was conveyed. The opinion of the Court in the case states that

> the development of the recreation center enhanced the value of petitioner's remaining lots, made them more desirable and in this manner stimulated sales. But this is a far cry

> from concluding that the transfer of the 12 lots was an advertising expense. It was a capital transaction similar to the construction of streets, sewers, utility lines and the like. Expenditures for such purposes or the dedication of a portion of the subdivision's property for such purposes are clearly capital in nature, notwithstanding that they may be intended to stimulate sales; they are of continuing benefit to the remaining lots and are recoverable by the owner upon sale of such remaining lots rather than through the medium of expense deductions.

Incidentally, the facts in Sevier Terrace Realty Company were very similar to those in Country Club Estates, Inc., and the Court relied on the findings in the earlier case in arriving at its decision in Sevier Terrace Realty Company.

Land Acquisition Costs

Before allocating "raw" land costs to sections within a project and in turn to individual lots, the developer must first determine what expenditures related to the purchase of the undeveloped land should be included among the land acquisition costs. In addition to the purchase price of the land, such items as the following are usually capitalized as land costs: the cost of options paid on the land; engineering, land surveying, site planning, and other technical planning costs; title search, title transfer, and other legal fees incident to the purchase transaction; and brokers' commissions and other fees pertaining to the purchase.

From a financial accounting standpoint, all of the foregoing items appear to be necessary to the acquisition of the land and, therefore, should be initially capitalized to the land account. For example, a widely used Intermediate Accounting textbook states the following:

> When land is purchased, its cost includes not only the negotiated purchase price, but also all other costs related to the acquisition including brokers' commissions, legal fees, title, recording, and escrow fees, and surveying fees. Any existing unpaid taxes, interest, or other liens on the property assumed by the buyer are added to cost.[27]

Although the text is referring to land as a "plant and equipment" asset, the only difference in the case of the land development enterprise is that the acquired land is considered a raw material inventory rather than an item of plant and equipment.

From an income tax reporting standpoint, the developer will likewise find that the above-mentioned expenditures represent items forming a part of the cost basis of the acquired land and, therefore, must be capitalized. In fact, one writer has even noted that during the period of research and acquisition of the land, it may be necessary to capitalize some of the general and administrative expenses related to the property.[28]

Once the undeveloped land is acquired, the developer has a great deal of flexibility in reporting interest, property taxes, and other carrying charges for tax purposes. These expenditure items will be discussed below.

In the event the developer fails to carry out the acquisition of the land, all of the incurred acquisition costs will become expenses deductible in the year the project is abandoned, assuming, of course, no benefits can be salvaged from the expenditures. If the expenditures do provide some future benefits, then the developer can deduct only the amount of such costs for which no benefits can be ascertained.[29]

Interest, Property Taxes, and Other Carrying Charges

Interest, property taxes, and other carrying charges occurring after the land is acquired cause various financial, as well as income tax, reporting problems regarding the question whether these costs should be expensed currently or capitalized as a land or an improvement cost and then allocated to individual lots or sites. On this matter, the Federal income tax laws and regulations are quite explicit. Yet, the tax laws and regulations provide the developer a great deal of flexibility in reporting these cost items for income tax purposes.

For financial reporting purposes, arguments can be presented for both capitalizing and expensing carrying charges. For example, the item of interest expense has generally been considered by many accountants as a financing cost to be expensed periodically. The argument for this procedure has been that this cost can be avoided if funds are obtained through sources of invested capital, e.g., sale of stock in a corporation, rather than through debt sources.

There are, however, some exceptions to the general practice of expensing interest currently. For instance, some accounting theory texts note that interest expense on borrowed funds used specifically for construction of plant and equipment assets is frequently capitalized to the asset accounts and considered a construction cost. During the period of construction no revenue is being derived from these assets to which the interest charges can be offset. Hence, it is felt that a better matching of revenues and expenses will result if interest charges arising during the construction period are capitalized to be charged later against the revenues earned while the assets are in use. Although this practice appears to have some logical support, a great deal of controversy exists at the present time regarding the question whether interest during construction should be considered an addition to the cost of the constructed asset or should be expensed periodically as a finance charge.[30]

Some accounting theorists even argue that implicit, or imputed, interest on ownership funds used for construction purposes should also be included in the cost of the constructed assets. For example, with respect to this issue, Eldon S. Hendriksen makes the following comments:

> Charging interest on funds provided by the owners is assumed to result in unrealized income and the valuation of assets in excess of "cost." Interest on ownership funds is rejected also because it is subjectively determined and its final realization is uncertain. But the uncertainty of the present value of the asset is the same, regardless of how it is financed. Thus, there is little justification for adding interest in one case and not in the other. It is difficult to argue that a building is more valuable simply because it was constructed with borrowed funds rather than funds acquired by the sale of stock. Furthermore, since funds are generally commingled, there is no way of determining what proportion of the asset is financed by debt equity and what proportion by stockholders' equity, except in a new firm.[31]

At any rate, the situation involving interest expense on funds used for the development of land is similar to that of interest charges on the construction of plant and equipment items. The major difference, of course, is that developed land represents an inventory item awaiting disposition through sale rather than a plant and equipment asset awaiting expiration through periodic depreciation.

Because of the characteristics of land development projects, mainly the long time period from the acquisition of the land until completion of the project, the customary practice in the land development field has been for developers to operate on unusually large amounts of borrowed funds. As a result, developers often feel that interest charges on funds borrowed to acquire land and to finance improvements constitute relevant development costs rather than simply finance charges.

Therefore, from the time of acquisition of land until such time as specific sections of the project are completely developed, land developers frequently desire for financial reporting purposes to capitalize these interest costs rather than to expense them.

The same logic is usually applied by developers to the accounting for property taxes and other carrying charges. As long as land remains undeveloped or is still in the process of development, developers will often consider these charges to be as important to the development process as the land and improvement costs. Furthermore, until portions of the land are completed, no revenues can be generated to which these costs can be matched. Hence, the practice of capitalizing carrying charges on undeveloped land and on land which is not yet fully developed appears to have merit on the same grounds as capitalizing interest charges used in the construction of plant and equipment assets.

Incidentally, THE Accounting System for ALL Builders, prepared by the National Association of Home Builders, recommends capitalizing financing expenses incurred in the acquisition and development of land but suggests expensing financing expenses related to housing construction. No particular reason is given for these recommendations. However, the publication does note that it is permissible in both cases to either charge financing costs to the period incurred or to allocate them to inventory.[32]

The significance of carrying charges to the measurement of periodic income by developers is illustrated by the efforts exerted by land development organizations to ascertain the amount of interest to be capitalized and the amount to be expensed currently. Some firms have developed complex computational schemes to determine the amount of interest applicable to each of the following uses: undeveloped land, land currently under development, land completed and ready for sale, and funds acquired for general operating purposes. Where borrowed funds have been obtained for multiple uses, one company, for instance, goes to great lengths, applying various ratios, to determine the amount of interest applicable to each use. The task of determining the amount of interest to be capitalized and the amount to be expensed currently is further complicated by the fact that this particular company usually follows different procedures for financial reporting and for income tax reporting.

Interest, property taxes, and other carrying charges are generally deductible on a current basis in filing Federal income tax returns. However, Section 266 of the Internal Revenue Code grants authority to the Secretary of the Treasury or his delegate to prescribe, through regulations, certain taxes and carrying charges which, at the election of the taxpayer, may be capitalized as a cost of the related property rather than being deducted currently. Regulation 1.266-1(b) lists the specific items pertaining to real property which at the taxpayer's election may be capitalized, and it also states the periods to be covered by the elections.

Regarding unimproved and unproductive real property, the following items may be capitalized: annual taxes, mortgage interest, and other carrying charges. An important feature here is that the election may be made each year as long as the property remains in an unimproved and unproductive state. Hence, the developer has alternatives available to him in reporting his deductions for carrying charges on such property. Incidentally, for the purposes of a subdivision development, land is considered unimproved or unproductive until each plat is recorded. For example, a recent Treasury Department revenue ruling states that "the recordation of each final subdivision plat identifies the time a specific area has reached the development stage."[33]

With respect to the development of real property or the construction of improvements to real property, the taxpayer may elect to capitalize certain expenditures, up to the time the work is completed, whether the property is improved or unimproved, productive or unproductive. The election involves the following expenditures: (1) interest on loans (but not including implicit interest on the taxpayer's own funds), (2) payroll taxes based on compensation paid to employees, (3) taxes paid on the purchase, storage, use, or other consumption of materials, and (4) other necessary expenditures related to the development or improvement of the property up to the time of the completion of such work. The election in the case of property being developed or improved is binding for all subsequent years until the development or construction work is completed.

As a matter of fact, Treasury Department regulations provide even further enhancement of the tax planning flexibility pertaining to carrying charges. For example, regarding the election to capitalize individual items within a given project, Regulation 1.266-1(c) states, in part, that

> the taxpayer may elect to capitalize any one or more of such items even though he does not elect to capitalize the remaining items or to capitalize items of the same type relating to other projects. However, if expenditures for several items of the same type are incurred with respect to a single project, the election to capitalize must, if exercised, be exercised as to all items of that type.

Incidentally, problems have arisen in defining the term "project." On this issue, one tax practitioner has made the following comment:

> The regulations offer no real assistance in defining a project. Experience has indicated that Agents have not been rigid on this point and considerable flexibility may be used in breaking a large development into several projects if done in a reasonable manner and with substantial supporting evidence.[34]

Whether or not a particular developer will find it desirable in income tax reporting to capitalize carrying charge items or to deduct them currently depends on the developer's present tax status and anticipated future tax positions. An important consideration, no doubt, is the developer's desire to defer income taxes and thereby make additional operating funds currently available.

Site Improvement Costs

Site improvement activities and their corresponding costs may be classified in a number of different ways. Frequently, they are separated into two general categories, off-site improvements and on-site improvements. These two categories, however, are relative in nature, and confusion sometimes exists regarding the exact distinction of each.

With respect to residential land development, off-site improvements are most often considered the development activities which are not directly identified with individual lots to be sold. These are activities which generally benefit in common the whole subdivision or major portions of it. Representative of off-site improvements are the following: initial clearing, draining, filling, and grading of broad site areas; grading and surfacing of streets and roads; installation of curbs and gutters; installation of water, drainage, and sanitary sewerage mains; installation of electric, gas, and other utility facilities; and the construction of parks, playgrounds, lakes, and other recreational or scenic facilities.

On-site improvements constitute those development activities which can be directly related to the individual residential lots to be sold. The most significant on-site improvement is the home or other structure constructed on the lot. Examples of other on-site improvements are the following: lot grading and leveling; terracing where sloping land is involved; construction of retaining walls; surfacing of driveways and walks; installation of sewer laterals, water laterals, gas pipes, and electric wires; and lot landscaping and planting.[35]

From a financial accounting standpoint, the basic difference between off-site improvement costs and on-site improvement costs is that the former are indirect costs with respect to a given lot and, therefore, must be indirectly allocated to individual lots using one or more allocation methods, whereas the latter may be accumulated by separate lots. However, as a matter of practice, resulting from the increased accounting detail required in the direct accumulation of on-site improvement costs by individual lots, most development firms do not attempt to make a distinction between off-site and on-site costs in their financial reporting. They simply accumulate and allocate the on-site costs along with the off-site costs.

Particularly from a Federal income tax standpoint, problems have arisen regarding the allocation of certain site improvement costs to salable lots. For the most part, the problems involve the following two types of expenditures: (1) expenditures for improvements which possess investment characteristics for the developer and (2) expenditures for development costs which may be refundable to the developer.

Expenditures for Improvements Possessing Investment Characteristics

Most of the court cases pertaining to improvements which to the developer represent a potential ownership, or investment, interest in the facilities provided involve water supply and sewerage disposal systems. Where an ownership interest is found to exist, the courts frequently do not permit such improvement costs to be allocated to salable lots. Instead, the facility must usually be accounted for as a separate capital item.

In Colony, Inc.,[36] for instance, the Tax Court held that the cost of a water supply system constructed by the developer to serve a subdivision project could not be added to the cost of the subdivision lots because the developer "retained full ownership and control of the water supply system during the taxable years, and that it did not part with the property for the benefit of the subdivision lots." The Court ruled against the allocation of cost to the lots even though the water supply system had not been operated at a profit during the taxable years and in spite of the taxpayer's contention that the pumping station would probably be abandoned when facilities of a public water company reached the subdivision.

On the other hand, in Estate of M. A. Collins,[37] the Tax Court ruled that the cost of constructing a sewerage disposal system to serve a subdivision could be included in the basis of the lots to be sold in the subdivision. The Court, in this case, agreed with the developers' contention that the basic reason for constructing the sewage disposal system was to make the lots in the subdivision salable. Furthermore, the Court found that the developers "did not retain full ownership and control of the sewage system, and that they parted with material property rights therein for the benefit of the subdivision lots." Incidentally, in Estate of M. A. Collins, the Tax Court clearly summarizes its position on the matter of the allocation of costs to salable portions of property in a subdivision development, as reflected in the following statement:

> . . . if a person engaged in the business of developing and exploiting a real estate subdivision constructs a facility thereon for the basic purpose of inducing people to buy lots therein, the cost of such construction is

> properly a part of the cost basis of the lots, even though the subdivider retains tenuous rights without practical value to the facility constructed (such as a contingent reversion), but if the subdivider retains "full ownership and control" of the facility and does "not part with the property. . .for the benefit of the subdivision lots," then the cost of such facility is not properly a part of the cost basis of the lots.

As a result of the foregoing statement, it is clearly evident that the major points to be considered in determining whether the cost of a facility provided in a subdivision development may be allocated to the cost basis of salable lots is (1) whether the facility was constructed to induce people to purchase the lots, (2) the extent of ownership and control of the facility retained by the developer, and (3) whether the developer gives up the property for the benefit of the lot owners. In general, where the developer retains a potential investment interest in the property or where ownership may revert back to the developer (except in the case of highly unlikely or contingent circumstances), the Internal Revenue Service and the courts will normally hold that the cost of the property cannot be included in the basis of the lots to be sold.

However, in a few recent court cases involving the construction of water and sewerage facilities by a developer in order to make development of a subdivision possible, the courts have held that the costs of the facilities could be added to the basis of the subdivision lots, even where the facilities were eventually sold to a municipally-owned utility company. In most of these cases, the construction of the facilities by the developer was necessary because the municipality could not, or would not, provide the facilities. In most instances, when the facilities were first constructed, they were transferred by the developer to a utility company owned by the developer, with the only consideration received from the utility company being the obligation to provide the required services to the lot owners.

One case illustrative of this practice is Commissioner v. George W. Offutt, III.[38] In this case, the Fourth Circuit Court of Appeals affirmed a Tax Court decision that the cost of developing water and sewerage facilities necessary for the development of lots in a subdivision was correctly included in the cost basis of the subdivision lots to be sold. The land development corporation, partly owned by the taxpayer, transferred its ownership of the water and sewerage facilities to a public service corporation, wholly owned by the taxpayer, with the only consideration received from the utility company being the utility firm's obligation to furnish water and sewer services to the purchasers of lots. According to the facts in the case, the county and the town in which the subdivision tract was located refused to accept the obligation of supplying the water and sewer facilities even where the developer offered to "install the necessary lines and facilities and convey them without other consideration than the assumption of an obligation . . . to operate them and through them to supply adequate water and sewer services to the purchaser of houses in the subdivision." As a matter of fact, other developers in the area, because of no alternative, transferred water and sewer lines to the taxpayer's public service corporation with the only consideration on the part of the utility firm being the obligation to operate the facilities and provide the necessary services. Eventually, the water and sewer lines and other facilities of the taxpayer's public service corporation were sold to a municipally-owned authority.

The Commissioner argued in the Offutt case that when the land development corporation transferred the water and sewer facilities to the taxpayer's public service corporation the transfer represented a taxable dividend to the taxpayer in the amount of the cost of the facilities to the land development corporation. Furthermore, the Commissioner contended that the cost of the investment should not be allocated to the cost of the land and that sufficient consideration for the transfer was not provided by the public service firm's obligation to operate the facilities. The Tax Court ruled, however, that the water and sewer facilities constructed by the development company were necessary for the development of the tract and that they did not constitute "an independent investment in salable or productive assets," or an attempt to siphon off profits from the development company to the individual taxpayer.

Facts very similar to those appearing in Commissioner v. Offutt occurred in a subsequent case, Willow Terrace Development Co., Inc., v. Commissioner.[39] In this case, as in the previous case, a Federal circuit court of appeals held that the cost to the developer of constructing and operating water and sewerage systems for a subdivision was properly allocable to the cost basis of the lots developed. In this court case, the developers also transferred the facilities to a utility company owned by them, and the facilities were likewise eventually sold to a municipality. The Commissioner argued in the Willow Terrace Development Company case

> that the facilities may be allocated to the cost of the lots only if they are constructed in order to sell the lots and are permanently and irrevocably dedicated to the lot owners so that the cost of the facilities is *recoverable in no other manner*. (Italics mine.)

The Court, however, was not in total agreement with the Commissioner and made the following statement:

> We cannot accept the rule advocated by the Commissioner, which in effect allows deduction only when the costs can be recovered in no other manner. Some relevant factors to be considered in determining the proper tax treatment

of the costs of such facilities are whether they were essential to the sale of the lots or houses, whether the purpose or intent of the subdivider in constructing them was to sell lots or to make an independent investment in activity ancillary to the sale of lots or houses, whether and the extent to which the facilities are dedicated to the homeowners, what rights and of what value are retained by the subdivider, and the likelihood of recovery of the costs through subsequent sale.

The water and sewerage systems which were at issue in Willow Terrace Development Co., Inc. v. Commissioner were dedicated, under an FHA trust deed, to the benefit of the lot purchasers, and a trustee held legal title to them for the lot owners' benefit. At the time the trust deed was executed, the assets comprising the systems were of little salable value. As a matter of fact, the value of the facilities depended on their sale to an adjacent city, the sale in turn resting on "the vagaries of future annexation." Only after the city actually did annex the subdivision did the possibility of cost recovery through sale of the facilities to the city become a reality.

The fact that utility facilities provided by a developer are unprofitable does not in itself relegate these items to the status of site improvements which may be allocated to the basis of salable lots. For instance, in Sabinske v. U.S.,[40] a 1962 Federal District Court case in Texas, the court ruled that the taxpayers' costs of installing water systems in subdivisions developed by them must be capitalized and recovered through depreciation charges rather than being added to the basis of lots in the development. The taxpayers had provided evidence that the systems were not profitable. Nevertheless, the Court felt that the taxpayers' evidence did not illustrate that the systems would not become profitable once the subdivisions were fully developed. Also, the Court felt that many of the assets which comprised the water systems had high values, and the individual assets, or the whole systems, could probably be sold for a substantial sum. The Court held that the taxpayers had parted with nothing of value and that they continued to retain full ownership and control of the systems. The systems were, therefore, considered to be businesses owned by the taxpayers.

A case not involving water or sewerage facilities but which does pertain to improvements possessing investment potential for a developer is Fairfield Plaza, Inc.[41] The Tax Court ruled in this case that the cost of paving and lighting a tract of land lying between two parcels sold by the taxpayer could not be allocated to the parcels that were sold. The Court held that the tract upon which the improvements were made was retained by the taxpayer and could possibly be sold at a later date.

To summarize, certain site improvement facilities may constitute investment items for a development firm and, therefore, must be capitalized to a separate asset account rather than be allocated to the cost basis of lots to be sold. The chief considerations in determining whether improvement costs possess investment characteristics are usually (1) whether the facilities were constructed to induce individuals to purchase lots, (2) whether the development firm retains "full ownership and control" of the property, and (3) does the firm "part with the property for the benefit of the subdivision lots." Other important factors which have recently been given consideration by the courts are (1) whether the facilities are necessary for the sale of lots and will not be provided by other sources, such as a municipality; (2) whether the developer's intention in providing the facilities "was to sell lots or to make an independent investment in activity ancillary to the sale of lots or houses"; and (3) the likelihood that the costs expended for the facilities will be recovered through later sale. Whether or not the development firm's operation of the facilities provides a profit does not appear to be a significant factor.

Development Cost Expenditures Refundable to Developers

Some of the expenditures incurred by developers in the process of improving subdivided property are frequently, under certain conditions, refundable to the developers. These expenditures often involve payments, or deposits, made to utility companies to cover the utility companies' costs of extending their services to subdivided property. The deposits are usually required by the utility companies before the companies will provide services to the subdivision. Similarly, utility companies sometimes provide reimbursement to developers for costs directly incurred by the developers in installing utility lines which connect subdivided property with the services provided by the utility companies.

Accounting for potentially refundable expenditures and accounting for the refunds when received create problems for developers from both a financial reporting and an income tax reporting standpoint. The difficulties in accounting for these items generally arise from the uncertainties surrounding the receipt of the refunds, or reimbursements. For instance, recoveries of these costs by developers may be dependent on the number of customers in a subdivision adding a utility company's services, or they may be based on the revenues generated from the sales of utility services to customers in the subdivision. Furthermore, the period over which the reimbursements will be tendered will usually be limited in duration to a specific number of years. Therefore, a developer is never certain just how much of the utility-related costs will be recovered from utility companies and when the reimbursements will occur. In some cases, all of the refundable costs will be recovered early in the life of the development project; in other cases, the full amount of the refundable costs will not be recovered before the termination of the refund period.

Incidentally, a unique characteristic of potentially refundable improvement expenditures is that the developer actually has two possible sources of their recovery. One source is, of course, through the receipt of the refund itself. The other is through the sale of lots. In either instance, recovery is conditioned by considerable uncertainty.[42]

Regarding the initial accounting for potentially refundable expenditures, the chief question facing the developer is whether these costs should be added to the cost of lots to be sold or whether they should be accounted for in a manner similar to that in which many refundable deposits are handled, i.e., as a separate asset account usually in the nature of a receivable account. Arguments can be presented supporting each of the two practices.

Current income tax authorities generally permit the inclusion of refundable expenditures in the cost of lots to be sold. In reference to these tax authorities, the author of an enlightening article dealing with subdivider utility deposit refunds, Dr. Gerald D. Brighton, states that "since 1960 it has been clear that utility deposits are capitalizable as a part of the cost of developing a subdivision."[43]

The current tax authorities pertaining to refundable expenditures incurred by developers consist of Revenue Ruling 60-3 and several court cases dealing with various types of utility services (gas, electricity, water, etc.).[44] These authorities will be reviewed below.

The tax authorities, as a matter of fact, have not always permitted the inclusion of utility deposits within the cost of lots to be sold. But, today, based mainly on the element of uncertainty surrounding the recovery of such costs by developers, the tax authorities support the practice of capitalizing these expenditures to the cost of subdivision lots. Elaborating on the "uncertainty of cost recovery" principle, Dr. Brighton makes the following statement:

> The fact which justifies capitalization to the subdivision account in the first place, instead of using a special deposit account as the Internal Revenue Service had held before 1960, is that refunds are uncertain. Sales of lots are also uncertain. As refunds do occur, the quantity of uncertainty is diminished, but the quality of uncertainty of the remainder is not altered.[45]

Although the income tax authorities currently permit the inclusion of refundable expenditures in the cost of lots sold, this fact alone, does not, in itself, provide grounds for following such a practice in financial reporting. However, the "uncertainty of recovery" argument, which represents the chief reason for the current position taken by the tax authorities, does provide considerable support for such a practice.

Therefore, on the basis of the uncertainty of recovering such costs, the practice of capitalizing refundable expenditures to the cost of subdivision lots rather than carrying these costs in separate asset accounts appears to have merit in financial reporting as well as in income tax reporting.

In addition to the problem of initially accounting for potentially refundable expenditures, the related--but much more difficult--problem of accounting for the refunds when they are received must also be dealt with by developers. Regarding this second issue, how to treat refunds, Dr. Brighton has made the statement that "the answer . . . is ambiguous."[46] Nevertheless, Brighton does an excellent job of categorizing the chief possibilities with respect to the accounting treatment of these items, and he presents some recommendations regarding their treatment. He lists, for example, four possible methods of accounting for utility deposit refunds which are as follows:

> 1. The refund is not income because it is a return of a "prepaid asset" separate from the development-costs, as the Government had contended in Divine, but which was not sustained.
> 2. The refund is not income because it is a return of capital to be credited to the subdivision account reducing basis of lots being sold.
> 3. The refund is income in full as received.
> 4. The refund is income to the extent of tax benefit from earlier deductions under authority of Section 111. It is a reduction of basis to the extent not reportable as income.[47]

In his article, Dr. Brighton illustrates, with respect to each of the above four methods of accounting for deposit refunds, some of the income tax consequences resulting from different combinations of refund and lot sale possibilities. For example, he shows the income tax differences under each of the four methods of handling deposit refunds when the timing of utility deposit refund receipts is varied and when different schedules of lot sales are considered, e.g., when 20 lots are sold the first year and 20 lots are sold in the second year; when 20 lots are sold in the first year, 10 lots in the second year, and 10 lots in the third year; etc. As a consequence of his analysis, he arrives at the following conclusions:

> In situations where it is realistic to assume that full refunds will result, Section 111 gives a fully equitable answer: report as income the portion of the refund in a given year which was a part of basis of lots sold in prior years, that is, the "tax benefit," and treat the remainder as an adjustment of basis. This needs to be tempered by the cost recovery method to the extent that full refund is not reasonably predictable. . . . If the combination of uncertainty of sales of lots and of refunds is great enough, only the cost recovery method will prevent overstatement of income.[48]

A review of some of the pertinent income tax authorities applicable to refundable expenditures will now be presented. The discussion will deal first with those authorities pertaining to the initial accounting for potentially refundable expenditures and will follow with a discussion of the authorities affecting the handling of deposit refunds.

In Colony, Inc.,[49] the Tax Court held that payments made to two utility companies to get them to extend their services to a subdivision could be included in the developer's cost basis of subdivision lots, even though the contracts with the firms provided for reimbursements of the payments based on the number of customers acquiring the services, up to a period of ten years for one company and five years for the other. The opinion of the Court states that the taxpayer

> made unconditional payments to the two companies in order to obtain utility service for The Colony, and thereby to attract customers for The Colony lots. The payments were thus closely related to the sale of the lots, and petitioner's income from the sale of lots will be more clearly reflected if a pro rata portion of the payments in question are included in its basis for gain or loss in each lot which was sold. On the other hand, the receipt of refund payments from the utility companies is less closely related to the improvement of the lots for sale. The payment of a refund would be made only if a new customer was connected to the utility companies' service extensions, rather than at the time a lot was sold. Thus, if lots were sold to purchasers who, for some reason, did not proceed to construct residences, the petitioner would not receive refunds; or, if a purchaser acquired two or more lots, on which only one residence was constructed, the petitioner would receive only one refund, rather than a number of refund payments equal to the number of lots sold to the purchaser. Under these circumstances, it is concluded that the payments to the utility companies were directly related to the improvement of The Colony lots for sale, and that the petitioner correctly included these payments in computing its basis for gain or loss in the lots which it sold.

In Albert Gersten,[50] refunds to be made by a water company to four related corporations participating in land subdivision and house construction activities were based on a percentage of gross revenue derived from the sale of water to the occupants of homes sold. The Tax Court held that the corporations' payments for the cost of extending the water company's lines into the subdivision, according to the contract with the water company, were properly allocable to the cost of the houses sold. The contract between the corporations and the water company provided for the water company to make payments to the corporations for a period of ten years, but not in an amount greater than the corporations' cost for constructing the waterlines. As was the case in Colony, Inc., the Court felt in Albert Gersten that "the controlling facts were that the corporations made unconditional payments to provide utility service for the subdivisions, and such payments were directly related to the property sold."

Further support for the inclusion of water line installation costs in the cost basis of salable lots, even where such costs are reimbursable to the developer, is provided by Revenue Ruling 60-3.[51] According to this Revenue Ruling,

> Where a taxpayer is engaged in the development and sale of lots in a subdivision, the cost of each lot, for purposes of determining gain or loss, includes a pro rata portion of the payment made for installing water lines in the subdivision, even though the taxpayer might receive a repayment of all or part of such payment.

In addition, Revenue Ruling 60-3 states that "the cost of the houses in the subdivision includes the payments made for the cost of installing water meters in such houses."

Divine v. U.S.,[52] a 1962 Federal District Court case in Tennessee, deals specifically with deposits made to public utility companies to get them to provide services to subdivided property. In the Divine case, the taxpayer included utility deposits in the cost basis of lots and later included in income the repayments received from the utility companies. The Court upheld the taxpayer's practice even though the Government contended that the taxpayer should have established a prepaid asset and then charged off the prepaid asset when reimbursement of the deposit was received. In support of its decision regarding refunds of utility deposits in the case, the Court stated that

> The Government pretty well concedes that its own Internal Revenue Code, Section 1011, and the Bulletin at page 285, is on the taxpayer's side on that issue, as well as the case of Gersten versus Commissioner, 28 Tax Court, at page 756.[53]

As Dr. Brighton notes in his article, the Divine case represents an unsuccessful attempt by the Government to reinstate its pre-1960 theory regarding refundable deposits, "a prepaid asset or receivable theory."[54]

Another interesting case in which a developer was allowed to allocate refundable expenditures to the cost of subdivision lots is Herzog Building Corporation.[55] What is unique about this case is that it involves a developer's purchase of sewerage revenue bonds required by a municipality to cover the municipality's cost of constructing an adequate sewerage system for the developer's subdivision.

The Commissioner argued in the Herzog case that,

> because petitioner agreed to and did buy sewerage revenue bonds rather than build the sewerage system itself, and because petitioner at all times during the taxable years exercised full ownership and control over the bonds, petitioner may not, under Colony, Inc., . . . allocate the agreed price of the bonds to its cost of lots sold.[56]

Nevertheless, the Court disagreed with the Commissioner's position and held that the developer could allocate to the cost basis of the subdivided land the amount it agreed to pay for the sewerage revenue bonds.

The Court recognized in Herzog that the municipality "would not have approved petitioner's subdivision plans, nor would it have issued building permits, until it was certain that an adequate sewerage system would be provided for the new area." Furthermore, the Court noted that the "petitioner's purpose in agreeing to buy the . . . sewerage revenue bonds was to make possible the construction and sale of houses in the proposed subdivision, and was not to make an investment in the bonds."

The Court apparently evaluated the sewerage revenue bonds from the standpoint of substance rather than form and concluded that the cost of the bonds more realistically represented potentially refundable utility deposits than the purchase of investment securities. Also, because the uncertainties surrounding the collection of the bonds were obviously quite similar to the uncertainties underlying the recovery of utility deposits, the Court permitted the expenditures for the bonds to be allocated to the cost basis of subdivision lots, in a manner similar to the handling of utility deposits.

In the Herzog case, the Court not only allowed the taxpayer to allocate to the basis of lots the cost of the sewerage revenue bonds, but the taxpayer was even permitted to allocate the full amount of the agreed price of the bonds before actual payment of the full price was made. With respect to this point, the Herzog case will be discussed below within the discussion of estimated future improvement costs.[57]

Unfortunately, the authorities dealing with the income tax treatment of utility refund receipts are not nearly as conclusive as those which relate to the initial recording of the expenditures. For instance, Dr. Brighton feels "that all of the available court cases are just vague enough so that they neither refute nor completely support" the logic underlying his recommendations for handling utility deposit refunds by developers, as presented above.[58]

With respect to the handling of deposit refunds, the four cases just discussed, Colony, Gersten, Divine, and Herzog, have only a slight bearing on the issue. A much earlier court case, Chevy Chase Land Co.,[59] is the most significant case dealing with the receipt of refunds.

The Chevy Chase case concerns the inclusion of refunds as taxable income in the year received. The case involves a situation in which a taxpayer had in 1925 paid special improvement taxes on land which it owned. These improvement taxes were capitalized to the cost of the property, all of which was sold prior to 1932. Because the law under which these taxes were assessed was found to be unconstitutional, the taxes were refunded to the taxpayer in 1932. The Commissioner argued that the refunded taxes must be included in the taxpayer's income for the year when received because the taxpayer had been allowed to receive a tax benefit from the inclusion of the taxes in the cost of lots sold. The Court upheld the Commissioner's argument.

Regarding the Court's ruling in the Chevy Chase case, Dr. Brighton states that "this is wholly logical." Because, as he notes, "It is a perfect example of a Section 111 situation and also of the general accounting rule that any receipts over and beyond capital recovery are income."[60]

However, it cannot be construed from Chevy Chase that refunds per se are automatically taxable income in full when received. The reason is that the "income in year received" theory applied in Chevy Chase appears to be conclusive only to the extent that all of the lots to which the refunded amount relates have been sold. In other words, the taxpayer must have already received full tax benefit from the inclusion in the cost of lots sold of the total amount of the improvement costs which are being refunded. If the taxpayer has received a tax benefit from only a portion of the improvement costs refunded; then, in line with Dr. Brighton's logic, the refund should be considered taxable income only to the extent of the tax benefit obtained from prior deductions. The additional amount of the refund would be a reduction in the cost basis of the unsold lots to the extent that such amount is not reported as income.

Although taxability of refunds was not an issue in Colony, Inc., the opinion of the Tax Court in the case does contain the statement that the taxpayer "concedes, on brief, that such refunds would, if made, constitute taxable income," and the Court cites the Chevy Chase case. At any rate, Dr. Brighton notes that the facts in Colony, Inc. do not indicate whether all of the land had been sold and, therefore, whether all of the cost had already been recovered before the refunds were received. Likewise, he mentions that the Divine case is not clear as to the manner in which the taxpayer computes income from deposit refunds nor does it indicate whether all of the lots had been sold.[61]

In short, the discussion of potentially refundable improvement expenditures reveals that these charges may, in general, be included in the cost basis of lots to be sold and, therefore, provide a reduction in the income to be reported from the sale of lots. On the other hand, the manner in which the refund receipts themselves when received are to be handled is not settled. Dr. Brighton's recommendations on this latter issue appear to be logical and warrant consideration. In review, Brighton recommends that in cases where full refunds can be expected the "tax benefit" rule be applied, i.e., "report as income the portion of the refund in a given year which was a part of basis of lots sold in prior years . . . and treat the remainder as an adjustment of basis." Where "full refund is not reasonably predictable" or where "the combination of uncertainty of sales of lots and of refunds is great enough," use the "cost recovery method."[62]

Estimated Future Improvement Costs

Perhaps the most difficult accounting problem facing land developers involves the sale of lots prior to the completion of all related site improvements. In order to have a proper matching of revenues and expenses for the period of the sale, additional costs necessary to complete the improvements to these lots must be estimated and included in the cost of sales for the period. Failure to follow this procedure will result in an understatement of the cost of lot sales for the period and a consequent overstatement of net income for the period.

One method of accounting for the future improvement costs applicable to lots sold involves charging these estimated costs either to the lot inventory account or directly to the cost of lot sales account and crediting an estimated liability account. As improvement costs applicable to lots sold are incurred, these expenditures are offset against the estimated liability account. Adjustments to the estimated liability account are made at the end of each accounting period in order to bring this account into balance with the current estimate of improvement costs to be incurred on lots already sold. These adjustments, unless extremely material in amount, are usually considered items affecting the current period's profits only. This method of accounting for future lot improvement costs has been referred to as the "liability method" because it reflects in the balance sheet the liability for estimated future improvement costs related to lots already sold.[63]

An alternative method of handling future lot improvement costs has been designated the "contingent method." Under the "contingent method," improvement costs for the project as a whole are estimated and entered in the accounts as a charge to a land and improvements inventory account, and a corresponding credit is made to an estimated liability account. Whenever a sale occurs, the proportionate amount of total cost is transferred from the land and improvements account to the cost of sales account. Actual improvement expenditures incurred during the period are charged against the estimated liability account. Adjustments are made at the end of the period, and perhaps at other times during the period, to increase the liability account. For balance sheet presentation, the amount of the estimated liability applicable to unsold lots is offset against the land and improvements inventory account, leaving in the inventory account on the statement date only the amount of improvement costs actually spent on unsold lots. Consequently, the estimated liability account then contains only the future costs to be expended on lots already sold.[64]

Both of the foregoing methods of handling future site improvement costs should provide essentially the same net results in a development firm's income statement and balance sheet. The "liability method" places emphasis on the estimation of costs to complete lots sold. The "contingent method" emphasizes the estimation of costs for the entire project.

Because so many of the costs to be incurred in completing a project are likely to apply to both lots already sold and those still to be sold, developers may find it easier to estimate costs for the project as a whole and then to allocate these costs between lots sold and those yet to be sold. Therefore, most developers will probably prefer the contingent method over the liability method.

For Federal income tax purposes, land developers are also permitted to include in the basis of lots sold the estimated cost of future improvements that they are contractually obligated to provide and which cannot be recovered through depreciation.[65] However, the requirements for qualifying for this provision are extremely complicated.

Mimeographed Letter 4027 (Mim. 4027), issued by the Treasury Department on June 10, 1933, and published in the Treasury Department Cumulative Bulletins, lists the types of information which the developer must furnish in support of his estimate of future improvement costs.[66] Some of the requirements contained in this publication are as follows:

> (1) The actual cost or other basis to the vendor of the entire tract of which the property sold forms a part; together with such facts and data as may be necessary to establish that the cost or other basis of the property

sold, as shown by the vendor, is the correct proportion of the total cost or other basis of the whole tract.

(2) An accurate description of each class of the proposed improvements and definite evidence that the vendor is contractually obligated to make all of such improvements to the property sold during the year under consideration, together with an estimate of the maximum period within which the improvements will be completed.

(3) Complete details regarding the method of estimating the total cost of each class of improvements to be made to the entire tract, together with such evidence as may be necessary to establish the correctness of the estimated costs.

(4) A plat or map of the entire tract and a detailed statement showing the portion of the total cost of each class of improvements allocated to each lot or subdivision of the entire tract, with such information as may be necessary to establish the correctness of that allocation.

Other provisions in Mim. 4027 deal with the reporting of actual expenditures incurred on property sold in prior years upon which estimated future improvement costs were included and the reporting of gain on collections or repossessions of installment sales made in prior years upon which the cost basis includes estimated future improvement costs.

According to Mim. 4027, if all of the required improvements related to lots sold in prior periods have been completed or if the period the developer anticipated for the completion of the estimated improvements or five years, whichever is shorter, have elapsed, and all estimated improvements have not been incurred, then the developer must determine for each prior year the additional tax liability arising with respect to the estimated future improvement costs not yet incurred. The tax liability for each period will be recomputed on the basis of the amounts actually spent, and possible deficiency assessments may be issued.

However, if the developer can show that he has "good and sufficient reasons" for not incurring all of the contractual obligations within the estimated period or five years, whichever is shorter, then the developer is permitted to file a waiver of the required time period, thereby deferring the final determination of the taxable gain arising from the sale of lots each year. However, Mim. 4027 points out that the developer cannot defer the ultimate determination of gain indefinitely.

As a matter of fact, Mim. 4027 also required the filing of the waiver, on the prescribed form, for the original period in which estimated future improvement costs are to be included in the cost basis of lots sold. However, some question exists regarding the validity of this requirement and the right of the Commissioner to refuse the inclusion of future improvement costs in the basis of lots sold where the taxpayer has failed to file the waiver.

In Cambria Development Co.,[67] the inclusion of estimated costs in the basis of lots was permitted although a waiver was not filed. The opinion of the Court in this case contained the following statement: "It is well established that as a matter of law the petitioner has the right to include in its cost such estimated future expenditures for the development of the property as required by its contract of sale."

In order to obtain acceptance of the inclusion of estimated future improvement costs in the basis of lots sold, the developer's estimates must be reasonable and the obligation to provide the improvements must be enforceable. In Frishkorn Real Estate Co.,[68] for instance, subsequent events revealed that the estimate of improvement costs was arbitrary, and the Court held that costs included in the basis of lots sold must be limited to amounts actually spent. In Butler-Fornari Realty Corporation,[69] the taxpayer was disallowed the inclusion of estimated costs of future improvements required under its sales contracts because no attempt was made for more than eight years to fulfill the obligation. Furthermore, the facts revealed that there was no indication that the obligation to provide the improvements would ever be enforced. Similarly, in Colony, Inc.[70] the developer failed to prove that estimated improvement costs beyond a given date were required or were actually incurred. Hence, the Court ruled that the inclusion of improvement costs in the basis of lots sold shall be limited to the expenditures incurred up to that date.

In Herzog Building Corporation,[71] discussed above with reference to refundable utility deposits, a development company was permitted to allocate to the cost of lots, prior to payment in full, the entire amount it agreed to pay a municipality for the purchase of sewerage bonds. The developer offered to purchase the bonds so that the municipality could build a sewerage system that would make it possible for the development project to be undertaken. The value of the bonds, as previously noted, was dependent upon the success of the development venture.

Estimated future improvement costs, as the above discussion reveals, contain many interesting facets. Especially important is the fact that the Federal income tax laws permit these costs to be included in the cost of lots sold during a period. Because the inclusion of estimated improvement costs in the cost of lots sold may significantly affect the periodic earnings of a development firm for book and tax purposes, the developer must give adequate consideration to the reporting of these items.

Summary

Various expense determination factors in land development operations were analyzed in the present chapter. Both financial reporting and income tax reporting aspects were considered. The factors discussed consisted of the following: the significance of joint costs in expense determination, cost allocation methods, non-salable portions of a development project, land acquisition costs, carrying charges, site improvement costs, and estimated future improvement costs.

The expense determination procedure in land development accounting is complicated by the extraordinarily large amount of joint land and improvement costs existing in the land development activity. Determining the cost of improved lots or sites involves the allocation of these joint costs.

Although a number of different cost allocation methods have been accepted for financial statement presentation and for income tax reporting, developers frequently experience difficulty in selecting allocation methods that are equitable in given situations. In spite of this fact, for income tax purposes, the courts have consistently refused to find the allocation of costs impossible in situations where real estate activities are involved. Thus, developers are forced to adopt cost allocation methods, and they are usually not permitted to use the "cost recovery method" in relating costs to revenues. As a result of this situation, as well as the additional fact that land acquisition costs must be allocated to individual lots as of the land acquisition date, developers will probably benefit from an examination of cost allocation methods prior to the acquisition of undeveloped land. In other words, in the initial planning phase of a project, developers should evaluate the tax consequences of selecting different allocation methods.

The income tax treatment of non-salable portions of a development project should also be evaluated prior to acquisition of the land or at least during the initial development stage. Particularly important in this respect is the consideration accorded the dedication of land for such community uses as parks, playgrounds, and country clubs.

Developers frequently face important decisions arising from, or related to, the treatment of land acquisition costs, carrying charges, and site improvement costs. For example, with respect to carrying charges, the Federal income tax laws provide developers a great deal of flexibility, and developers must elect to follow specific procedures from among available alternatives.

The accounting problems arising with regard to site improvement costs often involve two types of expenditures, (1) those constituting investment items for the developer and (2) those which may be refundable to the developer. In both instances, the developer would be wise to evaluate the income tax consequences of such items prior to incurring the expenditures.

A most significant factor pertaining to site improvement costs is that in both financial reporting and in income tax reporting these costs may often be estimated and included in the cost of lots sold before the expenditures have actually been incurred. However, the requirements for qualifying for this practice in income tax reporting are quite complicated.

The following chapter analyzes important income tax factors in selecting the form of business organization for residential land development enterprises. The discussion is primarily devoted to the tax planning considerations faced by small-scale development firms.

FOOTNOTES

[1] National Association of Home Builders, THE Accounting System for ALL Builders (Washington, D.C.: National Association of Home Builders, 1971), pp. 73-74.

[2] Wellesley A. Ayling, 32 TC 704 (1959).

[3] Arjan T. Sadhwani, "Accounting for Land Development" (Unpublished Ph.D. dissertation, Michigan State University, 1971), p. 79.

[4] Ibid.

[5] Ibid., pp. 107-108.

[6] Ibid., p. 80.

[7] Gardner M. Jones, "Some Problems in Accounting for Land Development," Management Accounting, IL (August, 1968), 27.

[8] Ibid.

[9] Sadhwani, "Accounting for Land Development," p. 182.

[10] Ibid.

[11] Ibid., pp. 183-184.

[12] Ibid., p. 184.

[13] Fairfield Plaza, Inc., 39 TC 706 (1963).

[14] Wellesley A. Ayling, 32 TC 704 (1959).

[15] Biscayne Bay Islands Co., 23 BTA 731 (1931).

[16] R. M. Clayton, 15 CCH Tax Ct. Mem. 105 (1956).

[17] 4 P-H 1972 Fed. Tax Serv. para. 31,207, referring to an article by John S. Kiefer (Internal Revenue Agent) in the October 1930 issue of the Internal Revenue News.

[18] J. S. Cullinan, 5 BTA 996 (1927), 19 BTA 930 (1930).

[19] 1 CCH 1971 Stand. Fed. Tax Rep. para. 664.01.

[20]Biscayne Bay Islands Co., 23 BTA 731 (1931). See also Searles Real Estate Trust, 25 BTA 1115 (1932).

[21]Point City Development Co., Inc. v. U.S., 7 AFTR 2d 401 (DC, Va.; 1960).

[22]Oak Woods Cemetery Association, 6 BTA 1003 (1927); Biscayne Bay Islands Co., 23 BTA 731 (1931); Commissioner v. Laguna Land and Water Co., 118 F.2d 112 (9th Cir. 1941); Country Club Estates, Inc., 22 TC 1283 (1954); Colony, Inc., 26 TC 30 (1956).

[23]Country Club Estates, Inc., 22 TC 1283 (1954).

[24]Rev. Rul. 68-478, 1968-2 CB 330.

[25]See p. 107 above.

[26]Sevier Terrace Realty Co., 21 CCH Tax Ct. Mem. 1289 (1962); aff'd per curiam 327 F.2d 999 (6th Cir. 1964).

[27]Harry Simons and Wilbert E. Karrenbrock, Intermediate Accounting, Comprehensive Volume (4th ed.; Cincinnati: South-Western Publishing Company, 1964), p. 417.

[28]Robert P. Jones, "Tax Problems of Real Estate Developers--From Acquisition Through Disposition," The Journal of Taxation, XXIV (January, 1966), 33, citing Rev. Rul. 56-600, 1956-2 CB 171.

[29]*Ibid.*, p. 33.

[30]See Simons and Karrenbrock, Intermediate Accounting, p. 416; Glenn A. Welsch, Charles T. Zlatkovich, and John Arch White, Intermediate Accounting (3rd ed.; Homewood, Ill.: Richard D. Irwin, Inc., 1972), p. 484; and Walter B. Meigs and others, Intermediate Accounting (2nd ed.; New York: McGraw-Hill Book Company, 1968), pp. 350-351.

[31]Eldon S. Hendriksen, Accounting Theory (Revised ed.; Homewood, Ill.: Richard D. Irwin, Inc., 1970), p. 373.

[32]National Association of Home Builders, THE Accounting System for ALL Builders, p. 15.

[33]Rev. Rul. 69-105, 1969-1 CB 88.

[34]Robert P. Jones, "Tax Problems of Real Estate Developers--From Acquisition Through Disposition," p. 34.

[35]Richard U. Ratcliff, Real Estate Analysis (New York: McGraw-Hill Book Company, Inc., 1961), p. 57.

[36]Colony, Inc., 26 TC 30 (1956).

[37]Estate of M. A. Collins, 31 TC 238 (1958).

[38]Commissioner v. George W. Offutt, III, 331 F.2d 483 (4th Cir. 1964).

[39]Willow Terrace Development Co., Inc. v. Commissioner, 345 F.2d 933 (5th Cir. 1965). See also Montclair Development Co. 25 CCH Tax Ct. Mem. 1029 (1966) and Derby Heights, Inc., 48 TC 900 (1967).

[40]Sabinske v. U.S. (DC, Tex. 1962), 9 AFTR 2d 599.

[41]Fairfield Plaza, Inc., 39 TC 706 (1963).

[42]Gerald D. Brighton, "Choosing the Correct Treatment for Subdivider Utility Deposit Refunds," The Journal of Taxation, XXXI (September, 1969), 177. (Hereinafter referred to as "Subdivider Deposit Refunds.")

[43]*Ibid*., p. 174.

[44]Rev. Rul. 60-3, 1960-1 CB 284; Colony, Inc., 26 TC 30 (1956); Albert Gersten, 28 TC 756 (1957); Divine v. U.S., 10 AFTR 2d 5403 (DC, Tenn.; 1962); Herzog Building Corp., 44 TC 694 (1965).

[45]Brighton, "Subdivider Deposit Refunds," p. 177.

[46]*Ibid*., p. 174.

[47]*Ibid*. The *Divine* case, mentioned by Brighton, will be discussed below with respect to its impact on the income tax treatment of utility deposit refunds.

[48]*Ibid*., p. 177.

[49]Colony, Inc., 26 TC 30 (1956).

[50]Albert Gersten, 28 TC 756 (1957).

[51]Rev. Rul. 60-3, 1960-1 CB 284.

[52]Divine v. U.S., 10 AFTR 2d 5403 (DC, Tenn.; 1962).

[53]Reference to "the Bulletin at page 285" is apparently to Rev. Rul. 60-3, 1960-1 CB 284-285, cited above. See p. 135 above.

[54]Brighton, "Subdivider Deposit Refunds," p. 174.

[55]Herzog Building Corp., 44 TC 694 (1965).

[56]See p. 124 above for discussion of the Colony, Inc. case.

[57]See p. 152 below.

[58]See p. 137 above.

[59]Chevy Chase Land Co., 34 BTA 150 (1936).

[60]Brighton, "Subdivider Deposit Refunds," p. 177.

[61]Ibid., pp. 176-177.

[62]Ibid., p. 177. See p. 137 above.

[63]Jack R. Brown, "Accounting for Future Lot Improvement Costs--A Comparison of Methods," Selected Papers, 1968--Haskins and Sells, pp. 179-181. (Reprinted from The Florida Certified Public Accountant, December, 1968.)

[64]Ibid.

[65]Kentucky Land, Gas and Oil Co., 2 BTA 838 (1925); Osgood Land and Livestock Co., 22 BTA 387 (1931); Birdneck Realty Corp., 25 BTA 1084 (1932); Cambria Development Co., 34 BTA 1155 (1936); Country Club Estates, Inc., 22 TC 1283 (1954); Colony, Inc., 26 TC 30 (1956); Herzog Building Corporation, 44 TC 694 (1965). Also see Mim. 4027, 1933-1 CB 60.

[66]Mim. 4027, 1933-1 CB 60.

[67]Cambria Development Co., 34 BTA 1155 (1936).

[68]Frishkorn Real Estate Co., 15 BTA 463 (1929), dismissed (6 Cir.; 1931), 51 F.2d 1077.

[69]Butler-Fornari Realty Corp., 37 BTA 933 (1938).

[70]Colony, Inc. 26 TC 30 (1956).

[71]Herzog Building Corporation, 44 TC 694 (1965).

CHAPTER V

TAX FACTORS IN SELECTING THE ENTITY FORM FOR RESIDENTIAL LAND DEVELOPMENT FIRMS

Introduction

Selecting the entity form for conducting the activities of land development enterprises is one of the most important initial tasks facing residential land developers. The ultimate financial returns to land development investors in many ways depend on the outcome of this decision. The purpose of this chapter is to analyze significant income tax factors to be considered in selecting the entity form of land development organizations. The discussion will concentrate on tax factors particularly relevant to small-scale development firms. (Small-scale development companies, as noted in Chapter I, have been designated for the purposes of this study as local or regional organizations undertaking residential development projects which are less than 500 acres in size.)

Small development companies generally have a great deal of flexibility in choosing a form of business organization in which to carry out their operations. In contrast, large-scale development firms, e.g., those firms undertaking projects approaching or on the scale of the "new-town" ventures (ordinarily 1,000 acres or more in size), are usually limited to the corporate form of organization or, to a certain extent today, to a very recent, and highly technical, innovation known as the "public real estate limited partnership."[1] In other words, because of the vast amounts of capital required to carry out their activities, the large land development firms must generally have access to public securities markets in order to obtain sufficient equity funds. As a consequence, these firms do not have the flexibility of selecting among a variety of entity forms as do the smaller firms.

Numerous factors must be evaluated in making the choice of the form of organization for a small-scale land development enterprise. As is the case with virtually all business enterprises, these factors involve financial, legal, income tax, and operational matters.

To an exceptional degree today, income tax factors tend to influence the selection of the entity form of the land development firm. In fact, the income tax consequences alone often encourage or discourage potential organizers and subsequent investors from participating in a development venture. As a result, particular emphasis is placed on some important income tax factors in selecting the entity form. The income tax factors studied will be viewed primarily from the standpoint of their peculiarities to land development enterprises. In addition, a few related non-tax aspects in choosing the form of organization of development enterprises will be briefly discussed.

At the present time, the list of entity forms available to small land developers is quite extensive. For example, it includes the following: the individual proprietorship, the general partnership, the limited partnership, the joint venture, the real estate syndicate, the business trust,[2] and the corporation (including particularly the income tax entity commonly referred to as the "Subchapter S" corporation). However, the list excludes the tax entity known as the "real estate investment trust," because this form of business organization cannot be used for Federal income tax purposes by firms buying or selling real estate in the regular course of their operations.[3]

With respect to non-tax features, a variety of differences exists among the above-mentioned entity forms. However, for Federal income tax purposes, all of the foregoing forms of doing business can generally be grouped into two broad categories, incorporated enterprises and unincorporated enterprises. Unincorporated firms consist of individual proprietorships, general and limited partnerships, joint ventures, and, in some cases, real estate syndicates. For the purposes of the discussion in this chapter, noncorporate enterprises will be represented primarily by general partnerships.

A real estate syndicate, incidentally, may be taxed as either a corporation or a partnership depending upon its fundamental characteristics. As a matter of fact, the term "real estate syndicate" is really rather ambiguous because it simply refers to a group of investors who have joined together to undertake some type of real estate investment activity. This activity may involve the development of raw land, or it may pertain to the development or acquisition of income-producing property, e.g., apartment houses, shopping centers, and office buildings. The regulations regarding the characteristics of corporations frequently rule in the determination of the taxation of a syndicate.[4]

The business trust form of ownership can also be used in land development activities. This entity form, where available, may be created simply by the signing of a trust agreement. For the most part, the business trust possesses non-tax features similar to the corporation. Furthermore, as a number of authorities have noted, the business trust arrangeme is usually so similar in many respects to the corporation that it is very difficult to avoid having such an entity taxed as a corporation.[5] Therefore, this entity form normally does not provide any particular income tax advantages.

Non-Tax Considerations

In conjunction with the evaluation of income tax aspects in the selection of the entity form for a land development firm, many non-tax factors should be considered. These non-tax considerations frequently include the following: (1) ease of formation and dissolution of the firm, (2) continuity of the entity life, (3) limitation of personal liability of owners, (4) ability to raise financial resources, (5) ease in maintaining and transferring real property ownership, (6) regulation by governmental bodies, and (7) simplicity of operation. Practically all of these factors must be assessed to some extent in selecting the entity form for any business enterprise. However, a few of the factors hold particular importance for land developers. For example, the limitation of personal liability of owners seems to have a major impact on the selection of the entity form.

The limited personal liability of the corporate form of organization strongly influences many developers to operate their firms as corporations. For the most part, the high risks of land development provide the inducement for land development investors to emphasize the curtailment of personal liability. The corporate limited liability feature, in fact, sometimes appears to be more important to developers than the possible unfavorable income tax consequences of the corporate form, e.g., "double taxation" and lack of ability to pass through to owners operating losses of the firm.

The corporate limited liability benefits are reduced to a degree by the fact that land developers operating their firms as corporations often have to pledge personal assets in support of certain debts of the firm, or they have to personally sign as guarantors of some debts. In other words, when lenders and suppliers are trying to decide whether to advance funds or materials to the development organization, they are probably more concerned with the reputation and credit worthiness of the individual owners of the development enterprise than with the particular form of ownership of the firm. An important consequence of this state of affairs is that the ability of a small land development firm to raise capital is probably not materially affected by the firm's form of doing business.

At any rate, the corporate form does provide a certain amount of protection to land development investors from the expropriation of their personal assets in the event of the failure of the enterprise. On the other hand, the limited partnership form of ownership likewise holds much promise in the area of limiting personal liability. In addition, the limited partnership affords investors various income tax advantages characteristic of noncorporate enterprises.

The election to have a land development corporation taxed as a Subchapter S corporation also provides the benefits of limited liability. In addition, the Subchapter S election provides other advantageous non-tax features of corporations, such as continuity of entity life and easy transferability of owner interests. At the same time, the Subchapter S election provides certain income tax advantages over the regular taxation of corporations. However, the complexity of the Subchapter S regulations, as is noted below, often detracts from the favorable features of this tax reporting entity.

Another non-tax factor receiving particular attention in the selection of the entity form of the development firm is the ease of maintaining and transferring legal ownership of the property. Because the corporation can hold legal title to real property in its own name, the corporate form of entity ownership tends to simplify the task of acquiring, holding, and transferring title to developed land.

Incidentally, related to the issue of the ability of corporations to hold legal title to real property is another matter which has become important in recent years. This issue involves the financing problem caused by the passage of local laws to curtail usurious interest rates. These laws generally provide that individuals and partnerships cannot be charged interest rates in excess of a specified legal limit, but the laws usually do not apply to corporations. The penalties to lenders who charge excessive interest rates to noncorporate borrowers can be extremely severe. For example, the lender may stand to lose not only the interest on the loan but also the principal as well, if the noncorporate borrower successfully raises the defense of usury.[6]

Because the financing of land development projects sometimes requires the payment of interest rates in excess of the legal limit, legal title to real property may be placed in a corporation, at least for financing purposes. Therefore, land developers are provided a further motivation to operate their firms as corporations.

Incidentally, some noncorporate entities have made attempts to have legal title to real property held in the name of a corporation (usually referred to as a "dummy corporation" or "straw corporation") for state usury law purposes but to have this corporation either completely ignored for the purposes of Federal taxation or merely treated as an agent of the noncorporate enterprise. However, many technical difficulties surround the attempt to have the dummy corporation held to be the nominal owner of the property for Federal income taxes, and, therefore, not subject to the income tax, while the noncorporate entity is deemed the equitable owner. Regarding the many court cases in the dummy area, one significant source states that the Commissioner of Internal Revenue has been "the victor more often than the taxpayer."[7]

In many ways, non-tax factors have a direct bearing on the income tax analysis to be exercised in selecting an entity form. For example, certain specific non-tax elements must be evaluated, under Treasury Regulation 301.7701-2, in determining whether a given business organization has more corporate attributes or more partnership attributes for tax reporting purposes. These factors are the following: (1) continuity of entity life, (2) limitation of personal liability, (3) transferability of owner interests, and (4) centralization of management. In some instances, unincorporated organizations (frequently real estate syndicates), which are considered for purposes of general law as partnerships, may be referred to as "associations" for income tax purposes and taxed as corporations because they possess more corporate than partnership characteristics.[8] The consequences of having an organization considered a corporation for tax purposes rather than a partnership can often be disastrous to the investors in the enterprise, particularly if the tax planning for the enterprise has been specifically based on the use of the partnership form of ownership.

The ease of physical and legal dissolution of the organization is another non-tax factor that can also have an effect on the firm's income tax planning. This may be true, for example, when the shareholders of a land development corporation anticipate the liquidation of the enterprise and would like to use the special liquidation provisions of Section 333 or Section 337 of the Internal Revenue Code, both of which are briefly discussed below.[9] As a matter of fact, at the time of the formation of any enterprise, the difficulties in liquidating the enterprise and the adverse income tax consequences of a possible liquidation of the firm should be carefully evaluated.

The significance of certain non-tax factors in the selection of the entity form for residential land development firms has been discussed in this section. Particular emphasis was placed on the relationship of non-tax factors to income tax considerations. The remainder of the chapter is devoted to discussions of income tax aspects of noncorporate and corporate forms of ownership.

Noncorporate Ownership

Use of the partnership or other noncorporate form of ownership generally provides the small land developer greater income tax advantages than are provided through the use of the corporate form of ownership (except perhaps when the Subchapter S election is exercised by the corporation). On the other hand, many important non-tax aspects of partnerships appear to be less favorable than those of corporate enterprises. For example, in comparison with the corporation, partnerships require more personal liability by owners (except in the case of limited partners in a limited partnership), provide less freedom in transferring ownership interests, experience more difficulties in maintaining the continuity of the business, provide fewer sources of capital, and usually have less centralization of management. The failure to limit personal liability, as already noted, is probably the biggest non-tax disadvantage to the use of noncorporate forms of ownership in the land development area.

The following discussion covers some of the favorable, as well as unfavorable, income tax features of partnerships. Coverage is limited to those aspects particularly important to land developers.

Avoidance of "Double Taxation"

To land development investors, the chief income tax advantage of partnerships is probably the avoidance of the "double tax" burden inherent in corporations. Not being a separately taxed entity, the partnership has its earnings taxed directly to the individual owners of the enterprise.[10] This characteristic also applies, with certain important modifications and with the exception of capital gains in certain cases, to the Subchapter S corporation.

"Pass Through" of Net Operating Losses

Another important income tax feature of partnerships from the standpoint of land developers is the fact that net operating losses of the firm can be used in the individual income tax returns of the owners to offset other income of the owners. However, a partner's deduction for his share of net operating losses is limited to the adjusted basis of his partnership interest at the end of the partnership year in which the loss was incurred.[11] A salient point, in this respect, is that the partner's partnership interest, for the purposes of determining the limitation of his loss deduction, includes his share of any liabilities of the partnership.[12]

The inclusion of partnership liabilities in computing the partnership interest of individual partners for loss deduction purposes is especially important in land development operations. Because of the large amount of debt (mortgages on raw land, site development loans, etc.) characteristic of these enterprises, developers usually have partnership interests large enough to provide them abundant opportunities to take advantage of partnership operating losses in their individual income tax returns.

Incidentally, in determining the limitation of the net operating loss deduction of individual partners, the following provisions of Regulation 1.752-1(e) are often pertinent:

> A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing *losses* under the partnership agreement. . . . However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the *profits*. . . . (Italics mine.)

The ability to "pass through" the company's operating losses to individual partners is particularly important during the early period in the existence of a land development partnership or during the initial stages of a new development project. In either event, the firm is likely to experience losses. Such losses, incidentally, often arise because of the firm's election for tax purposes to expense, rather than capitalize, interest, property taxes, and certain other carrying charges.

The ability to "pass through" net operating losses of the firm to the firm's owners is also a characteristic of the Subchapter S corporation. In the Subchapter S corporation, a shareholder's deduction for such losses is limited to the adjusted basis of the shareholder's stock plus the amount of any debts of the corporation to him.[13] Furthermore, losses in excess of a shareholder's loss limit are lost forever to the shareholder as a deduction.[14] On the other hand, in the partnership, any net operating losses that cannot be deducted by a partner because of the loss limitation may be deducted by the partner in later years to the extent of the partner's adjusted basis in his partnership interest at the end of those years.[15]

On the other hand, in the conventional corporate tax entity, net operating losses are "locked in" the enterprise and can only be used to offset earnings of the firm. The corporation may generally carry these losses backward three years and forward five years. However, unless sufficient profits are available during this period to offset these losses, the income tax benefits of the losses will be lost forever. Furthermore, the stockholders do not have the opportunity to directly benefit from these losses until they either sell or exchange their stock, or the stock is deemed worthless.

Other "pass through" or conduit features of partnerships which may be beneficial to land development investors apply to capital gains and losses and other special items such as charitable contributions and medical deductions. However, these other items are probably not as significant in selecting the land development entity form as is the net operating loss deduction.

Collapsible Partnership Provisions of Section 751

In selecting the entity form for the land development enterprise, the firm's organizers must give consideration to the collapsible partnership provisions of Section 751 of the Internal Revenue Code. According to Section 751(a), if a partner disposes of all or a part of his interest in a partnership, the cash or fair market value of any property which the partner receives in exchange for this interest may be taxable as ordinary income to the extent the money or property received by the partner is attributable to his share of the value of "unrealized partnership receivables" or "substantially appreciated inventory items." An important exception to this rule applies to the receipt of property which the partner had previously contributed to the partnership.[16]

The collapsible partnership provisions correspond in purpose to the collapsible corporation provisions of Section 341, which will be discussed in detail below. Both statutes represent measures to prevent the conversion of ordinary income into capital gains. The collapsible partnership provisions, however, appear to be much less complicated and much more specific in nature than the collapsible corporation provisions.

The chief problem land development partnerships face in the area of collapsibility involves the determination whether property held by the firms constitutes "substantially appreciated inventory items." The question of what represents "substantially appreciated" is fairly clear. For example, Section 751(d)(1) of the Internal Revenue Code states that inventory items are considered to be substantially appreciated in value if both of the following exist: (1) their fair market value exceeds 120 percent of the partnership's adjusted basis of such items and (2) their fair market value exceeds 10 percent of the fair market value of all partnership property other than money.

What is often not so clear, however, particularly with respect to land held by a partnership, is whether the property represents "inventory items" under the provisions of Section 751(d)(2). In general, the basic question is whether the land is "primarily held for sale to customers in the ordinary course of business or trade."

In Morse v. United States,[17] a taxpayer sold his interest in a partnership which had been originally formed for the purpose of developing and selling land. Although land held by the partnership was attributable to the taxpayer's interest that was sold, the Court of Claims held that the gain on the sale of the partnership interest qualified for capital gain treatment because the land was not an inventory item. The Court ruled that the land was held for appreciation in value at the particular time the taxpayer sold his interest and that, at that time, it was not for sale to customers in the ordinary course of business or trade. What is interesting in this case is the fact that the partnership had actually made previous, but unsuccessful, attempts to develop the land. The Court of Claims, however, placed more weight on the partnership's purpose for holding the land at the time the partner sold his interest than the fact that the partnership had initially held the land for sale to customers. In a subsequent case, Ginsburg v. United States,[18] pertaining to other partners in the same partnership firm as in the Morse case--and, in many instances, practically the same set of facts--the Court of Claims held to the same effect as in Morse.

On the other hand, in Freeland v. Commissioner,[19] the Ninth Circuit Court of Appeals held that the sale of partnership interests, of still other partners in the same land development partnership involved in the Morse and Ginsburg cases, resulted in ordinary income to the partners because the land was found by this Court to be an inventory item which had substantially appreciated in value. In its finding, the Ninth Circuit upheld the Tax Court's earlier decision that the partnership had acquired the land in question with the intention of developing it and that the land was held primarily for sale to customers in the ordinary course of business. Hence, the Tax Court, and ultimately the Ninth Circuit, reached a decision in Freeland contrary to that found by the Court of Claims in

Morse and Ginsburg. Incidentally, the Freeland case was heard after the Morse case but before the Ginsburg case. The Tax Court has also held, in J. T. Requard,[20] that gain on the transfer of interests in a real estate partnership was ordinary income because land owned by the partnership constituted an inventory item within the meaning of Section 751(d)(2).

The likelihood is very high that partners in a land development partnership will be vulnerable to attack under the collapsible partnership provisions of the Code if they dispose of all or a part of their partnership interests when the partnership holds Section 751 property [as defined in Section 751(d)]. However, a very important exception to this possibility, and one which tends to make the collapsibility provisions applicable to partnerships much less severe than those relative to corporations, is provided by Revenue Ruling 57-68.[21] According to this revenue ruling:

> Where, in liquidation of his interest in a partnership, a partner receives a distribution in kind of his proportionate share of partnership assets which would be considered "inventory items which have appreciated substantially in value," within the meaning of the definition of that term set forth in section 751(d) of the Internal Revenue Code of 1954, such distribution does not constitute a sale or exchange of such assets, subject to the provisions of section 751.

Therefore, a distribution in kind of a distributee partner's proportionate share of Section 751 property will not be subject to the provisions of Section 751. Furthermore, such a liquidation of a partner's interest will probably not produce income to the partner or to the partnership at the time of the liquidation.[22] The basis of the 751 property in the hands of the distributee partner will likely be limited to the adjusted basis of such assets in the hands of the partnership.[23] Gain or loss on the later disposition of the property will result in ordinary income, unless the property consists of "inventory items" and is sold or exchanged more than five years after the date of distribution. In this latter event, any gain or loss on the sale or exchange will not be ordinary income.[24]

Incidentally, the particular partnership involved in Revenue Ruling 57-68 was a firm engaged in subdividing and developing land and the development and construction of commercial buildings. The enterprise was completely liquidated and terminated, and a parcel of land, which apparently represented an "inventory item substantially appreciated in value," was physically partitioned among the partners in accordance with their respective partnership interests.

Use of Limited Partnership

To overcome the unlimited liability nature of partnerships and still maintain the income tax advantages of the partnership, the land development firm may be organized as a limited partnership. However, this form of organization still retains the requirement that there be at least one general partner in the firm who is subject to unlimited liability. Even so, the limited partnership is quite useful where the organizers of a development project are interested in attracting passive investors to the venture. In such a case the organizers or promoters will usually serve as the general partners.

Additional provisions in many instances have been included with the general partnership provisions of the Code and Regulations to cover the activities of limited partnerships. For example, Regulation 1.752-1(e) contains rules for controlling the effect of liabilities on a limited partner's partnership basis which are different from those affecting general partners. In this respect, the Regulation states the following:

> . . . In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. . . .

The above statement, incidentally, significantly restricts the amount of net operating loss deductions which may be used in the income tax returns of individual limited partners. However, with respect to partnership liabilities where no partner assumes personal liability (as is usually the case with mortgaged real property), all partners, including limited partners, may share in the liability and increase their partnership interests accordingly. This latter feature of Regulation 1.752-1(e) was cited above.[25]

An interesting aspect of limited partnerships, and one which has been increasing in popularity in recent years, is the use of a corporation as the sole general partner in the limited partnership. This form of organization is obviously quite advantageous from the standpoint of limiting the liability of all investors in the enterprise.

The primary difficulty from an income tax standpoint surrounding this entity form is to avoid having it classified as an "association" and, therefore, taxed as a corporation. As a matter of fact, the Internal Revenue Service has for some time required the corporate general partner of a limited partnership to meet specific net worth conditions before it would even grant a private ruling stating whether the proposed limited partnership entity qualifies as a partnership for Federal income tax purposes. These net worth requirements were not formally published until January 1972. They are now contained in Revenue Procedure 72-13.[26]

Revenue Procedure 72-13 merely contains the conditions which must be met before the Internal Revenue Service will consider issuing advance rulings concerning the classification of organizations as partnerships where these organizations are set up as limited partnerships with a corporation as the sole general partner. The document does not specify the conditions that will definitely qualify the organization as a partnership for income tax purposes. Furthermore, the conditions contained in the publication are very general in nature.

Many writers have taken issue with the Internal Revenue Service for the many questions left unanswered by the Revenue Procedure and also because the Service merely established its policy for issuing rulings with respect to such organizations and did not issue actual requirements for having such entities qualify for partnership taxation.[27]

In summary, the discussion in this noncorporate ownership section has primarily analyzed a selected number of income tax features of partnerships that are particularly significant in land development operations. There are, of course, numerous other income tax factors affecting various general aspects of partnership activities which the land developer must also consider in selecting the entity form of the development firm.

Corporate Ownership

Because of the many favorable non-tax features of the corporation, this form of ownership is frequently selected by small land developers. However, as noted above, the corporate form of ownership is generally less advantageous from an income tax standpoint to the small land developer than noncorporate forms of ownership (with perhaps the exception of the Subchapter S election). Even so, corporations have some particular income tax aspects which may be important to the small, local developer and which should be evaluated in selecting the entity form of development organizations. These include the following: (1) avoiding the penalty tax for the unreasonable accumulation of earnings, (2) executing taxable transfers of land to corporations, (3) avoiding the collapsible corporation provisions of Section 341, and (4) making use of the Subchapter S election. Some points regarding each of these factors are discussed below.

Avoiding the Penalty Tax on Improper Accumulation of Earnings

The Internal Revenue Code contains provisions for a penalty tax for the unreasonable accumulation of earnings by a corporation in order to avoid personal income taxes on its shareholders. The penalty tax is 27 1/2 percent of the first $100,000 of earnings subject to the tax and 38 1/2 percent of additional excess accumulated earnings. Corporations not formed primarily to avoid income taxes are allowed an exemption of $100,000 before becoming subject to the penalty tax.[28] However, if a corporation can show that its accumulation of earnings is for reasonable needs of the business, then it may be permitted a credit for the full amount of the undistributed earnings. Therefore, the accumulated earnings tax may be avoided.

The accumulated earnings tax is, no doubt, a deterrent to the use of the corporate form of organization because it serves to eliminate the possibility of high bracket taxpayers using the corporation as a medium to temporarily or permanently avoid paying personal income taxes on corporate earnings. With respect to land development firms, however, the penalty tax does not appear to be extremely detrimental because the high cash requirements of these firms usually provide adequate justification for the retention of earnings in the firm for working capital.

Although the Treasury Regulations contain some general grounds considered reasonable for accumulating earnings and others which are not,[29] no set of specific standards currently exists for deciding the issue in a given situation. As a result, the number of court cases dealing with various aspects of the accumulated earnings tax is quite extensive.

One particular case relevant to land developers is Dahlem Foundation, Inc. v. United States.[30] In this case, the U.S. Sixth Circuit Court of Appeals reversed a district court decision and held that a real estate developer who was engaged in the business of purchasing unimproved land, erecting stores and apartments, and leasing the improved property to tenants, was not liable for the accumulated earnings tax for the fiscal years 1960-1962, because the income was accumulated for the reasonable needs of the business. Justification for the earnings accumulation rested on such factors as the organization's need for cash to purchase undeveloped land, the reluctance of banks to lend money to developers on undeveloped land, and the organization's plans to continue the acquisition of undeveloped land. Another justification for the retained earnings was the need to remodel certain leased property in order to induce lessees to renew their leases. However, the chief reasons for the organization's retaining earnings were related to financing the acquisition of undeveloped land.

Transferring Land to a Corporation in a Taxable Transaction

Transferring unimproved land to a corporation in a taxable transaction can often be advantageous to investors who plan to subdivide and develop the property. This is particularly true if the land was acquired some time in the past and has a low tax basis in relation to its current market value.

If the land is subdivided, developed, and sold under the entity form in which it was originally acquired, then the full profit on the sale will normally be taxed as ordinary income. However, if the undeveloped land can be transferred in a taxable transaction to a close corporation, then the owners of the land may be able to obtain capital gains taxation on the appreciation in its value from the time of acquisition until the time of the transfer to the corporation. Furthermore, the corporation will, in such cases, receive the property at a stepped-up basis under provisions of Section 362(a) of the Internal Revenue Code. Hence, the taxable incorporation may convert to capital gains a considerable amount of the profit on the sale of the subdivided property which would otherwise have been taxed as ordinary income.

In order to obtain the advantages of the taxable incorporation, however, the provisions of Section 351, dealing with tax-free transfers of property to a corporation, must be avoided. There are generally two ways in which this can be accomplished. One is to have the transferors of the property deliberately receive less than 80 percent of the stock of the corporation and, therefore, not be in control of the corporation after the transfer. The other is to have the corporation issue to the transferors not only stock in exchange for the land but also an amount of short-term notes equal to the appreciation in value of the property. In other words, the transfer would actually qualify as a Section 351 exchange, but the amount of the short-term notes issued will be subject to taxation, under Section 351(b). If two conditions are met, then the taxable gain will likely be subject to long-term capital gains taxation. These conditions are (1) the property must have been held for more than six months, and (2) during the holding period, it could not be deemed property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

One danger to this latter approach to executing a taxable transfer of the property to the corporation is that the notes cannot have a long maturity date. If they are too long-term in nature, perhaps maturing beyond five years, then the Internal Revenue Service may contend that they are really "securities,"[31] and the entire transfer is tax-free under Section 351. Hence, the corporation would not receive the step-up in basis.[32]

A further problem also arises from the fact that simply having the corporation issue short-term notes in the amount of the appreciation will not guarantee a taxable transfer. The Internal Revenue Service may, for example, exercise the "thin capitalization" rules dealing with the ratio between debt and equity in the enterprise. In other words, if the ratio of debt to equity is too high, the Internal Revenue Service may consider the notes to be an equity investment in the enterprise and not allow the stepped-up basis.[33] An interesting case in this respect is Stanley, Inc. v. Schuster.[34]

In the Stanley, Inc. case, a district court in Ohio held that the transfer of land from Turkey Run, Inc., the holder of the land, to Stanley, Inc., the acquiring development firm, was a Section 351 transfer resulting in the carry-over of basis from the transferor to Stanley, Inc., rather than a bona fide sale creating a debtor-creditor relationship. Although the transaction took the form of a sale, a number of factors caused the Court to hold that the transaction was, in substance, an equity transaction.

For instance, Stanley, Inc., was organized with a paid-in capital of $4,500, and after acquiring the land, showed a liability of $247,000, arising from the note given to Turkey Run, Inc. Furthermore, the land represented the corporation's only substantial asset, and payment of the notes was based on the success of the business. As a matter of fact, Stanley, Inc., had to borrow funds in order to meet certain development costs. Hence, the Court felt "that the entire risk of the venture was Turkey Run's" and that Turkey Run maintained "a continuing beneficial interest" in the property. Therefore, the Court did not permit the Stanley firm to acquire the property at a stepped-up basis.

Another factor carefully scrutinized by the Internal Revenue Service in regard to the taxable transfer of unimproved land to a close corporation is the extent to which the transferors of the land undertake personal development activities prior to transferring the land to the corporation. In many instances, where the transferors have personally engaged in substantial subdivision activities before the land is transferred to the corporation, the gain on the transfer has been taxed as <u>ordinary income</u>. For example, in <u>Royce W. Brown v. Commissioner</u>,[35] the Tenth Circuit Court of Appeals upheld the Tax Court's decision that the gain on the transfer of land by a taxpayer to a corporation controlled by the taxpayer should be taxable as ordinary income because the taxpayer "made personal efforts at platting and other necessary prerequisites of subdivision" before executing the transfer. The taxpayer had received notes on the sale of the land to the corporation.

Of particular importance in the Royce W. Brown case is the fact that the Court went so far as to make the following statement:

> Lack of personal efforts at preparing property for resale in no way raises an implication that capital gains treatment can be secured by doing so through a closely held corporation. (Italics in original.)

According to this statement--which, incidentally, is presented without any supporting basis or logic--the amount of activity the taxpayer exercises with respect to the property prior to its transfer to the corporation will have no bearing on the taxability of the transfer. In other words, in spite of the transferor's lack of personal efforts toward the development of the land, the gain on the transfer will still be considered ordinary income. Obviously, the impact of the Tenth Circuit's statement can be quite detrimental to land investors if it is exercised by the Internal Revenue Service and upheld by the courts.

Incidentally, in its opinion in the Brown case the

Tenth Circuit also emphasized that

> Gain realized from an interest in land transferred to a closely held corporation, which in turn disposes of that interest to the ultimate purchaser, has been held ordinary income by the United States courts.

The opinion then cites a number of court cases in which this is true.[36]

The holder of a tract of substantially appreciated undeveloped land will probably encounter difficulties in trying to transfer the land to a corporation in a long-term capital gain transaction. With the corporation receiving a stepped-up basis, the favorable tax consequences of such an action usually warrant the effort, however. The holder of such appreciated property should not be made to suffer the penalty of having to pay income taxes at ordinary rates on the appreciation in land value arising during the holding period, simply because he desires to subdivide and develop the land into a more productive capacity. If the holder of the land were to sell the property outright to another party, who in turn subdivides and develops it, then the landholder would, more than likely, receive capital gain treatment. But, he is penalized if he develops the land himself.

Avoiding Collapsible Corporation Provisions of Section 341

Because small land development enterprises are often operated as close corporations which are likely to be partially or totally liquidated, they are frequently subject to the collapsible corporation provisions of Section 341 of the Internal Revenue Code. The fundamental principle of Section 341 is that a gain arising on the sale or exchange of stock in a corporation deemed a "collapsible corporation" must be reported as ordinary income, when the gain would, except for the provisions of Section 341, have been treated as a long-term capital gain. The legislative history underlying Section 341 reveals that the objective of Congress in enacting this statute "was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation."[37]

The determination of the collapsible status of a corporation rests on the definition in Section 341(b). As basically stated therein, a collapsible corporation is a corporation that is formed or availed of principally for the manufacture, construction, or production of property, or for the purchase of "Section 341 assets," or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of the stock by shareholders prior to the corporation's realization of a substantial part of the taxable income to be derived from the property, and (2) the shareholders realization of gain attributable to such property by the sale of their stock.[38] "Section 341 assets" represent property held for a period of less than three years which generally consist (with certain exceptions and limitations) of inventory, stock in trade, property held primarily for sale to customers, and unrealized receivables and fees.

According to Section 341(c), a corporation is considered to be collapsible if, at the time of the sale, exchange, or distribution of the stock, the "Section 341 assets" have a fair market value of (1) 50 percent or more of the fair market value of its total assets[39] and (2) 120 percent or more of the adjusted basis of the Section 341 assets. However, absence of these conditions, as Section 341(c) states, "shall not give rise to a presumption that the corporation was not a collapsible corporation."

Section 341(d) of the Code provides certain limitations on the application of collapsibility, and additional relief from the collapsible corporation rules is provided by Section 341(e) and Section 341(f). The limitations of Section 341(d), in short, state that the collapsible corporation provisions of Section 341 do not apply to a shareholder's gain on the sale or exchange of his stock or on the liquidation of the corporation if any one of the following three tests is met: (1) the shareholder owns not more than five percent in value of the outstanding stock of the corporation, (2) not more than 70 percent of the shareholder's gain is attributable to collapsible property, or (3) the gain with respect to the shareholder's stock is realized after three years following the completion of the manufacture, construction, production, or purchase of the property.

The last test for avoiding the application of collapsibility may provide some promise in regard to the holding of improved real property. In other words, if the construction can be completed and the property then held for three years, the collapsible corporation provisions can possibly be avoided. However, the taxpayer often has a difficult time showing that no construction has taken place on the property during the three years prior to the sale, exchange, or other disposition of the stock of the corporation. The smallest amount of activity which causes the value of the property to increase during this period may be held to be "construction" by the Internal Revenue Service and, therefore, begin a new three-year period.

The relief measures provided by Section 341(e) are generally aimed at protecting a non-dealer stockholder from collapsible treatment where the gain on the disposal of the stockholder's corporate stock is attributable primarily to assets that would have produced capital gain if they had been individually owned and sold by the stockholder. Section 341(f) provides relief against collapsibility with respect to certain sales of stock by shareholders of a corporation which gives written consent to recognize the gain on the sale of the stock when it later sells or disposes of so-called "Subsection (f) assets" in an otherwise tax-free transaction. "Subsection (f) assets" generally consist of noncapital assets, which for the purposes of the statute, include land, interests in real property, and unrealized fees and receivables. The stockholders must dispose of their stock within six months after the corporation files its consent. As a result of Section 341(f), which was added to the Code in 1964, shareholders of a corporation are given a limited opportunity to sell their stockholdings in the corporation without having the gain taxed as ordinary income, provided the corporation grants the appropriate consent to recognize the gain at a later date.

The collapsible provisions of Section 341 seem to cover practically all methods of disposing of corporate stock in which long-term capital gains rates are at issue.[40] One particular consequence is that these provisions usually eliminate the possibility of liquidating a corporation using the special liquidation procedures provided by Section 333 and Section 337 of the Code, if the corporation to be liquidated is deemed a collapsible corporation [except for certain limited situations covered under the relief provisions of Section 341(e)].

Section 333 provides for the deferral of gain, with certain restrictions, upon the complete liquidation of a corporation through the transfer of assets to "qualified electing shareholders," if the liquidation is completed in one calendar month. Section 337 contains provisions for a special type of liquidation procedure in which no gain or loss will be recognized at the corporate level from the sale or exchange of the corporate property if the corporation adopts a plan of complete liquidation and distributes all of its assets, with the exception of assets needed to discharge debts of the firm, in complete liquidation within twelve months from the date of adoption of the plan.

The chief benefit of both of the above remedial liquidation measures is that they avoid the double taxation condition prevalent under the general corporate liquidation provisions of Section 331, i.e., taxation at the corporate level when the assets are sold and taxation at the shareholder level when the sales proceeds are distributed to the shareholders. Furthermore, the provisions of Section 333 permit corporate shareholders to generally defer any gain on the receipt of assets received in the liquidation until they later dispose of the assets. Both remedial liquidation measures offer useful tax planning devices to corporations holding property appreciated in value, as long as the collapsible corporation provisions can be avoided.

To a great extent, the regulations, rulings, and court decisions dealing with the application of the collapsible corporation rules involve the following major issues arising in the Section 341(b) definition of the collapsible corporation: (1) when is there a "view to" avoiding taxes by "collapsing" the corporation, (2) when has a corporation realized "a substantial part" of the income to be derived from the property, and (3) what constitutes "construction" of property. The first two issues are more general in nature than the third, and the respective authorities related to them provide a broad basis for applying the collapsibility rules to many types of corporate enterprises. On the other hand, the third issue, dealing with the question of what constitutes "construction" for the purposes of defining a collapsible corporation, can be specifically analyzed with respect to individual enterprises, including particularly land development firms. The following discussion will place the greatest emphasis on the "construction" question as it applies to land development corporations. Unfortunately, in any event, the rulings and decisions regarding all three issues are frequently not too conclusive.

Regarding the "view to" question, the regulations state that the intent to exercise collapsibility

> is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was

> contemplated, unconditionally, conditionally, or as a recognized possibility. . . .[41]

Furthermore, the regulations provide that a corporation is collapsible if the requisite view to collapsing it existed at any time during the manufacture, production, construction, or purchase of the property concerned.[42]

Conflicting interpretations of the regulations pertaining to the "view to" problem are revealed by a review of the court decisions. For example, the Second and Fourth Circuits have tended to be very rigid in interpreting the collapsibility requirements of the regulations and have held that collapsibility is present if the "view to" collapsing the corporation existed at any time the corporation is "availed of" for the purpose of collapsing it, which may be at any time during its corporate life.[43] On the other hand, decisions of the Third and Fifth Circuits, in addition to many recent Tax Court, district court, and Court of Claims decisions, have frequently been more lenient in interpreting the collapsibility regulations. In general, these latter decisions have held that collapsible corporation treatment should be imposed on taxpayers only when the "view to" collapsing the corporation existed prior to or during the period of construction.[44]

Determining whether "a substantial part" of the income to be derived from corporate property has been realized prior to the sale, exchange, or liquidation of corporate stock by stockholders has also caused a number of problems in ascertaining whether a corporation is collapsible. "A substantial part," incidentally, refers to that portion of income already realized prior to the sale by the stockholders of their stock. However, no specific quantitative standard exists for determining "a substantial part."

In Commissioner v. James B. Kelley,[45] a 1961 Fifth Circuit Court of Appeals case, the Court held that collapsibility did not exist where 33 percent of a corporation's expected income was realized before the sale of stock by the stockholders. However, the Internal Revenue Service was definitely not satisfied with the Court's ruling in the Kelley case and issued Revenue Ruling 62-12,[46] which made it clear that the Service did not intend to follow the Kelley decision in the disposition of similar cases in the future. The Service was not satisfied that realization of one-third of the total net income that the firm might be expected to derive from its property should constitute "a substantial part" of the income to be derived.

Nevertheless, subsequent court cases, Commissioner v. E. J. Zongker,[47] Winn v. United States,[48] and George W. Day,[49] have ruled out collapsibility where the percentage of anticipated income that had been realized was respectively, 34 percent, 40 percent, and 56 percent. Finally, in 1972, Revenue Ruling 62-12, involving the Kelley case, was revoked by the issuance of Revenue Ruling 72-48.[50] This latter revenue ruling holds that

> A corporation which has realized one-third of the taxable income to be derived from property manufactured, constructed, produced or purchased is not on account of such manufacture, construction, production or purchase, a collapsible corporation within the meaning of section 341(b) of the Internal Revenue Code of 1954.

However, the revenue ruling also mentions that the fact that such a corporation is not collapsible does not preclude the Internal Revenue Service "from applying other provisions of the Code to tax the gain as ordinary income."

The issue of what constitutes "construction" for the purposes of determining a collapsible corporation under the definition in Section 341(b) has also given rise to a great deal of controversy and much litigation. In general, both the courts and the Internal Revenue Service have construed a broad meaning to the term, and the activities which these bodies have held as constituting "construction" are quite varied.

Section 341(b)(2) is very important in the "construction" determination problem. This section deals with the extent to which construction has taken place and contains the statement that

> . . . a corporation shall be deemed to have manufactured, constructed, produced, or purchased property if--(A) it

> engaged in the manufacture, construction, or production of such property to any extent. . .(Italics mine.)

Land development operations are frequently involved in the interpretation of "construction" for purposes of determining collapsibility. For example, as Samuel A. Frankel has noted, a builder may form a corporation and acquire a tract of land for subdividing and developing, but then discover that financing cannot be obtained or zoning changes cannot be instituted. If the corporation has in any manner begun construction on the tract, the corporation may be held to be collapsible upon the sale of its stock or upon its liquidation by the builder. In other words, as Frankel further emphasizes, preliminary activities which increase the value of the firm's stock may be considered by the courts to be "construction."[51]

In Abbott v. Commissioner,[52] the Third Circuit upheld a Tax Court decision in which a corporation was held to be collapsible because it had participated in subdividing land; installing streets, sewers, and other improvements; obtaining approval of the municipality; and securing financing through FHA commitments prior to its liquidation and distribution of the land to its stockholders. The stockholders, in turn, deeded a number of parcels of the land to buyers. Many of the improvements to the land were actually made after the liquidation had transpired, and some of the improvements occupied a part of the land which was dedicated to the municipality. The taxpayers argued that the corporation "was not engaged in construction in the first place" and, secondly, "that the increase in the value of the property was the result of the securing of FHA commitments and nothing else." The Tax Court held regarding the first argument that the preliminary aspects of construction which had taken place prior to liquidation were sufficient to qualify the corporation as a collapsible corporation, stating that "construction need not consist of the activities from start to completion." Regarding the second argument, the Tax Court presented the view that securing the FHA commitments was an act related to the other preliminary construction activities, and that "all the activity was interconnected and cannot be considered separately."

Similarly, in another case, Farber v. Commissioner,[53] the Second Circuit upheld the Tax Court's decision that a corporation was a collapsible corporation because the activities of the corporation were considered as constituting "construction," under the collapsible corporation provisions of the Code.[54] The corporation in question here had owned unimproved property suitable for residential development and had begun preparation for this type of development when the sole shareholder of the corporation sold all of his shares in the corporation to another corporation. The gain realized by the taxpayer on the sale was deemed to be ordinary income.

The preparations for the residential development, which the Tax Court held as constituting "construction," consisted of making arrangements with an architect to revise the map of the tract in accordance with the requirements of the municipality; filing applications for permits to erect houses; filing a bond to secure payment for water, sewer, and street improvements; paying a deposit for the purchase of materials for the improvements; making advance payments for utility connection; and filing applications with the FHA for conditional commitments to insure loans for the construction of houses.

Incidentally, an important point made in passing by the Second Circuit in the Farber case is that if a corporation was formed or availed of principally for the construction of property, "it is immaterial that this was not done principally with a view to collapse."[55] Hence, unsuspecting land developers may be caught in the collapsible corporation situation when they have no intention of collapsing their development corporation.

In Vernon W. McPherson,[56] a corporation, specifically organized to develop a tract of land and to build homes on the tract, was not held to be a collapsible corporation when the corporation was dissolved and unimproved land it was holding was distributed to its shareholders, even though a lot plan ("tentative plat") and topographic map of the entire tract was prepared prior to the dissolution. A review of the facts in the case convinced the Tax Court that the preliminary steps taken by the corporation did not constitute construction prior to the liquidation. Furthermore, the Court noted that the land asset was in the same condition at the time of liquidation as when it was purchased, i.e., a tract of rural timber land, and that no physical change had occurred to the land during the corporation's life. The Tax Court felt that at the time the corporation was formed and the land acquired that the incorporators had no intention of liquidating it before the realization of a substantial part of the income to be derived from the acquired property.

The corporation's expressed purpose at the time of formation and acquisition of the land was to subdivide the land into lots, build houses on the lots, and then sell the houses to the public. The intent to liquidate the corporation did not arise until the corporate officers found that they did not have sufficient working capital to carry out their building activities.

The McPherson case is interesting in that there was actually an expressed "construction" intent but no actual "construction" considered by the Court as having taken place and no "view to" collapsing the corporation. Therefore, the corporation was held by the Tax Court not to be collapsible.

Likewise, in Morris Cohen,[57] the Tax Court held that the limited development activities of a corporation did not constitute "construction" and, hence, the firm was not held to be collapsible. This case involves a non-real estate corporation which had acquired 80 acres of farmland, obtained a contour map of the land, prepared a preliminary plat to show how the land might be subdivided, and filed a petition to have the property rezoned as residential. The Tax Court, nevertheless, found that the corporation did not physically change or make improvements on the land and that the land was never held by the holders primarily for sale to customers in the ordinary course of business nor did they ever intend "to subdivide the properties and sell them as lots or as improved properties."

From the foregoing discussion it is obvious that the courts have not been very conclusive with regard to what constitutes "construction" in determining the collapsibility of corporations engaged in land development activities. The consequence is that land held by a corporation must be carefully scrutinized before any preliminary attempts are undertaken toward subdividing and developing it. Where a land development project is begun and then halted and the corporation liquidated, the likelihood that the corporation will be held collapsible is very high. Unfortunately, appreciation in the value of the land, even though attributable to the pre-incorporation period, may be taxed at ordinary income tax rates.

Making Use of the "Subchapter S" Election

Where the corporate form of business organization is found to be desirable for operating a small-scale land development enterprise, the developers should give careful consideration to the use of the election to have the firm taxed for Federal income tax purposes as a so-called "tax-option," or "Subchapter S," corporation, as provided by sections 1371 through 1378 of the Internal Revenue Code. As previously noted, the Subchapter S election often provides certain income tax advantages in comparison to the regular taxation of corporations.

The rigid requirements for qualifying for the Subchapter S election, however, as well as the mechanics of executing the election and maintaining the qualification once obtained, detract considerably from the attractiveness of using this tax-reporting measure. Furthermore, to obtain the greatest tax advantages from the election, the corporation officials must be aware of the many technicalities of the Internal Revenue Code and the corresponding regulations, rulings, and court decisions with respect to the election, particularly with regard to the distribution of earnings to stockholders.

One of the greatest dangers of operating under the Subchapter S election is that the election may be involuntarily terminated because of an act which causes one of the qualifying requirements to not be met. Considerable litigation and numerous revenue rulings have arisen regarding this matter. The result of having the election terminated is that for the year of the termination the corporation will be taxed as a regular corporation, which will usually have adverse effects on the amount of income taxes the firm will have to pay. Furthermore, when a corporation's election has been terminated, a new election cannot be made for five years.

Subchapter S corporations are often referred to as simply "corporations taxable as partnerships." As most writers on the subject are careful to note, this is far from true. Although there are similarities in the taxation of the Subchapter S corporation and the partnership, in many respects, the tax regulations applicable to each of the two types of entities are quite different. One particular area in which significant differences exist involves the taxation of the entity's earnings in the income tax returns of the individual owners of the enterprise. Unlike the partnership, the taxation of the Subchapter S corporation's earnings in the income tax returns of the firm's stockholders is affected by the distribution of the firm's earnings in cash.

As a matter of fact, the scheduling of earnings distributions in cash by Subchapter S corporations is a most significant consideration in selecting the Subchapter S election. Regarding this matter, one authority recommends that an "operating practice which should be observed by every Subchapter S corporation is the distribution by the corporation of all of its taxable income in cash to its shareholders every year."[58] Unless earnings are distributed in cash each year, a stockholder having a taxable year different from that of the corporation may be taxed on more than one corporate year's earnings in his income tax return of a given year. This unfavorable situation results from the complex manner in which earnings distributions of Subchapter S corporations are taxed in the individual income tax returns of corporation stockholders. Land development corporations, however, frequently lack sufficient cash to permit earnings distributions during the early periods of their development. Therefore, these firms may have difficulty in attaining the desirability of distributing all earnings currently in the event the Subchapter S election is adopted. This factor should not be overlooked in evaluating the desirability of selecting Subchapter S taxation for a land development enterprise.

Another important area of difference between the Subchapter S corporation and the partnership applies to the conduit nature of each. In relation to the partnership, the Subchapter S corporation is restricted as to the items which it can pass through to the entity owners. In general, it can only pass through the benefit of the corporation's net operating loss and long-term capital gain.

The ability to pass through to the individual owners the tax benefits of net operating losses of the business is one of the most important features common to both Subchapter S corporations and partnerships. The importance of this characteristic to land developers was previously noted in the discussion of partnerships.

The frequent occurrence of operating losses during the early years of a development venture encourages the use of the Subchapter S election by land development corporations so that these losses can be passed through to stockholders, rather than being "locked into" the corporation. As a matter of fact, in some cases the Subchapter S election will be executed while these losses are in existence so that the stockholders can take advantage of the losses in their individual income tax returns. Then, when the corporation becomes profitable, the election is sometimes revoked and regular corporate taxation commences. This latter practice normally occurs where the principal stockholders have individual income tax rates higher than the corporate tax rates, and the corporation can justify the accumulation of earnings for reasonable business uses and, therefore, avoid the "accumulated earnings tax."

In sum, the Subchapter S corporate tax election often provides small land development enterprises income tax advantages over the taxation of the firm as a conventional corporation. The election affords development firms many of the favorable non-tax features of corporate enterprises. However, the election to have a development firm taxed as a Subchapter S corporation must be exercised with caution because of the potential adverse consequences that may arise if the election is involuntarily terminated. Careful analysis of the rigid requirements for qualifying for the election and for maintaining the qualification once obtained must be exercised before the election is consummated. Furthermore, consideration should be given to the potential ability of the development firm to distribute all of its earnings in cash currently.

Summary

Small-scale residential land development firms can be operated under a variety of different entity forms. Evaluating the advantages and disadvantages of each of the various forms of doing business is an important task facing developers. Income tax factors occupy an extremely significant position in the selection of the appropriate entity form for a given development firm.

The present chapter has been devoted to an analysis of numerous income tax factors pertinent to the entity selection decision. The chapter discussion centered on specific income tax considerations relating to both noncorporate and corporate forms of ownership. The chapter also contained a brief review of certain non-tax factors.

In general, corporate enterprises possess more favorable non-tax features than do noncorporate firms. On the other hand, corporations generally have less advantageous income tax characteristics. To small-scale land developers, the limited personal liability feature seems to be the most significant non-tax corporate characteristic. As a matter of fact, small-scale developers frequently choose the corporate form of ownership primarily because of the limitation of liability of the investors in the firm.

Discussions of the following income tax considerations pertinent to <u>noncorporate</u> forms of ownership were contained in the chapter: (1) avoidance of the "double taxation" feature of corporations, (2) the "pass through" provisions relating to net operating losses of the firm, (3) the collapsible partnership provisions of the Internal Revenue Code, and (4) the use of the limited partnership form of ownership. Avoidance of the "double tax" burden is perhaps the chief income tax advantage of unincorporated enterprises. Second in importance is probably the ability to pass through operating losses to individual owners.

The pass through, or conduit, nature of noncorporate firms is particularly important in residential land development because of the likelihood that development firms will experience losses during the early years of their operations or during the initial stages of a new development project. The use of a noncorporate tax entity allows individual owners of a development firm to benefit from the deduction of company losses in their individual income tax returns. This conduit feature of noncorporate firms also applies to a certain extent to Subchapter S corporations.

Noncorporate land investors may be subject to the collapsible partnership provisions of the Code. The result in such cases is that gain on the sale of land will be taxed at ordinary income tax rates rather than at capital gains rates. Unsuspecting investors may be faced with this consequence if land which they sell is held to be "substantially appreciated inventory items." The chief issue with regard to the disposal of land is the determination whether the property represents "inventory items." The results of court cases in this area seem to be contradictory.

The limited partnership form of ownership holds considerable promise as an entity form which provides the basic income tax advantages of noncorporate firms, while at the same time affording certain investors in development firms the benefits of limited liability. An especially interesting feature of limited partnerships is the practice of using a corporation as the sole general partner in a limited partnership. The technicalities surrounding this unusual entity arrangement are presently in the formative stage. Future developments in this area should be extremely important to land developers, both small-scale and large-scale.

The discussion of income tax factors pertaining to <u>corporate</u> ownership included the following topics: (1) avoiding the penalty tax on improper accumulation of earnings, (2) transferring land to a corporation in a taxable transaction, (3) avoiding the collapsible corporation provisions of Section 341, and (4) making use of the "Subchapter S" election. Each of these corporate tax factors has a particular significance to land development firms.

The penalty tax on the improper accumulation of earnings, although a common deterrent to the use of the corporate form of organization, does not represent a major detriment to the retention of profits by land development corporations. The high cash needs of development firms ordinarily provide sufficient justification for the accumulation of earnings by these firms.

Through the transfer of unimproved land to a controlled corporation in a taxable transaction, landowners may be able to obtain capital gain taxation on the appreciation in value of the land from the time of acquisition until the time of the transfer to the corporation. In turn, the corporation, which is to serve as the subdivider and developer of the tract, will receive the property at a stepped-up basis. Through the taxable incorporation procedure, landholders can avoid having all of the profit on the ultimate disposition of developed land taxed at ordinary rates. However, many technicalities, as discussed in the chapter, surround the taxable transfer of land to a corporation.

Land development corporations are likely subjects of the collapsible corporation provisions of the Internal Revenue Code. For example, a land development corporation which acquires land with the intent to subdivide and develop it, but which later finds development not feasible, may be held to be collapsible when it is liquidated or dissolved. As a result, unwary investors may find that appreciation in the value of land held by the corporation may cause gain on the disposal of their stockholdings to be taxed at ordinary income tax rates. This situation usually arises where activities surrounding the holding of the land are considered as representing "construction" under the definition of collapsible corporations contained in the Internal Revenue Code and related tax authorities. Therefore, land held by a corporation must be carefully scrutinized before any measures are executed toward subdividing and developing it.

The Subchapter S corporate tax election is frequently suitable for use by small-scale land development organizations. The election provides these firms many favorable non-tax features of corporations while also providing them income tax advantages similar in nature to those of noncorporate enterprises. However, the desirability of exercising the Subchapter S election does not come without its difficulties. For example, the requirements for qualifying for the election and for maintaining the qualification once obtained are quite stringent. The dangers of having the election involuntarily terminated once it has been acquired must be carefully evaluated. Furthermore, consideration should be given to the potential ability of the development firm to distribute all of its earnings in cash currently. In short, land developers must exercise caution in selecting taxation as a Subchapter S corporation.

FOOTNOTES

[1]See Don Augustine and Ronald R. Hrusoff, "The Public Real Estate Limited Partnership," The Business Lawyer, XXVII (January, 1972), 615-626. According to these authors, the publicly-owned limited partnership "attempts to incorporate certain features of equity real estate investment trusts into the limited partnership framework." The public real estate limited partnership is a relatively new form of entity ownership in the real estate area which, unlike the "real estate investment trust," may be used for the purchase and development of unimproved property. However, as Augustine and Hrusoff note, many technical problems currently exist regarding public limited partnerships, and even though the number of such organizations is increasing, "they still have not received widespread acceptance by either the investment community or the governmental regulators." (Although details of the publicly-held real estate limited partnership will not be specifically discussed in this study, some important general aspects of limited partnerships will be presented in the present chapter.)

[2]The "business trust" is also commonly known as the "Massachusetts trust."

[3]The "real estate investment trust" is a type of tax entity (by definition, an unincorporated trust or unincorporated association meeting certain requirements) which is accorded special income tax treatment under Sections 856-858 added to the Internal Revenue Code in 1960. The special provisions of the Code applicable to this type of entity generally provide tax benefits to investors in firms which primarily obtain "passive income" from real estate investments, i.e., real estate rentals, interest, dividends, and gains from the sale of stock, other securities, and real property. Because the Code provisions do not permit such organizations to hold any property intended to be sold to customers in the ordinary course of business, the real estate investment trust cannot be used as the operating vehicle for a land development organization. However, real estate investment trusts do play an important role in the land development process by representing an important lending source to developers in financing the acquisition of raw land and the installation of site improvements.

[4]Reg. 301.7701-2. Also see Morrissey, 296 U.S. 344 (1935).

[5]See Martin J. Rabinowitz, "Realty Syndication: An Income Tax Primer for Investor and Promoter," Journal of Taxation,

XXIX (August, 1968), 93; and Julian R. Friedman, "Choosing a Form of Business Organization? Corporation Is Not Necessarily the Best Tax Route," Taxation for Accountants, VII (October, 1971), 212-213.

[6]The discussion of usurious interest rates is based primarily on information contained in Irving Schreiber, ed., How to Plan for Tax Savings in Real Estate Transactions (Based on a Tax Conference of The Tax Institute of C. W. Post College, Long Island University) (Revised ed.; Greenvale, N.Y.: The MacMillan Company by special arrangement with Panel Publishers, Inc., 1970), pp. I-4 & I-5; and Clay C. Long, "Tax Shelter in Real Estate Partnership: An Analysis of Tax Hazards That Still Exist," Journal of Taxation, XXXVI (May, 1972), 318. Both of these sources provide interesting points on the issue of usurious interest rates.

[7]Schreiber, How to Plan for Tax Savings in Real Estate Transactions, p. I-5. Incidentally, this source cites some of the representative cases heard by the courts on the issue of dummy corporations.

[8]See Reg. 301.7701-2(a)(3) and Morrissey, 296 U.S. 344 (1935).

[9]See p. 194 below.

[10]Sec. 701.

[11]Sec. 704(d) and Reg. 1.704-1(d).

[12]Sec. 752 and Reg. 1.752-1.

[13]Sec. 1374(c)(2).

[14]Reg. 1.1374-1(b)(4).

[15]Sec. 704(d) and Reg. 1.704(d)(1).

[16]Sec. 751(b)(2).

[17]Morse v. United States, 371 F.2d 474, 67-1 USTC 9186 (Ct. Cls. 1967).

[18]Ginsburg v. United States, 396 F.2d 989, 68-1 USTC 9429 (Ct. Cls. 1968).

[19] Freeland v. Commissioner, 393 F.2d 573, 68-1 USTC 9278 (9th Cir. 1968).

[20] J. T. Requard, 25 CCH Tax Ct. Mem. 732 (1966).

[21] Rev. Rul. 57-68, 1957-1 CB 207.

[22] Sec. 731(a).

[23] Sec. 732(b).

[24] Sec. 735(a)(2).

[25] See p. 173 above.

[26] Rev. Proc. 72-13, IRB 1972-2, 26.

[27] See Henry Weiler, "Limited Partnerships With Corporate General Partners: Beyond Rev. Proc. 72-13," Journal of Taxation, XXXVI (May, 1972), 306-311; and O'Hear W. Fraser, Jr., "Taxing the Limited Partnership as a Corporation," Taxes--The Tax Magazine, L (June, 1972), 333-342.

[28] Sec. 531 and Sec. 535.

[29] Reg. 1.537-2.

[30] Dahlem Foundation, Inc. v. United States, 405 F.2d 993, 69-1 USTC 9129 (6th Cir. 1969).

[31] For pertinent cases on this point see Camp Wolters Enterprises, Inc. v. Commissioner, 22 TC 737 (1954), affirmed 230 F.2d 555, 49 AFTR 283 (5th Cir. 1956); Pan American Trust Co., P-H Tax Ct. Mem. 45,183 (1945); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 11 AFTR 1112 (1932).

[32] "Taxable Incorporation of Land Can Pay Off--But Watch Your Step," Prentice-Hall Accountant's Weekly Report, April 7, 1969, Section One, p. 1.

[33] Ibid.

[34] Stanley Inc. v. Schuster, 295 F. Supp. 812, 23 AFTR 2d 69-715 (DC, Ohio; 1969). See also Burr Oaks Corporation v. Commissioner, 365 F.2d 24, 18 AFTR 2d 5018 (7th Cir. 1966).

[35]Royce W. Brown v. Commissioner, 448 F.2d 514, 28 AFTR 2d 71-5611 (10th Cir. 1971); 54 TC 1475 (1970).

[36]Burgher v. Campbell, 244 F.2d 863, 51 AFTR 463 (5th Cir. 1957); Tibbals v. United States, 362 F.2d 266, 17 AFTR 2d 1213 (Ct. Cls. 1966); Browne v. United States, 356 F.2d 546, 17 AFTR 2d 387 (Ct. Cls. 1966).

[37]Rev. Rul. 56-50, 1956-1 CB 174.

[38]Sec. 341(b).

[39]"Total assets" for this percentage test do not include cash, obligations which are capital assets of the corporation, short-term government obligations, or stock of another corporation.

[40]See Sec. 341(a).

[41]Reg. 1.341-2(a)(2).

[42]Reg. 1.341-2(a)(3).

[43]See Glickman v. Commissioner, 256 F.2d 108, 1 AFTR 2d 1883 (2nd Cir. 1958), affirming P-H Tax Ct. Mem. 57,124 (1957); Sidney v. Commissioner, 273 F.2d 928, 5 AFTR 2d 400 (2nd Cir. 1960), affirming 30 TC 1155; and Burge v. Commissioner, 253 F.2d 765, 1 AFTR 2d 1214 (4th Cir. 1958), affirming 28 TC 246.

[44]See Jacobson v. Commissioner, 281 F.2d 703, 6 AFTR 2d 5205 (3rd Cir. 1960), reversing 32 TC 893 (1959); Payne v. Commissioner, 268 F.2d 617, 4 AFTR 2d 5035 (5th Cir. 1959); Charles J. Riley, 35 TC 848 (1961); Southwest Properties, Inc., 38 TC 97 (1962); Elliott v. United States, 205 F. Supp. 384, 9 AFTR 2d 1418 (DC, Ore.; 1962); Tibbals v. United States, 362 F.2d 266, 17 AFTR 2d 1213 (Ct. Cls. 1966). Compare Max N. Tobias, 40 TC 84 (1963) and Epstein v. United States, 221 F. Supp. 479, 12 AFTR 2d 5598 (DC, Ohio; 1963).

[45]Commissioner v. James B. Kelley, 293 F.2d 904, 8 AFTR 2d 5232 (5th Cir. 1961); affirming 32 TC 135 (1959).

[46]Rev. Rul. 62-12, 1962-1 CB 321.

[47]Commissioner v. E. J. Zongker, 334 F.2d 44, 14 AFTR 2d 5242 (10th Cir. 1964), affirming 39 TC 1046.

[48]Winn v. United States, 243 F. Supp. 282, 16 AFTR 2d 5312 (DC, Mo.; 1965).

[49]George W. Day, 55 TC 257 (1970).

[50]Rev. Rul. 72-48, IRB 1972-6, 12.

[51]Samuel A. Frankel, "The Special Tax Problems of the Builder Who Operates in Corporate Form," Journal of Taxation, XXVI (January, 1967), 52.

[52]Abbott v. Commissioner, 258 F.2d 537, 2 AFTR 2d 5479 (3rd Cir. 1958), affirming 28 TC 795.

[53]Farber v. Commissioner, 312 F.2d 729, 11 AFTR 2d 511 (2nd Cir. 1963), affirming 36 TC 1142 (1961). See also E. J. Sterner, 32 TC 1144 (1959), pertaining to apartment house development, and Sproul Realty Company, 38 TC 844 (1962), pertaining to shopping center development.

[54]In this case, Section 117(m) of the Internal Revenue Code of 1939, the predecessor to Section 341 of the Internal Revenue Code of 1954.

[55]The Court is actually citing from a statement presented in Weil v. Commissioner, 252 F.2d 805, 1 AFTR 2d 1096 (2nd Cir. 1958).

[56]Vernon W. McPherson, 21 CCH Tax Ct. Mem. 583 (1962).

[57]Morris Cohen, 39 TC 886 (1963), dismissed 10th Cir., 1964.

[58]Richard L. Thomas, "Subchapter S . . . Eight Years Later," The Arthur Andersen Chronicle, XXVII (March, 1967), 37. This article contains an excellent discussion regarding the taxation of income to shareholders of Subchapter S corporations.

CHAPTER VI

SUMMARY AND CONCLUSIONS

The residential land development function has evolved from a previously unplanned process into an activity which emphasizes careful planning and coordination in the conversion of undeveloped land into residential homesites. Land development activities represent a manufacturing process which results in a product possessing many unique features, e.g., immobility, non-homogeneity of different development projects, and a long life span. The lengthy time period usually required for completion of development projects causes land development operations to be speculative in nature.

Organizations participating in residential land development are quite varied in nature. Firms in the industry range in size from one or a few individuals undertaking the subdivision and development of a limited number of acres to large, publicly-owned corporations carrying out development projects covering thousands of acres. Furthermore, participants in the land development activity vary considerably with respect to organizational forms of doing business, geographical extent of operations, duration of existence, and diversity of business activities.

A characteristic of practically all development firms is the extreme importance of carefully managing cash resources. Cash management is perhaps as significant in the land development field, if not more so, than in any other form of business activity. The particular emphasis on cash planning is the result of the strain on cash resources caused by the long time period required to complete development ventures and also by the fact that the period of time before a development firm can begin recouping its investment through the sale of lots may also be quite lengthy. Although developers ordinarily operate with large amounts of borrowed capital, they still face a drain on cash resources because of the sizable interest costs related to the borrowed funds.

The Federal income tax has a major influence on the operations of land development firms. For example, land development firms normally try to plan their activities so as to defer or reduce income taxes. This practice is particularly necessary because of the vital need of developers to conserve funds for current operating purposes.

In the area of accounting and financial reporting, the practices of land development firms have come under considerable scrutiny in recent years. Some authorities contend that inequitable accounting practices have been exhibited in the financial reports of firms in the industry, chiefly in the reports of the large-scale, publicly-owned enterprises. The significant increase in publicly-owned firms operating in the land development field intensifies the need for fair and reliable financial reporting procedures for the industry. The present interest in land development accounting practices seems to center on revenue reporting factors, particularly those factors related to revenue recognition.

Although a number of different authorities have proposed guidelines for assisting developers in applying the general revenue recognition rules (i.e., recognition of revenue at the point of sale) to retail land sales, none of the recommended guidelines has so far been very successful. The major difficulty in applying the general revenue recognition rules to retail land sales is the estimation of uncollectible receivable balances and the provision of adequate allowances for contract cancellations. None of the past attempts to develop revenue recognition guidelines has sufficiently resolved this problem. Furthermore, the revenue recognition guidelines proposed for retail sales of land have also been weak because of their inherent dependence on arbitrary rules and because of their discretionary application.

The "installment sales method" of reporting revenues was proposed in Chapter III of the study as the most appropriate method of recognizing revenue on retail land sales. The general nature of retail homesite sales (small down payment, lack of seller's recourse to buyer's general credit, difficulty in estimating uncollectible contracts, etc.) seems to require this departure from the general rule of recognizing revenue at the point of sale. The advantages of the installment method over the general revenue recognition method is that the installment method (1) eliminates the problem of establishing arbitrary standards regarding initial down payment and monthly cash payments, (2) eliminates the need for estimating uncollectible contracts and establishing a reserve for contract cancellations, (3) eliminates the need for using different methods of accounting for financial and income tax reporting when the development firm uses the installment method in its income tax reporting, and (4) tends to smooth out the revenue flows and, therefore, reduce the possible erratic, cyclical nature of the net profits reported by land development companies.

In reporting land sales revenue for income tax purposes, two particular features are especially important. These are (1) using the installment sales method in order to spread taxable income over more than one taxable year and (2) obtaining long-term capital gains treatment on the sales of certain parcels of land. Regarding the first feature, some noteworthy factors mentioned in the study are (1) payments received on an installment sale during the year of the sale cannot be more than 30 percent of the selling price of the property sold, (2) title to the property sold need not be conveyed to the purchaser, and (3) interest may be imputed for the contract (which will have the effect of altering the relationship between the amount of cash received in the year of sale and the sales price of the property and may cause the disallowance of the installment method for income tax reporting). With respect to the long-term capital gains feature, developers must be cognizant of the fact that they may be permitted taxation at capital gains rates on the sale of certain parcels of land if they can be considered an "investor" rather than a "dealer" with regard to the particular property sold.

In addition to the revenue reporting problems relating to land sales, land developers also face many difficulties in determining expenses in the periodic measurement of earnings. In general, the expense determination procedures in land development accounting are complicated by the extremely large amount of joint land and improvement costs existing in the land development activity. Determination of the cost of improved lots or sites involves the classification, accumulation, and allocation of these joint costs to individual lots or sites.

A number of different cost allocation methods have been accepted for financial statement presentation and for income tax reporting. For example, land and improvement costs have been allocated to various portions of a tract of raw land and to individual lots within the portions of a tract on such bases as relative values in existence during the year the tract was purchased, expected relative sales value of lots, number of lots in a tract, square footage, frontage feet, and assessed values. Unfortunately, in all instances, the applicability of a particular method in a given situation must rest on arbitrary considerations. As a result, developers have no way of avoiding a discretionary allocation of costs.

For income tax purposes, the courts have consistently refused to find the allocation of costs impossible in cases where real estate activities are involved. Thus, developers are forced to adopt cost allocation methods for tax purposes, and they are usually not permitted use of the "cost recovery method" in relating costs to revenues.

The important cost elements in the determination of periodic expenses in land development activities, as discussed in Chapter IV, are the following: land acquisition costs, non-salable portions of a development project, carrying charges, and site improvement costs. For the most part, these items create the same expense determination problems for developers from the standpoint of both financial reporting and income tax reporting. Likewise, the alternative accounting methods for handling these expense items under the two different reporting objectives are generally the same.

In some instances, however, land development firms use one alternative accounting method in income tax reporting and another in their external financial reporting. This is particularly true with respect to the handling of carrying charges. The Federal income tax laws provide developers a great deal of flexibility in this area. Likewise, considerable flexibility is available in financial reporting with respect to carrying charges. For example, arguments can be presented for both capitalizing and expensing these costs as they are incurred.

As Chapter IV noted, site improvement costs create some peculiar accounting problems for developers. One such problem pertains to the fact that certain site improvement costs may constitute investment expenditures for the developer, i.e., items to be accounted for in a separate asset account rather than as an inventory cost to be allocated to lots and expensed when the lots are sold. Site improvement expenditures possessing investment characteristics frequently involve the provision of water supply and sewerage disposal facilities. Numerous court cases have dealt with the issue whether such expenditures can be allocated to the cost of lots to be sold or whether they must be capitalized to a separate asset account. In the latter instance, cost recovery generally must await the sale of the facilities. The fundamental considerations in determining whether the expenditures can be allocated to the cost of lots to be sold are (1) whether the facilities were constructed to induce individuals to purchase lots, (2) whether the development firm retains "full ownership and control" of the property, and (3) does the firm "part with the property for the benefit of the subdivision lots." Other factors which have recently been given consideration by the courts are (1) whether the facilities are necessary for the sale of lots and will not be provided by another source (a municipality, for example), (2) whether the developer's intention in providing the facilities "was to sell lots or to make an independent investment in activity ancillary to the sale of lots or houses," and (3) the likelihood that the costs expended for the facilities will be recovered through later sale.

Another peculiar accounting problem pertaining to site improvement expenditures is that some of these costs may, under certain conditions, be refundable to developers. Such expenditures frequently involve payments, or deposits, made to utility companies to cover the utility companies' costs of extending their services to subdivided property. These expenditures may also involve instances where utility companies provide reimbursement to developers for costs incurred by the developers in installing utility lines which connect subdivided property with the services rendered by the utility companies. In either situation, the significant difficulty which exists with respect to these expenditures is that their recovery is usually uncertain. Arguments can be presented supporting each of the following two methods of accounting for these expenditures: (1) add the potentially refundable expenditures to the costs of lots to be sold or (2) account for them as a separate asset account in the nature of a receivable account. Current income tax authorities generally permit the inclusion of refundable expenditures in the cost of lots to be sold.

The issue of how to treat the utility refund receipts when they are received has not been fully resolved. A number of possible procedures exist, e.g., (1) treat the refund as income in full in the year received, (2) consider the refund as a deduction from the basis of lots to be sold ("cost recovery method"), and (3) consider the refund as income to the extent that income tax benefits were derived from earlier deductions of the improvement expenditures and treat the remainder of the refund as a recovery of the costs of lots yet to be sold. One source cited in the study recommends, at least for tax purposes, that the third method be followed.

A most significant factor pertaining to site improvement costs is that in both financial reporting and in income tax reporting future improvement costs may be estimated and included in the cost of lots sold before the expenditures have actually been incurred. The practice is necessary in financial reporting in order to reflect a proper matching of revenues and expenses when lots are sold prior to the completion of all related site improvements. Although the procedure should also be applied in income tax reporting, it is probably less used in this area because the income tax requirements for qualifying estimated future improvement costs for inclusion in the cost of lots sold is extremely complicated.

Chapter V of the study was devoted to an analysis of income tax factors in selecting the entity form for residential land development firms. The chapter also contained a brief review of certain non-tax factors. Primary emphasis in the chapter was directed toward factors pertinent to small-scale development firms.

In general, corporate enterprises were noted in Chapter V as possessing more favorable non-tax features than noncorporate firms. On the other hand, corporations usually have less advantageous income tax characteristics. To small-scale land developers, the limited personal liability feature seems to be the most significant non-tax corporate characteristic. Small-scale developers frequently choose the corporate form of ownership primarily because of the limitation of liability of the investors in the firm.

Some important income tax considerations relating to noncorporate forms of ownership are the following: (1) avoidance of the "double taxation" feature of corporations, (2) the "pass through" provisions relating to net operating losses of the firm, (3) the collapsible partnership provisions of the Internal Revenue Code, and (4) use of the limited partnership form of ownership. Avoidance of the "double tax" burden is perhaps the chief income tax advantage of unincorporated land development enterprises.

Some significant income tax considerations relating to corporate forms of ownership for land development firms, which were discussed in Chapter V, are the following: (1) avoidance of the penalty tax on improper accumulation of earnings, (2) transfer of land to a corporation in a taxable transaction, (3) avoidance of the collapsible corporation provisions of the Internal Revenue Code, and (4) making use of the "Subchapter S" election. Regarding the first consideration, high cash requirements of development firms ordinarily provide sufficient justification for the accumulation of earnings by these firms. Therefore, the penalty tax on the improper accumulation of earnings does not represent a major detriment to the retention of profits by land development corporations.

Through the transfer of unimproved land to a controlled corporation in a taxable transaction, a landowner may be able to obtain capital gains taxation on the appreciation in value of the land from the time of acquisition until the time of transfer to the corporation. Hence, landowners may avoid having all of the profit on the ultimate disposition of developed land taxed at ordinary rates. However, many technicalities surround the taxable transfer of land to a corporation.

Land development corporations are likely subjects of the collapsible corporation provisions of the Internal Revenue Code. For example, a land development corporation which acquires land with the intent to subdivide and develop it, but which later finds development not feasible, may be held to be collapsible when it is liquidated or dissolved. As a result, unwary investors may find that appreciation in the value of land held by the corporation may cause gain on the disposal of their stockholdings to be taxed at ordinary income tax rates. This situation usually arises where activities surrounding the holding of the land are considered as representing "construction" under the definition of collapsible corporations contained in the Internal Revenue Code and related tax authorities. Therefore, land held by a corporation must be carefully scrutinized before any measures are executed toward subdividing and developing it.

The Subchapter S corporate tax election is frequently suitable for use by small-scale land development organizations. The election provides these firms many of the favorable non-tax features of corporations while also providing them income tax advantages similar in nature to those of non-corporate enterprises. However, the desirability of exercising the Subchapter S election does not come without its difficulties. For example, the requirements for qualifying for the election and for maintaining the qualification once obtained are quite stringent. Furthermore, the dangers of having the election involuntarily terminated once it has been acquired must be carefully evaluated. In short, land developers must exercise caution in selecting taxation as a Subchapter S corporation.

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