Changes in the tax law during the past five years have adversely affected the income taxation of home builders and developers. As a result, for home builders faced with increased tax liabilities, income tax planning is critical.

**Choice of Tax Year**

Prior to 1987, partnerships, S corporations and personal service corporations could adopt non-calendar year ends in many circumstances. The use of non-calendar year ends typically results in the deferral of taxes from year to year.

The laws now require fiscal year S corporations and personal service corporations to adopt a calendar year end. Partnerships must adopt the same year end as the principal partner or a calendar year end if there is no principal partner. In some instances, entities have been allowed to retain their fiscal years but are required to make tax deposits with the Internal Revenue Service (IRS). Regular corporations (non-S corporations and personal service corporations) are unaffected by these provisions and are allowed to retain their fiscal year end for income tax purposes.

**Installment Reporting**

The installment method of reporting income allows taxpayers to defer reporting and paying taxes on gains from the sale of certain property. This favorable accounting method is only available to real estate investors selling property used in a trade or business. The Tax Reform Act of 1986 (IRA) repealed the use of this method for sales after 1987 for all developers and home builders. However, companies that sell certain time share units and residential lots may elect to report under the installment method by agreeing to pay IRS interest on the resulting tax deferral.

**Uniform Capitalization Rules**

Costs of constructing and improving real estate, including the cost of infrastructure, are subject to the uniform capitalization rules. These rules, enacted by the Tax Reform Act of 1986, provide for the capitalization and inclusion of certain expenses into inventory and are recoverable in the year such property is sold. This capitalization requirement includes all costs incurred with respect to property produced or acquired for resale, such as direct labor and material costs, indirect costs benefiting the production activity, interest, fringe benefits, health insurance, pension costs, and certain other general and administrative costs.

Interest costs must be capitalized throughout the production period beginning at the start of construction and ending when the property is ready for sale or use. However, if a home under construction is subject to a contract for sale, the production period ends on the contract completion date (close of escrow). The rules adopt an avoided cost approach, which requires the capitalization of interest on all direct construction loans and other loans to the extent that the construction costs exceed the amount of direct constructing loans.

**Cost Allocation Methods**

There are numerous methods available to allocate land and improvement costs, including the unit alloca-
tion method, the relative value method, the gross profit method, the sales price method, and the discounted present value method. These methods may result in significant differences in the cost basis of the various parcels.

Any one, or a combination, of these methods can be used. Land costs should be allocated on the date of acquisition, whereas improvement costs should be allocated when such improvements are complete or the property is sold. It is also important to distinguish between two types of improvement costs. “On-site” improvement costs benefit a particular parcel and should be allocated to such parcel. “Off-site” improvement costs benefit the project as a whole and should be allocated to all parcels using one of the above methods.

**Timing of Deductions**

The proposed regulations issued June 1990, under Section 461, adversely affect home builders and developers by revoking Revenue Procedure 75-25. This Revenue Procedure allowed developers and subdividers to include estimated costs of future improvements in the cost basis of property sold. As a result, income recognition may be accelerated to earlier years, until such estimated costs are actually incurred under the economic performance rules. However, in January 1991 the IRS issued Notice 91-4 providing guidance and temporary relief from the revocation of Revenue Procedure 75-25 until the proposed regulations are finalized. The notice provides that taxpayers can continue to follow Revenue Procedure 75-25, but must elect to do so for all sales after December 31, 1990. A copy of such election must be attached to the federal tax return for the first taxable year beginning after December 31, 1989.

**Passive Loss Provisions**

The Tax Reform Act of 1986 provides that losses generated from a passive activity can only be deducted to the extent of passive income. Disallowed passive activity losses and credits may be carried forward indefinitely and are generally allowed in full in the year of disposition. As a result, a large
portion of the tax benefits associated with real estate activities may be deferred until disposition or sale of the activity.

Real estate activities, such as home building, developing, and managing fall under these rules. The determination of whether an activity is passive or active is based on the degree of owner- or partner-participation in the activity. Rental real estates is deemed to be a passive activity, regardless of the level of participation.

**Long-term Contract Rules**

For all home builders and developers, other than those

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**Housing Manufacturers:**

**New Process and Foreign Challenges**

*By Allen Toman and James Shields*

The competition with Japan in processes (miniaturization, computerization, and least cost production) and in products (consumer goods, high tech goods, and automotive goods) is likely to expand to new housing production. Japan has several major firms that have applied modern technology and manufacturing principles to the production of housing, resulting in new materials, new products, and new distribution methods. The resulting development has started to revolutionize the Japanese housing industry and may lead to foreign domination of yet another American industry that has failed to modernize its production and distribution methods.

The housing systems of Japanese firms such as Misawa are produced in computer-controlled factories. The production methods involve ceramic-based materials poured into room-size molds in a variety of shapes and sizes resulting in room, or part-room, shaped modules that can be shipped to a site and bolted together. The modules meet stringent earthquake and fire standards, contain color in the material, can be finished in various surface textures, provide for rapid assembly, and can be configured into a variety of housing forms. Several of the Japanese manufacturers claim that the lapsed time between a customer order (via computer) and final assembly on a prepared site requires only two weeks.

The real challenge to the U.S. housing industry will be to understand and increase their efforts to apply modern manufacturing and distribution principles and to develop a sound capability to industrialize a growing amount of houses. This process may be accelerated should discussions between U.S. firms and Japanese housing producers result in a licensing agreement for the technology, or should these firms decide to enter the U.S. market themselves.

The prospects of Japanese industrialized housing firms to enter the U.S. market are low for the near term, given the current housing markets, the make-up of these firms, and the state’s regulatory environment.
who fit within the “small contractor” exception, the long-term contract rules were changed by the Tax Reform Act of 1986, by disallowing the use of the completed contract method for certain contracts entered into after February 28, 1986. However, these rules were subsequently modified and now allow the completed contract method for all “home construction contracts” entered into after June 20, 1988, for regular tax purposes, and for alternative minimum tax purposes, with respect to contracts entered into in tax years beginning after September 30, 1990.

Other

Tax credits have been enacted in order to encourage investment in low income housing and the rehabilitation of certain historical structures. The rehabilitation tax credit has a 20% credit for certified historic structures and 10% credit for other buildings, while the low income housing credit has a 70% credit for new non-federally subsidized building and a 30% credit for new federally subsidized buildings or existing buildings. Both credits are subject to recapture, if the structure is disposed of or becomes disqualified during the credit period, and are subject to the passive activity loss provisions.

The IRS recently ruled that homes used by a home builder as models or sales offices are not subject to allowances for depreciation. Therefore, the cost of such property can only be recovered in the year of sale. However, a home builder may want to consider a sale/leaseback transaction in order to mitigate the result of this ruling.

Tax benefits previously available to the real estate industry in the early 1980s have been curtailed by the Tax Reform Act of 1986 and subsequent law, resulting in higher tax costs in the early stages of development. With the application of numerous tax planning opportunities still available, a home builder or developer may be able to eliminate the adverse impact of these tax law changes.