[Bond Case Briefs]

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[Bellock v. United States]

United States District Court, D. Colorado - December 8, 2021 - F.Supp.3d - 2021 WL 5893982

"This case presents an issue of first impression on a question of the interplay between two different tax provisions: Rev. Proc. 92-29 and 26 U.S.C. § 103."

To construct the infrastructure for proposed residential subdivision, the developers (Developers) formed metropolitan districts (Metro Districts). The Metro Districts sought to pay for the necessary infrastructure through advances from Developers. The Developers invested a total of approximately $39 million for infrastructure in the various Metro Districts. In exchange for these payments, the Metro Districts issued the Developers bond anticipation notes (BANs). The Metro Districts intended to pay 8.5% interest on the BANs out of future property taxes levied on homeowners and businesses in the districts.

The Developers elected to treat their development costs pursuant to the Alternative Cost Method, set out in Rev. Proc. 92-29, 1992-1 C.B. 748. Under the Alternative Cost Method, upon the sale of a portion of property, a developer is entitled to take an allocable share of the estimated expenses for common improvements in computing the costs of goods sold with respect to the sold property. Costs of common improvement may include funds advanced to third parties, such as the advances made to the Metro Districts here. The Developers thus included the advances to the Metro Districts as costs of construction for purposes of determining the costs of goods sold. "There is no dispute that the Developers did not act improperly when using the Alternative Cost Method."

With regard to the interest from the Bond Anticipation Notes, the Developers used the "accrual basis," which required them to take income into account when earned, not necessarily when received. Each year, the Developers treated the repayment of principal on the BANs as ordinary income; the Developers separately took the interest accruals on the BANs in each year into income as tax exempt pursuant to 26 U.S.C. § 103. Pursuant to section 103, gross income does not include interest on any state or local bond.

The IRS audited the Developers' tax returns for 2010 to 2013. The IRS determined that it was permissible for the Developers to have treated their investments as development costs pursuant to the Alternative Cost Method. However, the IRS found that, having done so, the Developers were foreclosed from treating the interest accruals on the BANs as tax exempt. The IRS thus assessed increases in tax liability for the Developers.

Neither Party disputed that the interest paid on the bonds issued by the Metro Districts would ordinarily be tax-exempt and qualify for the section 103 exclusion. The United States instead argued that the Developers' application of the Alternative Cost Method transformed the underlying transaction, such that the section 103 exemption could no longer apply.

The Developers paid the assessed increases and sought a refund of their payments.

The United States District Court held that nothing in Rev. Proc. 92-29, or the Developers' application thereof, removed this transaction from the purview of section 103.

"The obligation at issue in this case is an obligation to repay the bonds issued by the Metro Districts — that is, to repay the principal on the bonds. The interest on that obligation reflects a promise to pay 8.5% for the right to defer payment on the bonds to allow the Metro Districts to pay out of future property taxes. Thus, regardless of whether the underlying obligation is characterized as a bond, a purchase of goods, etc., the interest on that obligation is distinct and remains tax-exempt under section 103."

"The exemption in section 103 applies to the transaction here. The interest at issue in this case is interest on an obligation of a political subdivision and, as such, is tax-exempt. Neither the case law nor the general tax principles cited by the United States supports its argument that the Alternative Cost Method, set forth in Rev. Proc. 92-29, forecloses tax-exempt treatment under section 103. The IRS's assessment in this matter was thus erroneous."