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April 27, 2009

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Proposed Regulations under Section 460

Dear Commissioner Shulman:

Enclosed are comments concerning proposed regulations under section 460, relating to accounting for long-term construction contracts that qualify for the home construction contract exemption. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis
Chair - Elect, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Eric A. San Juan, Acting Tax Legislative Counsel, Department of the Treasury
Brandon C. Carlton, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
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AMERICAN BAR ASSOCIATION SECTION OF TAXATION
COMMENTS CONCERNING
PROPOSED REGULATIONS UNDER SECTION 460

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jon G. Finkelstein of the Section’s Real Estate Committee. Substantive contributions were made by Carol Conjura, James B. Sowell, Peter J. Genz, Joseph G. Howe III, and Stephen M. Renna. These Comments were reviewed by Kevin Thomason, Chair of the Real Estate Committee, and Carol Conjura, Chair of the Tax Accounting Committee. These Comments were further reviewed by Jody J. Brewster of the Section’s Committee on Government Submissions, William H. Caudill, the Section’s Council Director for the Real Estate Committee, and Helen M. Hubbard, the Section’s Council Director for the Tax Accounting Committee.

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the Federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Jon G. Finkelstein
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Date: April 27, 2009

EXECUTIVE SUMMARY

On August 4, 2008, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) published a notice of proposed rulemaking in the Federal Register¹ containing proposed regulations (the “Proposed Regulations”) relating to the exemption from the mandatory application of the percentage of completion method of accounting for “home construction contracts” within the meaning of section 460(e)(6) (the “Home Construction Contract Exemption”) and regarding certain changes in method of accounting for long-term contracts.² We commend the Service and Treasury for issuing much needed guidance to the home construction industry, which is experiencing significant financial difficulties as a result of the current economic downturn.

The Proposed Regulations provide that the Home Construction Contract Exemption applies with respect to certain construction contracts related to land and condominium development. However, the Proposed Regulations provide that they may only be relied upon by taxpayers for taxable years beginning on or after the date final regulations are issued. As a result, calendar-year taxpayers would not be able to rely on these provisions until January 1, 2010, at the earliest. We are concerned that this proposed effective date unnecessarily delays the intended relief.

Separately, the preamble to the Proposed Regulations describes the Proposed Regulations as an expansion of the current scope of the Home Construction Contract Exemption. We believe that the Home Construction Contract Exemption currently applies to land development contracts. Further, given that Treasury and the Service have determined that the Home Construction Contract Exemption should apply to condominium developers and contractors in the same manner as the exemption applies to townhome and rowhouse developers and contractors, we recommend that, when finalized, the regulations clarify that the Service will not contest positions taken in tax years before the effective date of the final regulations that are consistent with the Home Construction Contract Exemption as set forth in the final regulations.

In addition, the preamble to the Proposed Regulations states that Treasury and the Service expect to propose specific severing and completion rules for home construction contracts accounted for using the completed contract method and requests comments on the types of severing and completion rules that should apply. We believe that the current regulations under section 460 provide appropriate general standards for determining whether a home construction contract or contracts should be severed or aggregated and considered complete. The existing regulations allow for the reporting of income by home construction contractors that is consistent with common business practice in the industry and clearly reflects income. We recommend that Treasury and the Service consider adding specific examples of multi-unit and multi-lot home construction contracts that would not be severed into multiple contracts under the existing regulations, consistent with the analysis of a multi-unit contract set forth in *General Dynamics Corporation v.*

¹ 73 Fed. Reg. 45,180 (2008).

² References to a “section” herein are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

*Commissioner.*³ In addition, we believe that any changes to the standards set forth in the current regulations should first be issued in proposed form.

³ T.C. Memo. 1997-420 (1997).

DISCUSSION

1. The Home Construction Contract Exemption – Generally

Section 460(a) generally provides that taxable income from any long-term contract must be determined under the percentage of completion method as set forth in section 460(b). For purposes of section 460(a), a long-term contract is “any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into.”

In general, under the percentage of completion method, net income is reported over the term of the long-term contract based on a ratio of costs incurred over total estimated costs to be incurred in connection with the contract. As a result, this method of accounting is not tied to actual receipt of payments on a contract and, for many home developers, results in the recognition of taxable income prior to the receipt of any cash that could be utilized by the developer to pay the tax attributable to such income.

Section 460(e) provides an exception to the application of the percentage of completion method for certain construction contracts. Specifically, section 460(e)(1) provides that sections 460(a), (b) and (c)(1) and (2) do not apply to any “home construction contract.” Regulation section 1.460-4(c) provides that a taxpayer may use the completed contract method for a home construction contract. Under the completed contract method, a taxpayer takes into account in the taxable year during which the contract is completed the gross contract price and all allocable contract costs incurred. In general, the gross contract price includes all amounts that a taxpayer is entitled by law or contract to receive with respect to the contract, whether or not the amounts are due or have been paid, including all bonuses, awards and incentive payments to the extent the “all events test” (as set forth in Regulation section 1.451-1(a)) is satisfied.⁴ Further, a taxpayer generally must annually allocate to the contract certain direct and indirect costs of any activities that are incident to or necessary for the taxpayer’s performance under the contract pursuant to Regulation section 1.460-5(d).

Section 460(e)(6) provides that, for purposes of section 460(e):

The term ‘home construction contract’ means any construction contract if 80 percent of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to [the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvement of, real property] with respect to –

(i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and

⁴ Reg. § 1.460-4(d)(3).

(ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

For purposes of clause (i), each townhouse or rowhouse shall be treated as a separate building.⁵

Regulation section 1.460-3(b)(2)(i) clarifies the definition of home construction contract as follows:

A long term construction contract is a *home construction contract* if a taxpayer (including a subcontractor working for a general contractor) reasonably expects to attribute 80 percent or more of the estimated total allocable contract costs (including the cost of land, materials, and services), determined as of the close of the contracting year, to the construction of –

(A) Dwelling units, as defined in section 168(e)(2)(A)(ii)(I), contained in buildings containing 4 or fewer dwelling units (including buildings with 4 or fewer dwelling units that also have commercial units); and

(B) Improvements to real property directly related to, and located at the site of, the dwelling units.

In addition, Regulation section 1.460-3(b)(2)(iii) provides that “a taxpayer includes in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units.”

2. Proposed Regulations on Definition of a Home Construction Contract

The Proposed Regulations provide that “a long-term construction contract is a home construction contract if a taxpayer (including a subcontractor working for a general contractor) meets the 80% test in paragraph (b)(2)(i) of this section as applied to either paragraph (b)(2)(i)(A) of this section [regarding dwelling units] or paragraph (b)(2)(i)(B) of this section [regarding improvements to real property], or both paragraphs (b)(2)(i)(A) and (b)(2)(i)(B) of this section, collectively.”⁶

Accordingly, the Proposed Regulations make it clear that a land developer or contractor that constructs improvements to real property directly related to, and located at the site of,

⁵ Section 168(e)(2)(A)(ii)(I) provides that “the term ‘dwelling unit’ means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis.”

⁶ Prop. Reg. § 1.460-3(b)(2)(iv)(B).

a dwelling unit, but does not construct any portion of the dwelling unit, can qualify for the Home Construction Contract Exemption.

In addition, the Proposed Regulations provide that, for purposes of determining whether a long-term construction contract is a home construction contract under Regulation section 1.460-3(b)(2), “the term townhouse and rowhouse includes an individual condominium unit.”⁷

We commend Treasury and the Service for providing regulatory guidance specifically addressing land and condominium developers and contractors. However, we note that, as proposed, the regulations would apply only to taxable years beginning on or after the date that final regulations are published in the Federal Register and taxpayers would not be able to change or otherwise use a method of accounting in reliance upon the principles contained in the Proposed Regulations until the issuance of final regulations. In addition, the preamble to the Proposed Regulations states that the provisions related to the application of the Home Construction Contract Exemption to land and condominium developers and contractors “expand” the current scope of the exemption. We believe that the Home Construction Contract Exemption does apply to land developers under current law and that the Proposed Regulations should be viewed as a clarification, rather than an expansion, of the scope of the exemption with respect to such contractors.⁸

Under the plain language of section 460(e)(6)(A) and the regulations thereunder, the Home Construction Contract Exemption currently applies to land developers. As described above, a construction contract currently qualifies as a “home construction contract” for purposes of the Home Construction Contract Exemption if a contractor (including a subcontractor) reasonably expects to attribute 80 percent or more of the estimated total contract costs to construction activities with respect to (i) dwelling units and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units. Section 460(e)(6)(A) and the regulations thereunder do not state that, in order for a contract to qualify as a “home construction contract,” contract costs must be attributable to *both* dwelling units and improvements to real property directly related to such dwelling units. In fact, the legislative history to section 460(e)(6)(A) suggests that Congress intended the Home Construction Contract Exemption to broadly cover both dwelling unit construction contracts and land development contracts.⁹

⁷ Prop. Reg. § 1.460-3(b)(2)(iii).

⁸ The Service has, however, taken a contrary position in certain nonprecedential documents. See TAM 200552012 (Dec. 30, 2005) (holding that income from land development sales did not qualify for the Home Construction Contract Exemption because the construction contract activities at issue did not involve the building of dwelling units); Internal Revenue Service, *Industry Director Directive on Super Completed Contract Method*, 2007 TAX NOTES TODAY 64-47 (March 13, 2007) (LEXIS, FEDTAX lib., TNT file, elec. cit. 2007 TNT 64-47) (providing field direction to Service examiners regarding the “improper” use of the completed contract method by, among other taxpayers, land developers and their subcontractors).

⁹ See H.R. Conf. Rep. No. 100-1104, at 118 (1988) (“a contract is a home construction contract if 80 percent or more of the estimated total costs to be incurred under the contract are reasonably expected to be

In addition, if section 460(e)(6)(A) were interpreted to require the construction of both dwelling units and improvements to real property directly related to such dwelling units, then an electrical or roofing subcontractor would not qualify for the Home Construction Contract Exemption because, although such a contractor would be considered to incur costs with respect to the construction of a dwelling unit, such a contractor would not be able to attribute any of their costs to improvements to real property described in (ii) above. In our experience, the Home Construction Contract Exemption has not been interpreted in such a manner. Accordingly, if the Home Construction Contract Exemption applies to a subcontractor that does not construct any land improvements, we believe the Home Construction Contract Exemption should also apply to a land developer that does not construct any dwelling units.

Finally, the current regulations under section 460(e)(6)(A) deem common improvement costs to be dwelling unit costs. Specifically, Regulation section 1.460-3(b)(2)(ii) provides that, for purposes of section 460(e)(6)(A)(i) construction activities (i.e., construction activities that are “with respect to dwelling units”),

a taxpayer includes in the cost of the dwelling units their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law to construct within the tract or tracts of land that contain the dwelling units.

The effect of this subsection is to require only that the taxpayer construct the common improvements, and not that the taxpayer construct any part of the dwelling units to which the common improvements relate. Therefore, we believe that the Proposed Regulations simply clarify the scope of the Home Construction Contract Exemption as currently drafted.

In addition, many land developers and contractors had accounted for their contracts as home construction contracts based on a reasonable interpretation of the current law. Given that the positions reflected in the Proposed Regulations confirm that this is a reasonable interpretation of the law, clarifying the ability to currently apply this interpretation would avoid what might otherwise be costly controversies for many years to come, which would seem an unwarranted use of limited resources.

Accordingly, we respectfully suggest that, when finalized, the regulations clarify that the Service will not contest positions taken by taxpayers in tax years before the effective date of the final regulations that are consistent with the Home Construction Contract Exemption as set forth in the final regulations.

attributable to the building, construction, reconstruction, or rehabilitation of, *or* improvements to real property directly related to and located on the site of, dwelling units . . .” [Emphasis added]).

3. Severing and Completion Rules for Home Construction Contracts

The preamble to the Proposed Regulations states that Treasury and the Service expect to propose specific severing and completion rules for home construction contracts accounted for using the completed contract method and requests comments on the types of severing and completion rules that would result in the clear reflection of income for such contracts. Specifically, the Proposed Regulations request comments on the circumstances in which it would not be appropriate to require severing and completion of a home construction contract to be determined on a dwelling unit-by-dwelling unit or lot-by-lot basis, or, when a contract is not for the sale of a dwelling unit or lot, on the basis of when the taxpayer receives a payment or payments on the contract.

Regulation section 1.460-1(e) provides that a taxpayer must determine whether one agreement should be treated as two or more contracts, or whether two or more agreements should be treated as one contract, based on the facts and circumstances known at the end of the contracting year. In addition, the Commissioner may apply the severing and aggregation rules contained in Regulation section 1.460-1(e) as necessary to clearly reflect income (*e.g.*, to prevent unreasonable deferral (or acceleration) of income or the premature recognition (or deferral) of loss).

For the reasons discussed below, we believe the circumstances in which it would be appropriate to sever a contract on a lot-by-lot or dwelling-unit-by-dwelling unit basis, or in the case of a contract for construction services not involving the sale of a unit or lot, on the basis of when payment is received, should be based on the principles set forth in the existing final regulations. The regulations provide that the determination as to whether an agreement should be severed, or two or more agreements aggregated, must take into account (1) pricing terms (*e.g.*, interdependent or independent pricing), (2) delivery and acceptance terms, and (3) a whether a reasonable business person would have entered into one or more agreements based on the terms of such agreement or agreements.

Regulation section 1.460-1(c)(3) provides that a taxpayer's contract is completed upon the earlier of:

- (A) Use of the subject matter of the contract for its intended purpose (other than for testing) and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or
- (B) Final completion and acceptance of the subject matter of the contract.

In addition, Regulation section 1.460-1(c)(3)(ii) provides that the completion date for a contract accounted for under the completed contract method is determined without regard to whether one or more secondary items have been used or finally completed and accepted. The regulations do not define what constitutes the "subject matter" or a "secondary item" with respect to a contract. As in the regulations related to severing and aggregation of contracts, Regulation section 1.460-1(c)(iv) provides that the determination of when final completion and acceptance of the subject matter of a contract

occurs is based on all the facts and circumstances. Thus, the determination of whether a home construction contract is complete necessarily requires an evaluation of the pricing, delivery and acceptance terms of the contract.

The Tax Court's analysis and application of the predecessor rules to a multi-unit contract in *General Dynamics v. Commissioner*¹⁰ is instructive. In *General Dynamics*, the Tax Court held that a contract to build 480 aircraft for the U.S. Government over a 48-month period was not required to be severed into four separate agreements, each for the delivery of 120 aircraft. The Tax Court analyzed the contract at issue under the rules contained in former Regulation section 1.451-3, which permitted the Service to sever a contract into multiple contracts based on criteria similar to those currently contained in Regulation section 1.460-1(e). Specifically, former Regulation section 1.451-3(e)(1)(ii) provided:

Whether an agreement should be so severed or several agreements so aggregated will depend on all the facts and circumstances. Such facts and circumstances may include whether there is separate delivery or separate acceptance of units representing a portion of the subject matter of the contract, whether such units are independently priced, whether there is no business purpose for one agreement rather than several agreements or several agreements rather than one agreement, and such other factors as customary commercial practice, the dealings between parties to the contract, the nature of the subject matter of the contract, the total number of units to be constructed, manufactured, or installed under the contract, and the contemplated time between the completion of each unit.

The Tax Court, quoting from the same regulation, noted that separate delivery or separate acceptance of portions of the subject matter of a contract does not necessarily require severing. The Tax Court also noted that it had previously emphasized that the independent pricing factor should, among the various facts and circumstances, be given "special emphasis."¹¹ The Tax Court in *General Dynamics* similarly focused primarily on the independent pricing factor in its analysis. The court noted that significant cost savings were obtained by the taxpayer and the U.S. Government by entering into a multi-year contract. The taxpayer did not agree to a fixed price for a portion of the contract or negotiate a separate price for later program years under the contract. Rather, all of the aircraft were priced in a single negotiation that resulted in a single pricing formula for all 480 aircraft. The Tax Court distinguished the binding contract at issue from a series of options under which a purchaser has complete discretion to cancel the contract at any time and purchase only the units delivered prior to the date of cancellation. In addition, the Tax Court found that the taxpayer and the U.S. Government had valid business purposes for entering into a multi-year contract, as opposed to four separate contracts. Specifically, the court concluded that the principal motive for entering into a multi-year contract was to realize

¹⁰ T.C. Memo 1978-420.

¹¹ Citing *Sierracin Corp. v. Commissioner*, 90 T.C. 341, 369 (1988).

substantial cost savings to the U.S. Government and higher profits to the taxpayer. Finally, the Tax Court acknowledged that the taxpayer's income would be accelerated if the contract were severed into four separate contracts, but that as a matter of principle, the completed contract method permits deferral beyond that which would be permitted under the accrual method and as such, the taxpayer's income is clearly reflected by treating the contract as a single contract.

Under the existing regulations, consistent with *General Dynamics*, separate delivery or acceptance of the subject matter of the contract does not necessarily require an agreement to be severed,¹² and the interdependent pricing and reasonable business person tests are also important factors.¹³ A rule that would require severing of a contract on a lot-by-lot or similar basis would produce results virtually identical to an accrual method of accounting and, therefore, would render the completed contract method virtually meaningless in the context of multi-unit contracts. We do not believe this is consistent with the statutory provision that permits use of the completed contract method for home construction contracts.

We believe that the existing facts and circumstances and reasonable business person tests are the proper guidelines for the application of the severing and completion rules with respect to home construction contracts. It is clear from their wording that the severing and completion rules were devised to operate primarily as anti-abuse rules by preventing taxpayers from structuring transactions in an uneconomic manner in order to achieve tax deferral. The severing rules were first instituted when the completed contract method was widely available to any and all long-term contracts and, thus, at a time when more tax deferral was at stake. By enacting section 460, Congress limited the deferral of income by mandating the percentage-of-completion method in most cases, rather than by imposing more stringent severing rules. Thus, we believe it is not appropriate for the severing rules to serve as a proxy to achieve results that are closer to the percentage-of-completion-method in those instances in which Congress expressly chose to retain the availability of the completed contract method.

The facts and circumstances and reasonable business person tests are an appropriate safeguard in this regard and should be applied to multi-unit and multi-lot home construction contracts of developers and their subcontractors. As such, we recommend that Treasury and the Service retain the facts and circumstances and reasonable businessperson standards as currently provided in the regulations under section 460. In addition, we think it would be helpful to provide examples

¹² Reg. § 1.460-1(e)(2)(ii).

¹³ 64 Fed. Reg. 24,096 (May 5, 1999) (the preamble to the notice of proposed rulemaking states the following: "The criteria adopted in the proposed regulations generally are consistent with the Tax Court's conclusions in *Sierracin Corporation v. Commissioner*, 90 T.C. 341 (1988), acq. 1990-2 C.B. 1 and *General Dynamics Corporation v. Commissioner*, T.C. Memo 1997-420").

of multi-unit and multi-lot home construction contracts, consistent with the analysis set forth in *General Dynamics*. We also believe that any changes to the standards provided in the regulations should first be issued in proposed form.

We believe a home construction contract should not be severed on a unit-by-unit or lot-by-lot basis when the parties negotiate a single price for all construction activities to be performed under the contract, the contract is binding so that a portion of the contract may not be cancelled at either party's sole discretion, and the parties have a business purpose for entering into a single contract rather than multiple contracts, such as to obtain cost savings. For example, a plumbing contractor that enters into a single binding multi-year contract to install plumbing equipment in connection with the development of a multi-unit condominium project should not be subject to having the contract severed into multiple unit-by-unit contracts if the pricing terms of the contract with respect to each condominium unit are interdependent. Such a subcontractor typically contracts to install plumbing for all of the units in the development for a single price rather than on a unit-by-unit basis and the plumber and developer obtain a cost savings as a result. Similarly, a land developer that enters into a binding multi-year contract to deliver lots in connection with multi-unit home development project should not be subject to having the contract severed into multiple contracts on a lot-by-lot basis where the pricing terms with respect to each lot are interdependent. In contrast, the contract of a land developer that provides for delivery of finished lots in phases, and that provides the homebuilder-customer with an option (or other agreement that has substantially the same economic effect as an option) to take or not take delivery of any particular lots should be severed on a lot-by-lot basis. Due to the option, the price of each lot would be independent because it would reflect the developer's speculative risk.