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Development Rights: Are Acquisition Costs Depreciable?

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Buildings are depreciable, land is not. This is a fundamental tenet of real estate income taxation. As a result, taxpayers have significant economic motivation to allocate costs to the tax basis of depreciable components of real estate. A commonly asked question is whether costs incurred to obtain favorable zoning for real property are included in the basis of the land and therefore nondepreciable or may be allocated to buildings which are depreciable. A recent tax court case, *Maguire/Thomas Partners Fifth & Grand, Ltd. v. Commissioner*, IRA TC Memo 2005-34 (Feb. 28, 2005), is one of the few cases to take a close look at this issue.

Maguire/Thomas Partners Library Square, Ltd. (Library Square) built Library Tower, a 73-story office building in Los Angeles. Maguire/Thomas Partners Fifth & Grand, Ltd. (Fifth & Grand) built Grand Place Tower, a 55-story building in Los Angeles. Both of these buildings were built pursuant to a development agreement reached in 1985 with the Community Redevelopment Agency of the City of Los Angeles. The agency was paid over \$33 million for certain land and development rights with respect to Library Tower and \$17.7 million for development rights with respect to Grand Place Tower. These development rights consisted of variations (what we call variances in New York) and zoning changes that enabled Library Square and Fifth & Grand to develop their properties

at greater density than would have otherwise been permitted.

Library Square included approximately \$18.9 million in the depreciable basis of the Library Tower, and Fifth & Grand included the \$17.7 million paid for development rights in the depreciable basis of the Grand Place Tower. Depreciation deductions based on those amounts were taken in their respective tax returns.

Capitalization of Costs

The Internal Revenue Service disallowed the depreciation Library Square and Fifth & Grand had claimed with respect to costs incurred to acquire development rights. It contended that the development rights could not be separated from the parcels, were interests in land akin to a zoning change, and did not have a limited useful life.

Section 167 of the Internal Revenue Code generally allows as a depreciation deduction a reasonable allowance for exhaustion and wear and tear of property used in business or property held for the production of income. Land, however, is generally not depreciable because it has no limited useful life and is not subject to exhaustion or obsolescence.

The court cited *Galt v. Commissioner*, 19 T.C. 892, 910 (1953), for the proposition that a taxpayer's cost of obtaining a zoning change for that taxpayer's land must be capitalized and is not depreciable if the benefits resulting from the zoning change are indefinite and undeterminable in duration.

[T]he court then analyzed the issue as follows:

. . .the Library Tower and Grand Place Tower variations would not survive the buildings for which those variations were granted. If Library Tower or Grand Place Tower were to be replaced, the owner could not build another building exceeding the then-zoning building density limit for the property without obtaining a second variation. . . .

The variations, by their terms, become irrevocable when the Community Redevelopment Agency certifies that construction and development of the property has been completed satisfactorily. Respondent argues that this means that the variations conveyed a benefit to the landowner that is either perpetual or indefinite. We disagree. Both parties' experts testified to the contrary and said essentially that the variations do not automatically apply to buildings built after those already placed in service.

The court concluded: (1) the costs of the Library Tower and Grand Place Tower variations are allocable to the particular building that was the subject of each variation and not to the land; (2) those variations have limited useful lives equal to the depreciable lives of Library Tower and Grand Place Tower; and (3) the costs of obtaining those variations are includable in the depreciable basis of Library Tower and Grand Place Tower.

In reaching those conclusions, the court distinguished between the variations and a zoning change the taxpayers had obtained at about the same time by way of a city ordinance. That ordinance (1) treated the five parcels of the Library Square tract as a single building site in order to comply with the city charter's 13-to-1 building density limitation, and (2) provided a mechanism whereby the unused building density of some adjacent parcels could be used for the Library Tower and Grand Place Tower parcels.

The Court reasoned that, unlike the Library Tower and Grand Place Tower variations, the zoning changes produced benefits of an indefinite and undeterminable duration, since they would continue in effect until repealed by the City. Although the City could repeal the ordinance that effected these zoning changes, that possibility exists for any zoning situation. No property owner, at least not in Los Angeles, said the court, has a vested right to have its property's current zoning continued.

Based on this reasoning, the court concluded that the zoning changes pro-

duced benefits of an indefinite and undeterminable duration for the Library Tower and Grand Place Tower parcels and/or the owners of those parcels. The Court thus held that the cost of obtaining this zoning change was not depreciable by either Library Square or Fifth & Grand, but it must instead be capitalized.

The discussion of whether a given cost is land or building in *Maguire* and other cases tends to obfuscate the real issue: does the benefit obtained by the expenditure have a definite, determinable useful life? The court seemed to decide *Maguire* solely based on whether each benefit had a determinable or an indeterminate useful life. Is it clear, however, that the indefinite duration of zoning changes is or should be dispositive? Where a taxpayer obtains zoning changes for the sole purpose of constructing a particular building, should it be determinative, to the exclusion of all other considerations, that when the building is demolished, after what could be 100 years, the zoning changes may still be in effect.

New York City has categories of development rights that seem to be analogous to those addressed in *Maguire*. There are variances that may become useless to the owner of the parcel if the building is entirely destroyed. On the other hand, we are told there are zoning lot mergers and other development rights which may have indefinite useful lives. While real estate counsel familiar with local zoning codes should be consulted to determine the attributes of any particular development right, *Maguire's* mandate to depreciate at least some of the costs incurred to acquire development rights should be helpful when deductions are challenged by a tax auditor.

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