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Whose Improvement Is It Anyway? —*Allocating Benefits and Burdens During Change*

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Developers who subdivide, improve and sell property are the least tax-advantaged of the real estate community. They recognize income as they sell units, or sometimes even earlier; they cannot defer income with like-kind exchanges or installment sales; and they pay tax at ordinary income rates. It follows that determining the basis of the units sold is of vital importance to this industry. *Hutchinson v. Commissioner*, 116 T.C No. 14 (2001), deals with the allocation to basis of the cost of common improvements which benefit the lots being sold by a developer.

The taxpayers in *Hutchinson* were shareholders in an S corporation, Valley Ranch Inc. ("VRI"). In December 1993, VRI acquired an option to purchase a 526-acre parcel of real estate that the sellers had begun developing as a golf course residential community. VRI also entered into an agreement with the sellers obligating VRI to continue to develop the property. In May 1994, VRI exercised its option and purchased the property.

At that time, VRI entered into a contract with Valley Club Inc. ("Club"), a nonprofit membership corporation. Under this contract, VRI reaffirmed its obligation to construct a golf course and a golf clubhouse and, upon completion, to transfer ownership thereof to Club, which would operate a golf membership club and sell memberships to homeowners within the golf course community and to the public. In return, Club would pay to VRI the total proceeds it received from the sale of memberships. The deed to the golf course and the clubhouse was to be transferred out of escrow to Club on the earlier of December 31, 2000, or when at least 25 charter memberships, 375 golf memberships, and 100 golf social memberships were sold.

Construction Begins

In 1994, VRI began construction of the golf course and the clubhouse, and started to sell the residential lots on the property. New owners of the residential lots, or their contractors, began building homes on the lots, and Club proceeded to sell memberships. Construction of the golf course and the clubhouse was completed in the summer of 1996. However, because Club had not sold the required number of memberships, VRI managed and operated the golf course and clubhouse during a three-year transition period (beginning upon the completion of the golf course and clubhouse in 1996 and ending upon their transfer to Club). The golf course and clubhouse were finally turned over to Club in April of 1999.

VRI's federal income tax return for 1994 was prepared allocating a ratable portion of actual and estimated costs of the golf course and clubhouse to VRI's cost bases in all of the residential lots on the property, thereby reducing VRI's reported gain with respect to the lots sold. The Internal Revenue Service initially contested the allocation of the golf course and clubhouse costs to the lots sold, but later conceded the allocation of the golf course costs.

Under Revenue Procedure 92-29, 1992-1 Cum. Bull. 748, a real estate developer is permitted to allocate to lots sold an allocable share of the estimated costs of common improvements, without regard to whether those costs have been actually incurred at the time the lots are sold. The amount of such costs that qualify for this allocation in any one year is limited to the total cumulative amount of actual construction costs for common improvements that, as of the end of such year, the developer has incurred in the entire development. Moreover, under Revenue Procedure 92-29 (1) the developer must be contractually obligated or required by law to provide the common improvements and (2) the cost of common improvements must not be properly recoverable by the developer through depreciation deductions.

The issue in Hutchinson regarding allocation of VRI's estimated clubhouse construction costs to lots sold turned on whether VRI, at any time, would have been able to recover its actual construction costs in the clubhouse through depreciation. The taxpayers contended that at no time would VRI have had the right to recover its clubhouse construction costs through depreciation and the IRS disagreed.

Thus, the requirements of Revenue Procedure 92-29 led the Court to the complex question of when a taxpayer has a depreciable interest in an asset. Clearly, VRI was not entitled to depreciation deductions while the clubhouse was under construction, since depreciation may not be taken before an asset is placed in service. The question was whether VRI had a depreciable interest in the clubhouse during the transition period (*i.e.*, the period beginning when the Clubhouse was placed in service and ending on the date that it was transferred to Club). The answer to this question depends on an analysis of the benefits and burdens relating to the ownership of the clubhouse during the transition period.

Prior to the time the clubhouse was placed in service, VRI transferred title to the clubhouse into escrow. The transfer of legal title to Club was scheduled to occur no later than December 31, 2000, regardless of how much had been received in membership fees and regardless of the amount of VRI's losses in connection with operation of the clubhouse during the transition period. Therefore, during the transition period, Club (not VRI) stood to benefit from an increase in the fair market value of the clubhouse, and conversely, Club (not VRI) would suffer economically for any decrease in the fair market value of the clubhouse. In this regard the court quoted from *Commissioner v. Moore*, 207 F.2d 265, 268 (9th Cir. 1953), rev'g. and remanding 15 T.C. 906 (1950),

> It is not the physical property itself, nor the title thereto, which alone entitles the owner to claim depreciation. The statutory allowance is available to him whose interest in the wasting asset is such that he would suffer an economic loss resulting from the deterioration and physical exhaustion as it takes place.

Until transfer of title from the escrow to Club, VRI was required to fund any deficit and was entitled to retain any net income from operating the clubhouse. Club, however, had control over the amount of dues charged to members, and Club thereby largely controlled the income or loss to be realized from operation of the clubhouse. Moreover, during the transition period Club was obligated to (and in fact did) pay for the insurance relating to the clubhouse.

Based on these factors, the court found that Club, and not VRI, possessed the benefits and burdens of ownership during the transition period. Therefore, because VRI was not entitled to depreciation deductions at any time, it was entitled to allocate the estimated cost of the clubhouse to the bases of the lots it sold.

A reader of the court's opinion in *Hutchinson* might conclude that the case revolves around an arbitrary prerequisite to obtaining the benefits of Revenue Procedure 92-29 (*i.e.*, establishing the lack of a depreciable interest). This is not the case. Revenue Procedures, at least in theory, do not establish principles of tax law; they merely establish procedures for taxpayers to follow. The principles underlying Revenue Procedure 92-29 were established by a long line of cases supporting the proposition that the future costs of a common improvement that a developer is obligated to make can be allocated among the lots sold.

Long Line of Cases

The first of these cases is *Kentucky Land, Gas & Oil Co.*, 2 BTA 838 (1925). The taxpayer in that case was a corporation engaged in the business of selling lots in a tract of land that contained oil deposits. Purchasers were entitled to a proportionate share of any income resulting from the extraction of oil from any portion of the tract. The taxpayer obligated itself to each purchaser to drill one well in the tract. The taxpayer took the position, and the Board of Tax Appeals agreed, that the taxpayer was entitled to include in the basis of lots sold during the tax year a proportionate share of the estimated cost of drilling the well, since the cost of drilling the well was in effect an additional cost of each lot sold.

Cambria Development Co., 34 BTA 1154 (1936), was the first case to apply the holding of *Kentucky Land* to a developer of residential properties. In *Cambria*, the developer sold individual lots in a residential tract and agreed with each purchaser to construct streets and install water mains throughout the tract. The developer was allowed to add the estimated cost of those improvements, to be incurred after the sales, to its basis in the lots at the time of each sale.

Cambria was followed by several cases, all of which involved costs of one kind or another incurred by residential developers. For example, in *Country Club Estates, Inc.*, 22 TC 1283 (1954), a developer who donated land to a country club for use as a golf course was permitted to add the cost of the donated land to the basis of adjacent residential lots because "the basic purpose of [the taxpayer] in transferring the land was to bring about the construction of a country club so as to induce people to buy nearby lots."

These cases establish two principles: (1) costs of a common improvement may be added to the basis of another asset and (2) even amounts not yet expended may be included in basis.

The requirement of the Revenue Procedure that the taxpayer not have a depreciable interest in the common improvement is also based on case law, since a taxpayer's ability to depreciate an asset is a measure of the taxpayer's ownership of the asset. In *Colony Inc.*, 26 TC 30 (1956), the court held that the cost of a water supply system could not be added to the cost of lots in the development for which the system was built, because the developer retained full ownership and control of the water system. The Court in *Colony* relied on an earlier case, *Biscayne Bay Islands Co.*, 23 BTA 731 (1931), which held that the cost of land set aside by a developer as a playground in a residential subdivision could not be added to the basis of lots in the subdivision, because the developer retained a reversionary right in the playground after the expiration of a ten-year period.

In *Estate of Collins*, 31 TC 256 (1958), the Tax court concluded that if a developer constructs a facility the "basic purpose" of which is to induce sales of the lots in the development, the cost of the facility is added to the basis of the lots, even though a developer retains "tenuous rights without practical value" to the facility. If, however, the developer retains full ownership and control of the facility, the cost of the facility is not includable in the basis of the lots.

Where a developer incurs costs to build an improvement benefiting other property, clearly, he should get a tax basis for the costs, but where? Does the basis inhere in the asset constructed or the asset benefited? If the developer owns the common improvement, then it is appropriate to allocate the basis to the improvement. However, if the developer does not own the improvement, (a) that fact indicates that the cost was really incurred to increase the value of the other assets, and (b) since he cannot depreciate the common improvement, the only way for him to recover his costs is to allocate basis to assets that he does own (even if those assets are disposed of before all of the common improvement costs are incurred).

Therefore, the principles underlying *Hutchinson*, including the requirement that the developer not have depreciable basis in the common improvement, are well grounded in case law and based on sound tax policy.