A Reprint from *Tierra Grande*, the Real Estate Center Journal

Estimated Future Costs Reduce Gains on Lots

By Jerrold J. Stern

The Internal Revenue Service now allows developers to reduce their gain from selling lots by subtracting estimated future common area costs. A recent tax court case demonstrates how developers can maximize this benefit.

A developer plans to build ten houses of equal value on a tract of land. The developer is contractually obligated to provide common improvements that will benefit all the houses equally. The developer estimates that these common improvements will cost $500,000, including the cost of the land associated with the common improvements.

Each house's allocable share of the **estimated future cost** of the common improvements is $50,000 ($500,000/10 houses). Thus, the general rule allows the tax basis of each house to include its $50,000 share, thereby reducing the amount of gain when the house is sold. There are, however, two exceptions to the general rule.

Exceptions to the Rule

Actual cost exception. The developer can only include costs **actually spent** in the tax basis of homes sold. Assume the developer sells four houses during the first year. To include a total of $200,000 (4 x $50,000) of common improvement costs in the tax basis of the houses sold, the developer must have actually spent $200,000 or more on common improvement costs by the end of that year.

If the developer spends only $130,000 during the first year, then the $130,000 is allocated among the four houses sold, rather than $200,000. If the developer spends a total of $225,000 during that year, each house is allocated its $50,000 maximum.

Depreciation exception. The second exception is that the cost associated with depreciable property owned by the developer (such as a $390,000 clubhouse) cannot be included in the cost basis of the lots. Instead, the developer can only recover that cost through annual depreciation deductions.

For the clubhouse, annual depreciation deductions would be $10,000 per year ($390,000 divided by 39 years, the minimum write-off period for nonresidential structures). Other examples of depreciable property include sidewalks, roads, sewers, tennis courts and swimming pools.

A Case in Point

In March 2001, the tax court decided a case that enables developers to avoid the depreciation rule. Seeds for the case were planted in 1993 when a developer purchased raw land and began developing a golf course residential community.

The following year the developer began selling lots and entered into a contract with a nonprofit membership corporation. The developer was to construct a golf course and clubhouse. Ownership of the completed golf course and the clubhouse would be transferred to the membership corporation, which would then establish and operate a golf membership club. In return, the membership corporation would pay the developer all fees received on the sale of club memberships.

Construction of the golf course and clubhouse was completed in 1996. During a nearly three-year transition period ending in April 1999, the developer managed and operated both facilities on behalf of the membership corporation.

Profits and losses from operating the golf course and clubhouse during the transition were included on the developer's tax return; the membership corporation was responsible for decisions and costs related to any further facility improvements. Increases or decreases in the underlying fair market value of the golf course and clubhouse occurring during the transition period would have ultimately benefited the membership corporation rather than the developer.

The membership corporation received the deed and legal title to the golf course and clubhouse on April 21, 1999. From then on, it was fully responsible for their operations.

The IRS contended that the developer retained an ownership interest in the clubhouse through the transition period. Therefore, the estimated construction costs should be recovered through annual tax depreciation. The court disagreed, however, and concluded that during the transition period, the membership corporation possessed the benefits and burdens of ownership of the clubhouse.

The estimated construction costs associated with the clubhouse, said the court, should not be recovered through depreciation deductions but should be allocated to the cost basis of the lots, thereby reducing the developer's taxable gains.

As this case demonstrates, tax rules and computations for development costs can be complex. Consultation with an accountant, attorney or real estate professional is recommended.

Dr. Stern is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University. His e-mail address is stern@indiana.edu.

LOWRY MAYS COLLEGE & GRADUATE SCHOOL OF BUSINESS

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031
800-244-2144 orders only

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal,* is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year.