

Reg. Section 1.1237-1(c)(5)(iii)

Real property subdivided for sale.

(c) Disqualification arising from substantial improvements—

...

(5) Special rules relating to substantial improvements. Under certain conditions a taxpayer, including a corporation to which subdivision (iv) of this subparagraph applies, may obtain the benefits of section 1237 whether or not substantial improvements have been made. In addition, an individual taxpayer may, under certain circumstances elect to have substantial improvements treated as necessary and not substantial.

- (i) When an improvement is not considered substantial. An improvement will not be considered substantial if all of the following conditions are met:
 - (a) The taxpayer has held the property for 10 years. The full 10-year period must elapse, whether or not the taxpayer inherited the property. Although the taxpayer must hold the property 10 years, he need not hold it for 10 years after subdividing it. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.
 - (b) The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, sub-surface, or both) or roads, including hard surface roads, curbs, and gutters.
 - (c) The district director with whom the taxpayer must file his return is satisfied that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites.
 - (d) The taxpayer elects, as provided in subdivision (iii) of this subparagraph, not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.
- (ii) Meaning of similar building site. A similar building site is any real property in the immediate vicinity whose size, terrain, and other characteristics are comparable to the taxpayer's property. For the purpose of determining whether a tract is marketable at the prevailing local price

for similar building sites, the taxpayer shall furnish the district director with sufficient evidence to enable him to compare (a) the value of the taxpayer's property in an unimproved state with (b) the amount for which similar building sites, improved by the installation of water, sewer, or drainage facilities or roads, have recently been sold, reduced by the present cost of such improvements. Such comparison may be made and expressed in terms of dollars per square foot, dollars per acre, or dollars per front foot, or in any other suitable terms depending upon the practice generally followed by real estate dealers in the taxpayer's locality. The taxpayer shall also furnish evidence, where possible, of the best bona fide offer received for the tract or a lot thereof just before making the improvement, to assist the district director in determining the value of the tract or lot if it had been sold in its unimproved state. The operation of this subdivision and subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. A has been offered \$ 500 per acre for a tract without roads, water, or sewer facilities which he has owned for 15 years. The adjacent tract has been subdivided and improved with water facilities and hard surface roads, and has sold for \$ 4,000 per acre. The estimated cost of roads and water facilities on the adjacent tract is \$ 2,500 per acre. The prevailing local price for similar building sites in the vicinity would be \$ 1,500 per acre (i.e., \$ 4,000 less \$ 2,500). If A installed roads and water facilities at a cost of \$ 2,500 per acre, his tract would sell for approximately \$ 4,000 per acre. Under section 1237(b)(3) the installation of roads and water facilities does not constitute a substantial improvement if A elects to disregard the cost of such improvements (\$ 2,500 per acre) in computing his cost or other basis for the lots sold from the tract, and in computing his basis for any other property owned by him.

Example 2. Assume the same facts as in example (1) of this subdivision, except that A can obtain \$ 1,600 per acre for his property without improvements. The installation of any substantial improvements would not constitute a necessary improvement under section 1237(b)(3), since the prevailing local price could have been obtained without any improvement.

Example 3. Assume the same facts as in example (1) of this subdivision, except that the adjacent tract has also been improved with sewer facilities, the present cost of which is \$ 1,200 per acre. The installation of the substantial improvements would not constitute a necessary improvement under section 1237(b)(3) on A's part, since the prevailing local price (\$ 4,000 less the sum of \$ 1,200 plus \$ 2,500, or \$ 300) could have been obtained by A without any improvement.



(iii) Manner of making election. The election required by section 1237(b)(3)(C) shall be made as follows:

(a) The taxpayer shall submit:

(1) A plat showing the subdivision and all improvements attributable to him.

(2) A list of all improvements to the tract, showing:

- (i) The cost of such improvements.
- (ii) Which of the improvements, without regard to the election, he considers substantial and which he considers not substantial.
- (iii) Those improvements which are substantial to which the election is to apply, with a fair allocation of their cost to each lot they affect, and the amount by which they have increased the values of such lots.
- (iv) The date on which each lot was acquired and its basis for determining gain or loss, exclusive of the cost of any improvements listed in subdivision (iii) of this subdivision.

(3) A statement that he will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lot in the tract and which either he listed pursuant to (a)(2)(iii) of this subdivision or which the district director deems substantial.

(b) The election and the information required under (a) of this subdivision shall be submitted to the district director:

- (1) With the taxpayer's income tax return for the taxable year in which the lots subject to the election were sold, or
- (2) In the case of a return filed prior to August 14, 1957, either with a timely claim for refund, where the benefits of section 1237 have not been claimed on such return, or, independently, before November 13, 1957, where such benefits have been claimed, or
- (3) If there is an obligation to make disqualifying improvements outstanding when the taxpayer files his return, with a formal claim for refund at the time of the release of the obligation, if it is then still possible to file a timely claim.

(c) Once made, the election as to the necessary improvement costs attributable to any lot sold shall be irrevocable and binding on the taxpayer unless the district director assesses an income tax as to such lot as if it were held for sale in the ordinary course of taxpayer's business. Under such circumstances, in computing gain,

the cost or other basis shall be computed without regard to section 1237.

- (iv) Exceptions with respect to necessary improvements and certain corporations. For taxable years beginning after December 31, 1954, individual taxpayers and certain corporations may obtain the benefits of section 1237 without complying with the provisions of subdivisions (i) (c) and (d), (ii), and (iii) of this subparagraph if the requirements of section 1237 are otherwise met and if:
 - (a) The property in question was acquired by the taxpayer through the foreclosure of a lien thereon,
 - (b) The lien foreclosed secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) secured the payment of an indebtedness to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of the stock of the corporation and other consideration, and
 - (c) In the case of a corporate taxpayer, no shareholder of the corporation holds real property for sale to customers in the ordinary course of his trade or business or holds a controlling interest in another corporation which actually so holds real property, or which, but for the application of this subdivision, would be considered to so hold real property.

Thus, in the case of such property, it is not necessary for the taxpayer to satisfy the district director that the property would not have brought the prevailing local price without improvements or to elect not to add the cost of the improvements to his basis. In addition, if 80 percent or more of the real property owned by a taxpayer is property to which this subdivision applies, the requirements of (a) and (b) of this subdivision need not be met with respect to property adjacent to such property which is also owned by the taxpayer.