REAL ESTATE & OIL AND GAS TAX UPDATE

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Real Estate Tax Matters.

***Sugar Land Ranch Development, LLC v. Commissioner*,**
T.C. Memo 2018-21 (Feb. 22, 2018)

This case concerned a real estate development partnership attempting to classify proceeds from the sale of real estate as a capital gain rather than ordinary income. In this case the partnership bought a tract of land in southwest Houston which contained an abandoned oil field intending to develop the land into single family residential building lots and commercial tracts. Between 1998 and 2008 the partnership capped oil wells, removed oil gathering lines, did environmental cleanup, built a levee and entered into a development agreement with the City of Sugar Land, Texas. There were certain fragmented sales of the property between 1998 and 2008. In 2008, because of the subprime mortgage meltdown, the partnership ceased all developmental activity on the real estate and decided to hold the property as an investment until the financial crisis abated. The partnership held the property until 2012 when it was sold in two large transactions and the balance and smaller transactions. With respect to one of the tracts of land, the partnership retained a 2% payment which would accrue as each home sale took place. On each tract a bonus fee was to be paid for each plat recorded. Initially at the final partnership administrative adjustment the sales proceeds were classified as ordinary income. Petitioner contested this assessment and the Court held that in the Fifth Circuit the three principal questions to be considered in deciding whether gain is capital are: (1) was the taxpayer engaged in the trade or business, and, if so, what was the business; (2) was the taxpayer holding the property primarily for sale in that business; and (3) were the sales contemplated by a taxpayer ordinary in that course of business.

The Court noted that the partnership's documents showed that it was originally intended to be in the business of selling residential and commercial lots to customers. However, the evidence also shows that in 2008 this intent changed. The evidence also showed that the partnership never even sold a single residential or commercial lot to a customer, nor did it ever subdivide the property. Therefore, the partners were entitled to classify the proceeds from the sale of the property as capital gains.

Repair vs. Capital Expenditures for Real Estate.

In *Wells v. Commissioner*, T.C. Memo 218-11 (January 31, 2018), the taxpayer owned a 265 acre property where she cultivated white French hybrid rind grape vines and leased parts of the property for grazing horses and cattle. There was a spring on the southern part of the property and in the past a pipeline ("springline") had been installed to carry water from the

spring to other areas of the property to provide irrigation for grazing for the pasture land and for the grapevines. In a prior year, a wildfire burned approximately 26 acres of the property which caused the land to be classified as hydrophobic; the heat from the fire had decreased or destroyed the land's capacity to absorb water. Petitioner had hired people to repair breaks in the springline for irrigation and in addition hired people to remove burned tree stumps and turn the soil so that the 26 area acres could again be used for forage. The repair of the springline became more comprehensive and finally the bulk of the line was replaced with new, improved piping which had a greater strength to avoid leakage. Petitioner deducted the costs of the springline repairs and the 26 acre remediation as an ordinary and necessary business expense.

Whether an expense is deductible or must be capitalized is a factual determination. This determination is made to determine whether or not the repair expenses either materially add to the value of the property or appreciably prolong its life. This contrasts with expenditures incurred to keep the property in an ordinarily efficient operating condition. The 10th Circuit Court of Appeals adopted what has been called the "one year" rule of thumb under which an expenditure should be capitalized if it involves the acquisition of an asset having a useful life in excess of one year. In examining the expenditures for the pipeline the Court noted that the bills for the repair or replacement were not clear as to what work had actually been done. They did, in essence, find that the entire line was replaced in 2009 and 2010 with new pipe that did not have susceptibility toward leakage. Petitioner argued that the life of the asset was not extended and the value of the springline was not increased by the repairs. The Court found it was difficult to understand how asset life and value could remain the same considering that the old, crumbling and leaky pipe was entirely replaced with a new and higher quality pipe. The Court concluded that the work on the springline and the ancillary repairs totaling $123,799.25 may not be deducted under Section 162 but must be capitalized. With respect to the burned area, the petitioner argued that the land was not being converted for a new and different use but merely to restore its value to what existed prior to the fire. The Court found that prior to the fire only a portion of the land was used for grazing and this conversion was designed to make the total 26 acre area adoptable for future use in the production of forage. Because of this fact the Court was unable to conclude that petitioner's expenditures did not adapt a significant portion of the land for new use. Accordingly, the expenditures must be capitalized.