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FILLING, GRADING, EXCAVATING

LAND IMPROVEMENTS MAY YIELD DEDUCTIONS

By **Jerrold J. Stern**

In general, the cost of land cannot be written off for tax purposes until the land is sold. Under certain conditions, however, some land improvement costs can be depreciated over 15 years. These depreciation deductions can provide substantial tax savings.

Tax Savings

Assume \$1.5 million is paid for various land improvement costs by a developer-investor who has a 35 percent marginal tax rate. If these costs are depreciable, the developer-investor will save \$35,000 in income taxes each year for 15 years or \$525,000 in total. The tax savings are computed as follows:

$$\begin{array}{r}
 \frac{\$1,500,000 \text{ depreciable cost}}{15 \text{ years}} = \$100,000 \text{ depreciation} \\
 \text{deduction per year} \\
 \times 35 \text{ percent tax rate} \\
 \hline
 = \text{\$35,000 tax savings} \\
 \text{per year} \\
 \times 15 \text{ years} \\
 \hline
 = \text{\$525,000 tax savings}
 \end{array}$$

This example illustrates straight-line depreciation, but accelerated depreciation is also allowable.

In contrast, if the land improvement costs are not depreciable, the \$1.5 million cost reduces taxable gain when the land is sold. This also provides \$525,000 in tax savings (35 percent of \$1.5 million) but not until the land is sold.

If the land is never sold (for example, if it is bequeathed to heirs), the owner realizes no tax benefit. If the land is sold many years in the future, the present

value of the tax savings is small in today's dollars.

Rule for Depreciable Costs

The general rule followed by the IRS and the courts is that land improvement costs incurred after initial clearing and grading, such as excavating and final grading, are subject to depreciation if they are "directly associated with buildings," rather than "inextricably associated with land." The underlying requirement for treating improvements as directly associated with buildings is that the improvements would normally be replaced (or their cost incurred again) if the building is replaced.

Initial land clearing, initial grading and other improvements necessary to make the land permanently suitable for any type of structure are considered inextricably associated with the land, making the costs nondepreciable. These improvements last indefinitely. They do not have a limited useful life and therefore are not depreciable for tax purposes.

Depreciable Land Improvements

- Landscaping, shrubberies, ornamental trees, fences, sewers, irrigation systems, sidewalks, roads and other paved surfaces are depreciable if they will be destroyed when the building is replaced.
- Roads and trails of a cattle ranch leading to stables and other improvements are depreciable.

- Costs of designing and constructing lagoons are depreciable.
- Grading and shaping land to carve out spaces for pads, patios and roadbeds for a particular mobile-home park were held to be depreciable costs because any other future use of the land would require removal of the pads and patios as well as reshaping the land.
- Building up, filling and grading for roads and a parking lot for a particular race track were held to be depreciable because of their direct association with the racing activity. The land improvements would not be suitable for other uses.

Careful Analyses

When land improvements are contemplated, careful analyses should be performed to segregate costs into depreciable and nondepreciable categories. Maintaining two separate accounts on the taxpayer's books will help substantiate the taxpayer's intentions. Both accounts should be separate from any building accounts, as buildings are depreciable over 27 to 40 years while depreciable land improvements are written off in 15 years.

Taxpayers who wish to depreciate land improvements should seek the advice of a tax accountant or attorney. ♦

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