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Part I

Section 167.--Depreciation

26 CFR 1.167(a)-2: Tangible property.
(Also § 168.)

Rev. Rul. 2001-60

ISSUE

Are land preparation costs incurred by a taxpayer in the original construction or reconstruction of golf course greens subject to an allowance for depreciation under § 167 of the Internal Revenue Code?

FACTS

Two types of golf course greens that are currently in use are "push-up" or natural soil greens and "modern" greens. Push-up or natural soil greens are essentially landscaping that involves some reshaping or regrading of the land. The soil is pushed up or reshaped to form the green. While push-up or natural soil greens may have limited irrigation systems (such as hoses and sprinklers adjacent to the greens), a subsurface drainage system is not utilized.

Modern greens make use of technological changes in green design and construction and contain sophisticated integrated drainage systems. The construction of the modern green occurs after the general earthmoving, grading, and initial shaping of the area surrounding and underneath the green. These greens are constructed with a network of subsurface drainage tiles or interconnected pipes, one or more layers of gravel and/or sand particles, a rootzone layer, and a variety of turfgrass. Over time, the

modern green loses its effectiveness as a drainage system due to tile or pipe deterioration, or sediment blockage. Replacement of the subsurface drainage tiles or pipes requires excavation and replacement of the gravel layer, rootzone layer, and turfgrass above the tiles or pipes. The subsurface drainage tiles or pipes typically are replaced within 20 years.

LAW AND ANALYSIS

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business or held for the production of income.

Section 1.167(a)-2 of the Income Tax Regulations provides that in the case of tangible property, the depreciation allowance applies only to that part of the property that is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to land apart from the improvements or physical development added to it.

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

The applicable recovery period for purposes of § 168(a) or § 168(g) is

determined by reference to class life. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former § 167(m) as if it were in effect and the taxpayer had elected under that section. Prior to its revocation, § 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary that reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowance under § 168. This revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities.

Asset class 00.3, Land Improvements, of Rev. Proc. 87-56 includes improvements directly to or added to land, whether the improvements are § 1245 or § 1250 property, provided the improvements are depreciable. Examples of these assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers, wharves and docks, bridges, fences, landscaping, shrubbery, or radio and television transmitting towers. Assets included in asset class 00.3 have a recovery period of 15 years for purposes of § 168(a) and 20 years for purposes of § 168(g).

Rev. Rul. 55-290, 1955-1 C.B. 320, concludes that expenditures incurred by a taxpayer in the original construction of golf course greens are capital expenditures that are added to the original cost of the land and are not subject to an allowance for depreciation. The revenue ruling also concludes that subsequent operating expenses for sod, seed, soil, and other sundry maintenance are ordinary and necessary business expenses that are deductible from gross income for federal income tax purposes.

In Edinboro Company v. United States, 224 F.Supp. 301 (W.D.Pa. 1963), the court held that golf course improvements, such as greens, tees, fairways, and traps, were not depreciable under § 167(a) because they are not distinguishable from the land, which is molded and reshaped to form them, and, like the land, they have an unlimited useful life. The court concluded that "[a] golf course is primarily a landscaping proposition[, although] [o]ccasionally a green or a trap or bunker is altered or rebuilt." The taxpayer in Edinboro failed to demonstrate a determinable useful life of the golf course improvements, or that the improvements were subject to wear and tear, exhaustion, or obsolescence that could not be fully reversed by annual maintenance.

Although the depreciation allowance generally does not apply to land because land has no determinable useful life, land preparation may be depreciable if it is closely associated with depreciable assets so that it is possible to establish a determinable period over which the land preparation will be useful in a particular trade or business. A useful life for land preparation is established if it will be replaced contemporaneously with a related depreciable asset. Whether land preparation will be replaced

contemporaneously with a related depreciable asset is a question of fact, but if the replacement of the asset will require the physical destruction of the land preparation, this test will be considered satisfied. Rev. Rul. 68-193, 1968-1 C.B. 79, clarifying Rev. Rul. 65-265, 1965-2 C.B. 52 (costs for a roadway grading that would be retired contemporaneously with a building are depreciable); Rev. Rul. 72-96, 1972-1 C.B. 66 (land preparation costs for a reservoir that would be retired contemporaneously with an electric generating plant are depreciable); Rev. Rul. 74-265, 1974-1 C.B. 56 (the cost of shrubbery immediately adjacent to apartment buildings is depreciable because the shrubbery would be retired contemporaneously with the buildings); Rev. Rul. 80-93, 1980-1 C.B. 50 (costs for excavation and backfilling that would be retired contemporaneously with laundry facilities and a storm sewer system are depreciable).

While § 168 determines the amount of the depreciation allowance provided by § 167(a) for tangible property placed in service generally after 1986, § 167 determines whether the tangible property is depreciable property. Under § 167 and the regulations thereunder, land is not depreciable. Similarly, the costs of general grading or shaping of land are not depreciable because the land preparation is inextricably associated with the land. However, if the land preparation is so closely associated with depreciable assets that it will be retired, abandoned, or replaced contemporaneously with those assets, a useful life for land preparation is established and, therefore, the cost of the land preparation is depreciable.

Push-up or natural soil greens are representative of the type of green commonly

in use when Rev. Rul. 55-290 was issued and Edinboro was decided. Push-up or natural soil greens are essentially landscaping that involves some reshaping or regrading of the land. Accordingly, the Service will continue to follow the holdings in Rev. Rul. 55-290 and Edinboro with respect to push-up or natural soil greens.

Unlike push-up or natural soil greens, the modern green is a sophisticated improvement to the land carefully designed to facilitate drainage. Essential components of the modern green are the underground drainage tiles or interconnected pipes. Because these tiles or pipes deteriorate over time, they have a determinable useful life and, therefore, are depreciable. Asset class 00.3, Land Improvements, of Rev. Proc. 87-56, includes drainage facilities. The gravel layer, rootzone layer, and turfgrass above the network of underground drainage tiles or interconnected pipes are so closely associated with these tiles or pipes that replacement of the tiles or pipes will require the contemporaneous physical destruction of that land preparation. Thus, it is possible to establish a determinable useful life for the land preparation above the underground tiles and pipes.

HOLDINGS

Land preparation undertaken by a taxpayer in the original construction or reconstruction of push-up or natural soil greens is inextricably associated with the land and, therefore, the costs attributable to this land preparation are added to the taxpayer's cost basis in the land and are not depreciable.

The costs of land preparation undertaken by a taxpayer in the original

construction or reconstruction of modern greens that is so closely associated with depreciable assets, such as a network of underground drainage tiles or pipes, that the land preparation will be retired, abandoned, or replaced contemporaneously with those depreciable assets are to be capitalized and depreciated over the recovery period of the depreciable assets with which the land preparation is associated. For purposes of § 168, the modern green described above is includible in asset class 00.3, Land Improvements, of Rev. Proc. 87-56. However, the general earthmoving, grading, and initial shaping of the area surrounding and underneath the modern green that occur before the construction are inextricably associated with the land and, therefore, the costs attributable to this land preparation are added to the taxpayer's cost basis in the land and are not depreciable.

Subsequent operating expenses for sod, seed, soil, and other sundry maintenance are ordinary and necessary business expenses that are deductible from gross income for federal income tax purposes.

CHANGE IN METHOD OF ACCOUNTING

Any change in a taxpayer's treatment of the cost of modern greens to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer wanting to change the method of accounting for the cost of modern greens owned by the taxpayer at the beginning of the year of change to conform with this revenue ruling must follow the automatic change in method of accounting provisions in Rev. Proc. 99-49,

1999-2 C.B. 725 (or its successor), unless the scope limitations in section 4.02 of Rev. Proc. 99-49 apply.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 55-290 is modified and superseded. Rev. Proc. 99-49 is modified and amplified to include this accounting method change in the APPENDIX.

PROSPECTIVE APPLICATION

A taxpayer may continue to use its present method of treating the cost of modern greens placed in service during any taxable year beginning before November 29, 2001, as a nondepreciable capital expenditure.

DRAFTING INFORMATION

The principal author of this revenue ruling is Mark Pitzer of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mark Pitzer at (202) 622-3110 (not a toll-free call).