

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

Real property subdivided for sale.

(c) Disqualification arising from substantial improvements—



- (1) General rule. Section 1237 will not apply if the taxpayer or certain others make improvements on the tract which are substantial and which substantially increase the value of the lot sold. Certain improvements are not substantial within the meaning of section 1237(a)(2) if they are necessary to make the lot marketable at the prevailing local price and meet the other conditions of section 1237(b)(3). See subparagraph (5) of this paragraph.
- (2) Improvements made or deemed to be made by the taxpayer. Certain improvements made by the taxpayer or made under a contract of sale between the taxpayer and the buyer make section 1237 inapplicable.
 - (i) For the purposes of section 1237 (a)(2) the taxpayer is deemed to have made any improvements on the tract while he held it which are made by:
 - (a) The taxpayer's whole or half brothers and sisters, spouse, ancestors and lineal descendants.
 - (b) A corporation controlled by the taxpayer. A corporation is controlled by the taxpayer if he controls, as the result of direct ownership, constructive ownership, or otherwise, more than 50 percent of the corporation's voting stock.
 - (c) A partnership of which the taxpayer was a member at the time the improvements were made.
 - (d) A lessee if the improvement takes the place of a payment of rental income. See section 109 and the regulations thereunder.
 - (e) A Federal, State, or local government, or political subdivision thereof, if the improvement results in an increase in the taxpayer's basis for the property, as it would, for example, from a special tax assessment for paving streets.
 - (ii) The principles of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. A held a tract of land for 3 years during which he made substantial improvements thereon which substantially enhanced the value of every lot on the tract. A then made a gift of the tract to his son. The son made no further improvements on the tract but held it for 3 years and then sold several lots therefrom. The son is not entitled to the benefits of section 1237 since under section 1237(a)(2) he is deemed to have made the substantial improvements made by his father, and under section 1223(2) he is treated as having held the property for the period during which his father held it. Thus, the disqualifying improvements are deemed to have been made by the son while the tract was held by him. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

- (iii) The taxpayer is also charged with making any improvements made pursuant to a contract of sale entered into between the taxpayer and the buyer. Therefore, the buyer, as well as the taxpayer, may make improvements which prevent the application of section 1237.
 - (a) If a contract of sale obligates either the taxpayer or the buyer to make a substantial improvement which would substantially increase the value of the lot, the taxpayer may not claim the application of section 1237 unless the obligation to improve the lot ceases (for any reason other than that the improvement has been made) before or within the period, prescribed by section 6511, within which the taxpayer may file a claim for credit or refund of an overpayment of his tax on the gain from the sale of the lot. The following example illustrates this rule:

Example. In 1956, A sells several lots from a tract he has subdivided for sale. Section 1237 would apply to the sales of these lots except that in the contract of sale, A agreed to install sewers, hard surface roads, and other utilities which would increase the value of the lots substantially. If in 1957, instead of requiring the improvements, the buyer releases A from this obligation, A may then claim the application of section 1237 to the sale of lots in 1956 in computing his income tax for 1956, since the period of limitations in which A may file a claim for credit or refund of an overpayment of his 1956 income tax has not expired.

- (b) An improvement is made pursuant to a contract if the contract imposes an obligation on either party to make the improvement, but not if the contract merely places restrictions on the improvements, if any, either party may make. The following example illustrates this rule:

Example. B sells several lots from a tract which he has subdivided. Each contract of sale prohibits the purchaser from

building any structure on his lot except a personal residence costing \$ 15,000 or more. Even if the purchasers build such residences, that does not preclude B from applying section 1237 to the sales of such lots, since the contracts did not obligate the purchasers to make any improvements.

- (iv) Improvements made by a bona fide lessee (other than as rent) or by others not described in section 1237(a) (2) do not preclude the use of section 1237.