INTERNAL REVENUE SERVICE
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CASE MIS No.: TAM-100743-00/CC:PSI:B5

Chief, Examination Division

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No:
Tax Year Involved:
Date of Conference:

LEGEND:

Taxpayer =

Project =

City =

Agency =

State A =

State B =

Gen Partner A =

Gen Partner B =

Gen Partner C =

Ltd Partner A =

Ltd Partner B =

Contractor A =

Contractor B =
Bank =

Lender	=
Statute	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=

ISSUE:

What costs incurred in the construction of a low-income housing building are included in eligible basis under § 42(d)(1) of the Internal Revenue Code? Specifically, are local impact fees, certain land preparation costs, construction loan costs, and certain contractor fees incurred by the Taxpayer in constructing the Project included in eligible basis under § 42(d)(1)?

CONCLUSIONS:

Eligible Basis

A cost incurred in the construction of a low-income housing building is includable in eligible basis under § 42(d)(1) if the cost is:

(1) included in the adjusted basis of depreciable property subject to § 168 and the property qualifies as residential rental property under § 103, or

(2) included in the adjusted basis of depreciable property subject to § 168 that is used in a common area or provided as a comparable amenity to all residential rental units in the building.[1]

Local Impact Fees

Local impact fees incurred by the Taxpayer to develop the Project constitute intangible property to the Taxpayer. The local impact fees incurred by the Taxpayer to develop the property do not constitute depreciable property to the Taxpayer because the fees are intangible property that do not have determinable useful lives. Accordingly, the fees are not includable in the Project's eligible basis under § 42(d)(1).

Land Preparation Costs

For the cost of a land preparation to be includable in the Project's eligible basis under § 42(d)(1), the cost must be for property of a character subject to the allowance for depreciation under § 168. The cost of a land preparation is a depreciable property if the land preparation is so closely associated with a particular depreciable asset that the land preparation will be retired, abandoned, or replaced contemporaneously with that depreciable asset. Whether the land preparation will be retired, abandoned, or replaced contemporaneously with the depreciable asset is a question of fact. If it is determined, upon further factual development, that a land preparation cost is depreciable, such cost may be included in eligible basis if it is also determined as part of the adjusted basis of § 168 property that qualifies as residential rental property under § 103, or § 168 property used in a common area or provided as a comparable amenity to all residential rental units in the building.

Construction Loan Costs

The Taxpayer's third-party costs and fees incurred in obtaining a construction loan are capitalized and amortized over the life of the loan. The Taxpayer's construction loan intangible is not subject to § 168 and therefore not includable in the Project's eligible basis. Section 263A requires the amortization deductions relating to the construction loan intangible be capitalized to the produced property during the construction period. The deductions must be reasonably allocated to all property produced. To the extent the amortization deductions are allocable under § 263A to the adjusted bases of § 168 property that qualifies as residential rental property under § 103 or § 168 property used in a common area or provided as a comparable amenity to all residential units in the building, the amortization deductions are includable in the Project's eligible basis under § 42(d)(1).

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1. This test does not exclude the application of other requirements that affect eligible basis under § 42. For example, the cost for constructing a parking area would qualify under this test. However, this cost would not be permitted in eligible basis if a separate fee were charged for use of the area. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-90 (1986), 1986-3 (Vol. 4) C.B. 90.

Contractor Fees

On its face, contractor fees satisfy the test for eligible basis under § 42(d)(1). However, the revenue agent challenges whether Contractor A can substantiate performance of the services underlying the fees. Further, the revenue agent challenges whether Contractor A was entitled to the fees because Contractor A is not a general contractor under Statute. These questions of material fact must be resolved at the examination level before technical advice can be rendered.

FACTS:

The Taxpayer is a State A limited partnership that was formed on a. The general partner of the Taxpayer is Gen Partner A, a State A limited partnership, with a b percent interest. The limited partners of the Taxpayer are Ltd Partner A and Ltd Partner B, State B corporations, with a combined interest of c percent. Gen Partner B, a State B corporation, is the general partner of Gen Partner A. The Taxpayer was formed for the sole purpose of constructing, owning, and operating the Project, a low-income housing project located in City. The Project consists of d buildings containing e units. In f, the Taxpayer received a carryover allocation from the Agency in the amount of $g in low-income housing tax credits under § 42. In h, the Taxpayer received a second carryover allocation from the Agency in the amount of $i in low-income housing tax credits. The Taxpayer entered into a contract for construction of the Project with Contractor A. Gen Partner C, a State A corporation, is the general partner of Contractor A. Contractor A entered into a contract with Contractor B for the actual construction of the Project.[2]

In the present case, the Taxpayer's costs at issue include local impact fees, certain land preparation costs, construction loan costs, and certain contractor fees.

LAW AND ANALYSIS:

Eligible Basis

Section 42(a) provides that the amount of the low-income housing tax credit determined for any tax year in the credit period is an amount equal to the applicable percentage of the qualified basis of each low-income building.

Section 42(c)(1)(A) defines the qualified basis of any qualified low-income building for any tax year as an amount equal to the applicable fraction, determined as of the close of the tax year, of the eligible basis of the building, determined under

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2. The facts relevant to these issues are subject to disagreement between the Taxpayer and the District Director's office. Pursuant to § 10.03 of Rev. Proc. 2000-1 I.R.B. 73, 86, the national office, if it chooses to issue technical advice, will base that advice on the facts provided by the district office.

§ 42(d)(5).

Section 42(c)(2) provides that the term "qualified low-income building" means, in part, any building to which the amendments made by section 201(a) of the Tax Reform Act of 1986 apply (the 1986 Act). Section 201(a) of the 1986 Act modified property subject to the accelerated cost recovery system (ACRS) under § 168 for property placed in service after December 31, 1986, except for property covered by transition rules.

Section 42(d)(1) provides that the eligible basis of a new building is its adjusted basis as of the close of the first tax year of the credit period. Section 42(d)(4)(A) provides that, except as provided in § 42(d)(4)(B), the adjusted basis of any building is determined without regard to the adjusted basis of any property that is not residential rental property. Section 42(d)(4)(B) provides that the adjusted basis of any building includes the adjusted basis of property (of a character subject to the allowance for depreciation) used in common areas or provided as comparable amenities to all residential rental units in the building.

The legislative history of § 42 states that residential rental property, for purposes of the low-income housing credit, has the same meaning as residential rental property within § 103. The legislative history of § 42 further states that residential rental property thus includes residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-89 (1986), 1986-3 (Vol. 4) C.B. 89. Under § 1.103-8(b)(4) of the Income Tax Regulations, facilities that are functionally related and subordinate to residential rental units are considered residential rental property. Section 1.103-8(b)(4)(iii) provides that facilities that are functionally related and subordinate to residential rental units include facilities for use by the tenants, such as swimming pools and similar recreational facilities, parking areas, and other facilities reasonably required for the project. The examples given by § 1.103-8(b)(4)(iii) of facilities reasonably required for a project specifically include units for resident managers or maintenance personnel.

Based on the above, a cost is incurred in the construction of a low-income housing building under § 42(d)(1) if it is:

(1) included in the adjusted basis of depreciable property subject to § 168 and the property qualifies as residential rental property under § 103, or

(2) included in the adjusted basis of depreciable property subject to § 168 that is used in a common area or provided as a comparable amenity to all residential rental units in the building.

The Taxpayer contends that each state housing credit agency determines what costs are includable in eligible basis when determining the financial feasibility of a project under § 42(m)(2)(A). Consequently, the Taxpayer concludes that once the Agency has verified and accepted the Taxpayer’s costs, the Service is bound by the

Agency's determination. We disagree.

Section 42(m)(2)(A) provides, in part, that the housing credit dollar amount allocated to a project shall not exceed the amount the housing credit agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project through the credit period. A state housing credit agency's responsibility under § 42(m)(2)(A) to determine the financial feasibility and viability of a project in no way abrogates the Service's authority and responsibility to administer the low-income housing tax credit and its various provisions.

The Taxpayer also cites Notice 88-116, 1988-2 C.B. 449, as authority for its position that all construction costs are costs includable in eligible basis. The Taxpayer's interpretation of Notice 88-116 is misplaced.

Notice 88-116, in part, provides guidance on what costs will be considered construction, reconstruction, or rehabilitation costs for the limited purpose of qualifying certain buildings for post-1989 credits after the (then) § 42(n) statutory sunset of a state's authority to allocate post-1989 credit. For this limited purpose, the notice provides that certain costs would satisfy the definition of construction, reconstruction or rehabilitation costs– but only if these costs are included in the eligible basis of the building. In other words, under the notice, a condition to qualifying a new building for post-1989 credit was that construction costs must also be included in eligible basis. The notice does not define what costs are included in eligible basis nor, as the Taxpayer proposes, does it stand for the proposition that all construction-related costs are included in eligible basis.

Local Impact Fees

The Taxpayer was required to pay local impact fees assessed by the county for site development. The fees are one-time costs on a piece of property that are assessed when new construction takes place. The rates are set by the county and are based on the type and size of the development. Once construction begins, the fees are not transferable and remain with the plot of land. If a building is razed and a larger structure is built, additional fees may be assessed above the original charge. However, if a smaller structure is built, no refund is given.

The Taxpayer incurred local impact fees for a variety of items including water capital, wastewater capital, roads, educational facilities, law enforcement, and fire/rescue facilities. The water capital fee is used for the construction and acquisition of additions and extensions of the water system and all components thereof in order to provide additional water service capacity to those customers who make new connections to the water system. The wastewater capital fee is used for the construction and acquisition of additions and extensions to the county wastewater system and all components thereof in order to provide additional wastewater service capacity to those new customers who connect to the wastewater system. The road fee is used for capacity-expanding improvements to the county's major road network system. The educational facilities fee is used for the construction of permanent schools, modular schools, portable classrooms, ancillary facilities, and transportation (purchase of school buses). The law enforcement fee is used for the cost of buildings to house law enforcement functions as well as capital costs (items costing more than $500). The fire/rescue fee is used for the cost of fire stations, other facilities, and equipment. All of the items underlying the various impact fees will be maintained and replaced when necessary by the local governmental entity.

The threshold issue is whether the local impact fees incurred by the Taxpayer to develop the property constitute tangible or intangible property to the Taxpayer.

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

Section 1.167(a)-2 of the Income Tax Regulations provides that the depreciation allowance in the case of tangible property applies only to that part of the property which 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 of physical development added to it.

Section 1.167(a)-3 of the regulations provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period such an intangible asset may be the subject of a depreciation allowance. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the Taxpayer, the intangible asset has a limited useful life.

Rev. Rul. 68-607, 1968-2 C.B. 115, involves a developer who incurred costs for improvements made on a state-owned highway right-of-way to provide ingress and egress to a shopping center developed on leased land. After construction of the improvements, the developer formally transferred ownership of them to the state. The improvements will be maintained and replaced, when necessary, by the state. The ruling held that the taxpayer acquired no tangible property interest in the improvements to the state-owned highway right-of-way, rather it acquired a long-term direct business advantage, an intangible asset. The ruling further held that the period of economic usefulness to the taxpayer is limited in duration to the lease term of 99 years. The ruling provided that if the taxpayer had owned the land on which the shopping center was constructed, the useful life of the business advantage would not be limited since not only the maintenance of the improvements, but also their replacement, when necessary, will be provided by the state. Thus, the improvements would indefinitely benefit such land.

In order to have a depreciable interest in a tangible asset, several factors are considered including whether the taxpayer has a proprietary interest in the asset, whether the taxpayer uses the asset directly in the taxpayer's business, and whether the taxpayer will maintain and replace the asset as necessary. The third factor is the critical one. According to the facts underlying Rev. Rul. 68-607, the taxpayer had no proprietary interest in the assets and the state assumed liability for both the maintenance and replacement of the assets. The taxpayer therefore gave up all connection with the tangible elements of the improvements. All the taxpayer retained was the benefit of improved access to its shopping center. This benefit has no relationship to the life of any tangible asset and is not treated as a tangible asset of the taxpayer. See also Noble v. Commissioner, 70 T.C. 916 (1978), nonacq. on other grounds, 1979-2 C.B. 2, in which the court ruled that a sewer tap fee required by a city ordinance to be payed by the taxpayer conferred an intangible right to the taxpayer.

In F.M. Hubbell Son & Co., Inc. v. Burnet, 51 F.2d 644 (8th Cir. 1931), cert. denied, 284 U.S. 664 (1931), the taxpayer was required by special assessments to make expenditures on account of paving, curbing, and sidewalk improvements abutting the taxpayer's property. The court noted that the taxpayer needs to have some sort of proprietary interest in the property which has depreciated to incur a loss due to the depreciation. The increase in value which the taxpayer has received from the improvements does not diminish by reason of its exhaustion, wear and tear, but by reason of the exhaustion, wear and tear of property in which the taxpayer has no special pecuniary interest and on account of whose exhaustion, wear and tear the taxpayer is entitled to no deduction. The court found that the improvements benefit the taxpayer's business, but they are not "in" the business and are not a part of it, even if the owner may have constructed them. Although the improvements incidentally benefit the taxpayer, they primarily are used in the business and for the service of the public.

In Algernon Blair, Inc. v. Commissioner, 29 T.C. 1205 (1958), the taxpayer constructed sidewalks, curbs, paved streets, sewers, and water mains concurrently with the construction of housing units. Upon completion of the improvements, the local government took over all the functions of maintenance of these facilities and they became part of the street systems for public use and convenience. The court noted that since the improvements were public property, the taxpayer does not have a pecuniary interest in the property. The fact that the taxpayer owned all of the adjoining properties is without controlling significance in view of the fact that the improvements are used primarily in the public business. See also Wilshire-La Cienega Gardens Co. v. Riddell, 148 F.Supp. 938 (S.D. Calif., 1956).

In the present case, the Taxpayer is required to pay local impact fees for a variety of items including water capital, wastewater capital, roads, educational facilities, law enforcement, and fire/rescue facilities. The Taxpayer does not own any of the assets purchased by the fees and has no proprietary interest in those assets. The local government entity is responsible for both the maintenance and replacement of the assets purchased with the fees. The Taxpayer merely ends up with a capital expenditure resulting in a benefit to the Taxpayer's business. This benefit has no relationship to the life of any tangible asset and constitutes an intangible asset.

The second issue is whether the intangible asset acquired by the Taxpayer through payment of the local impact fees constitutes depreciable property to the Taxpayer.

Under § 1.167(a)-3, an intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the Taxpayer, the intangible asset has a limited useful life. Similar to the ruling in Rev. Rul. 68-607, the Taxpayer acquired a business advantage, an intangible asset, the useful life of which is not limited since not only the maintenance of the assets purchased with the local impact fees, but also their replacement, when necessary, will be provided by the local government entity. Thus, the improvements have an unlimited useful life and are therefore not depreciable.

In Rev. Rul. 73-188, 1973-1 C.B. 62, a city made assessments against business property owners for their share of the expense of converting a downtown city street into an enclosed pedestrian mall. Title to the mall remained with the city, but the assessed landowners maintained the mall and paid the costs of heating and air conditioning it. The mall was expected to provide the affected landowners with a business advantage for a period of ten years. It was held that the assessments incurred by the property owners were capital expenditures that may be depreciated over the ten-year period in which the mall is expected to provide a business advantage.

According to Rev. Rul. 73-188, the assessment constitutes a capital expenditure in acquisition of an intangible asset in the form of an economic benefit that may be recovered through depreciation ratably over the period the economic benefit is expected to exist. If the payment of a tax assessed against local benefits produces or improves an asset that is used in the trade or business or for the production of income and that has a determinable useful life, such asset is subject to depreciation under § 167. The differences between Rev. Rul. 73-188 and the present case are who is responsible for maintenance and whether the intangible asset has a determinable useful life. In Rev. Rul. 73-188, the economic benefit of the pedestrian mall had a useful life of ten years whereas in the present case, the economic benefit of the local impact fees have an unlimited useful life and are therefore not depreciable under § 167. See §1.167(a)-3.

In Noble v. Commissioner, 70 T.C. 916 (1978), nonacq., 1979-2 C.B. 2, a city ordinance required the taxpayer to connect properties to the city's sewer system, as a condition to continued use of the properties. The taxpayer was also required to pay an initial "tap fee" to the city which gave the taxpayer the indefinite right to use the sewer system (subject also to a monthly charge). The purpose of the tap fee was to pay the cost of expanding the sewage treatment plant. The court held that the sewer tap fee is a capital expenditure amortizable over the life of the sewer system because the benefits (use of the new plant) obtained by payment of the sewer tap fee have a life coextensive with the life of the sewer system.

The Service disagreed with the court's decision in Noble that the sewer tap fee has a determinable useful life with regard to the taxpayer and nonacquiesced. 1979-2 C.B. 2. It is the Service's position that the critical factor is that the city assumed liability for both the maintenance and replacement of the assets acquired with the fees and, as a result, the taxpayer has a long-term business benefit that is not limited in duration and bears no relationship to the useful life of any tangible asset. In the present case, the county assumes liability for both the maintenance and replacement of the assets acquired with the impact fees. The Taxpayer has obtained an intangible business benefit that bears no relationship to the useful life of any tangible asset and, therefore, this intangible asset has an indeterminate useful life. Further, the Taxpayer has not provided any evidence supporting the useful life of the intangible asset. Thus, the Taxpayer has acquired an intangible asset with an indeterminable useful life, the cost of which is not depreciable under § 167.

The Taxpayer cites Oriole Homes Corp. v. U.S., 705 F.Supp. 1531 (S.D.Fl. 1989), in support of its position. In that case, the issue was whether various impact fees that were required by the county for the approval and recordation of plats are deductible as ordinary and necessary business expenses or whether they must be capitalized. The court noted that without the plat approvals, the site could not have been developed. Therefore, the court concluded that each of the impact fees increased the value of the site and secured a benefit which lasted beyond the taxable year in which they were incurred. It held that the impact fees must be capitalized as a development cost and deducted pro rata as each house is sold. The court never specifically addressed whether the impact fees constituted depreciable property; it merely concluded that the impact fees are recovered by the developer upon the sale of the property. Thus, Oriole Homes is inapplicable to the present issue.

Accordingly, the asset acquired by the Taxpayer through payment of the local impact fees constitutes nondepreciable intangible property and, therefore, is not includable in the Project's eligible basis under § 42(d)(1).

Land Preparation Costs

The Taxpayer incurred a variety of land preparation costs when constructing the Project that the Taxpayer included in the eligible basis of the Project's buildings under § 42(d)(1). These costs included the following land surveys: boundary, topographic, mortgage, tree, architectural, Gopher Tortoise, and ALTA. The Taxpayer also incurred costs for the following environmental surveys: percolation tests, soil borings, geotechnical investigations, contamination studies, suitability study, wetland reviews, mapping of wetland, inspection of wetland, wetland characterization, and groundwater investigation. Additionally, the Taxpayer incurred costs for soil and erosion control, earthwork and sitework, clearing and grubbing, fill dirt, and landscaping.

The following is a general discussion of when land preparation costs are depreciable and consequently may qualify for inclusion in eligible basis. Whether the Taxpayer's specific costs are includable in eligible basis will depend upon further factual development by the revenue agent.

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

Section 1.167(a)-2 provides that the depreciation allowance in the case of tangible property applies only to that part of the property which 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 of physical development added to it.

Generally, the depreciation deduction provided by § 167(a) for tangible property is determined under § 168 by using the applicable depreciation method, the applicable recovery period, and the applicable convention. In the case of residential rental property, the applicable depreciation method is the straight line method (§ 168(b)(3)(B)), the applicable recovery period is 27.5 years (§ 168(c)), and the applicable convention is the mid-month convention (§ 168(d)(2)(B)). Land improvements, whether § 1245 property or § 1250 property, are included in asset class 00.3, Land Improvements, of Rev. Proc. 87-56, 1987-2 C.B. 674, 677, and have a class life of 15 years for the general depreciation system. Thus, for land improvements the applicable depreciation method is the 150 percent declining balance method (§ 168(b)(2)(A)), the applicable recovery period is 15 years (§ 168(c)), and the applicable convention is the half-year convention (§ 168(d)(1)).

The grading of land involves moving soil for the purpose of changing the ground surface. It produces a more level surface and generally provides an improvement that adds value to the land. Rev. Rul. 65-265, 1965-2 C.B. 52, clarified by Rev. Rul. 68-193, 1968-1 C.B. 79, held that such expenditures are inextricably associated with the land and, therefore, fall within the rule that land is a nondepreciable asset. Rev. Rul. 65-265 further held that excavating, grading, and removal costs directly associated with the construction of buildings and paved roadways are not inextricably associated with the land and should be included in the depreciable basis of the buildings and roadways. Accordingly, the costs attributable to the general grading of the land, not done to provide a proper setting for a building or a paved roadway, become a part of the cost basis of the land and, therefore, are not subject to a depreciation allowance. See Algernon Blair, Inc. v. Commissioner, 29 T.C. 1205 (1958), acq., 1958-2 C.B. 4. As such, the costs are not includable in eligible basis under § 42(d)(1).

Rev. Rul. 74-265, 1974-1 C.B. 56, involves the issue of whether landscaping for an apartment complex is depreciable property. The area surrounding the apartment complex was landscaped according to an architect's plan to conform it to the general design of the apartment complex. The expenditures for landscaping included the cost of top soil, seeding, clearing and grading, and planting of perennial shrubbery and ornamental trees around the perimeter of the tract of land and also immediately adjacent to the buildings. The replacement of these apartment buildings will destroy the immediately adjacent landscaping, consisting of perennial shrubbery and ornamental trees.

This revenue ruling held that land preparation costs may be subject to a depreciation allowance if such costs are so closely associated with a depreciable asset so that it is possible to establish a determinable period over which the 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 the related depreciable asset. Whether land preparation will be replaced contemporaneously with the related depreciable asset is necessarily a question of fact, but if the replacement of the depreciable asset will require the physical destruction of the land preparation, this test will be considered satisfied. Accordingly, landscaping consisting of the perennial shrubbery and ornamental trees immediately adjacent to the apartment buildings is depreciable property because the replacement of the buildings will destroy the landscaping. However, the balance of the landscaping, including the necessary clearing and general grading, top soil, seeding, finish grading, and planting of perennial shrubbery and ornamental trees around the perimeter of the tract of land, is general land improvements that will be unaffected by the replacement of the apartment buildings and, therefore, will not be replaced contemporaneously therewith. Accordingly, these types of property are not depreciable property but rather are considered inextricably associated with the land and as such are not includable in eligible basis under § 42(d)(1).

Rev. Rul. 80-93, 1980-1 C.B. 50, involves the issue of whether a taxpayer is allowed to take a depreciation deduction for costs incurred in the construction of electrical and natural gas distribution systems and for land preparation costs incurred in connection with the development of a mobile home park. Regarding the distribution systems, the taxpayer made expenditures for the distribution systems, but the utility company retained full ownership of them and would repair and replace the systems as necessary. The taxpayer also incurred costs for the clearing, grubbing, cutting, filling, and rough grading necessary to bring the land to a suitable grade. In addition, the land preparation costs incurred in the digging and the rough and finish grading necessary to construct certain depreciable assets will not be repeated when the depreciable assets are replaced. However, the excavation and backfilling required for the construction of the laundry facilities and the storm sewer system are so closely associated with those depreciable assets that replacement of the depreciable assets will require the physical destruction of that land preparation.

This revenue ruling held that the land preparation costs (clearing, grubbing, cutting, filling, rough and finish grading, and digging) that are unaffected by replacement of the components of the mobile home park and will not be replaced contemporaneously therewith are nonrecurring general land improvement costs and, therefore, are considered to be inextricably associated with the land and are added to the taxpayer's cost basis in the land. These land preparation costs are not depreciable and, therefore, not includable in eligible basis under § 42(d)(1). However, the land preparation costs that are so closely associated with depreciable assets (laundry facilities and storm sewer system) such that the land preparation will be retired, abandoned, or replaced contemporaneously with those depreciable assets are capitalized and depreciated over the estimated useful lives of the assets with which they are associated. The amounts paid to the utility for the electrical and natural gas distribution systems are nonrecurring costs for betterments that increase the value of the land and are includable in the taxpayer's cost basis of the land. These costs likewise are not depreciable and not includable in eligible basis under § 42(d)(1).

In Eastwood Mall, Inc. v. U.S., 95-1 USTC ¶ 50,236 (N.D. Ohio 1995), aff'd by unpublished disposition, 59 F.3d 170 (6th Cir. 1995), the issue before the court was whether the taxpayer, a developer, should depreciate the cost of reshaping land as part of the cost of a building. The court stated that costs for land preparation may or may not be depreciable depending on whether the costs incurred are inextricably associated with the land (nondepreciable) or with the buildings constructed thereon (depreciable). It further asserted that the key test for determining whether land preparation costs are associated with nondepreciable land or the depreciable building thereon is whether these costs will be reincurred if the building were replaced or rebuilt. Land preparation costs for improvements that will continue to be useful when the existing building is replaced or rebuilt are considered inextricably associated with the land and, therefore, are to be added to the taxpayer's cost basis in the land and are not depreciable. On the other hand, land preparation costs for improvements that are so closely associated with a particular building that they necessarily will be retired, abandoned, or replaced contemporaneously with the building are considered associated with the building and, therefore, are added to the taxpayer's cost basis in the building and are depreciable.

The cost of a land preparation inextricably associated with the land is added to a taxpayer's cost basis in the land and is not depreciable property. See Rev. Rul. 65-265; Algernon Blair; Eastwood Mall. Land preparation costs that are nonrecurring or that will continue to be useful when the related depreciable asset is replaced or rebuilt are considered to be inextricably associated with the land. See Rev. Rul. 80-93; Eastwood Mall. However, the cost of a land preparation inextricably associated with a particular depreciable asset (for example, an apartment building) is added to a taxpayer's cost basis in that depreciable asset and is depreciable property. The cost of a land preparation that is so closely associated with a particular depreciable asset that the land preparation will be retired, abandoned, or replaced contemporaneously with that depreciable asset is considered inextricably associated with the depreciable asset. See Rev. Rul. 74-265; Rev. Rul. 80-93; Eastwood Mall.

In applying this standard, the issue of whether a land preparation will be retired, abandoned, or replaced contemporaneously with a particular depreciable asset is a question of fact.

In the present case, further factual development is needed to determine whether each land preparation cost at issue is so closely associated with a particular depreciable asset (for example, building) that the land preparation will be retired, abandoned, or replaced contemporaneously with that depreciable asset. This test is satisfied if it is reasonable to assume the replacement of the depreciable asset will require the actual physical destruction of the land preparation. See Rev. Rul. 74-265. It is irrelevant that a state housing credit agency may require a taxpayer to incur a particular land preparation cost (for example, the planting of trees on the perimeter of the tract of land). Similarly, it is irrelevant that an ordinance may require a taxpayer to incur a particular land preparation cost (for example, tree preservation or endangered species survey).

Under these guidelines, the costs of clearing, grubbing, and general grading to prepare a site suitable for any type of structure are inextricably associated with the land and are added to the cost of land and, therefore, are not depreciable. Similarly, costs incurred for fill dirt that is used to raise the level of the site are considered to be inextricably associated with the land and, therefore, are not depreciable. Therefore, the costs are not includable in eligible basis under § 42(d)(1). However, earth-moving costs incurred for digging spaces and trenches for a building's foundation and utilities generally are considered to be inextricably associated with the building and are added to the cost of the building and, therefore, are depreciable. Similarly, costs incurred for fill dirt that is used to set the foundation of a depreciable asset generally are considered to be inextricably associated with the related depreciable asset and, therefore, are depreciable.

Land and environmental surveys are generally conducted over the entire property of the development, not just where the buildings and improvements will specifically be placed. Some surveys, such as boundary or mortgage surveys, help to define the property whereas other surveys, such as percolation tests and contamination studies, are used to determine if the improvements can properly be built on the site. Costs incurred for the former type of survey are clearly related to the land itself and are inextricably associated thereto and, therefore, are not depreciable and not includable in eligible basis under § 42(d)(1). The latter type of survey is performed on the land to determine its suitability for supporting the improvements to be constructed thereon. If this type of survey will not necessarily need to be redone contemporaneously when the depreciable improvement is replaced, the costs incurred for the survey are inextricably associated with the land and, therefore, are not depreciable and not includable in eligible basis under § 42(d)(1). A survey is considered to be redone contemporaneously with the replacement of the depreciable improvement if the physical replacement of the depreciable improvement mandates a reperformance of the survey. Although an ordinance may require reperformance of the survey, such requirement is irrelevant as to whether the physical replacement of a depreciable improvement necessarily mandates a reperformance of the survey.

If a cost of land preparation is associated with both nondepreciable property (for example, land) and depreciable property (for example, building), the cost should be allocated among the nondepreciable property and depreciable property using any reasonable method. For example, if staking costs are incurred to demarcate a variety of items related to the development of the project and such items may be depreciable improvements (for example, sidewalks) and nondepreciable improvements (for example, landscaping not immediately adjacent to a building), the staking costs should be allocated among the depreciable and nondepreciable assets. Similarly, if engineering services are performed partly for nondepreciable assets and partly for depreciable assets, the cost of such services should be allocated among the nondepreciable and depreciable assets.

The Taxpayer's main argument as to why the land preparation costs should be depreciable property is that without construction of the buildings and other infrastructure for the project, none of these expenses would have been incurred. However, the court in Eastwood Mall specifically denounced this argument as being incorrect. The court noted that in almost every instance, some costs–whether it be the cost of moving a single tree or the larger costs of raising a site–will be incurred in preparing the land for the construction of the building. The court further noted that under the taxpayer's argument, all costs incurred in preparing a site are depreciable and that the only situation where land preparation costs would not be depreciable is where nothing is constructed on the land. The court stated that "[t]his interpretation is illogical and contrary to the law." Eastwood Mall, at para. 9. Juxtaposing the Taxpayer's main argument with the argument made by the taxpayer in Eastwood Mall, the arguments are the same. Thus, the Taxpayer's main argument is without merit.

The Taxpayer further asserts that some of the land preparation costs may need to be redone if the building was replaced due to possible changes in applicable ordinances. The court in Eastwood Mall stated that "land preparation costs for improvements that are so closely associated with a particular building that they necessarily will be retired, abandoned, or replaced contemporaneously with the building are considered associated with the building." Eastwood Mall, at para. 12. See also Rev. Rul. 74-265 and Rev. Rul. 80-93. The Taxpayer's argument, however, does not satisfy the test that the costs necessarily will be replaced contemporaneously with the building. The fact that an ordinance may require a taxpayer to incur a particular land preparation cost does not mean that it thereby is considered to be inextricably associated with a building.

Based upon the above, once a land preparation cost is determined to be depreciable, that cost may be included in eligible basis to the extent it is treated as part of the adjusted basis of § 168 property that qualifies as residential rental property under § 103, or § 168 property used in a common area or provided as a comparable amenity to all residential rental units in the building.

Construction Loan Costs

The Taxpayer incurred two separate and distinct loans in connection with the

Project.[3] The first loan was a construction loan which was closed with Bank on j. The costs associated with the loan include closing costs, service charges, professional fees, title costs, loan origination, interest rate lock-in, commitment, mortgage taxes, documentary stamps, title insurance, and endorsement costs. The proceeds of the loan were used for the construction of the Project. The Taxpayer included the costs in the Project's eligible basis under § 42(d)(1). The second loan occurred in k with Lender. This permanent financing occurred after the completion of the Project. None of the costs associated with the permanent loan were included in the Project's eligible basis under § 42(d)(1).

Costs incurred in obtaining a loan are capitalized and amortized over the life of the loan. See Enoch v. Commissioner, 57 T.C. 781, 794-5 (1972), acq. on this issue, 1974-2 C.B. 2. See also Rev. Rul. 70-360, 1970-2 C.B. 103, Rev. Rul. 75-172, 1975-1 C.B. 145, and Rev. Rul. 81-160, 1981-1 C.B. 312. Accordingly, the Taxpayer's third-party costs and fees incurred in obtaining a construction loan for the Project are not capitalized to depreciable property, but are treated as an amortizable § 167 intangible.

Only property subject to §168 is included in eligible basis under §42(d)(1). However, to the extent some of the amortization deductions relating to the construction loan are capitalized under § 263A to the produced property and the produced property is subject to § 168, some of the amortization deductions indirectly may qualify for inclusion in the Project's eligible basis.

Section 263A generally requires direct costs and an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer to be capitalized to the property produced.

Costs subject to § 263A capitalization are discussed in § 1.263A-1(e). In § 1.263A-1(e)(3)(i) indirect costs are defined as all costs that are not direct costs (in the case of produced property). All such costs must be capitalized under § 263A if the costs are properly allocable to the produced property. Costs are properly allocable when the costs directly benefit or are incurred by reason of the performance of production activities. A nonexclusive list of indirect costs to be capitalized is provided in § 1.263A-1(e)(3)(ii) and included in this list are depreciation, amortization, and cost recovery allowances on equipment and facilities. Section 1.263A-1(e)(3)(ii)(I).

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3. In addition to the two loans, the revenue agent's submission mentions a bridge loan in connection with the Project. However, because the technical advice request does not provide sufficient factual development for this loan, we are limiting our review to the two loans, as described above.

Section 1.263A-1(f) discusses various cost allocation methods that can be used to allocate direct and indirect costs to produced property. For example, a taxpayer can use the specific identification method (§ 1.263A-1(f)(2)), the burden rate and standard cost methods (§ 1.263A-1(f)(3)(i) and (ii)) and any other reasonable method (§ 1.263A-1(f)(4)). Whichever method is used to allocate costs to the produced property, the method selected must satisfy the requirements of § 1.263A-1(f)(4).

Section 263A(g) defines produce as including constructing, building, installing, manufacturing, developing, or improving. See also § 1.263A-2(a)(1)(i).

The Taxpayer is producing real property within the meaning of § 263A. The Taxpayer owns the underlying land and constructs on the land the housing areas as well as common areas. Further, the Taxpayer improves the land by installing items such as sidewalks and curbs and by landscaping.

The Taxpayer's intangible asset consists of third-party costs and fees incurred in obtaining a loan that was used to fund construction activities. These costs would not have been incurred by the Taxpayer but for its housing construction activities. Thus, the costs were incurred by reason of the production of property and are properly allocable to the property as indirect costs.

Section 263A requires that the costs that are capitalized be reasonably allocated to the property produced. Section 1.263A-1(f)(4) describes when an allocation method will be judged reasonable. The Taxpayer has capitalized all of its costs to the buildings in the Project it constructed and has failed to allocate any of these costs to the other property it was producing. Whether the Taxpayer's method is reasonable depends on the Taxpayer's facts and circumstances and thus, this decision is best left for the revenue agent. However, the costs for obtaining a construction loan relate to the land acquired as well as the land improvements, in addition to the buildings. Further, the property being produced includes land, land improvements, and the buildings. Thus, a reasonable allocation method would allocate the amortization deductions among all of the produced property using some reasonable basis. To the extent the amortization deductions are allocable under § 263A to the adjusted bases of § 168 property that qualifies as residential rental property under § 103 or § 168 property used in a common area or provided as a comparable amenity to all residential units in the building, the amortization deductions are includable in the Project's eligible basis under § 42(d)(1).

Contractor Fees

The Taxpayer included $l in the Project's eligible basis under § 42(d)(1) for fees charged by Contractor A for general requirements, profit, and overhead. The revenue agent asserts that these fees are excessive and unreasonable under § 42(m)(2), and are therefore, not includable in the Project's eligible basis under § 42(d)(1).

Section 42(m)(2)(A) provides that the housing credit dollar amount allocated to a project shall not exceed the amount the housing credit agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period.

Section 42(m)(2)(B) provides that in making the determination under § 42(m)(2)(A), the housing credit agency shall consider, among other things, the reasonableness of the developmental and operational costs of the project.

The Taxpayer represents that the fees at issue have been received, verified, and accepted by the Agency as eligible costs which meet the requirements of § 42(m)(2). The Taxpayer, therefore, contends that the costs are properly includable in the Project's eligible basis under § 42(d)(1).

A state housing credit agency's responsibility under § 42(m)(2)(A) to determine the financial feasibility and viability of a project in no way abrogates the Service's authority and responsibility to administer the low-income housing tax credit and its various provisions.

On its face, contractor fees satisfy the test for eligible basis under § 42(d)(1). However, the revenue agent challenges whether Contractor A can substantiate performance of the services underlying the fees. Further, the revenue agent challenges whether Contractor A was entitled to the fees because Contractor A is not a general contractor under Statute. These questions of material fact must be resolved at the examination level before technical advice can be rendered.

CAVEATS:

No opinion is expressed on whether the Project otherwise qualifies for the low-income housing tax credit under § 42. A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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