TAB X

Technical Assistance Memorandums (TAMS)

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
July 14, 2000

Number: **200043015**
Release Date: 10/27/2000
Index (UIL) Nos.: 42.00-00 42.04-00 42.04-01 167.14-11
168.00-00 263A.00-00 142.04-00
CASE MIS No.: TAM-100727-00/CC:PSI:B5

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Project =

Address =

Agency =

State =

x =

y =

z =

a =

b =

c =

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 certain land preparation costs and bond issuance costs 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 § 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]

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.

Bond Issuance Costs

Costs associated with the issuance of tax-exempt bonds are not includable in the Project's eligible basis under § 42(d)(1) because they do not qualify as either § 168 property that is residential rental property under § 103 or as § 168 property that is used

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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.

in a common area or provided as a comparable amenity to all residential rental units in a building.

FACTS:

The Taxpayer, a State limited partnership, was formed to construct, develop, own and operate the Project, a x unit residential rental apartment complex located at Address. On y, the Project received from the Agency an allocation in the amount of $z in low-income housing credits under § 42 and began to develop the Project. The Taxpayer included certain land preparation costs and bond issuance costs in the Project's eligible basis under § 42(d)(1).[2]

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 § 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

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 facts provided by the district office.

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.

<u>Land Preparation Costs</u>

The Taxpayer incurred a variety of land preparation costs in constructing the Project that the Taxpayer included in the eligible basis of the Project buildings under § 42(d)(1). These costs included the following land surveys: boundary, topographic, mortgage, tree, architectural, Gopher Tortoise, ALTA, and recordation of the final plat. The Taxpayer also incurred costs for the following environmental surveys: percolation tests, soil borings, geotechnical investigations, contamination studies and suitability study. Additionally, the Taxpayer incurred costs for architectural services and traffic engineering services.

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, holds 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 holds 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.

Bond Issuance Costs

Funding for the Project was sourced, in part, by $a in proceeds from a 30-year tax-exempt bond. The bond proceeds were received when construction of the Project began and were used as the construction loan. When construction was completed, the proceeds were used for permanent financing. The costs associated with issuing the tax-exempt bond (bond issuance costs) included FHFA fees, state board fees, rating agency fees, trustee fees, underwriter fees, investment fees, legal counsel fees, bank inspector fees, and costs for photos, prints, and renderings. The bond issuance costs totaled $b. Of this amount, the Taxpayer included $c as eligible basis costs in their final costs certification. The Taxpayer contends that the bond proceeds were used to fund both the construction loan and a permanent loan, which were separately negotiated loans, and any and all costs associated with the construction loan are includable in eligible basis.

Costs incurred in obtaining a loan (or tax-exempt bond) are capitalized and amortized over the life of the loan (or bond). 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 bond issuance costs incurred by the Taxpayer in obtaining the tax-exempt bond for the Project are not capitalized to depreciable property, but are treated as an amortizable § 167 intangible.

Section 42(c)(2) defines a qualified low-income building as a building subject to section 201(a) of the 1986 Act. Only property subject to §168 is subject to section 201(a). Property amortizable under §167 such as intangibles cannot be depreciated under §168. Accordingly, property not subject to depreciation under §168 such as the Taxpayer's bond issuance costs intangible cannot be included in the Project's eligible basis under §42(d)(1).

Nevertheless, an argument can be made under § 263A that an allocable portion of indirect costs of real or tangible personal property produced by a taxpayer can be capitalized to the property produced. Indirect costs that should be capitalized under § 263A to produced property are those that are properly allocable to the property. These are costs that directly benefit or are incurred by reason of the production of property.

In this case, the Taxpayers' bond issuance costs were used, in part, 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 under the general rules of § 263A could reasonably be allocated to the property produced as indirect costs. However, notwithstanding the general rule of § 263A, we believe these bond issuance costs are not includable in eligible basis under the specific requirements of § 42(d)(1).

Section 103(a) provides that gross income does not include interest on any state or local bond. Section 103(b)(1), however, provides that the exclusion does not apply to any private activity bond unless it is one of the qualified bonds under § 141(e). Among these qualified bonds are exempt facility bonds.

Section 142(a) describes an exempt facility bond as any bond issued as part of an issue of bonds if 95 percent or more of the net proceeds of the issue are to be used to provide listed types of projects or facilities. Within the list, in §142(a)(7), are qualified residential rental projects.

Section 142(d) defines a qualified residential rental project as a project for residential rental property that houses occupants who meet one of the alternative income tests at all times throughout a qualified project period. In the 1986 Act, 1986-3 (Vol. 1) C.B. 519-575, Congress reorganized § 103 and § 103A of the Code of 1954 (the "1954 Code") regarding tax-exempt bonds into § 103 and §§ 141 through 150 of the Code of 1986. Congress intended that to the extent not amended by the 1986 Act, all principles of pre-1986 Act law would continue to apply to the reorganized provisions. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-686 (1986), 1986-3 (Vol., 4) C.B. 686. (Conference Report). Because no Income Tax Regulations have been promulgated under § 142(d), the regulations promulgated pursuant to § 103(b)(4) of the 1954 Code continue to apply to residential rental property except as otherwise modified by the 1986 Act and subsequent law.

As stated above, § 42 and its legislative history make clear that a necessary condition for tax credit eligibility is that the costs be included as part of the adjusted basis of depreciable property subject to § 168 that is residential rental property, or 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. Furthermore, the legislative history of § 142 provides that bond issuance costs cannot be paid from the 95% portion of the issue. Conf. Rpt. at II-729. Here, the exempt purpose to which the 95% test is applied is for qualified residential rental projects. Section 142(d)(1) provides, in part, that the term qualified residential rental project means any project for residential rental property. Since bond issuance costs are not costs used for qualified residential rental projects and since residential rental projects must be projects for residential rental property, we conclude that bond issuance costs are not residential rental property or costs used to provide residential rental property.[3] Since bond issuance costs are not residential rental property or costs used for residential rental property within the meaning of § 142 (nor do we believe these costs are depreciable property subject to § 168 that is used in a common area or provided as comparable amenities to all residential rental units in the building-- such as a stove or refrigerator) and since residential rental property has the same meaning under § 42 as it does for § 142, no § 42 credit may be claimed for these costs.

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3. Nothing in § 1.103-8(b)(4) (which applies to both §§ 42 and 142) or the legislative history to § 42 includes bond issuance costs within the definition of residential rental property, thereby preempting an argument that residential rental property has a broader meaning than residential rental project and that bond issuance costs fall within the definition of residential rental property but not within the definition of residential rental project.

Congress has determined that bond issuance costs, the components of which are identified in the legislative history to § 142, are not costs sufficiently associated with providing residential rental housing to satisfy the exempt purpose of the offering. Characterizing a certain portion of bond issuance costs under § 263A as satisfying the exempt purpose of the offering is directly contrary to this specific congressional determination. Permitting such a § 263A characterization of bond issuance costs for purposes of § 42 would result in the disparate treatment of the term residential rental property between §§ 42 and 142. This result is contrary to the statutory and legislative history construct governing § 42, that requires that residential rental property have the same meaning for purposes of both §§ 42 and 142.

Accordingly, notwithstanding the general rule of § 263A, no portion of bond issuance costs (as these costs are described in the legislative history to § 142) are included in eligible basis for purposes of § 42(d)(1).

CAVEAT:

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 the Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

- END -

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
July 14, 2000

Number: **200043016**
Release Date: 10/27/2000
Index (UIL) No.: 42.00-00, 42.04-00. 42.04-01, 167.14-11, 168.00-00, 263A.00-00
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. <u>See</u> §1.167(a)-3.

In <u>Noble v. Commissioner</u>, 70 T.C. 916 (1978), <u>nonacq</u>., 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.

- END -

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
July 14, 2000

Number: **200043017**
Release Date: 10/27/2000
Index (UIL) No.: 42.00-00, 42.04-00. 42.04-01, 167.14-11, 168.00-00, 263A.00-00
CASE MIS No.: TAM-100748-00/CC:PSI:B5

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

LEGEND:

Taxpayer =

State A =

State B =

State C =

City A =

Project =

GP =

LP1 =

LP2 =

Developer 1 =

Developer 2 =

Agreement =

Bank =

Lender =

b =

c =

d =

e =

f =

g =

h =

k =

ISSUE:

What costs incurred by Taxpayer in constructing the Project are includable in the Project's eligible basis under § 42(d)(1) of the Internal Revenue Code? Specifically, are certain partnership syndication and formation costs, land preparation costs, developer fees, construction loan costs, construction contingency and rent-up costs, and certain Developer 2 fees incurred by Taxpayer with respect to the Project includable in eligible basis under § 42(d)(1)?

CONCLUSION:

Eligible Basis

Costs incurred by Taxpayer in constructing the Project are includable in eligible basis under § 42(d)(1) if they are:

(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]

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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.

Partnership Syndication and Formation

If Developer 2 engaged in organizational or syndication activities relating to and on behalf of the Taxpayer, then the corresponding percentage of the developer fees paid by the Taxpayer should be treated as nondeductible expenses incurred in either the organization or syndication of the partnership under § 709(a), and would not be includable in 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.

Developer Fees Allocated to Land

Amounts paid to developers for services in acquiring the land should not be includable in eligible basis. The principles relating to the land preparation fees in the conclusion above are applicable. Therefore, to the extent the costs relate to the land, the costs are not includable in eligible basis under § 42(d)(1).

Construction Loan Costs

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).

Construction Contingency Costs and Rent-Up Costs

Taxpayer has not provided any records that substantiate whether the construction contingency costs were in fact incurred. Further, there are no facts to adequately describe the nature of these costs. These questions of material facts must be resolved at the examination level before technical advice can be rendered.

Rent-up costs are not related to the construction of the buildings, but for the securing of tenants. Consequently, these costs do not establish or add to the basis of depreciable property subject to § 168. Thus, rent-up costs are not includable in eligible basis under § 42(d)(1).

Developer 2 Fees

Generally, the amount of developer fees are not at issue when determining eligible basis under § 42(d)(1). However, the revenue agent challenges whether Developer 2 can substantiate performance of the services underlying the fees. This question of fact must be resolved at the examination level before technical advice may be rendered.

FACTS:

Taxpayer is a State A limited partnership that owns the Project, a City A low-income housing Project consisting of b residential rental units. Taxpayer's general partner is GP, a State B limited partnership. Taxpayer's limited partners are LP1 and LP2, State C corporations.[2]

The Project was developed and constructed by a number of interrelated entities owned by the same individuals. The initial developer for the Project was Developer 1. Subsequently, Developer 2 replaced Developer 1 as the developer for the Project. The agent asserts that Developer 2 was involved in the finding of a limited partner for the partnership, the negotiation of a partnership agreement and related terms, and the acquisition of a partnership interest in return for contributed capital. To support this assertion, the agent states that Developer 2 created numerous financial spreadsheets among its developer duties. These financial pro formas included annual operating budgets and annual rental income projections; cash flow analysis work papers; and return on investment calculations. According to the agent, these projections were

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2. The facts relevant to these issues are subject to disagreement between 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. Thus the facts as submitted by the agent have been provided.

computed numerous times with different factors. For example, calculations were done based on expected mortgage interest rates, the price paid for credits, the apartment mix, median income of the area, and many additional criteria.

The partnership agreement details payment of developer notes based on various contingencies. It addresses the available cash flow and repayment of general partner advances on operating deficits. Also covered in Taxpayer's partnership agreement is the sharing of cash and capital gain when the property is sold at the end of the compliance period. The agent cites provisions of the Agreement between Developer 2 and Taxpayer as further evidence of Developer 2's activities in promoting the sale of partnership interests. One section of the Agreement provides that Developer 2 developed a preliminary budget for the Project and consulted with various professional advisors relevant to the structuring of Project ownership. Taxpayer's developer fee payment schedule, dated c, contains four line items that the agent believes should be capitalized under § 709(a). These items are as follows: Preliminary Cost Estimates & Pro Forma, which lists a fee of $d; Equity Consulting, which lists a fee of $e; Equity Commitment, which lists a fee of $f; and Equity Closing, which lists a fee of $g. The agent asserts that these fees relate to activities that constituted syndication activities, and thus are nondeductible syndication expenses. Likewise, GP incurred legal and professional fees during GP's acquisition of its partnership interest in Taxpayer. According to agent, these legal expenses relating to the acquisition of partnership interests or partnership organization are not includable in eligible basis.

Taxpayer incurred two separate and distinct loans in connection with the Project. The first loan was a construction loan which was closed with Bank on h. The costs associated with the loan include title fees, commitment fees, legal fees, search fees, and recording 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 on 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). The agent points out that the development agreement and developer fee payment schedule indicate that Developer 2 had been credited for services performed in securing construction and permanent loans for the Project. Taxpayer included these costs in eligible basis as well. The agent maintains that costs relating to the loans require capitalization and amortization over the life of the loans because costs of this nature create separate and distinct assets that are not eligible for the low-income housing tax credit.

The agent asserts that certain land preparation costs relating to the Project are not includable in eligible basis because they are more closely related to the land than the buildings. These costs include, for example, surveys (boundary, topographic, mortgage, tree, architectural, and environmental), plat recording, earthwork/sitework clearing and grubbing, fill dirt, staking, impact fees, architectural services, engineering services, soil tests, soil and erosion control, and landscaping costs. Further, the agent asserts that a portion of the developer fees were paid for land acquisition services performed by the developers and for services performed by the developers in securing construction and permanent loans. The agent concludes that portions of the developer fees are attributable to land costs and the financing of land related activities (primarily sitework), which are not includable in eligible basis.

The agent questions whether certain fees are unreasonable or excessive and should be excluded from eligible basis. The agent states that the initial developer, Developer 1, rather than Developer 2, performed most of the required developer duties relating to the Project including the following: acquiring the land, preliminary cost estimates and pro formas, market research and project feasibility, preliminary site and building plans, equity consulting, development plan approval and building permits, construction loan financing, equity commitment and closing, and construction supervision. The agent suggests that the developer fees collected by Developer 2 should not be included in eligible basis because Developer 1 had actually performed the tasks.

The agent also questions whether amounts in a construction contingency account created by Taxpayer for unexpected construction overruns should be includable in eligible basis under § 42(d)(1). Finally, the agent suggests that costs for securing tenants for unit vacancies should not be includable in eligible basis.

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 § 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.

Partnership Syndication and Formation

With certain exceptions, § 709 provides that fees incurred to organize or to syndicate a partnership must be capitalized. Thus, § 709(a) provides that except as provided in § 709(b), no deduction shall be allowed under chapter 1 to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in the partnership.

Section 709(b)(1) provides that amounts paid or incurred to organize a partnership may, at the election of the partnership be treated as deferred expenses. These deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of the 60-month period, the deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in § 165.

Section 709(b)(2) defines "organizational expenses" as expenditures which are (A) incident to creating the partnership; (B) chargeable to capital account; and (C) of a character that, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over that life.

Section 1.709-1(a) provides that except as provided in §1.709-1(b) (the amortization of organizational expenses), no deduction shall be allowed under chapter 1 of the Code to a partnership or to any partner for any amounts paid or incurred, directly or indirectly, in partnership taxable years beginning after December 31, 1975, to organize a partnership, or to promote the sale of, or to sell, an interest in the partnership.

Section 1.709-2(a) defines “organizational expenses” as expenses that are: (1) incident to the creation of the partnership; (2) chargeable to capital account; and (3) of a character that, if expended incident to the creation of a partnership having an ascertainable life, would (but for § 709(a)) be amortized over that life. An expenditure that fails to meet one or more of the three tests does not qualify as an organizational expense for purposes of § 709(b) and § 1.709-2(a). To satisfy the statutory requirement described in § 1.709-2(a)(1), the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (excluding extensions) for the taxable year the partnership begins business. In addition, the expenses must be for the creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in § 1.709-2(a)(3), the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership.

The following are examples of organizational expenses within the meaning of § 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. Examples of organization expenses within the meaning of § 709 are: legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. Examples of expenses that are not organizational expenses within the meaning of § 709 (regardless of how the partnership characterizes them) are: expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

Section 1.709-2(b) defines “syndication expenses” as expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional material. These expenses are not subject to the election under section 709(b) and must be capitalized.

Thus, neither the Taxpayer nor any partner would be allowed a deduction for any amounts paid or incurred, directly or indirectly, to organize the partnership or to promote the sale of, or to sell, an interest in the partnership. Organizational expenses must be capitalized, although a partnership may elect to amortize these expenses. However, since no election was made by the Taxpayer in this case, no amortization of organizational expenses by the partnership under § 709(b) would be allowed. Syndication expenses are those expenses connected with issuing and marketing interests in the partnership. These expenses cannot be amortized and must, therefore, likewise be capitalized.

The issue we are asked to consider in this case involves neither how the rules under § 709 are applied nor what kinds of costs constitute organizational or syndication expenses. Rather, the issue presented by the agent involves a factual determination of whether Developer 2 actually engaged in organizational or syndication activities the costs for which should be capitalized pursuant to § 709(a). This, however, is a determination we cannot make based on the facts submitted. Moreover, we believe that such a factual determination is more properly made by the agent rather than the national office. We believe, however, that the agent does present facts that raise the possibility that Developer 2 may have engaged in organizational or syndication activities on behalf of the Taxpayer. Thus, we can address the issue only by stating that if Developer 2 engaged in organizational or syndication activities on behalf of the Taxpayer, then those expenditures must be capitalized. Accordingly a corresponding portion of the developer fees paid by Taxpayer would be allocable to those activities and treated as nondeductible costs and expenses incurred in either the organization or syndication of the partnership under § 709(a).

If Developer 2 engaged in organizational or syndication activities relating to and on behalf of the Taxpayer, then the corresponding portion of the developer fees paid by the Taxpayer should be treated as nondeductible expenses incurred in either the organization or syndication of the partnership under § 709(a), and should not be included in eligible basis under § 42(d)(1).

<u>Land Preparation Costs</u>

Taxpayer incurred a variety of land preparation costs in constructing the Project that Taxpayer included in eligible basis under § 42(d)(1). These costs included, for example, the following land surveys: boundary, topographic, mortgage, tree, architectural, Gopher Tortoise, and ALTA. Taxpayer also incurred costs for the following environmental surveys: contamination studies and suitability study. Additionally, Taxpayer incurred costs for earthwork and sitework, 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, holds 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 holds 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 (6^{th} 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.

Developer Fees Allocated to Land

The agent asserts that Taxpayer paid the developers for services in acquiring the land, and that such land costs should not be includable in eligible basis because they are land costs. The principles in the land issues analysis above are applicable. To the extent the costs relate to the land, the costs are not includable in eligible basis.

Construction Loan Costs

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 h. The costs associated with the loan include title fees, commitment fees, legal fees, search fees, and recording 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 on 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). The agent points out that the development agreement and developer fee payment schedule indicate that Developer 2 had been credited for services performed in securing construction and permanent loans for the Project. Taxpayer included these costs in eligible basis as well. The agent maintains that costs relating to the loans require capitalization and amortization over the life of the loans because costs of this nature create separate and distinct assets that are not eligible for the low-income housing tax credit.

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.

3. In addition to the two loans, the revenue agent's submission mentions a bridge loan in connection with the Project. However, because of the insufficient factual development, we are limiting our review to the two loans, as described above.

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).

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).

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

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).

Construction Contingency Costs and Rent-Up Costs

The agent questions whether amounts in a construction contingency account created by Taxpayer for unexpected construction overruns should be includable in eligible basis under § 42(d)(1). According to the revenue agent, the amount is an estimate. The Taxpayer has not provided any records that substantiate costs for this estimate demonstrating that they were in fact incurred. Further, there are no facts to adequately describe the nature of these costs. The Taxpayer included the amount in the Project's eligible basis under § 42(d)(1). Consequently, this issue lacks sufficient factual development to determine whether such costs are includable in eligible basis under § 42(d)(1).

The agent also questions whether costs of Taxpayer associated with securing tenants for the unit vacancies are includable in eligible basis under § 42(d)(1). Rent-up costs are not related to the construction of the buildings, but for the securing of tenants. Consequently, these costs do not establish or add to the basis of depreciable property subject to § 168. Thus, rent-up costs are not includable in eligible basis under § 42(d)(1).

Developer 2 Fees

The agent states that certain fees charged by Developer 2 are unreasonable or excessive under § 42(m)(2) and should be excluded from eligible basis under § 42(d)(1). The agent states that the initial developer, Developer 1, rather than Developer 2, performed most of the required developer duties relating to the Project, and that fees were paid to Developer 2 for services that included land acquisition, preliminary cost estimates and pro-formas, market research and project feasibility, preliminary site and building plans, equity consulting, development plan approval and building permits, construction loan financing, equity commitment and closing, and construction supervision. The agent suggests that the developer fees collected by Developer 2 should not be included in eligible basis because Developer 1 already had performed the required developer duties.

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.

Taxpayer represents that the fees at issue have been received, verified, and accepted by the state housing credit agency as eligible costs which meet the requirements of § 42(m)(2). 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, these kinds of costs generally satisfy the test for eligible basis under § 42(d)(1). However, the revenue agent challenges whether Developer 2 can substantiate performance of the services underlying the fees. This question of fact must be resolved at the examination level before technical advice may be rendered.

CAVEAT:

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(k)(3) of the Code provides that it may not be used or cited as precedent.

- END -

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
July 14, 2000

Number: **200044004**
Release Date: 11/3/2000
Index (UIL) No.: 42.04-00, 42.04-01, 168.00-00
CASE MIS No.: TAM-100745-00/CC:PSI:B5

Chief, Examination Division

LEGEND:

Taxpayer =

Project A =

City B =

Managing General Partner =

General Partner 2 =

Developer =

Individual 1 =

Individual 2 =

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 section 42(d)(1) of the Internal Revenue Code? Specifically, is the amount of a “Developer Fee Note,” provided in part payment for services rendered for the Taxpayer by the Developer, includible in the Taxpayer's eligible basis for purposes of determining the amount of low-income housing tax credit under section 42(d)(1)?

CONCLUSION:

Eligible Basis

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

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

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

Developer Fee Note

The amount of the Developer Fee Note is currently includible in the partnership's eligible basis under section 42(d)(1). However, this conclusion is conditioned on certain factual assumptions, as discussed in more detail below.

FACTS:

The Taxpayer was formed to construct, develop, and operate a low-income housing tax credit property (Project A) in City B. The Taxpayer's a percent limited partner is comprised of various corporate entities. The Managing General Partner of the Taxpayer is majority owned by Individual 1 and Individual 2, who also own or control, directly or indirectly, a number of related entities formed to construct residential rental properties. Project A's other general partner is General Partner 2, a non-profit corporation. Project A's Developer is owned b percent by Individual 1 and Individual 2; the remaining c percent is owned by two individuals who are also officers and employees in other Individual 1 and Individual 2 affiliated entities.

In connection with services rendered for the Taxpayer, Developer received a fee of approximately d. In e, when the Taxpayer did not have sufficient cash to pay the entire fee at construction completion, it issued a note (the Developer Fee Note) for the balance, f. The Developer Fee Note was one of three notes making up the Turnkey Development Note; the other two were a General Partner Cost Note and a Construction Cost Note, payable respectively to the Managing General Partner and a construction company owned by Individual 1 and Individual 2. The Taxpayer included the amount of the Developer Fee Note in the eligible basis of Project A for purposes of claiming low-income housing tax credits.

The note provided that the Taxpayer "hereby promises to pay to [Developer] ... the principal amount of ... f ... together with interest, in accordance with the terms and conditions set forth below." It bore interest, compounded monthly, at the greater of g percent or long-term AFR. It was assignable, but nonnegotiable. It was unsecured.

The Developer Fee Note contained source-of-payment restrictions. The payment terms of the Developer Fee Note were as follows:

(a) Payments shall be made from Development Funds, from Cash Flow, from Capital Transactions proceeds at the times and in the manner set forth in Section 4.1, Section

[1] This test does not exclude the application of other requirements that affect eligible basis under section 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.

6.9, and Article X of the Amended and Restated Agreement of Limited Partnership dated as of h of the Partnership (the "Partnership Agreement").

(b) Any interest not paid currently shall accrue and be added to principal semi-annually. All outstanding principal shall be payable at maturity, which shall be on the 13th anniversary of the occurrence of Full Completion.

Section 6.9 of the Partnership Agreement, referred to in the Developer Fee Note, provided that each of the notes making up the Turnkey Development Note "shall be a debt of the Taxpayer which shall not be secured, ... [and] shall mature on the 13th anniversary of Full Completion." With respect to sources of payment on the notes, it provided that each debt:

> shall be repaid only from any Development Funds which become available after Full Completion and otherwise from the sources in the manner set forth in Article X, in Section 4.1 and in the last sentence of Article III.C. Except as expressly provided for otherwise in this Agreement, all payments on said Notes shall be applied first to payment of the General Partner Cost Note, then to the Construction Cost Note and finally to the Development Fee Note.

Section 10.3 of Article X of the Partnership Agreement provided that upon partnership dissolution the assets of the Taxpayer would be distributed to the partners "after payment of, or adequate provision for, the debts and obligations of the Taxpayer (including the Turnkey Development Note ...)."

Section 10.2 of Article X of the Partnership Agreement describes repayment of the note out of cash flow and capital transactions. Regarding cash flow, under Section 10.2.A.,

(1) All cash flow shall first be applied to make any Adjustor Distribution not previously made to the Investor Limited Partner and then second shall be applied to repay first interest and then principal due on first the General Partner Cost Note and then the Construction Cost Note ... [subject to a cap if the amounts due exceed 10% of the principal mortgage].

(2) Twenty percent (20.0%) of Cash Flow remaining after application pursuant to clause (1) shall be applied to repay any then outstanding Operating Deficit Loans.

(3) Eighty percent (80.0%) of Cash Flow remaining after application pursuant to clauses (1) and (2) shall be applied in the following priority:

(a) To payment (first of interest and then principal) of any amounts still outstanding under the Turnkey Development Note after payments made pursuant to clause (1) until the Turnkey Development Note is paid in full;

(b) To the payment of the Incentive Management Fee; and

(c) To a distribution to the General Partners.

(4) Twenty percent (20.0%) of Cash Flow remaining after application pursuant to clauses (1) and (2) shall be distributed 2.0% to the General Partners ... and 98.0% to the Limited Partners.

With respect to repayment from capital transactions, Section 10.2.A. provided:

> Prior to dissolution, and subject to any applicable Lender regulations, if the General Partners shall determine from time to time that there is cash proceeds available for distribution from a Capital Transaction, such cash proceeds shall be applied or distributed, as the case may be, as follows:
>
>> First, to the discharge, to the extent required by any lender or creditor, of debts and obligations of the Taxpayer, but ... excluding repayment of the Turnkey Development Note unless such cash proceeds arise from a Capital Transaction which is a sale of the entire Property or is a refinancing of the Permanent Mortgage for which no Consent of the Special Limited Partner is required as provided in Article III.C. ... . [2]

Article III of the Partnership Agreement provided for borrowings by the Taxpayer. Article III.C.—referenced in Article X, Section 10.2.A.—generally restricted the General Partners from modifying a mortgage or otherwise pledging partnership assets without the consent of the Special Limited Partner. However, no consent was required for:

> a refinancing of the Permanent Mortgage (or an additional borrowing from a non-Affiliate) [3] at any time within one year before the maturity of the Turnkey Development Note if such refinancing (or additional borrowing) shall produce net proceeds sufficient ... to repay in full the Turnkey Development Note ....

Finally, under Section 4.1, referenced in the Developer Fee Note, the General Partners were:

> obligated to make such additional Capital Contributions at the maturity of the Turnkey Development Note in an amount sufficient to enable the Taxpayer to repay the Turnkey Development Note in full.

The financial statements of the Taxpayer for i and j indicate that, after obtaining permanent financing, operating cash flow is available as follows:

> 80% as payment on the unsecured developer fee notes ... , and 20% first as payment on any outstanding operating deficit guarantee loans ... and then as distributions to the general and limited partners.

Some payments have been made on the Developer Fee Note. The financial statements indicate that, as of k, the balance on the note had been reduced to l, and state: "Payments from operating cash flows were allocated to the developer fee notes on a prorata basis based on original principal balances."

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[2] Any remaining proceeds were to be applied, in order of priority, to (1) contingent liability reserves; (2) operating deficit loans; (3) undistributed adjustor distributions to the Investment Limited Partner; (4) reimbursement of the General Partners' obligation to repay the Turnkey Development Note; and (5) various partner distributions.

[3] As defined in Article XIV, an "affiliate," as applied to a general partner, referred to a variety of family members and other related persons and entities.

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 section 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 section 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 section 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 section 42 states that residential rental property, for purposes of the low-income housing credit, has the same meaning as residential rental property within section 103. The legislative history of section 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 section 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 section 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 section 42(d)(1) if it is:

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

(2) included in the adjusted basis of depreciable property subject to section 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 includible in eligible basis when determining the financial feasibility of a project under section 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 section 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 includible in eligible basis. 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) section 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.

Developer Fee Note

Generally, debt, whether recourse or nonrecourse, is includible in the basis of property. Commissioner v. Tufts, 461 U.S. 300 (1983); Crane v. Commissioner, 331 U.S. 1, 11 (1947). However, the obligation must represent genuine, noncontingent debt. Nonrecourse debt is not includible if the property securing the debt does not reasonably approximate the principal amount of the debt, or if the value of the underlying collateral is so uncertain or elusive that the purported indebtedness must be considered too contingent to be includible in basis.[4]

Recourse liabilities are generally includible in basis because they represent a fixed, unconditional obligation to pay, with interest, a specific sum of money. However, the mere fact that a note is recourse on its face is not determinative.[5] For example, an obligation, whether recourse or nonrecourse, will not be treated as a true debt where payment, according to its terms, is too contingent, or repayment is otherwise unlikely. A liability is contingent if it is dependent upon the happening of a subsequent event, such as the earning of profits.[6]

In the case of both recourse and nonrecourse debt, the underlying inquiry is the same: whether, in the light of all the facts and circumstances, the debt is reasonably certain to be paid.[7] In determining whether an obligation represents genuine, noncontingent debt, important factors include: the intent of the parties, as evidenced by subjective and objective factors; the relationship between the parties; the term of the obligation; its interest rate; whether the principal amount is fixed or contingent; payment terms prior to maturity; sources of repayment; and, in general, the ability of the obligor

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[4] See Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); Gibson Products Co. v. United States, 637 F.2d 1041, 1047-48 (5th Cir. 1981); Estate of Baron v. Commissioner, 83 T.C. 542 (1984) aff'd, 798 F.2d 65 (2d Cir. 1986).

[5] See Roe v. Commissioner, T.C. Memo. 1986-510, aff'd without published opinion sub nom., Sincleair v. Commissioner, 841 F.2d 394 (5th Cir. 1988).

[6] See Denver & Rio Grande Western R.R. Co. v. United States, 505 F.2d 1266, 1269 (Ct. Cl. 1974); Rev. Rul. 80-235, 1980-2 C.B. 229; Rev. Rul. 81-262, 1981-2 C.B. 164 (franchise fee). See also, with respect to purportedly recourse debt, Durkin v. Commissioner, 872 F.2d 1271, 1277 (7th Cir. 1989), cert. denied, 493 U.S. 824 (1989) (recourse debt nearly certain to be converted to nonrecourse debt); Graf v. Commissioner, 80 T.C. 944, 948 (1983) (payments made only out of profits); Houchins v. Commissioner, 79 T.C. 570, 600 (1982) (taxpayer's personal liability scheduled to expire two and a half years after execution of agreement); Herrick v. Commissioner, 85 T.C. 237, 251, 255, 260 (1985) (taxpayer lacked a profit motive, purchase price was excessive, no scheduled payments had been made on the notes, and creditor made no demand for payment); Waddell v. Commissioner, 86 T.C. 848, 901-902 (1986), aff'd, 841 F.2d 264 (9th Cir. 1988) (note convertible to nonrecourse); Upham v. Commissioner, 923 F.2d 1328, 1335 (8th Cir. 1991) (none of the partners expected creditor to enforce recourse note).

In a recent case involving the issue of eligible basis under § 42, Corbin West Limited Partnership v. Commissioner, T.C. Memo. 1999-7, the court held that the amount of the note was not includible in basis, even though the note was recourse against the partnership.

[7] See, e.g., Graf, 80 T.C. at 948; Durkin, 872 F.2d at 1276; Ortmayer v. Commissioner, 265 F.2d 848, 855 (7th Cir. 1959), rev'g. on this issue 28 T.C. 64 (1957).

to make the payments on the obligation. See generally cases cited in notes 4-7 above.

On its face, the Developer Fee Note in the present case is an obligation on the part of the Taxpayer to pay a fixed amount, with interest, at maturity. While, prior to maturity, payments of principal and interest are dependent on cash flow or receipts from capital transactions, all remaining principal and accrued interest are payable at maturity, in 13 years. Neither the note itself nor the Partnership Agreement states explicitly whether the source-of-payment restrictions apply at maturity.

Nevertheless, the note is a debt of the Taxpayer, not just the General Partners, and—while payments are contingent prior to maturity—it is payable at maturity for a fixed amount that is not contingent. Second, although the sources of payment in Article X of the Agreement are contingent, and Developer as creditor could not foreclose on any security interest in any specific asset, at maturity the General Partners “shall be obligated” to contribute to the Taxpayer in an amount sufficient “to enable the Taxpayer to repay the Turnkey Development Note in full” (emphasis added), and the Taxpayer appears to be obligated to reimburse the General Partners if possible. See section 4.1. of the Partnership Agreement. Finally, the last sentence of Article III.C. (which is referenced in section 6.9, which is referenced in the note) grants the General Partners a special power, within one year prior to maturity, to refinance the permanent mortgage, or pledge partnership assets to borrow from a non-affiliate, in order to repay in full the Turnkey Development Note.

While the question is not free from doubt, on balance we believe that—assuming Developer sought to enforce the debt—a court would find either (1) that the note was recourse against the Taxpayer at maturity, or (2) at minimum, the Taxpayer was obligated to use good-faith efforts to refinance the mortgage and/or borrow from “non-affiliates,” if possible, in order to pay off the note at maturity. Since the Taxpayer's ability to refinance or borrow at that point would be largely a function of the value of the Taxpayer's assets, the note would, at minimum, be “recourse” in that sense.

As noted above, whether an obligation is currently includible in basis rests on an evaluation of all the facts and circumstances. On balance, at least from a legal standpoint, we conclude that the Developer Fee Note is sufficiently substantial and noncontingent so as to be includible in basis under sections 1012 and 1016.[8]

Our conclusion that the Developer Fee Note is genuine, noncontingent debt is conditioned, first and foremost, on the fact that repayment of the note is backed

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[8] As an accrual-basis taxpayer, the Taxpayer is subject to the rules for the timing of items such as deductions—and basis—under section 461. For the reasons discussed above, and subject to the factual caveats discussed below, we conclude that the obligation represented by the Developer Fee Note meets the”all-events test,” including the “economic performance” requirement, in section 1.461-(a)(2)(i). The fact of the liability has been established and is not subject to significant contingencies; the amount of the liability is determinable; and, since the liability arose in connection with services already provided to the taxpayer, economic performance has occurred.

by the equity the Taxpayer has in the assets, primarily the real estate in Project A, beyond the General Partners' guarantee—plus cash flow, if any, from operating the project.[9] Although we do not address the value of the specific assets, the following factors are important for factoring the real estate value into the determination of the overall issue.

In an influential case in this area, Gibson Products v. United States, 637 F.2d 1041 (5th Cir. 1981), the court, ruling that a note payable from oil and gas well production was too contingent to support a deduction, observed:

> We conclude on this record that the nonrecourse note from the McNeil/Midwest joint venture to Galaxy was not a true loan. In a true lending transaction, the borrower normally possesses assets nearly equal or greater in value than the amount of indebtedness, whether or not those assets are hypothecated to secure the debt. In addition, the lender usually expects the borrower to maintain those assets at such a level until the obligation is satisfied. Moreover, in a true lending transaction, there exists the reasonable likelihood that the lender will be repaid in light of all reasonably foreseeable risks. In other words, there must be 'a reasonable basis for the prediction that the ability of the borrower to repay will not be wholly or substantially contingent upon the success or failure of the business venture.'
>
> * * *
>
> The single most important factor dictating our conclusion that the transaction between Galaxy and McNeil/Midwest was not a true loan is the fact that the total combined assets of both joint venturers were not sufficient to pay the note on or before the maturity date, even if McNeil/Midwest was so inclined, absent production from any of the leases.

637 F.2d at 1047 (emphasis added, citations omitted).[10] In our view, this represents the appropriate approach to take with respect to the valuation issue in the present case: if, as a factual matter, the value of the Taxpayer's assets available for the Taxpayer to borrow against--plus the value, if any, of the General Partners' guarantee, and less the value of the obligations to which the Developer Fee Note is subordinate--is less than the amount of the Developer Fee Note, that would be a strong indication that, in the words of the Gibson opinion, there was no "reasonable likelihood that the lender will be

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[9] See, e.g., Chamberlain v. Commissioner, T.C. Memo. 1987-20; Estate of Baron, 83 T.C. 542 at 552:

> The transaction involved herein is also distinguishable from a situation where the acquisition of rental real estate or equipment is involved. In such situations, not only are the payments on a nonrecourse note usually fixed in amount, but the obligation to make the payments is not, by its terms, confined to the income produced, and the underlying property has a potential value apart from the income stream which it is expected to generate. Moreover, the value of the underlying property is not so directly and totally dependent upon public acceptance as is the case with a master recording or similar property ... .

[10] See also id. at 1048-49 n. 14 and accompanying text. Note that the court's reasoning in Gibson Products was broad enough to encompass secured and unsecured assets, as well as a hypothetical "recourse" scenario in which the borrower, despite the nonrecourse nature of the note, is nevertheless "inclined" to pay.

repaid in light of all reasonably foreseeable risks." In such a case, the Developer Fee Note should be treated as contingent unless, and only to the extent that, it is actually paid.

Second, it has been asserted that the Developer does not have the ability to act independently in relation to the Taxpayer and would therefore be unlikely to enforce the Developer Fee Note. The factual finding of Developer independence is contingent on a number of factors, including the prior course of dealings between Individual 1 and Individual 2 and their employees, the likelihood that ownership of the creditor or debtor entities might change, and the consequences arising from the sale of the property and the subsequent payment of the Developer Fee Note. Since the nature of the dealings between the parties is a significant factor under the case law,[11] it would clearly affect our conclusion.

Third, it has been asserted that the General Partners would be unlikely to fulfill their potential obligation to contribute to the Taxpayer in order to pay the Developer Fee Note at maturity. However, we do not believe that the General Partners' guarantee is the sole source of repayment of the note at maturity. It is one factor supporting our conclusion above, and to the extent it is determined that the General Partners' guarantee is of little or no value, this fact would affect the conclusion that the debt is includible in basis.

Lastly, one factor in determining whether an obligation is likely to be paid is whether the creditor parted with value when the obligation was incurred. In most cases, where the debt is incurred in return for property—as in the case of a purchase-money note—this question is phrased in terms of whether the amount of the note exceeds the true fair market value of the property. In this case, the debt was incurred in return for the provision of services. Accordingly, if it is determined that the amount of the note, combined with the cash previously paid to Developer, exceeded the fair market value of the services provided by Developer, this would be an objective factor indicating that the note was unlikely to be paid.

CAVEAT

No opinion is expressed on whether Project A otherwise qualifies for the low-income housing tax credit under section 42. Similarly, we express no opinion on the allocable portion of the Developer Fee Note that may belong with land versus building costs. A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

-END-

[11] See, e.g., Corbin West, T.C. Memo 1999-7.

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
July 14, 2000

Number: **200044005**
Release Date: 11/3/2000
Index (UIL) Nos.: 42.00-00 42.04-00 42.04-01 167.14-11
168.00-00 263A.00-00
CASE MIS No.: TAM-100740-00/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 =

Agency =

State A =

State B =

State C =

Gen Partner A =

Gen Partner B =

Gen Partner C =

Ltd Partner =

Contractor A =

Contractor B =

Bank =

Lender =

a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=

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 certain land preparation costs, costs for obtaining a construction loan, and construction contingency costs incurred by the Taxpayer in constructing 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]

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).

Construction Contingency Costs

The Taxpayer has not provided any records that substantiate whether the construction contingency costs were in fact incurred. Further, there are no facts to

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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.

adequately describe the nature of these costs. 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 B limited partnership, with a b percent interest and the limited partner of the Taxpayer is Ltd Partner, a State C limited partnership, with a c percent interest. Gen Partner B, a State B corporation, is a general partner of Gen Partner A. The Taxpayer was formed for the sole purpose of constructing and operating the Project. The Taxpayer purchased the land for construction of the Project on d. On e, the Taxpayer received a carryover allocation from Agency in the amount of f in low-income housing credits under § 42 and began to develop the Project. The Taxpayer entered into a contract for construction of the Project, which was to consist of g units, with Contractor A. Gen Partner C is the general partner of Contractor A. Contractor A entered into a contract with Contractor B for the construction of the Project.

The Taxpayer included certain land preparation costs, costs for obtaining a construction loan, and construction contingency costs in the Project's eligible basis under § 42(d)(1).[2]

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 § 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

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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 facts provided by the district office.

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

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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 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.

Land Preparation Costs

The Taxpayer incurred a variety of land preparation costs when constructing the Project which the Taxpayer included in the Project's eligible basis under § 42(d)(1). These costs included the following land surveys: boundary, topographic, mortgage, tree, architectural, ALTA, and recordation of the final plat. 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 staking. Further, the Taxpayer incurred costs for the following engineering services: detailed construction drawing, erosion control plan, grading plan, utility plans, general details, easement descriptions, sewer and sanitary plans, and traffic engineering.

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, holds 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 holds 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. The first loan was a construction loan which was closed with Bank on h. 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 i 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).

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).

Construction Contingency Costs

The Taxpayer included j in the final cost certification to the Agency for construction contingency. According to the revenue agent, this figure is an estimate and relates to possible construction overruns. The Taxpayer has not provided any records that substantiate costs for this estimate demonstrating that they were in fact incurred. Further, there are no facts to adequately describe the nature of these costs. The Taxpayer included the amount in the Project's eligible basis under § 42(d)(1). Consequently, this issue lacks sufficient factual development to determine whether such costs are includable in eligible basis under § 42(d)(1).

CAVEAT:

No opinion is expressed as to 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 the Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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