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# Tax Accounting

**BY JAMES E. SALLES**

This month's column discusses Revenue Ruling 2002-9, which allows developers to depreciate "impact fees" paid to local governments to obtain permission to build. The ruling may pave the way for taxpayers to argue for similar treatment for other costs directly associated with development.

## "IMPACT FEES" PART OF BUILDING COST

The IRS has ruled in Revenue Ruling 2002-9[1] that developer impact fees are capitalizable, but that these fees should be treated as part of the cost of the associated building, rather than that of the land. This treatment benefits taxpayers by allowing them to depreciate the impact fees as well as include them in "eligible basis" in computing the low-income housing credit. The ruling arose out of the IRS's Industry Issue Resolution Program, an IRS initiative to resolve troublesome recurring issues in consultation with affected taxpayers.[2] The IRS's conclusion drew praise from a spokesman for the Real Estate Roundtable, which had requested consideration of the issue.[3] Although Revenue Ruling 2002-9 is confined to impact fees—indeed, the IRS refused to include other types of costs in the guidance project[4]—its reasoning may have implications for other costs connected with development.

### Background

The costs of an attempted rezoning,[5] as well as other expenditures undertaken to facilitate the commercial exploitation of real property,[6] are capital. Capitalization is required whether or not the taxpayer plans to develop the property, because the rezoning will in any event enhance the value of the land.[7] For example, in *Hustead v. Commissioner*,[8] the taxpayers were required to capitalize the cost of their successful challenge to a local zoning ordinance even though they intended from the outset to "flip" the property to a builder if they got the existing restrictions set aside.

The outlays are capital regardless of whether the taxpayer's efforts are successful,[9] although the cost of a failed attempt to get property rezoned may become deductible as a loss under Code Section 165. When the taxpayer abandoned a contemplated rezoning project, the Tax Court in *Chevy Chase Land Co. of Montgomery County, Md. v. Commissioner*[10] allowed a loss deduction for the costs of the unsuccessful rezoning effort, except for the costs of a topographical map that the court found had continuing value.[11]

Developers have also been required to capitalize conveyances and other transfers to or for the benefit of local authorities that are made to obtain approval to build, and other "permitting costs."[12] In *Oriole Homes Corp. v. United States*,[13] cited in Revenue Ruling 2002-9, the court extended the same reasoning that is applied to impact fees, and required these costs to be capitalized into the cost of the property.

### The Uniform Capitalization Rules

Where they apply, the uniform capitalization (UNICAP) rules enacted in 1986 reinforce the requirement to capitalize such permitting costs. Section 263A generally requires capitalizing direct and indirect costs relating to property that is either "produced" by the taxpayer or "acquired by the taxpayer for resale."[14] In *Von-Lusk v. Commissioner*,[15] the Tax Court held that the costs of obtaining permits and zoning variances for a planned development were costs relating to property that the taxpayer was "producing." The court reasoned that these types of outlays were "ancillary to actual physical work on the land" and "represented the first steps of development," and therefore had to be capitalized even though the project might later be abandoned.

Some commentators have argued that *Von-Lusk*'s classification of permitting costs as production costs means that these costs should be included in the depreciable basis of the associated buildings.[16]

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However, the analysis is not that simple. First, the impact fees are capital regardless of Code Section 263A. Zoning and permitting costs were consistently held to be capital before the UNICAP rules were enacted, and continued to be considered such, even in a later Tax Court case where the court expressly did not apply Code Section 263A because the taxpayer was neither a developer nor a dealer.[17] *Oriole Homes*, which applied the capitalization rule to impact fees, likewise involved pre-UNICAP taxable years. Second, not all costs that the UNICAP rules treat as a cost of production are necessarily depreciable. For example, the cost of raw land, which is clearly not depreciable,[18] is included in "accumulated production expenditures" relating to the real estate under construction.[19]

## A Critical Question

The question therefore remains: Once impact fees (or other permitting costs) are capitalized, are they part of the cost of the land, the building, or something else? The classification of the costs will generally not matter to a developer that does not use the property itself and sells the building and underlying land together. However, if the building is being constructed for use in the property owner's own operations or in a rental business, the classification becomes important because the building is depreciable while the land is not. Moreover, for eligible properties, the low-income tax credit is computed by reference to the tax basis of the building.[20]

Similar questions arise frequently with respect to "land preparation costs" such as expenditures for clearing, grading and landscaping, or excavation and dredging. Unless the resulting "improvements" have independent useful lives, such outlays are normally nondepreciable unless they are attributed to another asset that is depreciable, such as a building. Sometimes the issue is whether the improvements are "inextricably associated" with the land, or alternatively "directly associated" with the depreciable asset.[21] In the latter case, the improvements' useful lives are determined by reference to that asset and they effectively become part of its cost.[22]

Similarly, when a taxpayer pays to improve property it does not own, or dedicates property to public use to obtain a benefit such as public access,[23] improvements to an adjacent road,[24] or utility services,[25] the costs are capital. The IRS view, which is probably the correct one, is that the "benefit" to the taxpayer's property is an intangible asset.[26] If the property is a fee interest in land, the intangible asset will not be amortizable unless it has its own useful life.[27] However, if the associated property has a definite useful life, the associated intangible will be amortized along with it. For example, Revenue Ruling 68-607[28] permitted the taxpayer to amortize the cost of improvements to adjacent public highways over the term of its 99-year lease.

## Apportioning Land Preparation Costs

There is a fair amount of law on apportioning land preparation costs and the like between the land itself and the buildings erected upon it. The critical inquiry is whether the improvements' useful lives will terminate along with that of the building.[29] For example, the IRS ruled in Revenue Ruling 68-193[30] that roadways specially constructed to service storage buildings were to be depreciated along with the buildings. The costs subject to depreciation included the costs for land grading necessary in the course of constructing the roads. The IRS noted that "[t]he grading would no longer be useful if the buildings were retired, abandoned, or reconstructed, and if new buildings were constructed or the old buildings reconstructed, it would be necessary that the roadways be regraded."[31] Revenue Ruling 74-265[32] allowed depreciation of landscaping immediately surrounding a building that would be destroyed if the building were replaced. Revenue Ruling 80-93[33] reached the same result regarding excavation costs incurred in the course of constructing laundry facilities and a storm sewer system when replacing those assets would entail "physical destruction of that land preparation."[34]

Courts apply the same test to developers' land preparation costs. In *Trailmont Park, Inc. v. Commissioner*,[35] the taxpayer converted steep wooded land into a mobile home park by carving out level terraces for each trailer. The Tax Court held that the grading costs were depreciable along with the associated "trailer pads" and patios, noting that "any other business use of the land would require the clearing up of the pads and patios and again reshaping . . . the land."

The other side of the coin is illustrated by *Eastwood Mall, Inc. v. United States*.[36] The taxpayer in *Eastwood* spent nearly $10 million to level a few acres in the mountains of West Virginia sufficiently to permit construction of a shopping mall. The issue was whether the taxpay-

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er could depreciate that amount along with the costs of constructing the mall itself. The initial jury verdict in favor of the government was overturned on procedural grounds by the Sixth Circuit, and the case was remanded to the district court for formal findings. Notably, one member of the panel considered the question to be settled by uncontested testimony that "none of the work performed . . . would have to be repeated if a similar project were to be constructed on the site in the future"[37] and that the appellate court should have held for the government as a matter of law. On remand, the district court stated that "[t]he key test . . . is whether these costs will be reincurred if the building were replaced or rebuilt,"[38] and held for the government. The Sixth Circuit summarily affirmed.

## Revenue Ruling 2002-9

Revenue Ruling 2002-9 involved garden-variety local impact fees imposed on a real estate developer. The fees were computed based upon the size and projected number of rental units in the proposed project. The ruling first concluded that the fees were capital both under general capitalization principles and as "indirect costs of production" under Code Section 263A. The next issue was whether they were allocable to the land or to the building. The IRS noted that the fees were computed based upon the characteristics of the particular development, and that "generally" impact fees were refundable if the project was cancelled. Therefore, the fees were properly depreciated along with the other costs associated with the building—either as residential or nonresidential real property—and were also includable in "eligible basis" for purposes of the low-income housing credit. This represents a reversal of the position that the IRS had previously taken in technical advice.[39]

In an unusual move, provisions for automatic changes of accounting method and audit protection were included in the ruling itself. Moreover, if the change is made for calendar year 2001, or the taxpayer's first fiscal year ending in 2002, the ordinary restrictions on automatic changes of accounting method are inapplicable and audit protection will be provided even if the issue has already been raised.

## Classifying Permitting Costs

Revenue Ruling 2002-9 must be read against the backdrop of the existing law on allocating costs to land and/or buildings. As with other expenditures providing a benefit to property, permitting costs have consistently been held to be capital. However, the existing authorities do not clearly distinguish which of these costs are allocable to the land and which to the building or other improvement. Most of the old cases involved residential real estate developers that sold buildings and lots together, so the issue was unimportant. In a few instances where the costs' allocation might have made a difference, the courts skirted the issue.[40]

There would appear, however, to be a good argument that the principles recognized in the "land development cost" cases should apply to permitting costs and similar intangible outlays. Such an approach would allow these types of costs to be included in the constructed property so long as they were "directly associated" with the construction and did not otherwise enhance the value of the land for other uses.

For example, the cost of rezoning would ordinarily not be "associated" with specific construction. A favorable zoning change is likely to enhance the value of the land apart from any development,[41] and the reconstruction or replacement of existing buildings with similar structures will not ordinarily require rezoning. Similarly, benefits from improved road access to a property would ordinarily be expected to outlast any particular buildings on it. On the other hand, under the logic of the land preparation cost cases, permitting costs and other expenditures to obtain permission to build a specific project would be likely candidates for capitalization into the basis of the constructed assets. Significant new construction would likely entail another run at the permitting process, and possibly fresh impact fees.

The Real Estate Roundtable had originally requested consideration of the treatment of "local impact fees, publicly dedicated infrastructure improvements, and similar costs." The IRS, in accepting the issue for treatment under the Industry Issue Resolution program, limited consideration to impact fees.[42] Significantly, however, the guidance was issued in the form of a revenue ruling rather than a revenue procedure, indicating that the IRS was applying legal principles rather than making an administrative concession. Moreover, the ruling clearly marks IRS acceptance of the principle that the cost of an intangible benefit can, if closely enough associated with another asset, be included in that asset's basis. It is hard to see why impact fees should be treated differently

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from other costs directly related to obtaining permission to build. The IRS and the courts may start to see taxpayers citing Revenue Ruling 2002-9 in support of similar treatment for other permitting costs.

1. 2002-10 I.R.B. ___; see News Release IR-2002-20 (Feb. 15, 2002).

2. *See* Notice 2000-65, 2000-52 I.R.B. 599.

3. *See* "IRS Requires Real Estate Impact Fees to be Capitalized, But Allows Depreciation," BNA Daily Tax Report, February 19, 2002, at GG-1.

4. *See* IRS News Release IR-2001-48, Apr. 26, 2001, p. 4.

5. *E.g.*, Chevy Chase Land Co. of Montgomery County, Md. v. Commissioner, 72 T.C. 481 (1979); Galt v. Commissioner, 19 T.C. 892, 910 (1953) (reviewed), *aff'd and rev'd on other issues*, 216 F.2d 41 (7th Cir. 1954); Hustead v. Commissioner, 68 T.C.M. (CCH) 342 (1994); Godfrey v. Commissioner, 22 T.C.M. (CCH) 1 (1963), *aff'd*, 335 F.2d 82, 84-85 (6th Cir. 1964), *cert. denied*, 379 U.S. 966 (1965).

6. *E.g.*, Louisiana Land & Exploration Co. v. Commissioner, 7 T.C. 507 (1946), *aff'd on other issues*, 161 F.2d 842 (5th Cir. 1947) (geophysical survey); Godfrey, *supra* ("use survey").

7. *E.g.*, Soelling v. Commissioner, 70 T.C. 1052, 1056 (1978) (capitalizing rezoning costs relating to property held for investment).

8. 68 T.C.M. (CCH) 342 (1994).

9. *E.g.*, Chevy Chase; Godfrey.

10. 72 T.C. 481 (1979).

11. The taxpayer in Godfrey attempted to claim an ordinary deduction under section 212, but did not claim a loss under section 165. *See* Chevy Chase, 72 T.C. at 488 n.5.

12. *E.g.*, Stubbs v. United States, 428 F.2d 885 (9th Cir. 1970), *cert. denied*, 400 U.S. 1009 (1971) (property dedicated to ensure favorable zoning and access); Sutton v. Commissioner, 57 T. C. 239 (1971) (easement granted to expand road to required width); Lots, Inc. v. Commissioner, 49 T.C. 541, 549-51 (1968), *aff'd on other issues sub nom;* Christie v. Commissioner, 436 F.2d 1216 (5th Cir. 1971) (recreation shelter constructed in public park); Perlmutter v. Commissioner, 45 T.C. 311 (1965) (portion of developed property conveyed for public use); Eggert v. Commissioner, 36 T.C.M. (CCH) 1071 (1977) (similar).

13. 705 F. Supp. 1531 (S.D. Fl. 1989).

14. I.R.C. § 263A(a), (b)(1), (2)(A). An exception from the "reseller rules" applies to certain small taxpayers.

15. 104 T.C. 207 (1995).

16. *See generally, e.g.*, P. Anthony Brown & Patricia Hughes Mills, "Impact Fees and Publicly Dedicated Improvements: Are They Really Nondepreciable Intangibles?" 28 J. Real Est. Tax'n 361 (Summer, 2001).

17. Husted, *supra.*

18. *See* Reg. § 1.167(a)-2.

19. Reg. § 1.263A-11(b)(1).

20. *See* I.R.C. § 42(c), (d).

21. *See, e.g.*, Algernon Blair, Inc. v. Commissioner, 29 T.C. 1205, 1220-21 (1958); Snyder v. Commissioner, 47 T.C.M. (CCH) 355, 377 (1983); Eastwood Mall, Inc. v. United States, 95-1 U.S.T.C. ¶ 50,236 (N.D. Oh. 1995) at 87,855-57, on remand from unpublished opinion, 47 F.3d 1168 (6th Cir. 1994) (memorandum opinion at 74 A.F.T.R.2d ¶ 94-5649), *aff'd per curiam* in unpublished opinion, 59 F.3d 170 (6th Cir. 1995) (memorandum opinion at 1995 WL 334634); Trailmont Park, Inc. v. Commissioner, 30 T.C.M. (CCH) 871 (1971); Rev. Rul. 65-265, 1965-2 C.B. 52, clarified by Rev. Rul. 68-193, 1968-1 C.B. 79.

22. *See, e.g.*, Eastwood, 95-1 U.S.T.C. ¶ 50,236 at 87,856 (costs directly associated with construction are "considered associated with the building, and, as such, added to the taxpayer's cost basis in the building and are depreciable,"); TAM 200043015 (July 14, 2000) (discussing "when land preparation costs are depreciable and consequently may qualify for inclusion in eligible basis [of the building]").

23. *See, e.g.*, Stubbs; Woodside Mills v. United States, 260 F.2d 935, 936 (4th Cir. 1958) (alternative holding) (streets dedicated to public use).

24. *E.g.*, United States v. Transamerica Corp., 392 F.2d 522 (9th Cir. 1968); Rev. Rul. 57-488, 1957-2 C.B. 157; *see also, e.g.*, TAM 200017046 (Sept. 10, 1999); compare, *e.g.*, Citizens & Southern Bank of South Carolina v. United States, 243 F. Supp. 900 (W.D. S.C. 1965) (taxpayer's conveyance of land for a highway found to have been for public benefit).

25. *E.g.*, Algernon Blair, Inc. v. Commissioner, 29 T.C. 1205 (1958); TAM 200017046 (Sept. 10, 1999) (sewage and utility systems dedicated to city).

26. Rev. Rul. 68-607, 1968-2 C.B. 115 (highway improvements to provide access to mall); TAM 200017046 (Sept. 10, 1999).

27. *See, e.g.*, Noble v. Commissioner, 70 T.C. 916, 921-22 (1978) (indefinite right of access to sewer system has same 50-year life as system itself); Rev. Rul. 73-188, 1973-1 C.B. 62 (costs to turn public street into enclosed pedestrian mall expected to provide a ten-year benefit).

28. 1968-2 C.B. 115 (benefit amortizable over term of taxpayer's 99-year lease).

29. For the IRS's present position, *see generally* TAMs 200043015-16-17 and 200044005 (July 14, 2000).

30. 1968-1 C.B. 79, clarifying Rev. Rul. 65-265, 1965-2 C.B. 52.

31. Accord, *e.g.* Rev. Rul. 72-96, 1972-1 C.B. 67 (costs of clearing, stripping, and grading the site included in costs of a reservoir in computing depreciation and investment tax credit).

32. 1974-1 C.B. 56.

33. 1980-1 C.B. 50.

34. Rev. Rul. 80-93, 1980-1 C.B. 50.

35. 30 T.C.M. (CCH) 871 (1971).

36. 95-1 U.S.T.C. ¶ 50,236 (N.D. Oh. 1995) at 87,855-57, on remand from unpublished opinion, 47 F.3d 1168 (6th Cir. 1994) (memorandum opinion at 74 A.F.T.R.2d ¶ 94-5649), *aff'd per curiam* in unpublished opinion, 59 F.3d 170 (6th Cir. 1995) (memorandum opinion at 1995 WL 334634).

37. Eastwood, 74 A.F.T.R.2d ¶ 94-5650 at 94-7039 (Joiner, J., concurring and dissenting).

38. Eastwood, 95-1 U.S.T.C. ¶ 50,236 at 87,856.

39. *See* TAM 200043016 (July 14, 2000), retroactive relief denied, TAM 200203013 (Oct. 9, 2001).

40. *See, e.g.*, Eggert v. Commissioner, 36 T.C.M. (CCH) 1071 (1977), where the court concluded that the costs were either allocable to land which had not been sold or had been recovered as part of the cost of homes that had been sold, and did not press the issue further.

41. *Cf.* Husted, discussed above.

42. *See* IRS News Release IR-2001-48 (Apr. 26, 2001).