

Low Income Housing Credit Program
Eligible Basis Issues: Land Costs
November 2000

ISSUE

Whether certain costs, associated with land, are includable in the property's eligible basis under Section 42(d)(1) of the Internal Revenue Code.

DISCUSSION OF LAW

A cost incurred in the construction of a low-income housing building is includable in eligible basis under IRC 42(d)(1) if, as of the close of the first tax year of the credit period, the cost is:

1. included in the adjusted basis of depreciable property subject to IRC 168 and the property qualifies as residential rental property under IRC 103, or
2. included in the adjusted basis of depreciable property subject to IRC 168 that is used in a common area or provided as a comparable amenity to all residential rental units in the building. (Note: this test does not exclude the application of other requirements affecting eligible basis under IRC 42. For example, the cost of constructing a parking area would qualify under this test. However, if a separate fee were charged for use of the parking area, the cost would not be included in the eligible basis.)

IRC 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 a trade or business of the taxpayer, or of property held for the production of income. Regulation 1.167(a)-2 further provides that the depreciation allowance, in the case of tangible property, applies only to the 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 IRC 167(a) for tangible property is determined by using the applicable depreciation method, the applicable recovery method, and the applicable convention. For residential rental property, the applicable depreciation method is the straight line method, the applicable recovery period is 27.5 years, and the applicable convention is the mid-month convention. Land improvements, whether IRC 1245 property or IRC 1250 property, are included in asset class 00.3, Land Improvements, and have a class life of 15 years for the general depreciation system. Thus, for land improvements, the applicable depreciation method is the 150% declining balance method, the applicable recovery period is 15 years, and the applicable convention is the half-year convention.

In Eastwood Mall, Inc. v. U.S., 95-1 USTC 50,236 (N.D. Ohio 1995), aff'd without published opinion, 59 F.3d 170 (6th Cir. 1995), the courts 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 on the land (depreciable). It further asserted that the key test for determining whether land preparation costs are associated with nondepreciable land or the depreciable buildings 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 are to be added to the taxpayer's cost basis in the land and are not depreciable. 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; the costs are depreciable.

For a land cost to be included in eligible basis, it must be so closely associated with a particular *depreciable* asset that the land cost will be retired, abandoned, or replaced *contemporaneously* with that depreciable asset; i.e., the cost will be reincurred. Whether a specific land cost will be retired, abandoned, or replaced contemporaneously with the depreciable asset, is a question of fact. It is irrelevant that a state housing credit agency or ordinance may require a taxpayer to incur a particular land preparation cost.

CONSIDERATION OF SPECIFIC LAND COSTS

Land Grading

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. 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 IRC 42(d)(1).

Clearing, Grubbing, Cutting, Filling, and Rough Grading

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 for the clearing, grubbing, cutting, filling and rough grading necessary to bring the land to a suitable grade for constructing certain depreciable assets. These costs will not be repeated when the depreciable asset is replaced. This revenue ruling held that the land preparation costs (clearing, grubbing, cutting, filling and rough grading) are unaffected by replacement of the depreciable assets and will not be replaced contemporaneously. Therefore, they are nonrecurring general land improvement costs that are inextricably associated with the land; they are to be added to the taxpayer's cost basis in the land. These land preparation costs are not depreciable and, therefore, are not includable in eligible basis under 42(d)(1).

Excavating, Grading and Removal Costs

Earth-moving costs incurred for digging spaces and trenches for a building's foundation and utilities are generally considered to be inextricably associated with the building, are added to the cost of the building and, therefore, are depreciable. Similarly, costs incurred for fill dirt used to set the foundation of a depreciable asset are generally considered to be inextricably associated with the depreciable asset and are depreciable. Rev. Rul. 65-265, 1965-2 C.B. 52, clarified by Rev. Rul. 68-193, 1968-1 C.B. 79, holds that excavating, grading, and removal costs directly associated with the construction of buildings and paved roadways are not inextricable associated with the land and should be included in the depreciable basis of the buildings and roadways. Similarly, Rev. Rul. 80-93, 1980-1 C.B. 50, holds that excavation and backfilling required for the construction of a laundry facility and storm sewer system were so closely associated with those depreciable assets that replacement of the depreciable assets will require the physical destruction of the land preparation. As such, the costs are includable in eligible basis under IRC 42(d)(1).

Landscaping

Rev. Rul. 74-265, 1974-1 C.B. 56, 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 to the taxpayer 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 landscaping 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 landscaping, this test will be considered satisfied.

This revenue ruling involved 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 to the general design of the apartment complex. The expenditures for landscaping included the cost of top soil, seeding, clearing and grading, and planting perennial shrubbery and ornamental trees around the perimeter of the tract of land and also immediately adjacent to the building. Replacing the apartment buildings would destroy the immediately adjacent landscaping, consisting of perennial shrubbery and ornamental trees. Accordingly, landscaping 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 is general land improvements that will be unaffected by the replacement of the apartment buildings and, therefore, will not be replaced contemporaneously. This includes the necessary clearing and general grading, top soil, seeding, finish grading, and the planting of perennial shrubbery and ornamental trees around the perimeter of the tract of land. Accordingly, these types of costs are not depreciable property, but are considered inextricably associated with the land.

Similar to the treatment of landscaping in Rev. Rul. 74-265, such landscaping immediately adjacent to a low income housing building, including depreciable property used in common areas, so that it would be replaced contemporaneously with the building, or common area property, is depreciable property and its costs are includable in eligible basis under IRC 42(d)(1). However, for landscaping that will not be replaced contemporaneously with the low income housing building, or common area property, its costs are not includable in eligible basis.

Utility Systems

The amounts paid for 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. The taxpayer paid for the distribution system, but the utility company retained full ownership and repairs/replaces the systems as needed. (See Rev. Rul. 80-93, 1980-1 C.B. 50.) These cost are not depreciable and, therefore, are not includable in eligible basis under IRC 42(d)(1).

Local Impact Fees

Impact fees are assessed by county governments for site development. The fees are one-time property costs that are assessed when new construction takes place. The fees may be used for a variety of purposes, including construction or extension of a water delivery system, build roads, provide educational facilities, law enforcement, or fire/rescue services. 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 replaced by a larger structure, additional fees may be assessed above the original charge. However, if a smaller structure is built, no refund is given.

IRC 167(a) allows, as a depreciation deduction, a reasonable allowance for the exhaustion, wear and tear, or obsolescence of property used in a trade or business of the taxpayer, or of property held for the production of income. In order to have a depreciable interest in a tangible asset, several factors are considered, including (1) whether the taxpayer owns or has exclusive use of the asset, (2) whether the asset is used directly in the taxpayer's business, and (3) whether the taxpayer will maintain and replace the asset as necessary. In Rev. Rul. 68-607, 1968-2 C.B. 115, 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 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 had no relationship to the life of any tangible asset and was not treated as the taxpayer's tangible asset. See also Noble v. Commissioner, 70 T.C. 916 (1978), nonacq. on other grounds, 1979-2, C.B. 2 and F.M. Hubbell Son & Co., Inc. v. Burnet, 51 F.2nd 644 (8th Cir. 1931), cert. denied, 284 U.S. 664 (1931).

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 a part of the street systems for public use and convenience. The court noted that since the improvements were public property, the taxpayer did not have an interest in the property that would allow a depreciation deduction. *The fact that the taxpayer owned all the adjoining properties was without controlling significance in view of the fact that the improvements were used primarily in the public business.*

Impact fees are assessed *to finance public services* such as water delivery systems, sidewalks and roads, schools, law enforcement, and fire/rescue services. Taxpayers do not own any of the assets purchased with the fees, nor do they have exclusive use of the 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 constitutes an intangible asset.

Regulation section 1.167(a)-3 provides that if an intangible asset is known from experience or other factors to be of use in the business or production of income for only a limited period, such intangible assets may be subject to a depreciation allowance. For example, 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 business owners maintained the mall and paid the costs of heating and air conditioning. The mall was expected to provide the affected business owners with a business advantage for a period of ten years. In this case, it was held that the assessments incurred by the property owners were capital expenditures that may be depreciated over the ten-year period for which the mall was expected to provide a business advantage.

Impact fees are a capital expenditure for which taxpayers receive an *intangible* benefit for an undeterminable period of time and without responsibility for maintenance or replacement of the underlying assets; i.e., the local government entity assumes liability for the maintenance and replacements of the assets acquired with the fees. 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.) The asset acquired with the impact fees is nondepreciable intangible property. These costs are not includable in the property's eligible basis under IRC 42(d)(1).

Land and Environmental Surveys

Land and environmental surveys are generally conducted over the entire property of the development, not just where the buildings and improvements will be specifically placed. Some surveys, such as boundary or mortgage surveys help to define the property. Costs incurred for these types of survey are clearly and inextricably associated with the land, are not depreciable, and not included in the eligible basis under IRC 42(d)(1).

Environment surveys such as percolation tests and contamination studies are used to determine if the land is suitable for the construction of the contemplated improvements. Other similar surveys include soil borings, geotechnical investigations, suitability studies, wetland reviews, mapping of wetland, inspection of wetland, wetland characterization, and groundwater investigations. 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 are not depreciable or includable in the eligible bases under IRC 42(d)(1).

Engineering and Architectural Services

Engineering and architectural services may include (but are not limited to) the preparation of detailed construction drawings, erosion control plan, grading plan, utility plans, general details, easement descriptions, sewer and sanitary plans, and traffic engineering. Such services associated with nondepreciable land are not includable in eligible basis under IRC 42(d)(1). The services associated with a tangible depreciable asset, however, are includable in eligible basis under IRC 42(d)(1). While it is a case-by-case factual determination, these services should be characterized consistently with the subject of the service. For example, detailed construction drawings for a building would be includable in eligible basis.

Services that may be associated with both nondepreciable property (for example, land) and depreciable property (for example, a building) should be allocated among the nondepreciable property and the 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.

CORRECTION OF INCORRECT CHARACTERIZATION OF LAND COSTS BY TAXPAYERS

Taxpayers should review their eligible basis computations to determine whether land costs were correctly characterized and appropriately included in the computation of eligible basis. In the event that the eligible basis of the credit was incorrectly computed, taxpayers should file amended returns reflecting the correct credit amount for all years open by statute.

If incorrect characterization of land costs for determining the eligible basis of the Low Income Housing tax credit also impacted the depreciation, amortization, or capitalization of land cost, taxpayers will need to file Form 3115, Application for Change in Accounting Method. (See Revenue Procedures 97-27 and 99-49.) Taxpayers voluntarily correcting their method of accounting for land costs can spread the adjustment prospectively over a four year period, will not be subject to interest charges or penalties, and will receive audit protection (for this issue) in years prior to the year of change.

EXAMINATION ACTIVITIES

To the extent that issues involving the correct treatment of land costs are identified during examinations of returns claiming low income housing credits, Internal Revenue Code section 481 will be applied; i.e., the entire adjustment will be made in the earliest year open to examination and the taxpayer is subject to interest charges and potential penalties.

REFERENCES

1. IRC 42(d)(1), New Buildings
2. IRC 168, Accelerated Cost Recovery System
3. IRC 103, Interest on State and Local Bond
4. IRC section 167(a), Depreciation – General Rule
5. Regulation 1.167(a)-2,
6. Regulation section 1.167(a)-3
7. In Eastwood Mall, Inc. v. U.S., 95-1 USTC 50,236 (N.D. Ohio 1995), aff'd without published opinion, 59 F.3d 170 (6th Cir. 1995)
8. Rev. Rul. 65-265, 1965-2 C.B. 52, clarified by Rev. Rul. 68-193, 1968-1 C.B. 79
9. Algernon Blair, Inc. v. Commissioner, 29 T.C. 1205 (1958), acq., 1958-2 C.B. 4
10. Rev. Rul. 80-93, 1980-1 C.B. 50
11. Rev. Rul. 74-265, 1974-1 C.B. 56
12. Rev. Rul. 68-607, 1968-2 C.B. 115
13. Noble v. Commissioner, 70 T.C. 916 (1978), nonacq. on other grounds, 1979-2, C.B. 2
14. F.M. Hubbell Son & Co., Inc. v. Burnet, 51 F.2nd 644 (8th Cir. 1931), cert. denied, 284 U.S. 664 (1931)
15. Rev. Rul. 73-188, 1973-1 C.B. 62