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Date:
January 05, 2009

LEGEND

A =

Project =

Subdivision =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year =

Amount 1

Amount 2 =

Amount 3 =

City =

Dear

This letter is in response to a letter dated July 7, 2008, and subsequent correspondence submitted on A's behalf requesting a letter ruling on whether certain land improvements are capitalized into the basis of certain qualified low-income housing buildings. The request is filed under the provisions of Revenue Procedure 2008-1, 2008-1 I.R.B. 1.

FACTS

A represents that the facts are as follows:

A is an State limited liability company, taxable as a partnership for federal income tax purposes, consisting of a managing member and an investor member and formed on Date 1, for the purpose of constructing and operating the Project. The Project comprises one phase of a multi-phase project and will encompass Amount 1 buildings, with each building housing two apartment units, and certain ancillary improvements in a two-block neighborhood. The ancillary improvements are landscaping, a children's playground, a basketball court, four roof/post structures to shade picnic tables, a maintenance building , and related land improvements, e.g., driveways, walkways (collectively, the "Ancillary Improvements").

A intends to construct and operate the Project to meet the requirements of § 42 of the Internal Revenue Code for qualifying for the low-income housing credit. A received a reservation of Year low-income housing tax credits from the State Housing and Finance Association pursuant to the State Housing and Finance Association Reservation, dated Date 2, and State Housing and Finance Association Commitment, dated Date 3, in the amount of Amount 2, and the State Housing and Finance Association Reservation for additional credit, dated Date 4 in the amount of Amount 3. Other than the maintenance building, the Ancillary Improvements were commitments in A's tax credit application to the State Housing and Finance Association.

The Project is being constructed on a large, unimproved tract in City, which was previously used as farmland. The Project will spread across more than seven acres with some of the residential rental buildings located more than six hundred feet from the nearest existing arterial streets and infrastructure of City. Because these buildings would otherwise be cut off from the existing arterial streets and infrastructure, the Code of City requires A to construct streets and other infrastructure improvements to provide residents of the residential rental buildings access to the existing streets and infrastructure.

The streets required by the City Code to be constructed by A are two-lane local streets and include curbs, sidewalks, storm water drainage, and domestic water in-flow. In addition, A must purchase and install, at its own cost, the infrastructure needed by utility companies to install underground utilities, including utility steel casings within the streets through which the utilities run gas lines, electrical wiring, cable, and phone wires.

Upon completion of the improvements required by the City Code, A must dedicate all streets to the use of the public. For this purpose, "streets" includes all of the streets, curbs, sidewalks, storm water drainage, and domestic water in-flow improvements required by the City Code. Further, according to the Office of the City Attorney, City has always held the position that dedication of the streets transfers ownership of the utility steel casings within the streets to City.

The City Code requires minimum dimensions for any streets that will be dedicated to City. The dimensions vary depending on whether the street serves a residential, commercial, or manufacturing district. City approved the Project's proposed streets based on the characteristics of the Project's residential rental buildings, without reference to the Ancillary Improvements.

Under the City Code, streets of a subdivision are dedicated to the use of the public through City's process for street dedication. The process for dedicating streets of a proposed subdivision to the public requires three-steps: (1) before construction of the streets begins, the owner records a City-approved plat showing the subdivision, which delineates and places in the public record those portions of the land belonging to City on which the owner will construct the streets and those portions of the land remaining in the owner's possession, (2) the owner constructs the streets and other infrastructure required by the City Code, and (3) upon completion of the streets, City accepts the dedication by releasing building permits for the construction of the buildings of the subdivision.

Because of A's strong commitment to the community, City decided to deviate from this third step of the process, by withholding the certificates of occupancy for the Project's buildings, in lieu of the building permits, pending completion of the required improvements. Building permits and certificates of occupancy are required for the Project's residential rental buildings. Other than the maintenance building and the picnic shade structures, the Ancillary Improvements do not require building permits or certificates of occupancy. However, plat recordation and the building permits for Project's residential rental property were not contingent upon A producing the Ancillary Improvements.

Upon acceptance of the dedication, City will own and maintain the streets and the utility steel casings. Each utility provider will own and maintain its respective connective pipes and wires.

If a developer decides not to construct a project as planned, City will modify the scope of the improvements. In this case, City would expect more street construction if the Project expanded and less street construction if the Project constricted, without reference to the Ancillary Improvements.

RULINGS REQUESTED

A requests that the Internal Revenue Service issue the following rulings:

1. The costs incurred by A to construct (a) local streets, (b) curbs, (c) sidewalks, (d) storm water drainage, (e) domestic water in-flow, and (f) utilities, including utility steel casings, wiring, and installation fees (collectively, (a) through (f) are the "Infrastructure Improvements") for the Project are dedicated improvements for purposes of § 263(a) and § 1.263(a)-4(d)(8)(iv) of the Income Tax Regulations and, therefore, are not capitalizable as amounts paid to create an intangible.

2. The costs incurred by A to construct the Infrastructure Improvements are indirect costs within the meaning of § 1.263A-1(e)(3)(i) for purposes of § 263A, and are capitalizable into the bases of the Project's residential rental buildings, using a reasonable method of allocation under § 1.263A-1(f) to allocate the costs among the residential rental buildings.

3. The costs incurred by A to construct the Infrastructure Improvements are includable in the eligible basis of a qualified low-income building under § 42(d)(1).

LAW AND ANALYSIS

Issue 1

Section 263(a) provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any new property or estate.

Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture, and similar property have a useful life substantially beyond the taxable year.

Section 1.263(a)-4(d)(8)(i) generally provides that a taxpayer must capitalize amounts paid for real property if the taxpayer transfers ownership of the real property to another person (except to the extent the real property is sold for fair market value) and if the real property can reasonably be expected to produce significant economic benefits to the taxpayer after the transfer. A taxpayer also must capitalize amounts paid to produce or improve real property owned by another (except to the extent the taxpayer is selling services at fair market value to produce or improve the real property) if the real property can reasonably be expected to produce significant economic benefits for the taxpayer.

Section 1.263(a)-4(d)(8)(iv) provides, in part, that § 1.263(a)-4(d)(8)(i) does not apply to amounts paid for real property or improvements to real property constructed by the taxpayer where the real property or improvements benefit new development or expansion of existing development, are immediately transferred to a state or local government for dedication to the general public use, and are maintained by the state or local government ("dedicated improvements").

Example (3) of § 1.263(a)-4(d)(8)(v) illustrates the above rules with respect to dedicated improvements as follows: X corporation is engaged in the development and sale of residential real estate. In connection with a residential real estate project under construction by X in city Z, X is required by city Z to construct ingress and egress roads to and from its project and immediately transfer the roads to city Z for dedication to general public use. The roads will be maintained by city Z. X pays its subcontractor $100,000 to construct the ingress and egress roads. X's payment is a dedicated improvement within the meaning of § 1.263(a)-4(d)(8)(iv). Accordingly, X is not required to capitalize the $100,000 payment under § 1.263(a)-4(d)(8). See § 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in § 1.263(a)-4(d)(8)(iv).

Here, A is engaged in the construction and operation of the Project and is required by City to construct the Infrastructure Improvements and to dedicate them to the use of the public. By providing residents of the residential rental buildings access to the existing streets and infrastructure, the Infrastructure Improvements benefit the Project. By recording the City-approved plat of the property, A immediately delineates and places in the public record those portions of the land belonging to City on which A will construct the Infrastructure Improvements. The dedication is accepted by City upon completion of the Infrastructure Improvements and, consequently, such improvements are immediately transferred to City. The Infrastructure improvements will be maintained by City. Thus, the Infrastructure Improvements are dedicated improvements within the meaning of § 1.263(a)-4(d)(8)(iv) and, therefore, the costs incurred by A to construct the Infrastructure Improvements are not capitalizable as amounts paid to create an intangible.

Issue 2

Section 263A provides, in part, that direct costs and a properly allocable portion of indirect costs of real or tangible personal property produced by a taxpayer must be capitalized to the property produced. See also § 1.263A-1(a)(3)(ii).

Section 263A(g)(1) provides that the term "produce" includes construct, build, install, manufacture, develop, or improve. See also § 1.263A-2(a)(1)(i). Property produced may include land, buildings, land improvements, and other tangible property owned by the taxpayer for federal income tax purposes. See § 1.263A-2(a)(1)(ii).

Section 1.263A-1(c)(1) provides that to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities. After § 263A costs are allocated to the appropriate production activities, these costs generally are allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

Section 1.263A-1(e) provides rules for determining the direct and indirect costs that are required to be capitalized to property produced. Section 1.263A-1(e)(2)(i) provides that direct costs consist of direct material and direct labor.

Section 1.263A-1(e)(3)(i) defines indirect costs as all costs other than direct material costs and direct labor costs. Indirect costs are properly allocable to property produced when the costs directly benefit, or are incurred by reason of, the performance of production activities. Indirect costs that are allocable to production activities then must be allocated among the properties produced. See § 1.263A-1(f).

Section 1.263A-1(f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale. Section 1.263A-1(f)(2) describes a specific identification method as a type of facts and circumstances method that traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective.

In *Von-Lusk v. Commissioner*, 104 T.C. 207 (1995), the Tax Court held that the cost of obtaining building permits and zoning variances, negotiating permit fees, and similar activities, incurred by a real estate developer before actual physical work began on undeveloped land are indirect costs capitalizable under § 263A. The court found that these activities represent the “first steps in the development of the property.” The court further noted that the pursuit of building permits and zoning variances, negotiating permit fees, and similar activities “are ancillary to actual physical work on the land and are as much a part of a development project as digging a foundation or completing a structure's frame. The project cannot move forward if these steps are not taken.”

In Revenue Ruling 2002-9, 2002-1 C.B. 614, a taxpayer constructed a new residential rental building on unimproved land located in a county that imposed impact fees on new and expanded development. The ruling found that because the impact fees directly benefited, or were incurred by reason of, the taxpayer's production activity, the impact fees were indirect costs required to be capitalizable under § 263A. In addition, because (1) the impact fees were assessed as a result of the taxpayer's plans to construct the building, (2) the amount of the impact fees was calculated based upon the characteristics of the building, and (3) the impact fees generally would be refundable if the taxpayer decided not to construct the building as planned, the impact fees were allocable to the new residential rental building under § 263A.

In the instant case, as the developer of the Project, A is a producer of real or tangible personal property and, consequently, is subject to § 263A. Therefore, A must capitalize the direct costs and a properly allocable portion of indirect costs to property produced in the Project development. To determine which costs are capitalizable, taxpayers must first allocate or apportion costs to their various activities, including their production activities. Sections 1.263A-1(c)(1) and 1.263A-1(e)(3)(i). Here, A is engaged in both the construction and operation of the Project. Clearly, the costs of constructing the Infrastructure Improvements are a part of the construction of the Project. Thus, the costs of constructing the Infrastructure Improvements are allocable to A's construction activities.

After costs are allocated to an appropriate production activity, the costs generally are allocated to the items of property produced during the taxable year. Section 1.263A-1(c)(1). Although the Infrastructure Improvements are, in themselves, real or tangible personal property produced by A, A is required to transfer them to City, for the use of the public, in order for A to obtain the requisite certificates of occupancy (in lieu of building permits) for the Project. Thus, like the costs at issue in *Von-Lusk* and the impact fees in Rev. Rul. 2002-9, the costs directly benefit, or are incurred by reason of, the construction of the Project. Therefore, the costs are indirect costs as defined in § 1.263A-1(e)(3)(i), and are capitalizable to the property produced in the Project.

Section 1.263A-1(f) discusses various detailed or specific (facts and circumstances) methods that can be used to allocate indirect costs to the items of produced property. A specific identification method traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective. Section 1.263A-1(f)(2). In Rev. Rul. 2002-9, because the impact fees were assessed as a result of the taxpayer's plans to construct the building, the amount of the fees was calculated based on the characteristics of the building, and the impact fees were generally refundable if the building was not constructed as planned, the impact fees were allocable only to the basis of the new residential rental building. Thus, because of those factors, a cause and effect or other reasonable relationship existed between the impact fees and the residential rental building.

Here, the Infrastructure Improvements are necessary to provide the residents of the Project's residential rental buildings access to the existing streets and infrastructure of City. City requires A to construct those improvements and to dedicate them for the public use as a condition for issuing the certificates of occupancy (in lieu of building permits) for the Project's residential rental buildings. The scope (i.e., the type and size) of the Infrastructure Improvements are determined by the characteristics of the Project's residential rental buildings. For example, City approved the dimensions of the streets that A will dedicate to City based on the residential use of the buildings. In addition, City will modify the scope of the Infrastructure Improvements if the number of residential rental buildings is increased or decreased. Because of these factors, a cause and effect or other reasonable relationship exists between the costs incurred for the Infrastructure Improvements and the Project's residential rental buildings. Conversely, the Ancillary Improvements have no material effect on the requirement to construct, or the scope of, the Infrastructure Improvements and, therefore, there is no cause and effect or other reasonable relationship between the Ancillary Improvements and the costs incurred to construct the Infrastructure Improvements. Thus, under a specific identification method as described in § 1.263A-1(f), the costs incurred by A to construct the Infrastructure Improvements, like the impact fees in Rev. Rul. 2002-9, are properly allocable only to, and among, the Project's residential rental buildings.

Issue 3

Section 42(a) provides that the amount of the low-income housing tax credit determined for any taxable 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 taxable year as an amount equal to the applicable fraction, determined as of the close of the taxable 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 for purposes of the low-income housing credit, residential rental property 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. 11-89 (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, the eligible basis of a low-income housing building under § 42(d)(1) includes (1) the adjusted basis of depreciable property subject to § 168 that qualifies as residential rental property under § 103, and (2) 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.

Because the Infrastructure Improvements are dedicated improvements within the meaning of § 1.263(a)-4(d)(8)(iv), the cost of which are indirect costs capitalized under § 263A into the basis of the Project's residential rental buildings, and because A represents that it intends to construct and operate the Project's residential rental buildings to qualify the Project's residential rental buildings for the low-income housing tax credit under § 42 (thus, implying that the project buildings will be depreciated as residential rental property under § 168), the cost of the Infrastructure Improvements will be includable in the eligible basis of the Project's residential rental buildings under § 42(d)(1).

Based solely on the facts and representations provided, and the relevant law and analysis set forth above, we conclude that:

1. The costs incurred by A to construct the Infrastructure Improvements for the Project are dedicated improvements for purposes of § 263(a) and § 1.263(a)-4(d)(8)(iv) and, therefore, are not capitalizable as amounts paid to create an intangible under § 1.263(a)-4(d)(8)(i);

2. The costs incurred by A to construct the Infrastructure Improvements for the Project are indirect costs, within the meaning of § 1.263A-1(e)(3)(i) for

purposes of § 263A, and are capitalizable into the bases of the Project's residential rental buildings, using a reasonable method of allocation under § 1.263A-1(f) to allocate the costs among the residential rental buildings.

3. Assuming that Project's residential rental buildings will be depreciated as residential rental property under § 168, the eligible basis of the Project's residential rental buildings under § 42(d)(1) includes the cost of the Infrastructure Improvements.

We note that the costs incurred by A for the Infrastructure Improvements must be depreciated under § 168 as residential rental property or nonresidential real property (as defined in § 168(e)(2)), as applicable, beginning when each residential rental building in the Project is placed in service by A.

Except as specifically set forth above, we express no opinion regarding the application of any other provisions of the Code or Income Tax Regulations. Specifically, no opinion is expressed or implied on whether the Project's residential rental buildings are depreciated as residential rental property under § 168 or whether each of the Project's residential rental buildings is a qualified low-income building under § 42.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the provisions of a power of attorney on file with this office, we are sending copies of this letter ruling to A's authorized representatives. We are also sending a copy of this letter to the appropriate division director.

Sincerely,

Kathleen Reed
Chief, Branch 7
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures:
Copy of this letter
Copy for Section 6110 purposes

cc: