

LIHC MONTHLY REPORT

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IRS Takes Aim at Eligible Basis: A General Summary And Discussion of The Five TAMs

By Randal M. Alligood, Esq. & Gene E. Crick, Jr., Esq.

The Internal Revenue Service's (IRS) National Office recently issued five technical advice memorandums (TAMs)¹ following a request initiated by a revenue agent in connection with a tax audit of five low-income housing projects. The District Director for the office of the Revenue Agent asked the National Office to determine whether certain items were properly included in the eligible basis of a qualified low income building pursuant to Internal Revenue Code (IRC) Section 42(d).²

Technical advice is permissible if the revenue agent in the course of an audit encounters issues that cannot be resolved by applying current legal authorities (e.g., statutes, regulations, cases and revenue rulings).³ The advice presented in a TAM is limited to the taxpayer for whom the TAM is requested,⁴ but may be used by other taxpayers as guidance regarding the IRS' positions with respect to the issues decided. Going forward, revenue agents in conducting audits of low-income housing projects will use these TAMs to support their proposed adjustments and will apply these TAMs both retroactively and prospectively.⁵

The TAMs provide, consistent with IRC Section 42, that the test for inclusion of a cost in eligible basis is whether the cost incurred is: (i) included in the basis of depreciable property that constitutes residential rental property; or (ii) included in the basis of depreciable property that is used in a common area or provided as a comparable amenity to all residential rental units in the building.⁶

Land Preparation Costs

The TAMs provide a general rule for the characterization of land preparation costs as depreciable property. Under the TAMs, land preparation costs are depreciable property if the costs are so closely associated with a particular depreciable asset that they will be retired, abandoned, or replaced contemporaneously with that depreciable asset.⁷ This question is determined based on the facts of each case. If found to be depreciable property, all of the land preparation costs discussed below also must meet the eligible basis test described above.

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TAMs

1. Earth Moving Costs. The TAMs provide that general clearing, cutting, grubbing and removal expenditures to eliminate trees, brush and ground cover and rough and finish grading, digging and fill dirt expenditures to change the level of land that will not be repeated upon replacement of depreciable property becomes part of the basis of land. If, however, clearing, rough and finish grading, excavating, fill dirt and removal costs are done to provide a proper setting for a building's foundation and utilities, a paved road, a parking lot, a sidewalk, a laundry facility or like depreciable property, they are included in the depreciable basis of such property.⁸ In the TAMs, the IRS seems to have a conservative view of when earth-moving expenses are required to be retired, abandoned or replaced contemporaneously with the buildings to which they are inextricably associated. By comparison, various cases generally appear to have a more favorable view of this issue for project owners, but ultimately the determination depends on the facts and circumstances of the case.⁹

The effect of the TAMs is that project owners should account for the various types of earth-moving expenses in detail. As a helpful hint, project owners should be conscious of the tax rules for earth-moving expenses in the bidding process and require that each architect, contractor or subcontractor provide the necessary allocations. The project owner will need to provide the education concerning how to make the allocations. Project owners should ask for area and cost detail for general clearing, grading, and fill dirt expenses, as well as those expenses incurred for providing a foundation or otherwise installing depreciable property such as a road or building.

2. Landscaping Costs. Likewise, the TAMs provide that landscaping consisting of perennial shrubbery and ornamental trees immediately adjacent to the apartment buildings is depreciable property as long as the replacement of the buildings will destroy the landscaping. However, necessary clearing and general grading, top soil, seeding, finish grading and planting of perennial shrubbery and ornamental trees around the perimeter of the tract are improvements attributable to and included in the basis of land because they will not likely be replaced along with the buildings.¹⁰ The IRS has a narrow view of when landscaping is depreciable, requir-

ing the project owner to establish that the expenses have a limited life and are properly includable in depreciable and eligible basis. In its view, this occurs only when the landscaping expenses will be replaced contemporaneously with the structure. At least one court has found that landscaping expenditures were depreciable because they were attributable to the construction of depreciable property and would have to be repeated for any other business use of the property.¹¹

In light of the TAMs, project owners should work with the architect, contractor and subcontractors to ensure that the tax treatment for landscaping expenses is proper. It may be helpful for the architect to provide a written assessment of the landscaping that will be destroyed if the buildings are destroyed or replaced.

3. Survey Costs. In the case of boundary and other property surveys, staking expenses and engineering costs, the TAMs fashion similar rules to include in or allocate to the basis of land those items not associated with construction of depreciable property or those items that have to be performed only once in the construction of depreciable property. The TAMs provide that survey, staking and engineering costs are included in the basis of buildings or allocated to buildings if they are attributable to construction of the buildings and will have to be repeated if the buildings are replaced.

The effect of these rules is that a project owner should make sure that it treats the cost of any survey (or the portion of the survey) required for the purchase of the land as part of the cost of the land and the remainder as part of the cost of the buildings. Similarly, with respect to staking and engineering expenses, the effect of these rules is that a reasonable allocation should be made between those that relate to the land and those that relate to the buildings.

TAMs

Bond Issuance Costs

The TAMs provide that bond issuance costs associated with a construction loan are includable in depreciable basis but are not includable in eligible basis. For tax purposes, these costs are not immediately deductible but are capitalized as a separate intangible asset and amortized over the term of the loan.¹² Pursuant to IRC Section 263A, bond issuance costs incurred by reason of the building construction are treated, in part, as an indirect cost of production and included in the depreciable basis of the buildings and other produced property in the project. However, since bond issuance costs are treated under the bond tax provisions as a bad cost for purposes of meeting the test of a qualified residential rental project,¹³ such costs cannot meet the residential rental property test for eligible basis purposes.

Construction Loan Costs

On the other hand, the TAMs provide that conventional construction loan costs may be included in both depreciable and eligible basis. Construction loan costs are capitalized as a separate intangible asset and amortized over the life of the loan.¹⁴ However, amortization deductions arising from the construction loan intangible are capitalized into all property produced during the construction period under Section 263A. To the extent allocated to buildings and other property included in eligible basis, the amortization deductions likewise are included in eligible basis. The difference between the tax treatment of conventional construction loan costs and the tax treatment of bond issuance costs appears to be based solely on the fact that bond issuance costs are subject to the bond tax rules and conventional construction loan costs are not.

Impact Fees

The TAMs provide that local impact fees are treated as a separate nondepreciable intangible asset to the taxpayer and are not included in eligible basis of the buildings to which the payments relate or in the basis of land. First, the IRS looks behind the impact fees and cites that local impact fees include one-time payments for tangible assets relating to water service, wastewater service, roads, schools, law enforcement and fire protection. Then the IRS cites that, in order to have a depreciable interest in tangible property, the taxpayer must have a proprietary interest in the asset, must use the asset directly in its business, and must maintain and replace the asset as necessary.¹⁵ Then, the IRS applies these rules to come to the conclusion that impact fees are an intangible asset of the taxpayer because the taxpayer has no ownership interest in the assets purchased by the payment of the fees, the local government authority is responsible for maintenance and replacement of the assets and the payment of the impact fee benefits the taxpayer's business but has no relation to the life of any tangible asset. Second, the IRS argues that because the governmental authority will maintain and replace the assets acquired with the impact fee payments, the intangible asset has an unlimited useful life to the taxpayer and therefore is not depreciable property.

People in the Industry

Fannie Mae has named Phyllis Klein Director of Marketing in the Multifamily Division in Pasadena, Calif. In her new role, Klein will be involved in capital market transactions, tax-exempt bond financing structures and various affordable housing initiatives.

Before joining Fannie Mae, Klein served as Executive Director of the California Debt Limit Allocation Committee (CDLAC), the Golden State's bond allocating agency.

ECI Group, a privately held full service real estate firm, has named Phil Carlock president. Carlock will lead ECI's management team as well as expand other business ventures such as third-party property management, construction and development activities.

The National Council of State Housing Agencies (NCSHA) has named Robert Strickland, Executive Director of the Alabama Housing Finance Authority, as the trade association's vice president. Strickland previously served two terms each as secretary and treasurer and four terms as a member of the organization's board of directors.

People in the Industry

Simpson Housing Solutions, LLC has named Gary Mitton senior portfolio manager. Mitton previously worked for the National Partnership Investments Corp. in Beverly Hills, Calif.

The Enterprise Foundation has announced that former Housing Secretary Henry Cisneros has rejoined its board of directors. Cisneros, who had served as U.S. Department of Housing and Urban Development (HUD) secretary during the first term of the Clinton administration, had previously served on the Columbia, Md.-based board from 1990 to 1993.

Former HUD Secretary Samuel Pierce, Jr. recently passed away. Pierce served as HUD secretary for two terms under former President Ronald Reagan(R).

Former Rep. Henry Gonzalez (D-Texas) passed away recently. Gonzalez chaired the House Banking Committee for six years until 1995. He championed key housing legislation including the McKinney Homeless Assistance Act. He helped pass legislation that made the banking industry more responsive to the needs of low-income communities.

TAMs

A good argument against the result reached by the TAMs is that impact fees are an indirect cost of production and are allocable to the eligible basis of the buildings in the project pursuant to IRC Section 263A. Section 263A applies to a taxpayer that produces real property to be used in its trade or business. If property is produced for a taxpayer under a contract, the taxpayer is regarded as a producer if it makes payments or otherwise incurs costs with respect to the project.¹⁶ Allocable costs required to be capitalized into the basis of property produced are direct costs and a properly allocable share of indirect costs attributable, in whole or in part, to the property, regardless of when they are incurred.^{17 18}

Generally, indirect costs include all costs other than direct material and direct labor costs associated with the property produced. With respect to determining the extent to which indirect costs are allocated to property produced, indirect costs are properly allocated when the costs directly benefit or are incurred by reason of the performance of production activities.¹⁹ Based on the foregoing, impact fees constitute an indirect cost of production allocable, in whole or in part, to the buildings in the project because the fee is incurred solely by reason of the production activities.²⁰ In fact, impact fees must be paid before a government will issue a building permit and thus allow the project owner to begin erection of the buildings. No impact fees are paid with respect to the holding of raw land.

Despite this, the IRS finds that the payment of impact fees is not associated with any tangible asset of the taxpayer. The TAMs treat impact fees as a separate intangible asset largely because the payment of impact fees is treated as a credit against an additional assessment of the impact fees for the property. Impact fees are generally not required to be paid again for the property unless construction of a new development or a change in use of an existing development materially increases the impact on schools, roads, water and wastewater systems, etc.

One idea is to have the project owner and the local government agree that the credit is unavailable to the project, and the impact fee will be repaid in full upon subsequent replacement or material change in the building. If this is permitted, the payment of impact fees and the building will have the same useful life. Therefore, the IRS position will be less persuasive that the payment of impact fees is an asset distinct from the building.

In the TAMs, the IRS ruled that under the particular facts presented, the developer fee payable by the partnership was includable in the depreciable basis and eligible basis of the building. To be includable in the depreciable basis of the underlying property acquired with a debt obligation, the obligation must be genuine and non-contingent, and based on all facts and circumstances, the obligation must be reasonably certain to be paid. As described in the TAMs, the developer fee note issued by the partnership at construction completion (i) bears interest at no less than the Applicable Federal Rate (AFR); (ii) matures on the earlier of the 13th anniversary of construction completion or dissolution; (iii) is payable before maturity from cash flow; (iv) provides for unpaid accrued interest to be added to the principal balance semi-annually; (v) states that the partnership can refinance the permanent mortgage loan or obtain a loan from a third party to pay the developer fee note within one year of the maturity date; and (vi) requires the general partner to contribute funds to the partnership at maturity to pay the remaining balance of the developer fee note.

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To support the conclusion that the developer fee note was included in depreciable basis and eligible basis, the IRS indicated that the developer fee note was an obligation to pay a fixed sum, with interest, at the earlier of maturity or dissolution. 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 amounts are payable at a fixed maturity date in 13 years. Moreover, the note is recourse in the sense that the partnership has the ability to borrow against the equity of the assets of the partnership to pay the remaining balance of the developer fee note, and the general partner is obligated to contribute funds to the partnership for the purpose of paying the balance owing on the developer fee note.

In the TAMs, the IRS also announced standards relating to how the value of the partnership assets, mainly real estate, supports payment of the developer fee note and the effect if the developer and general partner fail to comply with the terms relating to payment. A contrary determination with respect to one or more of the following factors would alter the IRS' conclusion, the TAMs said.

First, if the value of the partnership's assets available as collateral for borrowing against – plus the value, if any, of the general partner's guarantee to contribute funds to the partnership, less the value of the obligations to which the developer fee note is subordinate – is less than the amount of the developer fee note, then it would be a strong indication that the note will not be paid. A second factor is whether the developer has the ability to act independently in relation to the partnership and would enforce the terms of the developer fee note. A third factor is whether it is likely that the general partner would fulfill its potential obligation to contribute funds to the partnership to pay the developer fee note at maturity. The last factor is whether the developer parted with value when the obligation was incurred. If the cash and developer fee note received by the developer exceed the value of the developer services rendered, this would be a factor indicating that the note would not likely be paid.

The effect of the TAMs is to provide guidance regarding the required terms and standards that should be followed to support inclusion of a deferred developer fee in depreciable and eligible basis. It should be noted, however, that a taxpayer may not cite the TAMs as authoritative precedent for its position if questioned by the IRS.

Related Concerns

For projects financed with tax-exempt bonds, the TAMs point out the risk of using tax-exempt bond proceeds to pay impact fees. If the IRS prevails and the impact fees are treated as an item excluded from basis, then the project's tax credits could be jeopardized if the project owner paid for impact fees with tax-exempt bond proceeds. If disallowed, this would reduce the numerator for the 50 percent test under Section 42(h)(4)(B). Although the denominator of the 50 percent test would also be reduced, in most cases the resulting fraction will be a lower number. If the fraction is less than 50 test, then the credits will be dramatically reduced.

Upcoming Industry Events

(continued from page seven)

International Builders Show
February 9-12 in Atlanta.
For more information,
contact (800) 368-5242,
ext. 111 or visit
www.buildersshow.com.

March 2001

The National Housing and
Rehabilitation Association
(NH&RA) will host its 2001
Annual Meeting, March 8-11
in St. John, U.S. Virgin
Islands. For more
information, contact NHRA
at 1625 Massachusetts Ave.,
NW, Suite 601, Washington,
D.C. 20036-4435; (202)
939-1750; or visit
www.housingonline.com.

The National Association of
Home Builders (NAHB) will
host its Pillars of the
Industry Trends Conference
& Awards Gala March 18-20
in San Diego. For more
information, contact NAHB
at 1201 15th St., N.W.
Washington, DC 20005;
(800)386-5242 or visit
www.nahb.com.

The National Council of State
Housing Agencies (NCSHA)
will host its Annual
Legislative Conference
March 19-21 in Washington,
DC. For more information,
contact NCSHA 444 N.
Capitol St., N.W., Suite 438,
Washington, DC 20001;
(202) 624-7710.

TAMs

Furthermore, if impact fees paid from bond proceeds are no longer a qualified project cost, the tax exemption of the bonds may be at risk due to the 95 percent test found in Section 142(a)(7). If that test is not met, the bonds would become taxable. This may result in a complete loss of the tax credits and, depending on the terms of the trust indenture, the immediate acceleration of the bonds.

It is too early in the process to know what impact the TAMs will ultimately have on the industry. However, industry participants are trying to determine how best to deal with them. Efforts are underway to assist Congress in providing guidance with respect to the costs addressed in the TAMs.

The TAMs represent the IRS' views with respect to the issues addressed in the TAMs. Taxpayers are not bound by the TAMs and neither the IRS nor taxpayers can use the TAMs as precedent. Taxpayers, therefore, need to address the issues raised in the TAMs with knowledge that the TAMs are not the final word. ❖

Randal M. Alligood, Esq. is a partner and Gene E. Crick Jr., Esq. is an associate at the Orlando office of Broad and Cassel. Mr. Alligood is Chairperson of the firm's Affordable Housing/Tax Credit Practice Group and Mr. Crick is a tax attorney in the firm's Corporate and Securities and Affordable Housing/Tax Credit Practice Groups. Mr. Alligood and Mr. Crick can be reached at Broad and Cassel, Bank of America Center, Suite 1100, 390 N. Orange Ave., Orlando, FL 32801-1641: (407) 839-4200.

1. Technical Advice Memoranda 200043015, 200043016, and 200043017 were released October 27, 2000 and Technical Advice Memoranda 200044004 and 200044005 were released November 6, 2000.
2. Rev. Proc. 2000-2, 2000-1 I.R.B. 73.
3. Id.
4. Code Section 6110(k)(3).
5. There is no indication that the TAMs are limited in their retroactive application. Rev. Proc. 2000-2, 2000-1 I.R.B. 73.
6. Residential rental property has the same meaning as residential rental property under Code Section 103. Under this section and Treas. Reg. Sec. 1.103-8(b)(4), the definition includes residential rental units, facilities for use by tenants, other facilities reasonably required for the project, and facilities functionally related and subordinate to the units. Examples listed are swimming pools, other recreational facilities, parking areas, and units for managers and maintenance personnel.
7. Rev. Rul. 80-93, 1980-1 C. B. 50.
8. Rev. Rul. 65-265, 1965-2 C.B. 52, as clarified by Rev. Rul. 68-193, 1968-1 C.B. 79; *Eastwood Mall, Inc. v. U.S.*, 95 U.S.T.C. ¶50,236 (N.D. Ohio 1995).
9. *Trailmont Park, Inc. v. Commissioner*, T.C. Memo 1971-212; 30 T.C.M. (CCH) 871 (1971); *Tunnell v. U.S.*, 367 F. Supp. 557 (D. Del. 1973).
10. Rev. Rul. 74-265, 1974-1 C. B. 56.
11. *Trailmont Park, Inc. v. Commissioner*, 30 T.C. M. (CCH) 871 (1971).
12. *Enoch v. Commissioner*, 57 T.C. 781 (1972).
13. Code Section 142(a)(7).
14. *Enoch v. Commissioner*, 57 T.C. 781 (1972).
15. Rev. Rul. 68-607, 1968-2 C.B. 115; *Noble v. Commissioner*, 70 T.C. 916 (1978), nonacq. on other grounds, 1979-2 C.B. 2.
16. Treas. Reg. Sec. 1.263A-2(a)(1).
17. Code Section 263A(a)(2); Treas. Reg. Sec. 1.263A-2(a)(3).
18. Any cost not taken into account in computing taxable income for any taxable year is not treated as a cost to be capitalized under this section. Code Section 263A(a)(2); Treas. Reg. Sec. 1.263A-1(c); Examples of the otherwise deductible requirement are the disallowed portion of the business meal deduction under Section 274(n) or under the legislative history, personal interest expense under Section 163(h). Even if the IRS is correct in holding that impact fees are non-depreciable intangible costs, these costs would be taken into account in computing taxable income in the year the owner disposed of his interest in the project.
19. Treas. Reg. Sec. 1.263A-1(e)(3).
20. Treas. Reg. Sec. 1.263A-1(e)(3) provides a non-exhaustive list of indirect costs, but neither building permits nor impact fees are listed.

Briefs & Resources

An affordable housing coalition of 16 industry groups has urged the Treasury Department to issue a "clear and unequivocal" statement indicating that recent Internal Revenue Service (IRS) pronouncements regarding eligible basis should not be followed pending the completion of the formal rule-making process.

"Less equity for a project means higher debt or additional subsidies," said National Association of Home Builders' Housing Credit Group Director Margaret McFarland, who helped organize the effort. "And because the new rules are fully retroactive and, in many instances, are directly contrary to established industry practice, they will disrupt existing business arrangements and may threaten the viability of ongoing low-income housing projects that are in compliance with all aspects of the tax credit program."

The IRS recently released five Technical Advice Memorandums (TAMs) that address numerous issues surrounding the calculation of eligible basis in LIHC projects. (See related article on page 1.)

While cast as private rulings, the TAMs read like general rules, observers charge.