Part I

Section 263A.-- Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A-1: Uniform capitalization of costs.
(Also, §§ 42, 167, 168, 263, 446, 481; 1.263(a)-1.)

Rev. Rul. 2002-9

ISSUE

Are “impact fees” incurred by a taxpayer in connection with the construction of a new residential rental building capitalized costs allocable to the building under §§ 263(a) and 263A of the Internal Revenue Code?

FACTS

Taxpayer is in the business of developing, owning, and leasing residential rental property. Taxpayer purchased unimproved land located in County on which Taxpayer will construct a new residential building that it will rent to tenants. The development plan submitted by Taxpayer to County indicates that the building is expected to have x number of rental units. County imposes “impact fees” on new and expanded development.

Impact fees are one-time charges that are imposed by a state or local government against new development or expansion of existing development to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. Generally, impact fees are refundable (in full or in part) if the new or expanded development ultimately is not constructed as planned.

Taxpayer was required by County to pay various impact fees (for example, for schools and law enforcement and fire protection facilities) in order to compensate County for the financial impact of Taxpayer's new building. These impact fees were calculated based on Taxpayer's projection of the number of rental units in, and on the size of, the building. Taxpayer paid the impact fees when the construction permit for the building was issued.

LAW AND ANALYSIS

Section 263(a) and § 1.263(a)-1(a) of the Income Tax Regulations provide 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 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 fixtures, and similar property having a useful life substantially beyond the taxable year.

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-2(a)(3)(i) provides that any cost required to be capitalized by § 263A must be capitalized regardless of whether the cost was incurred before, during, or after production.

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 costs. 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).

In Oriole Homes Corp. v. U.S., 705 F.Supp. 1531 (S.D. Fla. 1989), the court held that road, educational, regional park, and municipal park impact fees required for the approval and recordation of plats for subdivisions are capital expenditures, to be capitalized as a development cost and deducted pro rata as each house is sold. In reaching its holding, the court stated that “the impact fees increased the value of the subdivisions and secured a benefit which lasted beyond the taxable year in which they were incurred.” Similarly, the impact fees incurred by Taxpayer resulted in a permanent improvement or betterment to Taxpayer’s development project. Accordingly, consistent with Oriole Homes, the impact fees incurred by Taxpayer must be capitalized to the property produced under § 263(a).

Moreover, because Taxpayer’s development project constitutes production of property within the meaning of § 263A(g)(1), Taxpayer is required to capitalize under § 263A the direct costs and a proper share of the allocable indirect costs associated with the development. In Von-Lusk v. Commissioner, 104 T.C. 207 (1995), the court held that certain expenses incurred by a real estate developer before actual physical work began on undeveloped land are subject to § 263A. The court found that the developer's activities, such as obtaining building permits and zoning variances, negotiating permit fees, and similar 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."

The impact fees incurred by Taxpayer are not direct costs within the meaning of § 263A because they are neither direct material nor direct labor costs. However, the impact fees are indirect costs under § 263A because they directly benefit, and are incurred by reason of, Taxpayer's production activity. Similar to the costs at issue in Von-Lusk, the impact fees were assessed by County because of Taxpayer's plans to construct the new residential building, and thus are "as much a part of a development project as digging a foundation or completing a structure's frame." Thus, in accordance with § 1.263A-1(f), Taxpayer must allocate the impact fees to the property produced based on all the facts and circumstances. Because the impact fees are assessed as a result of Taxpayer's plans to construct the building, the amount of the impact fees is calculated based upon the characteristics of the building, and the impact fees generally would be refundable if Taxpayer decides not to construct the building as planned, the impact fees are allocable to the building. Accordingly, the impact fees must be capitalized under § 263A as indirect costs allocable to the new residential rental building.

HOLDING

"Impact fees" incurred by a taxpayer in connection with the construction of a new residential rental building are capitalized costs allocable to the building under §§ 263(a) and 263A.

APPLICATION

Any change in a taxpayer's treatment of impact fees incurred in connection with the new construction or expansion of a building to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

A taxpayer wanting to change the method of accounting for impact fees to conform with this revenue ruling must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (or its successor), as modified and clarified by Announcement 2002-17, 2002-8 I.R.B. ___, with the following modifications:

(1) If the taxpayer changes its method of accounting for impact fees to conform with this revenue ruling for the first taxable year ending on or after December 31, 2001, the scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply; and

(2) To assist the Internal Revenue Service in processing changes in method of accounting under this revenue ruling, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002-9 is modified to require that a Form 3115 filed under this revenue ruling include the statement "Automatic Change Filed Under Rev. Rul. 2002-9." This

statement should be legibly printed or typed on the appropriate line on the Form 3115.

If a taxpayer changes its method of accounting for impact fees to conform with this revenue ruling, the treatment of impact fees will not be raised as an issue in any taxable year before the year of change, consistent with the audit protection provision of section 7.01 of Rev. Proc. 2002-9. If this change in method of accounting is made for the taxpayer's first taxable year ending on or after December 31, 2001, and the treatment of impact fees has already been raised as an issue in a taxable year before the taxpayer's first taxable year ending on or after December 31, 2001, the treatment of impact fees will not be further pursued.

If a depreciation deduction is allowable under § 167(a) for the building and it is subject to § 168, the taxpayer must depreciate the impact fees under § 168 as residential rental property or nonresidential real property (as both are defined in § 168(e)(2)), as appropriate, beginning when the newly constructed building or the expansion of the building is placed in service by the taxpayer. Moreover, for purposes of § 42, impact fees are included in the eligible basis of a qualified low-income building. A change in method of accounting for impact fees to conform to this revenue ruling does not affect the amount of credit that has been allocated under § 42(h)(1) or allowed for buildings financed with tax-exempt bonds subject to the volume cap as determined under § 42(h)(4).

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this accounting method change in section 4 of the APPENDIX.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Kathleen Reed and Christopher J. Wilson of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding § 42, 167, or 168, contact Gregory Doran at (202) 622-3040 or Mr. Wilson at (808) 539-2874. For further information regarding § 263(a) or 263A, contact Cheryl L. Oseekey at (202) 622-4970. These are not toll-free calls.