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Department of the Treasury
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LEGEND

A =

State =

City =

LLC 1 =

LLC 2 =

Affiliate =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Amount 1 =

X =

Dear

This letter is in response to a letter dated May 12, 2014, and subsequent correspondence, submitted on A's behalf requesting a letter ruling on whether certain easement relocation costs incurred by A in constructing a low income residential rental building are includible in eligible basis for purposes of section 42(d)(1) of the Internal Revenue Code.

FACTS

A represents that the facts are as follows:

A is a limited partnership, duly organized, validly existing, and in good standing under the laws of the State. A is governed by an Amended and Restated Agreement of Limited Partnership dated Date 1, as amended, pursuant to which LLC 1, a State limited liability company, acts as the Administrative General Partner of A, and LLC 2, a State limited liability company, acts as the Managing General Partner of A.

A is constructing a single building, 76-unit low-income residential rental complex (the "Project") at a site in City. A, through Affiliate, opened escrow for acquisition of the land underlying the Project and began negotiations with City regarding the design of the Project in Date 2. Affiliate acquired the site and took ownership in Date 3. The site was zoned for commercial use and, therefore, A was required to obtain a Conditional Use Permit (CUP) to allow for residential development.

In Date 4, the City Council of City issued a resolution approving the final design of the Project and construction of the Project, subject to the satisfaction of a number of conditions. One of these conditions was that a specific third-party easement (the "Easement") on the land underlying the Project be relocated before City would issue any building permits for the Project. Had A elected a different use for the site that did not require a CUP (such as the development of a commercial building), it would have been able to undertake construction without the City-imposed requirement of relocating the Easement. However, A desired to construct a residential rental building and City was unwilling to recommend and/or approve any designs that did not require relocation of the Easement for initiating construction.

The Easement granted the grantee an easement and right to maintain on the land underlying the Project an existing pylon sign and electrical conduit. In Date 5, Affiliate, on behalf of A, reached agreement with the grantee of the Easement for the relocation of the Easement. Pursuant to the agreement,

Affiliate, on behalf of A, paid Amount 1 in relocation consideration to the grantee along with paying all of the costs necessary to relocate the infrastructure supporting the existing pylon sign (the "Relocation Costs"). Absent City's condition requiring the relocation of the Easement in order to obtain all building permits necessary to construct the Project, Affiliate, on behalf of A, would not have relocated the Easement and, thus, would not have incurred the Relocation Costs associated with the Easement relocation.

A purchased the site from Affiliate on Date 1. The purchase agreement for the site between A and Affiliate is effective as of Date 6, which is more than three years before Date 1. A needed to establish control over the site in order for A to apply for low-income housing tax credits with X. A established control over the site as of Date 6. During the 3-year period between Date 6, and the closing date, Date 1, A applied for such low-income housing tax credits and obtained financing for the Project.

At closing A reimbursed Affiliate for all costs incurred by Affiliate on behalf of A prior to Date 1, including the payment of Amount 1 to the grantee of the Easement. A recorded this reimbursement amount, including the payment of Amount 1 to the grantee of the Easement, in A's construction work in progress account. The Project had not been placed in service as of the date A submitted this letter ruling request.

RULINGS REQUESTED

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

1. The Relocation Costs incurred by A to relocate the Easement are indirect costs within the meaning of section 1.263A-1(e)(3)(i) of the Income Tax Regulations, and are capitalizable to the basis of the Project's residential rental building under section 263A.

2. The Relocation Costs incurred by A to relocate the Easement are includible in the eligible basis of the Project's residential rental building under section 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)-1(d)(1) provides that capital expenditures include amounts paid to acquire or produce a unit of real or personal tangible property.

Section 1.263(a)-2(d)(1) provides that a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under section 1.263(a)-3(e)), including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Example (8) of section 1.263(a)-2(d)(2) illustrates the coordination of the above rules with section 263A as follows: J constructs a building. J must capitalize under section 1.263(a)-2(d)(1) the amount paid to construct the building. See section 263A for the costs required to be capitalized to the real property produced by J.

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 section 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 section 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 section 1.263A-2(a)(1)(ii).

Section 1.263A-1(c)(1) provides that to determine capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities. After section 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(c)(3) provides that capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs and, in the case of other property, to charge to a capital account or basis.

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 allocable to production activities then must be allocated among the properties produced.

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.

Section 1.263A-2(a)(3)(i) provides that, except as specifically provided in section 263A(f) with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in section 263A(f)(4)(B)).

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 section 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 section 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 section 263A.

Here, A is engaged in the construction of Project, a residential rental building. Consequently, A is a producer of real property and is subject to the capitalization requirements under section 263A. Therefore, A must capitalize the direct costs and a properly allocable portion of indirect costs to property produced in the Project, without regard to whether those costs are incurred before, during, or after the production period.

In this case, A represents that (1) the City required the Easement on the land underlying the Project to be relocated before the City would issue any building permits for the Project, and (2) had A elected a different use for the site that did not require a CUP (such as the development of a commercial building), it

would have been able to undertake construction without the City-imposed requirement of relocating the Easement. Both representations are material representations.

Although, in some circumstances, easement relocation costs may be capitalized in whole or in part to the land, there is in this instant case a direct and specific nexus between the Relocation Costs and the specific residential rental building that A is constructing. City required the Easement on the land underlying the Project to be relocated before City would issue the building permits necessary to construct the Project. But for the condition requiring the relocation of the Easement, A would not have incurred the Relocation Costs. Like the costs at issue in *Von-Lusk*, the Relocation Costs were incurred to obtain the building permits solely for producing the residential rental building. Like the impact fees in Rev. Rul. 2002-9, the Relocation Costs were incurred because of A's plans to construct the residential rental building. Further, the scope of the Easement relocation and, accordingly, the amount of the Relocation Costs, were determined by the characteristics of the residential rental building. City had authority over and approved the final design of the residential rental building (having rejected prior designs). The approved design of the residential rental building necessitated complete relocation of the Easement. If the approved design had been different, then the scope and cost of the Easement relocation would have been different. Because of these factors, a cause and effect or other reasonable relationship exists between the Relocation Costs and the residential rental building. Therefore, the Relocation Costs directly benefit, or are incurred by reason of, the construction of the residential rental building and are capitalizable indirect costs as defined in section 1.263A-1(e)(3)(i), properly allocable to the residential rental building under a specific identification method as described in section 1.263A-1(f).

Issue 2

Section 42 provides a 10-year tax credit for investment in qualified low-income buildings placed in service after 1986. Section 42(a) provides that for purposes of section 38, the amount of the low-income housing credit for any taxable year in the credit period is equal to the applicable percentage of the qualified basis of each qualified low-income building (as defined in section 42(c)(2)).

Section 42(b)(2) provides the applicable percentage for each qualified low-income building.

Section 42(c)(1)(A) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to (i) the applicable fraction (determined as of the close of the taxable year) of (ii) the eligible basis of the building (determined under section 42(d)).

Section 42(c)(1)(B) defines the applicable fraction for each qualified low-income building.

Section 42(d)(1) provides that the eligible basis of a new building is its adjusted basis as of the close of the first taxable year of the credit period. Section 42(d)(4)(A) provides that, except as provided in section 42(d)(4)(B) and (C), the adjusted basis of any building is determined without regard to the adjusted basis of any property that is not residential rental property.

The legislative history of section 42 states that the term "residential rental property" for purposes of the low-income housing credit has the same meaning as it does for purposes of section 103. The legislative history of section 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. II-89 (1986), 1986-3 (Vol. 4) C.B. 89.

Rev. Rul. 2002-9 states that if a depreciation deduction is allowable under section 167(a) for the residential rental building and it is subject to section 168, then for purposes of section 42, the impact fees are included in the eligible basis of a qualified low-income building.

Because the Relocation Costs are indirect costs capitalized under section 263A into the basis of the Project, a residential rental building, and because A represents that it intends to construct and operate the residential rental building to qualify the building for the low-income housing tax credit under section 42 (thus, implying that the building will be depreciated as residential rental property under section 168), the cost of the Relocation Costs will be includable in the eligible basis of the residential rental building under section 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 Relocation Costs incurred by A to relocate the Easement are indirect costs within the meaning of section 1.263A-1(e)(3)(i), and are capitalizable to the basis of the Project's residential rental building under section 263A.

2. Assuming that the Project's residential rental building will be depreciated as residential rental property under section 168, the Relocation Costs incurred by A to relocate the Easement are includible in the eligible basis of the Project's residential rental building under section 42(d)(1).

We note that the costs incurred by A to relocate the Easement must be depreciated under section 168, beginning when the residential rental building 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 residential rental building is depreciated as residential rental property under section 168, whether the residential rental building is a qualified low-income building under section 42, or whether the costs to demolish the restaurant on the land underlying the Project are subject to section 280B.

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 a copy of this letter ruling to A's authorized representative. We are also sending a copy of this letter to the appropriate division director.

Sincerely,

Kathleen Reed

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

Enclosures:
Copy of this letter
Copy for section 6110 purposes