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subject: Treatment of Recovery of Expenses

This Chief Counsel Advice responds to your request for assistance dated January 30, 2015. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

State A =
Year 1 =
Years 2 through 14 =
x =
Parcel =
$y =
Special Districts =

Service Plan =

$z =

ISSUES

1. May Taxpayer, a real estate developer, treat amounts advanced to a special municipal district for the construction of infrastructure for Taxpayer's development as, in substance, costs of developing its real property, although, in form, the amounts advanced are loans to the district, evidenced by bonds.

2. If Taxpayer treats its advances as costs of developing its real property, may Taxpayer treat repayments designated as "interest" on the bonds as tax-exempt under § 103 or must Taxpayer treat all repayments, whether designated as interest or principal, as a reduction of cost or income, consistent with its treatment of the advances as costs of developing lots held for sale.

CONCLUSIONS

1. Taxpayer properly treated amounts advanced to a special municipal district for the construction of infrastructure for Taxpayer's development as costs of developing its real property.

2. Taxpayer must treat any repayments from the district, whether designated as interest or principal, as a reduction of cost or income. No portion of the payments is tax-exempt interest under § 103.

FACTS

Taxpayer is an S corporation, organized in State A. Taxpayer uses an overall accrual method of accounting. Taxpayer is in the business of acquiring unimproved real estate, subdividing the land, and selling the improved parcels to third-party home builders or commercial developers.

In Year 1, Taxpayer entered into option contracts to purchase approximately x acres of real property (the Parcel) located in a township of State A for a total of approximately $y. In Years 4 through 6, Taxpayer exercised its options and purchased the complete Parcel.

As early as Year 1, in anticipation of purchasing and developing the Parcel, Taxpayer began working with the local township, with the goal of turning the Parcel into a mixed-use (commercial and residential) development. The local township tentatively approved the mixed-use development, subject to the proviso that Taxpayer provide the public

infrastructure, such as water, wastewater, streets, that was necessary for the development.

In Year 3, the owners of Taxpayer assisted the township in the formation of two interconnected – Service and Financing -- Special Districts. The Special Districts were created under the law of State A, which treats such Special Districts as quasi-municipal subdivisions of townships within State A. The township authorized the formation of the Special Districts in Year 3, and the agreement between Taxpayer and the Special Districts was reflected in a Service Plan. The Special Districts purport to be political subdivisions.[1]

According to the Service Plan, the Special Districts will provide the necessary public improvements. The Service District is responsible for managing the construction and operation of facilities and improvements needed for the Parcel, while the Finance District is responsible for providing the funding and tax base needed to support the financing plan for capital improvements and for operations. Thus, the Special Districts are nominally responsible for the financing, construction, and operation of the public improvements of the Parcel.

The Service Plan, in a section called "General Financing Information and Assumptions," provides more information on the financing, construction, and operation of the public improvements of the Parcel:

> The Districts anticipate obtaining financing for capital improvements initially through Developer advances, and then through the issuance of limited tax general obligation bonds or other debt instruments, including revenue bonds. General obligation debt will be payable from revenues derived from ad valorem property taxes and from other legally available sources. The Financing District may issue limited tax general obligation bonds after its determination that the assessed valuation is sufficient to pay debt service with reasonable mill levies. …
> …
> The financial structure contemplated in the Financing Plan demonstrates that the risks associated with the development of [the Parcel] will be borne initially by the Developer of the project. Due to the nature of the liabilities associated with issuance of revenue bonds and Developer owned debt, the entire risk of development will rest with Developer until such time as the Financing District develops sufficient assessed valuation to support the debt service requirements of the bonds issued.

[1] For purposes of analyzing the issues in this case, we assume that the Special Districts are political subdivisions as defined in § 1.103-1(b), although we reach no official conclusion in that regard.

Prior to the formation of Special Districts, Taxpayer paid expenses necessary for both the formation of Special Districts and further development of the Parcel. Subsequent to the formation of Special Districts, Taxpayer continued to pay expenses on behalf of the Special Districts, and also advanced funds directly to Financing District. In exchange for the advances and payments, the Financing District issued promissory notes to Taxpayer.

Through Year 3, Taxpayer provided all of the funding that the Special Districts needed in order to fulfill obligations under the Service Plan. During Years 4 and 5, the Financing District issued $z of promissory notes to outside investors, which notes had priority over the notes payable to Taxpayer.

In Year 5, the Financing District issued a bond anticipation note (BAN) to Taxpayer in exchange for its outstanding promissory notes. The Year 5 BAN had a stated interest rate and a maturity date in Year 10.

Subsequently, in Years 6 through 10, Taxpayer continued to advance funds to Financing District to fund the public improvements necessary for the Special Districts to comply with obligations under the Service Plan and to allow Taxpayer to continue to subdivide the Parcel. The Financing District provided Taxpayer with a promissory note, which evidenced advances from Taxpayer. In Year 10, the Financing District issued a separate BAN to Taxpayer. The Year 10 BAN replaced the Year 5 BAN and the outstanding promissory note. The Year 10 BAN had a stated interest rate and a maturity date in Year 14.

Taxpayer sells lots in the Parcel to builders. Taxpayer elected to use the “alternative cost method” described in Rev. Proc. 92-29, 1992-1 C.B. 748, to account for the common improvement costs of its development. It treated amounts advanced to and on behalf of Special Districts as amounts incurred for common improvement costs.[2] Pursuant to Rev. Proc. 92-29, these amounts were reflected in the bases of lots sold by Taxpayer, to the extent of each lot’s allocable share of total estimated common improvement costs.[3]

On Schedules K-1 issued to its shareholders, Taxpayer reported accrued interest on the obligations of the Financing District as tax-exempt interest income under § 103. Certain but not all shareholders increased their basis in Taxpayer stock by these reported amounts and, as a result, claimed losses not otherwise allowable.

Taxpayer has treated repayments designated as “principal” as a reduction of cost. Pursuant to Rev. Proc. 92-29, this reduction in cost has been reflected as lower bases in lots sold in the year of repayment and subsequent years.

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[2] We do not address the issue of whether advances to and on behalf of the Special Districts resulted in costs “incurred” within the meaning of section 461.
[3] We do not address the issue of whether Taxpayer’s agreements for lot sales were long-term contracts subject to required use of the percentage-of-completion method of accounting under § 460.

LAW AND ANALYSIS

Relevant Law

Section 103(a) provides generally that gross income does not include interest on any state or local bond. Section 1.103-1(a) provides, in part, that interest upon obligations of a state or any political subdivision thereof generally is not includable in gross income.

Section 1011 provides, in part, that the adjusted basis for determining gain or loss from the sale or other disposition of property is the basis, determined under §1012, as adjusted as provided in §1016. Section 1012 provides, in part, that the basis of the property is the cost of such property. Section 1.1016-2(a) provides, in part, that the cost or other basis will be properly adjusted for any expenditure properly chargeable to a capital account, including the cost of improvements and betterments made to the property.

The bases of lots held for sale include allocable shares of the cost of common improvements, if (1) the basic purpose of the taxpayer in constructing the common improvements is to induce sales of the lots, and (2) the taxpayer does not retain too much ownership and control of the common improvements. *Norwest Corp. and Subsidiaries v. Commissioner*, 111 T.C. 105, 134-35 (1998), citing *Estate of Collins v. Commissioner*, 31 T.C. 238, 256 (1958). Thus, when a developer makes a payment to a third party for common improvements for a new development -- such as payments to utility companies to extend services to a new development or to construct a water or a sewerage system -- the payments may be added to the bases of the developer's lots sold. *Herzog Building Corporation v. Commissioner*, 44 T.C. 694, 699-700 (1965), *acq.*, 1968-2 C.B. 2.

Service position with respect to common improvement costs is consistent with the cited case law. If a person engaged in the business of developing and exploiting a real estate subdivision constructs a facility thereon for the basic purpose of inducing the purchase of lots, the cost of such construction is properly part of the cost bases of the lots, even though the developer retains tenuous rights, without practical value, to the facility constructed. Rev. Rul. 68-478, 1968-2 C.B. 330. Similarly, if a developer constructs a facility in the subdivision for the purpose of inducing the purchase of lots and the developer conveys all substantial rights in the facility to a utility, the cost of the facility is properly includable in the cost basis of the subdivision. Rev. Rul. 81-83, 1981-1 C.B. 434.

In certain cases, developers have been permitted to treat amounts that in form are cast as advances or loans, and made in exchange for bonds or other debt instruments, as in substance expenditures for common improvements and thus included in the bases of lots sold. The developer in *Hallcraft Homes v. Commissioner,* 40 T.C. 199 (1963), *aff'd*, 336 F.2d 701 (9th Cir. 1964), made advances to a water utility, so that the water utility would extend its water lines to the developer's property. The water utility agreed to

repay the advances over a twenty-year period from sales of water to the eventual owners of the developed properties. Although the holding addressed the issue of whether the sale of future repayments of advances was the sale of an ordinary income asset or a capital asset (the court finding an ordinary income asset), the court confirmed that the advances were includable in the bases of the developer's properties and that all repayments were income:

> Here, in order to complete its houses so they could be sold in the ordinary course of its business petitioner was required to advance to the water company the cost of extending water service to those houses. The water company agreed to repay petitioner these advances over a 20-year period out of its sales of water to eventual owners of the houses. . . . [P]etitioner added the amount of the advances to the cost of houses sold in computing its income from the sale of the houses. . . . Petitioner agrees that the refunds received from the water companies are taxable as ordinary income, and it has so reported them prior to, subsequent to, and, in fact, during the year here involved.

40 T.C. at 204-05.

The developer in *Herzog* had included the cost of purchasing bonds from the local municipality in the basis of its lots sold. The municipality used the proceeds to build a sewerage system. The government challenged this treatment on the grounds that the developer did not build the sewerage system itself, and at all times exercised full ownership over the bonds. Ruling against the government, the Tax Court held that the developer in substance had agreed to pay for the infrastructure and did so to make possible the construction and sale of its homes:

> We are satisfied that petitioner's purpose in agreeing to buy the Wheeling sewerage revenue bonds was to make possible the construction and sale of houses in the proposed subdivision, and was not to make an investment in the bonds. Considering this state of facts, we believe the soundest analysis of the case at bar will result from treating petitioner as having agreed to pay directly the costs of building the sewerage system.

44 T.C. at 700.

The fact that interest was paid on the bonds did not distinguish *Herzog* from other cases holding that contingent repayment obligations do not prevent a developer from adding common improvement costs to basis in property held for sale. In *Herzog*, repayment of the bonds was largely dependent on the success of the developer's subdivisions. *Id.* at 701. Consistent with its position that the cost of the bonds was in substance the cost of a common improvement, the developer in *Herzog* reported interest received on the bonds as a reduction of its bases in its lots, rather than as tax-exempt interest on municipal bonds under the predecessor of § 103. *Id*. at 698. Likewise, the developer in

Herzog reported amounts received on disposition of the bonds as ordinary income ("petitioner on brief seems to concede that the amounts received for the bonds constituted ordinary income"). *Id.* at 702, citing *Hallcraft Homes*.

If expenditures for common improvements are to be included under § 1016 as an upward adjustment to the bases of a developer's lots held for sale, Rev. Proc. 92-29, 1992-1 C.B. 748, permits an election to allocate common improvement costs to each lot, under the alternative cost method. Under this method, a real estate developer allocates to lots sold a proportionate share of common improvement costs that includes estimated future construction costs without regard to whether the costs would qualify as incurred under the economic performance rule of § 461. However, the cumulative amount of such costs taken into account in the current and prior tax years cannot exceed the total cumulative amount of common improvement costs incurred by the developer in the development.

Section 2.01 of Rev. Proc. 92-29 defines "common improvements" to mean any real property or improvements to real property that benefit two or more properties that are separately held for sale by a developer. The developer must be contractually obligated or required by law to provide the common improvement and the cost of the common improvement must not be properly recoverable through depreciation by the developer. Examples of common improvements include streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools.

Section 2.02(1) of Rev. Proc. 92-29 addresses the treatment of a change in estimated common improvement costs. It provides, in part:

> A developer may not adjust the estimated cost of common improvements for a prior taxable year when events after filing the prior year federal income tax return show the original estimate has been either understated or overstated. If, after the return is filed, it is determined that a greater or lesser amount should have been claimed, the remedy is to make the correction in and for the year the determination is made.

Taxpayer's Advances and Repayments

As described above, prior to the formation of the Special Districts, Taxpayer paid expenses necessary for both the formation of the Special Districts and other costs necessary to further the development of the Parcel. Subsequent to the formation of the Special Districts, Taxpayer continued to pay expenses on behalf of the Special Districts and also advanced funds directly to the Financing District. In exchange for the advances and payments, the Financing District issued promissory notes to Taxpayer. Those promissory notes were eventually exchanged for bond anticipation notes, the latest of which was issued as the Year 10 BAN.

As noted, the Special Districts were created exclusively to finance, construct and operate public improvements for the Parcel, as reflected in the Service Plan. Taxpayer has consistently treated all advances to and on behalf of the Special Districts as additional costs incurred in developing Taxpayer's properties and has accounted for the costs by using the alternative cost method described in Rev. Proc. 92-29. Thus, in its treatment of the advances and payments, Taxpayer has disregarded the form of the transaction – the purchase of a debt instrument (note or bond) – and treated the transaction according to its substance – expenditures made to improve properties held for sale. This treatment appears to have been proper in light of the authorities discussed above. Although the Special Districts were nominally designated to finance, construct and operate the common improvements, the common improvements were needed to enhance the value of Taxpayer's development, and repayment of Taxpayer's advances – whether designated as principal or interest -- was contingent on the success of Taxpayer's development.

While Taxpayer disregarded the form of the transaction and took a return position consistent with its substance in treating advances to and on behalf of the Special Districts as common improvement cost expenditures, it took a different approach when it accrued "interest" on the notes and bonds and reported these amounts to its shareholders as tax-exempt interest under § 103.

Repayments received from the Financing District are properly treated as a reduction in Taxpayer's estimated common improvement costs under Rev. Proc. 92-29. Accordingly, Taxpayer's estimated common improvement costs are reduced in the year of repayment.[4] Under section 2.02(1) of Rev. Proc. 92-29, this will result in reduced allocations to the bases of lots sold in the year of repayment and succeeding tax years. Any repayments made after Taxpayer has completed lot sales must be reported as ordinary income. *Hallcraft Homes*, 40 T.C. at 205 (refunds from the water company are taxable as ordinary income); *Herzog*, 44 T.C. at 702 (amounts received for the bonds constituted ordinary income). No portion of any payment from the Special Districts is tax-exempt interest under § 103.

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Please call (202) 622-7006 if you have any further questions.

[4] Any repayments received will also reduce the "alternative cost limitation" described in section 4.01 of Rev. Proc. 92-29.