June 26, 2002

The Impact of Impact Fees

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Revenue Ruling 2002-9, recently published by the Internal Revenue Service, has caught the interest of many in the real estate community. The ruling addresses the following questions:

- Are "impact fees" incurred by a taxpayer in connection with the construction of a new residential rental building deductible or capitalized?
- If they are required to be capitalized, how are they allocated between land and building?

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

The taxpayer in the ruling was required to pay various impact fees (for example, for schools and law enforcement and fire protection facilities) in order to compensate the county for the financial impact of its new building. These impact fees were calculated based on projections of the number of rental units in the building and the size of the building. The taxpayer paid the impact fees when the construction permit for the building was issued.

The ruling, not surprisingly, found authority for requiring capitalization of the impact fees under sections 263 and 263A of the Internal Revenue Code.

'Permanent Improvement'

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 property or estate." Treasury Regulations under section 263 provide 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."

The ruling cites *Oriole Homes Corp. v. U.S.*, 705 F.Supp. 1531 (S.D. Fla. 1989), where the court held that road, educational, regional park, and municipal park impact fees required for the approval and recordation of plans for subdivisions are capital expenditures and, therefore, must be capitalized as a development cost. The court stated:

> Under the stipulated facts of this case, it was necessary for the Plaintiff to pay the impact fees, or it could not have developed the properties. Therefore, these costs were incurred for

> the development and construction of the residential housing units just as the costs of the land, the labor, or the construction materials. These fees are similar to accounting or legal fees incurred in the development of property and must therefore be considered capital expenditures, to be capitalized as a development cost and deducted pro rata as each house is sold.

The court held that impact fees must be capitalized pursuant to section 263.
Section 263A provides additional rules requiring capitalization (which in many cases overlap with section 263). Section 263A provides that direct costs and a properly allocable portion of indirect costs of real or tangible personal property produced by a taxpayer must be capitalized with respect to the property produced. Section 263A(g)(1) provides: "the term produce includes construct, build, install, manufacture, develop, or improve." Property produced may include land, buildings, land improvements, and other tangible property owned by the taxpayer. Any cost required to be capitalized by section 263A must be capitalized regardless of whether the cost was incurred before, during, or after production.

Regulations under section 263A provide rules for determining the direct and indirect costs that are required to be capitalized. Under these rules, direct costs consist of direct material and direct labor costs and indirect costs include all other costs allocable to the produced property. 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.

'Von Lusk'

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 section 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 court continued:

> Having determined that Von-Lusk's activities represented the first steps in the development of the property, it then follows that Von-Lusk produced the property, as contemplated by Congress. As such, section 263A applies to the property, and Von-Lusk must capitalize the direct and a proper share of the indirect costs of the property.

Based on *Von-Lusk*, the ruling held that impact fees are indirect costs under section 263A because they directly benefit, and are incurred by reason of the production activity. Similar to the costs at issue in *Von-Lusk*, impact fees are assessed by local authorities because of 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."

After concluding that the impact fees must be capitalized, the ruling turns to the more interesting question of how to allocate the impact fees to the property produced. The ruling holds that impact fees are added to the basis of the building (rather than the land) and, therefore, that the taxpayer must depreciate the impact fees as residential rental property or nonresidential real property, 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 the low-income housing credit, impact fees are included in the eligible basis of a qualified low-income building.

The ruling reaches the conclusion that 100% of the impact fees are allocable to the building 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....

Although the ruling disposes of the allocation question quickly, the issue is complex. Since land and building are used as an integrated unit, how can one determine which element is "bettered" by the payment of impact fees? Is it a less valuable building built on more valuable land or vice versa? The ruling emphasizes that if the building were not built, this cost would not be incurred, because the impact fees would be refunded. However, what if the land were sold after payment of the impact fees but before the building was built? The value added by payment of the impact fees would surely be reflected in the value of the land. Moreover, if the building were subsequently destroyed, the value added by payment of the impact fees would remain, presumably in the land.

The allocation aspect of the ruling may have significant impact upon New York City developers, even though New York City does not generally impose impact fees. The ruling's discussion of the *Von-Lusk* case compares impact fees to the costs incurred in *Von-Lusk* (costs of obtaining zoning variances, building permits, etc.). Thus, the ruling's holding regarding the allocation of impact fees may support a similar allocation to building of a variety of analogous costs.

"Zoning-lot mergers," colloquially referred to as "air rights transfers," are transactions where an owner purchases development rights, usually from adjacent parcels, which enable him to increase the height of his building. How does one allocate this cost to basis? Should it be allocated to land, since in effect the zoning-lot merger accomplishes a transfer of some of the "fee" rights of the adjacent parcels to the developer's parcel, or should it be allocated to the building, since the only benefit the developer receives is the ability to construct a larger building, or should it be allocated in some combination to both land and building? To the extent that these costs are allocated to the building, should they be allocated solely to the additional floors the developer is able to build? The impact fees discussed in the ruling have much in common with these zoning-lot merger costs, since both are necessary only if a building is to be built, both are potentially convertible into cash if the building is not built, and the cost of each relates to the size of the building being constructed. Revenue Ruling 2002-9, therefore, may support the proposition that zoning-lot merger costs should be allocated to the building and depreciated over the appropriate period.

Conclusion

The conclusion of Revenue Ruling 2002-9 that impact fees must be capitalized does not come as a surprise; real estate developers, however, concerned with the rising cost of impact fees and other similar costs, should be pleased to see the ruling's conclusion allocating the impact fees to the basis of the building.