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IRS Guidance—Rules for Depreciating "Infrastructure" Items

By: Attorney(ies)

The IRS National Office concluded in a recent technical advice memorandum that costs incurred by a developer to build street, sewage, and utility systems for two commercial projects could not be recovered through depreciation once the improvements had been assigned to a municipality. TAM 200017046 (Sept. 10, 1999). This conclusion may be consistent with prior rulings and cases that are discussed in the TAM, but may also represent an unpleasant surprise to many developers and their advisers.

Background

The description of facts in the TAM is very limited. It appears that a corporation sought to develop a parcel of property through two commercial projects requiring various approvals by municipal authorities. The city in which the property was located made its approval of the proposed development plans contingent on the developer's construction of certain improvements.

The developer and the city then entered into an "Acquisition/Financing Agreement" under which public improvements built by the developer for the two projects would be dedicated to the city, and the city, in turn, would transfer to the developer the proceeds from a sale of bonds. The TAM does not say who would repay the debt evidenced by the bonds, but there is no suggestion that the bond proceeds were transferred as consideration for the improvements.

The improvement expenditures at issue were made for street improvements, including the widening of roads, and for sewer system, water system, and storm drainage infrastructure. Following the passage to the city of title to the improvements, the city was responsible for the maintenance, repair, and reconstruction of the improvements as needed.

The developer claimed depreciation deductions with respect to the improvement expenditures, which deductions were computed using a 15-year life and the declining balance method.

The depreciation deductions were apparently challenged by the IRS on audit, and a "Request for Technical Advice" was then submitted, together with letters describing the developer's position, to the IRS National Office. The TAM notes that the developer did not participate in the submission of the request and declined a conference of right with regard to the issuance of the TAM.

Tangible vs. Intangible Property

The TAM describes the threshold question as being whether the infrastructure items constituted tangible or intangible property to the developer.

In the course of a discussion of a published ruling and several cases apparently on point, the TAM cites three factors as relevant to the question of whether someone has a depreciable interest in a tangible asset. The first two factors are whether the person has a proprietary interest in the asset, and whether the asset is used directly in the person's business. The third factor, referred to in the TAM as the "critical" one, is whether the person will maintain and replace the asset as needed—indicating that the person bears the economic burden of depreciation of the asset.

The TAM concludes that the developer, by dedicating the streets to the city and granting easements for the construction and maintenance of sewage and drainage facilities, relinquished its proprietary interest in the improvements. This, and the fact that the city, rather than the developer, was obligated to maintain the streets and other improvements, led the IRS to conclude that the streets and other improvements dedicated to the city were not tangible assets with respect to the developer, but rather provide a benefit to the developer that is an intangible asset.

The TAM cites Revenue Ruling 68-607 (1968-2 C.B. 115), which involved the treatment of expenditures made by a developer to provide access to a shopping center from an adjacent highway, as supporting this conclusion. That ruling concluded that the expenditures resulted in the acquisition by the developer of an intangible asset, subject to amortization over the term of the developer's 99-year leasehold interest in the shopping center.

The TAM observes that the developer of the two commercial projects that the TAM addresses similarly derived a benefit from the improvements in the form of improved access to its developments. Since this benefit "has no relationship to the life of any tangible asset", it constituted an intangible asset, consistent with Rev. Rul. 68-607.

Determinable vs. Indeterminate Life

It appears that the developer also argued to the IRS that, if the expenditures at issue gave rise to an intangible asset, that asset had a limited useful life, such that a deduction for depreciation (or amortization) should be allowed under Internal Revenue Code section 167 and Treas. Reg. section 1.167(a)-3.

The developer cited Revenue Ruling 73-188 (1973-1 C.B. 62) in support of allowance of a deduction. That ruling addressed the treatment of assessments made against business property owners to fund the conversion of a city street into an enclosed pedestrian mall. The assessments were held to be capital expenditures subject to depreciation over the ten-year anticipated useful life of the mall.

The TAM distinguishes that ruling from the circumstances addressed in the technical advice on the grounds that the landowners in the 1973 ruling were required to maintain the mall and to pay heating and air conditioning costs, and that the mall was expected to provide a business benefit for only a limited period, in that case 10 years.

Of the several cases cited by the developer on this issue, the strongest for its position appears to have been *Glenn Noble v. Commissioner* (70 T.C. 916 (1978)), concerning the treatment of a "tap fee" required to be paid to a city by the owner of three properties in order to connect to the city's new sewer system. The tap fee was imposed to raise funds to pay for the system, but there was no indication that the owner had any continuing responsibility to maintain the system.

The IRS argued to the Tax Court in *Noble* that the benefits from the tap fee were indeterminate and therefore nondepreciable. Mr. Noble argued that he should be entitled to amortize the cost over the life of existing improvements on his properties.

The Tax Court took a third approach. It observed that, if the sewer system required replacement, Noble would likely again be subjected to an assessment to help pay for the replacement; and that, even if he would not be so assessed, "the value of petitioner's contribution to the capital cost of the present system will have been exhausted" at the end of the expected life of the sewer system. For that reason, the Tax Court held the tap fee to be amortizable over the anticipated useful life of the sewage system, which the court concluded (by reference to class life guidelines for similar assets published by the IRS) to be 50 years.

In the situation addressed by the TAM, however, the IRS observed that the city had an obligation to replace the improvements when necessary, and that there was no indication that the city would assess the developer or a subsequent landowner for replacement costs. Therefore, the intangible asset acquired by the developer—i.e., the benefits of improved streets, sewers and so forth—had an indeterminable useful life, and no depreciation deduction was allowable under Code section 167.

Change in Method of Accounting

The final part of the TAM discusses whether the conclusion that the infrastructure expenditures were not depreciable, and the resulting disallowance of prior depreciation deductions, constituted a change in method of accounting within the scope of Internal Revenue Code section 481. Because the conclusions regarding the principal issues addressed in the TAM affected when the developer could recover the costs of the improvements for tax purposes (delaying the recovery of those costs to the time of disposition), the technical advice concludes that there was a change in method of accounting.

Accordingly, for the first year under review, the TAM recommended that an adjustment be made not only for the depreciation claimed for that year but also for all previous years. Such an adjustment would be needed to be consistent with the conclusion that the developer's basis in that intangible asset would not be reduced periodically by depreciation.

Observations

There is no indication in the TAM as to whether the developer attempted to establish that the infrastructure items, or some portion of them, were limited in usefulness to the specific projects built by the developer—for example, that sewer and utility systems would likely have to be replaced at the property owner's expense when the project buildings became decrepit or obsolete and the property was therefore redeveloped. If the facts supported such an argument, that would appear to present a stronger case for the allowance of deductions for depreciation or amortization.

The expenditures at issue could have been analogized to a fee paid to a governmental entity to obtain permission to develop a property in a specified manner. Such a fee should logically be allocable in large part, if not entirely, to the development itself, and therefore includible, at least in part, in the (depreciable) basis in the development. The nature of the expenditures in this matter, however (which expenditures likely enhanced the value of the land), and the approaches taken in prior cases and rulings in this area, may have made this analogy unpersuasive, if indeed it was considered at all.

The TAM also makes no reference to Code section 197, which authorizes the amortization of certain intangible property ratably over a 15-year term. The absence of any reference to that section may be attributable to the improvements having been made before the enactment of section 197. Alternatively, the developer and its advisors may have considered it unlikely that the expenditures could qualify as a "section 197 intangible" as defined in that section.

In sum, although the developer failed to convince the IRS of the merits of its position here, the underlying issue is highly fact-dependent, and different results may be anticipated in other circumstances.