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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Allocation of Basis Between Subdivision Lots and Golf Course

This Field Service Advice responds to your memorandum dated May 28, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Sellers:
X Corp.:
Y Corp.:
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Date 1:
Date 2:
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Year 5:

ISSUES:

1) Whether a developer of real estate may allocate the costs of a golf course and related facilities to the the basis of homesite lots sold for purposes of determining gain or loss resulting from the sale.

2) How should the costs of the golf facilities be allocated in using the alternative cost method?

CONCLUSION:

1. Where the developer has properly filed an election pursuant to Rev. Proc. 92-29, the cost of a golf course and related facilities which benefit two or more homesites in the subdivision may be included in basis of the homesite lots for purposes of computing gain or loss.

2. The alternative cost method does not affect the application of general capitalization rules to the developers of real estate. Moreover, although costs of common improvements may be included in basis of properties sold for purposes of computing gain or loss under the alternate cost method, the cost included may not exceed the amount of common improvement costs that have been incurred under I.R.C. § 461(h) as of the end of the taxable year.

FACTS:

Taxpayers are shareholders of a small corporation, X Corp., engaged in the business of developing real estate. The Project includes a residential subdivision community and an 18-hole golf course, open areas, and related facilities. The Project encompassed development of m acres of land. Approximately n acres of land are for subdivision property, o acres are devoted to the golf facilities and the remaining p acres are for roads, common areas, and right of way areas. The subdivision residential community has n acres of land and a total of q home sites. The homesite lots range from 1.5 to 2.5 acres. The golf facilities includes an 18-hole golf course; a driving range, two practice putting greens; one outdoor swimming pool; four tennis courts; and a clubhouse with a restaurant and bar facilities, a pro shop, and men’s and women’s locker facilities.

Purchasers of homesites are entitled to exclusive rights to charter memberships; priority rights as to Golf memberships, with discounts; or free Golf Social memberships.

In Year 1 the original developer (Sellers) received approval from the local planning and zoning commission of a preliminary plat for the Project. In a Year 2 agreement with the county, Sellers agreed to reserve certain housing units for golf course employees and to make the golf course available to all residents of the county on a regular basis during the golfing season. As a condition for approval of the final plat, the commission required the original developer to construct a golf course, to provide adequate bonding and to provide assurances allowing public use of the golf course.

When X Corp. acquired the Project on Date 1, the company also entered into a Completion Agreement with the county and its lender, guaranteeing the completion of the golf course and other recreational amenities (as required by the county as a condition of giving its approval to the final plat). X Corp. was required to reimburse any cost the county incurred in completing those improvements in the event that X Corp. failed to do so. Under the purchase agreement, X Corp. had to give r preselected homesites to Sellers, leaving only s homesites available for X Corp. to sell. Prior to X Corp.'s acquisition, the Sellers had entered into sales agreements with t prospective purchasers of the s homesites and entered into agreements with p prospective purchasers of memberships in the club. These sales contracts conditioned the buyer's obligation to complete the purchase of a homesite on the Sellers' obligation to construct the golf facilities. On Date 1, X Corp. closed on these contracts for sale, assuming the contractual obligations of Sellers.

On the same day that X Corp acquired the Project, it also entered into an agreement with Y Corp., a newly created nonprofit membership corporation. Under the terms of that agreement, X Corp. was obligated to construct the golf facilities, to operate the golf club and facilities, to fund any operating deficits and was entitled to return any operating profits. Y Corp. was to receive title to the golf facilities on Turnover Date, the earlier of the date upon which at least u Charter memberships, v Golf memberships and w Golf Social members had been sold to persons other than X Corp.; or Date 2. In consideration for the transfer of the golf facilities, Y Corp. agreed to pay the following amounts to X Corp.: 1) the proceeds from the initial sale of u Charter memberships, v Golf memberships and x Golf Social members, y Junior memberships and w Social memberships; and 2) all transfer fees received by Y Corp. until the 15th anniversary of Turnover Date.

Construction of the golf facilities began in Year 3. The Club opened on Date 3 and was operated by X Corp. from Year 4 to Year 5. For the Year 3 tax year, X Corp. elected to use the alternative cost method for determining when common improvement costs could be included in the basis of properties sold in the Project, under Revenue Procedure 92-29.

LAW AND ANALYSIS

Section 461(h)(1) provides that, in determining whether an amount has been incurred with respect to any liability during any taxable year, the all events test shall not be treated as met any earlier than the taxable year in which economic performance with respect to such liability occurs. Section 1.446-1(c)(1)(ii)(B) provides that the term "liability" includes any item allowable as a deduction, cost, or expense for federal income tax purposes. In addition to allowable deductions, the term "liability" includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense.

The enactment of section 461(h) changed the time for adding common improvement costs to the basis of property. In general, under section 461, common improvement costs may not be added to the bases of properties benefitted by those improvements until the common improvement costs are incurred within the meaning of section 461(h). Common improvement costs that have not been incurred under section 461(h) when benefitted properties are sold may not be included in the bases of the properties in determining the gain or loss resulting from the sales.

Prior to the enactment of section 461(h), Rev. Proc. 75-25, 1975-1 C.B. 720, amplified by Rev. Proc. 78-25, 1978-1 C.B. 505, allowed a subdivider of real estate to request permission from the district director to include in the basis of lots sold the estimated cost of certain common improvements for the purpose of determining the gain or loss resulting from the sale of the lots. Rev. Proc. 92-29, 1992-1 C.B. 748, generally obsoleted Rev. Proc. 75-25 and Rev. Proc. 78-25 with regard to sales of property after 1992, while retaining the general rule that certain taxpayers may use the alternative cost method. Under the alternative cost method, a developer is permitted to include in the basis of properties sold their allocable share of the estimated cost of common improvements without regard to whether the costs are incurred under section 461(h) of the Code.

Rev. Proc. 92-29 sets up the procedure whereby taxpayers may elect to add the future costs of common improvements to properties as they are sold using the alternative cost method. The revenue procedure provides that in addition to the requirement that the election be timely, consent to use that method is generally conditioned on the following:

> (1) The developer must be contractually obligated or required by law to provide the common improvements, and the cost of the common improvements must not be properly recoverable through depreciation by the developer.
>
> (2) The developer must sign a consent extending the period of limitation on the assessment of income tax with respect to the use of the alternative

cost method on a project-by-project basis as described in section 7 of the revenue procedure.

(3) The developer must file an annual statement for each project for which the developer has received permission to use the alternative cost method in accordance with section 8 of the revenue procedure.

The information provided to this office indicates that X Corp. filed its election to use the alternate cost method. Pursuant to the terms of X Corp.'s Completion Agreement with the county, its purchase agreement with Y Corp. and its sales contracts with the individual purchasers of Project homesites, X Corp. is obligated to construct the golf facilities. As such, X Corp. is contractually required to provide these facilities.

Rev. Proc. 92-29 defines the term "common improvement" 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. Examples of common improvements listed in the revenue procedure include streets, sidewalks, sewerlines, playgrounds, clubhouses, tennis courts, and swimming pools. The improvements constructed by X Corp. as part of the golf facility benefit two or more properties and thus fall within the meaning of common improvements.

Examination has question whether X Corp. has properly defined the golf facilities and the residential subdivision as one project. Section 4.01 of Rev. Proc. 92-29 provides that a developer may use any reasonable method to define a project in light of the common improvements to be provided. Here, taxpayer's definition of the residential homesites as the project would appear to be reasonable in light of the improvements provided. The facts provided do not allow us to determine whether other requirements of Rev. Proc. 92-29 are satisfied.

You have also asked how the costs of common improvements should be allocated. The estimated cost of common improvements as of the end of any taxable year is equal to the amount of common improvement costs incurred under section 461(h) of the Code as of the end of the taxable year, plus the amount of common improvement costs the developer reasonably anticipates it will incur under section 461(h) during the ten succeeding taxable years (the "ten-taxable year horizon"). As of the end of any taxable year, however, the total amount of common improvement costs included in the basis of (or otherwise taken into account with respect to) the properties sold may not exceed the amount of common improvement costs that have been incurred under section 461(h) of the Code ("the alternative cost limitation"). Section 4.01 of Rev. Proc. 92-29. If the alternative cost limitation precludes a developer from including the entire allocable share of the estimated cost of common improvements in the basis of the properties sold, the costs not included may be taken into account in a subsequent taxable year to the extent additional common improvement costs have been incurred under section 461(h) of the Code.

Moreover, the alternative cost method does not affect the application of general capitalization rules to developers of real estate. Thus, common improvement costs incurred under section 461(h) of the Code are allocated among the benefitted properties and may provide the basis for additional computations (e.g., interest capitalization under section 263A(f)). The facts provided do not allow an analysis of how these limitations affect the proper basis allocation in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

According to the facts presented, the grounds upon which Examination seeks to deny use of the alternative cost method are not consistent with how we construe the terms "contractual obligation," "project" and "common improvements" as used in Rev. Proc. 92-29. Examination implies that because the benefits of the golf facilities are not limited solely to the homesites in the Project, the golf facilities should not be considered common improvements. However, the benefit of streets, swimming pools and other improvements mentioned in the revenue procedure, will often extend beyond the owners of properties in the subject project. To the extent that these assets meet the definition of common improvements, it is not appropriate to designate them as a separate project. At this point, on the basis of the facts supplied to this office, it does not appear reasonable to deny X Corp. the right to use the alternative cost method.

Deborah A. Butler
Assistant Chief Counsel

/signed/

By: _____

GERALD M. HORAN
Senior Technician Reviewer
Associate Chief Counsel (Domestic)