IRS's Eligible Basis Lacks Basis

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice.

The authors of this column are Sarah Eshera, Associate, Baker & McKenzie, Chicago, Illinois, Connor Mallon, Associate, Baker & McKenzie, Chicago, Illinois, and Richard M. Lipton, Senior Counsel, Baker McKenzie, Dallas, Texas.

Readers are invited to write to the editors: Richard M. Lipton, Senior Counsel, Baker McKenzie, Dallas, Texas, richard.lipton@bakermckenzie.com; Samuel P. Grilli, Partner, Baker & McKenzie, Chicago, Illinois, samuel.grilli@bakermckenzie.com; and Leah Gruen, Counsel, Baker & McKenzie, Chicago, Illinois, leah.gruen@bakermckenzie.com.

This past February, the Tax Court smacked down the IRS's concept of "eligible basis" for purposes of low-income housing credits ("LIHCs") in *23rd Chelsea Associates v. Commissioner*.[1] In so doing, the Tax Court held that bond issuance financing costs, even for tax-exempt bonds, can be included in the Section 42 "eligible basis" of qualified low-income buildings. This reverses a long-standing position taken by the IRS in technical advice memorandum ("TAM") 200043015.

23rd Chelsea Associates, L.L.C. ("23rd Chelsea"), the taxpayer, was a partnership that built a multifamily residential apartment complex—called the "Tate"— in New York City from 2001 to 2002. 23rd Chelsea financed this construction with a loan from the New York State Housing Finance Agency (the "HFA"). The HFA, itself, raised funds for the construction loan by issuing bonds, some of which were tax-exempt. As a condition for the HFA granting 23rd Chelsea the construction loan, the HFA required 23rd Chelsea to satisfy several requirements. First, the Tate was to be subject to restrictions on the eventual tenant mix (by income level) and the rental rates for low-income tenants. These restrictions preserved the tax-exempt status of the HFA's bonds and would help qualify the Tate for LIHCs. Second, 23rd Chelsea was to fully secure the construction loan and related payment obligations by obtaining letters of credit from Bayerische Hypo-und Vereinsbank AG ("Hypo Bank") or another lender approved by the HFA. Third, the HFA required 23rd Chelsea to, directly or indirectly, pay certain financing costs. These costs included an origination fee payable to Hypo Bank for its letters of credit and fees payable to the HFA for costs incurred in issuing the bonds necessary to provide 23rd Chelsea the construction loan.

23rd Chelsea claimed LIHCs under Section 42 with respect to the Tate for 2003 through at least 2009. Assuming certain requirements are met, a taxpayer can receive a LIHC equal to the "applicable percentage" (published annually by the IRS) of a residential rental property's "qualified basis." The amount of a property's "qualified basis" depends on its "eligible basis." Under Section 42(d)(1) and Section 42(d)(4), a new building's "eligible basis" will equal its "adjusted basis" at the end of the first taxable year of the credit period, but only to the extent such adjusted basis is allocable to residential rental property and comes before any reduction for depreciation.

In calculating its LIHCs, 23rd Chelsea included in the Tate's eligible basis a portion of the various financing costs it incurred in connection with the HFA construction loan, including fees paid to the HFA and Hypo Bank as part of securing the construction loan and the letters of credit, respectively. 23rd Chelsea included each component of the financing costs in the Tate's eligible basis only to the extent that it deemed that component to relate to both (i) the portion of the real estate composed of residences and common areas, and (ii) costs incurred during the construction period.

Nonetheless, the IRS issued a final partnership administrative adjustment ("FPAA") determining, in part, that 23rd Chelsea should not have included the financing costs in the eligible basis used to calculate the LIHCs. The IRS's position rested on two arguments: first, the IRS argued that the financing costs were not properly capitalizable to the Tate, but instead were capitalizable to the loan itself, and thus were not depreciable under the modified accelerated cost recovery system ("MACRS"). Consequently, they were not part of the qualified low-income building that gave rise to an LIHC. Second, the IRS argued that the legislative history of Section 42 demonstrated that costs allocable to securing tax-exempt bonds (i.e., the fees paid to the HFA) are not includable in eligible basis.

According to the IRS, *none* of the financing costs should have been included in eligible basis. This argument matched the position of the IRS in TAM 200043015. Like 23rd Chelsea, the taxpayer in that TAM included certain bond issuance costs in its eligible basis under Section 42. The IRS determined that costs incurred in obtaining a loan (or a tax-exempt bond) are capitalized and amortized over the life of the loan or bond; accordingly, so said the IRS, bond issuance costs are not capitalizable to depreciable property (such as the Tate) but instead to the loan, which is intangible property and not subject to MACRS. Thus, the costs cannot be included in the building's eligible basis, because they are not capitalized to the building at all.

The Tax Court neutralized this argument by holding that Section 42 eligible basis can include indirect bond issuance costs attributable to the taxpayer's production and construction of the relevant property. The Tax Court first sought to define "adjusted basis" because Section 42 defines "eligible basis" as "adjusted basis." The Tax Court concluded that "adjusted basis" includes a property's share of properly allocable indirect costs. This conclusion flowed from a three-step analysis: (i) a property's properly allocable share of indirect costs must be capitalized to that property pursuant to Section 263A, (ii) "capitalize" means to charge to a capital account or basis pursuant to the Section 263A regulations, and (iii) basis is adjusted for any expenditures charged to the capital account pursuant to Section 1016(a)(1). Thus, the Tate's eligible basis included its share of properly allocable indirect costs.

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The Tax Court further held that the costs incurred by 23rd Chelsea related to obtaining the bond issuance were properly allocable to the Tate. The Section 263A regulations provide that "indirect costs" are "all costs other than direct material costs and direct labor costs." Indirect costs are properly allocable to a taxpayer-produced property when those costs "directly benefit or are incurred by reason of the performance of production . . . activities." That phrase was interpreted by the Tax Court under a Second Circuit decision, *Robinson Knife Mfg. Co., Inc. & Sub. v. Commissioner*,[2] to mean that capitalizable indirect costs are costs that are a "but-for" cause of the taxpayer's production activities. The Tax Court concluded that the bond issuance costs were necessary to induce the HFA to provide the construction loan, and thus were a "but-for" cause of the production activities. The costs were properly allocable to the Tate, and not the construction loan itself, as the costs were incurred "by reason of" the production activities related to the Tate. Additionally, other portions of Section 263A provide support for this position, as they require interest on loans used to finance the production of property to generally be capitalized to the relevant produced property if paid or incurred during the "production period" and allocable to property with "a long useful life." In 23rd Chelsea's case, it included the financing costs in eligible basis only to the extent of the Tate's construction (i.e., production) period and allocated such costs to the Tate—residential real property with a long useful life.

In both *23rd Chelsea* and TAM 200043015, the IRS attempted to use the legislative history of Section 42 to rebut this argument with respect to tax-exempt bonds. In the TAM, the IRS admitted that "an argument can be made" that Section 263A allows indirect costs of real property produced by the taxpayer to be capitalized by that taxpayer. Thus, "under the general rules of [S]ection 263A," the indirect costs could reasonably be allocated to the property produced. Nonetheless, the IRS cited a conference report stating that "residential rental property" under Section 42 meant "residential rental property" as used in Section 103. Section 103, in turn, is linked to Section 142. Section 142 defines "exempt facility bond" to mean any bond issued as part of an issue where 95% or more of the net proceeds are used to provide "qualified residential rental projects." The conference report, in discussing whether net proceeds under Section 142 were used for *any* exempt purpose (including qualified residential rental projects) that met the 95% test, noted that amounts paid for costs of bond issuance are not reduced from the amounts that qualify for the 95% test because they are not treated as "spent" for that test. From this, the IRS concluded that, because tax-exempt bond issuance costs are not included as costs for the 95% test, they should not be treated as costs spent for (and thus capitalizable in the basis of) qualified low-income buildings under Section 42. To do otherwise, so argued the IRS, would create "disparate treatment" between Section 42 and Section 142 and, further, reject the conference report's definition of "residential rental property."

The Tax Court rejected this argument for two reasons. First, the plain text of Section 42 was clear; there was no ambiguity that warranted the IRS's long-winded explanation of the legislative history. This conclusion is consistent with the Supreme Court's decision in *Gitlitz v. Commissioner*,[3] where the Court refused to look at the legislative history or purpose of a Code provision when the statutory language was clear. Second, and even assuming the legislative history of Section 42 was relevant to the case, the Tax Court's holding did not provide for "disparate treatment" of Section 42 and Section 142. The Tax Court's interpretation of "residential rental property" in Section 42 did not actually differ from the definition provided in the legislative history; rather, the Tax Court recognized that Congress imposed different requirements on the use of tax-exempt bonds for purposes of the two sections. Under Section 142, 95% of bond proceeds (a threshold unreduced by financing costs) must be used to provide certain exempt property, including qualified residential rental projects. By contrast, bond issuance costs are includable in eligible basis under Section 42. The definition of "residential rental property" does not change, only the required uses and allocation of bond proceeds and costs.

In sum, the Tax Court overruled an IRS position that had been held (and continually litigated, as shown in *23rd Chelsea*) for over twenty years. The plain text of Section 42 and the capitalization rules of Section 263A state that eligible basis, as a derivative of adjusted basis, includes bond issuance costs that are related to the production of property. Nonetheless, the IRS took a position contrary to that plain text due to their refusal to consider uniform capitalization rules regarding taxpayer-produced property and a questionable interpretation of Section 42's legislative history. As *23rd Chelsea* demonstrates, such questionable positions can be overturned, even decades later, when pressure tested.

We welcome our readers' comments.

End Notes

1. 162 T.C. No. 3 (Feb. 20, 2024).
2. 600 F.3d 121, 131–32 (2d Cir. 2010).
3. 531 U.S. 206 (2001).

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