

# Marquee

Providing business and financial news for the hospitality and real estate industries

Grant Thornton 

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## A capital priority: tracking and capitalizing land development costs

*By Southern California Tax Practice Leader Don Dahl and Cincinnati Senior Tax Associate Pat McLaughlin*

Certain adages seemingly live on forever. Benjamin Franklin penned a winner in 1789 when he wrote, “In this world, nothing can be said to be certain except for death and taxes.” This adage holds true today, regardless of how much or how little you might owe Uncle Sam.

Whether you are a father-son company clearing lots for a block of new bungalows or a large builder developing the latest and greatest lifestyle community, it is important for any residential developer to be familiar with basic tax concepts related to tracking and capitalizing land development costs.

### What activities should be considered?

Costs incurred to produce real property are not currently deductible. Such costs will be recouped either through depreciation or recovered when the property is sold. “Production costs” include the cost to construct, build, develop or improve real property. Included in this definition is any activity related to the development or improvement of land. Processes such as the grading and clearing of land, excavation for the purpose of roads, laying foundation

or lines for utilities and plumbing and electrical work would qualify.

Internal Revenue Service (IRS) regulations may require the capitalization of interest under certain circumstances. In such cases, it is important to determine the period during which construction is performed. In the case of real property, construction can be said to have started when the very first activity is performed on the property. The construction period is only completed once the property is ready for sale or, if the taxpayer is going to use the property, when the property is ready to be put into use.

Completion date can be a thorny subject for those involved in construction of multi-unit buildings. In the tax world, each unit is considered to be independent of the others as long as each is not contingent on another to pass the “ready to be placed in service” test.

All construction activities are subject to some type of capitalization rules. In general, construction property is subject to the same costing standards as

manufactured  
inventories.

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### What costs should be capitalized?

Taxpayers must capitalize the direct costs of real property produced along with the portion of indirect costs properly allocable to the real property. The direct costs include the cost of the land as well as materials and labor. Examples of capitalized costs include:

- Standard wages
- Overtime
- Employee benefits
- Payroll taxes
- Unemployment benefits



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Despite a specifically defined construction period, there are some pre-production costs that must be capitalized even though they are incurred before any development occurs. One frequently overlooked expense is property taxes, which are subject to capitalization if it is more than likely the property will subsequently be developed by the owner. It is essential to consider this in a situation where property is likely to sit undeveloped for an extended period of time. Other expenses potentially subject to capitalization include costs incurred for government permits, zoning variances, permit fees, engineering and feasibility studies and drafting architectural plans.

Advertising and promotional costs, although essential to the sale of property, are not considered construction-related costs. These can be taken as an expense against income in the year paid.

### What about overhead costs?

Remember that construction property is effectively treated the same as manufactured inventory, to which certain indirect costs are allocated. Therefore, indirect costs properly allocable to the construction activities should be capitalized. Because there can be a disconnect between a final construction project and indirect costs so allocated, these types of costs may be easy to neglect.

Most indirect labor costs (e.g., supervisory costs) are capitalized, as long as they are not minimally related to construction. Management fees paid to a related company would more than likely also fall into this category.

Other equipment and construction facility overhead that can be allocated to construction is subject to capitalization. Rent, repair and

maintenance, insurance, utilities and depreciation all qualify. Once again, certain allocated property taxes must be capitalized. Special care should be taken in categorizing taxes, because state and local income and franchise taxes will be currently deductible.

### Are the costs associated with financing a project subject to capitalization?

The short answer is, generally, yes, although there are other considerations.

The interest capitalization period is defined in concert with rules for when construction begins or ends. Interest paid after the sale of property cannot be retroactively considered part of the basis in that property for any reason.

Although the capitalization period begins when construction commences, that capitalization can only occur to the extent of actual expenditures. Interest capitalization should accurately reflect the actual amount of development completed.

In the event that financing exists as a note between related parties, interest capitalization still applies, provided interest rates are adequately stated.

### How do capitalized costs for an entire project affect the sale of individual properties?

When multiple properties exist within a single construction project, capitalized costs must be allocated to particular units using some reasonable method.

In theory, any reasonable allocation method is accepted by the IRS. However, three general methods have been accepted that have either relative sales value, average cost or square footage as a basis.

Additional thought should be given to future improvements. Examples include swimming pools, tennis courts or other public recreation areas, the costs of which can be allocated to individual properties sold.

Rules for capitalization are important not only because they affect profit and the recognition of taxable income, but also because they determine the allowance of deductions taken currently or in years past.

In the interest of tax compliance, knowledge of these rules and regulations should be a capital priority for any size of company. ■



## Did you know partnerships should be keeping three sets of books?

By Charlotte Tax Manager Bridgett Earnhardt

It often comes as a surprise that many partnerships and limited liability companies (LLC) taxed as partnerships should be keeping three sets of books. These entities generally maintain two sets of books: generally accepted accounting principles (GAAP) basis and tax basis.

The GAAP books record transactions based on the rules of the financial accounting board; the tax books record the transactions based on the rules of the Internal Revenue Code (the code) for determining taxable income.

There is a more important set of books, however, that should be maintained, but is often not. This set of books is called “Section 704(b)” books, based on the regulations under Section 704(b). The income tax regulations that explain these rules call these books “book.” This adds to the confusion as GAAP is also called “book.” So when someone refers to “book basis,” they may be referring to GAAP, or they may be referring to the Section 704(b) rules. And some incorrectly refer to the Section 704(b) rules as “tax” as they are contained in the income tax regulations.

### About Section 704(b) books

While the GAAP books are based on the financial accounting rules and the tax books are based on the code, the Section 704(b) books are based on the Section 704(b) regulations and attempt to reflect the economics of the deal.

Section 704(b) generally requires that allocations among partners have “substantial economic effect.” It takes more than 80 pages of regulations to determine what this really means.

These regulations require that capital accounts be maintained in accordance with specific rules that are neither GAAP nor

tax. For example, where property is contributed to a partnership, the Section 704(b) capital account for the contributing partner must be credited with the fair market value (FMV) of the property. Also, if property is distributed, the distributee’s capital account must be debited with the FMV of the property.

The determination of FMV for maintaining Section 704(b) books generally does not require that an appraisal be obtained. The regulations say that the partners can agree upon the FMV if it is an arm’s-length transaction and the parties are adverse.

### The need for three sets of books

To illustrate the need for three sets of books, assume that partner A and partner B form a 50-50 partnership. Partner A contributes cash of \$1,000; B contributes property having a FMV of \$1,000. For tax purposes, B has claimed accelerated depreciation that has reduced the tax basis of the property to \$400; for GAAP, straight-line depreciation has been used that has reduced the basis of the property to \$700.

Partner B initially will have the following capital accounts: \$400 for tax, \$700 for GAAP and \$1,000 for Section 704(b). The property contributed by B will have the following basis to the partnership: \$400 for tax, \$700 for GAAP and \$1,000 for Section 704(b).

Once the Section 704(b) basis is determined, if the property is depreciable, the depreciation must be computed for Section 704(b) purposes. To determine this, the regulations provide that the Section 704(b) depreciation is to bear the same ratio that the tax depreciation bears to the tax basis (unless the partnership adopts the remedial method under Section 704(c)).

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## Did you know partnerships should be keeping three sets of books? (Continued from page 3)

In the previous example, if the tax depreciation on the property contributed by B for the first year of the LLC is \$20, the Section 704(b) depreciation will be \$50 ( $\$20/\$400$  times  $\times$   $\$1,000$ ).

The Section 704(b) regulations require that, upon liquidation, liquidating proceeds be distributed to the partners in accordance with their positive capital accounts. These are referring to Section 704(b) capital accounts, not GAAP or tax capital accounts.

To the surprise of many partners, the capital accounts referred to in their partnership or LLC agreements are Section 704(b) capital accounts – not GAAP or tax.

Therefore, it is important to maintain Section 704(b) books for two reasons: (1) the tax law generally requires it and (2), most likely, the partnership agreement requires it. Section 704(b) books are not required to be shown on the partnership's tax return balance sheet; however, they need to be available as they determine the economics of the deal. ■

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