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IRS Issues Guidance on Developers' Common Improvements

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When a real estate developer constructs multiple residential units to be held for sale as part of a single project, the developer is often legally or contractually required to construct certain common improvements, such as roads, sidewalks, sewer lines, and amenities. The construction of these improvements is often not complete by the time the developer begins to sell the units.

For income tax purposes, a developer can generally allocate the costs of these common improvements to the tax basis of the individual units, which will reduce the developer's gain when the units are sold. However, an accrual-basis taxpayer generally cannot include costs in basis until those costs have actually been incurred. Thus, if not all of the costs of the common improvements have been incurred by the time the developer begins to sell the units, the developer may have to recognize too much taxable income from such sales.

To ameliorate this result, the IRS recently issued Revenue Procedure 2023-9, which provides an optional safe harbor method for developers to account for certain common improvement costs of real estate projects. The Revenue Procedure replaces older IRS guidance from 1992, which had provided for similar rules but contained much more complex and burdensome reporting requirements.

Under the new Revenue Procedure, a developer can include in its tax basis of each unit of a project such unit's allocable share of both the costs of common improvements that have previously been incurred and the estimated costs of common improvements that the developer reasonably anticipates incurring within the next 10 years. These costs can be allocated among the units using any reasonable method (for example, by size or by fair market value of the units). If, in the future, the actual common improvement costs incurred are more or less than the estimated costs that were taken into account, the developer must adjust its gain from previously sold units by taking into account additional income or an additional deduction in the year the costs are actually incurred. The developer would not amend any prior-year tax returns.

One important limitation to this procedure is that for any year, the total amount of common improvement costs that the developer may take into account with respect to units that have been sold by the end of the year is limited to the total common improvement costs that have actually been incurred by the end of that year (regardless of which portion of this total is allocable to sold units). For example, assume that by the end of a year a developer has sold 25 out of 100 units, has incurred $100,000 of common improvement costs, reasonably anticipates incurring an additional $900,000 of common improvement costs, and allocates all common improvement costs equally to each unit.

The developer would normally allocate one quarter of its total common improvement costs, or $250,000, to the sold units. However, because the developer has only incurred $100,000 of total costs to date, the developer can only include $100,000 of costs in the tax basis of the sold units. The remaining $150,000 of costs that are anticipated to be allocable to the sold units may be recovered as a deduction in future years once $250,000 of cumulative costs have actually been incurred.

A developer must formally elect to use the safe harbor described in the Revenue Procedure and must apply it consistently across all applicable projects. The safe harbor can only be used by real estate developers to the extent they are legally or contractually required to construct common improvements.

It also is only available to developers that either sell units under an accrual method of accounting or that enter into construction contracts that are accounted for under the completed contract method (which is a method of accounting that is generally available to developers entering into contracts to construct homes in buildings containing four or fewer units). The safe harbor does not apply to rental properties, or to any common improvements that would be depreciable for income tax purposes.

If a developer elects to use the safe harbor, it must keep adequate records showing, among other things, its calculation of the estimated costs of common improvements and its methods of allocating costs among units. However, the records only need to be submitted to the IRS upon request.

This is in contrast to the 1992 IRS guidance, which had required developers to submit detailed statements to the IRS to request the safe harbor, as well as detailed annual statements and consents to extend the statute of limitations. The new guidance also permits most developers to switch to the safe harbor automatically by filing a form with the IRS.

The new safe harbor is a significant positive development for many real estate developers because it enables them to take into account estimated common improvement costs using a relatively simple method without the burdensome administrative requirements of prior guidance. However, there are a number of other cost allocation issues that must also be considered in connection with the development of residential units held for sale.

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