

## When will Interest be Capitalized Under the New Proposed Regulations?

### ATTORNEYS

Leslie J. Schneider

Patrick J. Smith

### PRACTICE AREAS

Business Tax

Tax Accounting

Leslie J. Schneider, Patrick J. Smith and Michael F. Solomon

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If production period and cost thresholds are met, taxpayers may be faced with significant recordkeeping burdens under the avoided cost approach.

**Author: BY LESLIE J. SCHNEIDER, MICHAEL F. SOLOMON, AND PATRICK J. SMITH**

**LESLIE J. SCHNEIDER, MICHAEL F. SOLOMON, and PATRICK J. SMITH are members of the Washington, D.C., law firm of Ivins, Phillips & Barker, Chartered. They are frequent lecturers on tax accounting subjects and are previous contributors to The Journal.**

One of the central features of the uniform capitalization (UNICAP) rules enacted as part of TRA '86 is the requirement in Section 263A(f) that taxpayers capitalize interest expense in certain circumstances. While this requirement has been effective for five years, guidance was limited to Notice 88-99, 1988-2 CB 422 . Finally, in August of 1991, the Treasury issued its initial installment of Proposed Regulations on the capitalization of interest expense (IA-120-86, 8/9/91). The lengthy and complex Proposed Regulations affect a significant number of taxpayers in a variety of industries. They are difficult to evaluate because significant limitations on the deductibility of interest, as well as the enactment, in 1986, of Section 864(e) (allocating interest for purposes of the income-sourcing rules), may make interest capitalization beneficial for some taxpayers and detrimental to others.<sup>1</sup>

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### **AFFECTED PROPERTY AND ACTIVITIES**

The application of the interest capitalization rules is more circumscribed than that of the UNICAP rules generally. In general, Section 263A(f) applies to taxpayers (1) constructing, developing, or improving real property or (2) constructing or producing tangible personal property that has a class life of 20 years or more, or takes more than two years to complete, or takes more than one year to complete and production costs exceed \$1 million.

### **REAL PROPERTY**

Taking an expansive view, Prop. Reg. 1.263A(f)-1(c) treats as real property not only land and buildings, but also the structural components of buildings, mineral interests, and natural products growing on land. As a result, activities such as drilling an oil or gas well, providing structural improvements to a mine, and cultivating crops, plants, and trees are all the development of real property. While the oil and gas and mineral industries will be significantly affected, the effect on farmers is more limited because the interest capitalization rules apply to growing crops and plants only if the preproductive period of the crop or plant exceeds two years.<sup>2</sup>

Another principal activity to which the interest capitalization rules apply is the construction of any type of building. These rules apply not only to the general contractor, but also to many subcontractors, since the installation of building components such as plumbing, wiring, and central heating and air conditioning all would be the construction of real property under Prop. Reg. 1.263A(f)-1(c)(1).<sup>3</sup> The new rules provide that, contrary to concerns that had been expressed, the capitalization of interest expense on the production of such products will not be required unless they are acquired for installation in a building to be owned and used by the manufacturer (or a related party within the meaning of Section 267(b) or 707(b)).<sup>4</sup> Nevertheless, a special rule in Prop. Reg. 1.263A(f)-3, defining a unit of property, requires that the manufacture and installation of property be aggregated, once a contract for the installation of the property is executed. While the scope of this provision is somewhat unclear, it could subject the manufacture of building components to interest capitalization as real property construction, because the components are installed in a building pursuant to a contract with the customer.

Prop. Reg. 1.263A(f)-1(c)(3) applies the interest capitalization rules to the erection of "inherently permanent structures" on land. This category covers a wide variety of activities, including the construction or erection of bridges, tunnels, roads, fences, docks, railroad tracks, telephone poles, power generation and transmission facilities, pipelines, and storage silos. This extends the interest

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capitalization rules to a number of additional industries, such as public utilities, farmers otherwise excluded from these rules, railroads, and oil, gas, and water pipeline companies.

**PERSONAL PROPERTY**

The other major area to which the interest capitalization rules apply is the production of certain personal property. First, the property must be tangible property under the liberal definition of that term in Section 263A.<sup>5</sup> Thus, the production of certain intangible property that has a long production period, such as certain movies and books, may be covered by the interest capitalization rules.

Second, the personal property must constitute "long-lived" property or meet certain production period and cost thresholds. Under Prop. Reg. 1.263A(f)-1(b)(1)(ii)(A) , personal property is long-lived property if it has a class life of 20 years or more in the taxpayer's hands.<sup>6</sup> Accordingly, the production of long-lived property solely for sale to unrelated customers does not subject the producer to the interest capitalization rules unless the property otherwise meets the production period and cost thresholds discussed below. As in the case of building components, this favors manufacturers of equipment that has a 20-year class life in the hands of customers.

**Production period.** If personal property produced by the taxpayer is not long-lived property, it will be subject to the interest capitalization rules if it is expected to take more than either (1) two years to produce, or (2) one year to produce at a cost of more than \$1 million. Taxpayers likely to be affected by these rules include producers of liquor, wine, or cigarettes, and manufacturers of large expensive property components (such as generators and engines) that are produced in advance of sales contracts and therefore are outside of the application of Section 460 . For purposes of the threshold tests, at the beginning of the production period the taxpayer must estimate how long it will take to produce the particular unit of property. Prop. Reg. 1.263A(f)-1(d)(2)(ii) requires that the estimate relate to the anticipated time of actual production, taking into account work delays, suspension of production, rework and change orders, and production problems. Where a contractor produces property under a contract for a customer, a special rule (discussed below) deems the production period to begin only when the contractor's production costs equal 5% of the total expected costs of production.<sup>7</sup>

**Production cost.** To determine whether personal property meets the \$1 million cost threshold, at the beginning of the production period the taxpayer must estimate how much it will cost to produce the unit of property (taking into account the same factors used in estimating the production period). The basis of

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assets used in production is disregarded, even though such basis is included as part of the accumulated production expenditures that serve as the interest capitalization base.<sup>8</sup> Where a contractor produces property under a contract for a customer, a special rule in Prop. Reg. 1.263A(f)-1(e)(2)(iii) provides that the cost of production is measured solely by reference to the contractor's anticipated costs and without reduction for the customer's progress payments, even though such progress payments may reduce the contractor's interest capitalization base when they are made.

**Reasonability.** The status of the property will be unaffected by how long it actually takes or how much it actually costs to produce the unit of property, if the initial estimates were reasonable. The taxpayer is required, by Prop. Reg. 1.263A(f)-1(d)(2)(ii), to maintain contemporaneous records to support its estimates.

**COVERED PRODUCTION OR CONSTRUCTION ACTIVITIES**

For purposes of the interest capitalization rules, "production" has the same expansive meaning as in Section 263A(g)(1) for purposes of the UNICAP rules generally.<sup>9</sup> Thus, installation of property, capitalized repairs, and improvements to property would be covered. While the mere purchase of property would be excluded from these rules, property produced for a customer under contract is production both by the contractor (as discussed above) and by the customer. Under Prop. Reg. 1.263A(f)-1(e)(2)(i), if the construction of real property under contract for a customer is subject to the interest capitalization rules, the customer is automatically subject to the interest capitalization rules. If, however, the contract is for the production of personal property for a customer, each party would separately determine whether the property meets the requirements for interest capitalization. This favors taxpayers who order expensive special equipment, since a customer's own allocable production costs are much less likely to exceed the cost threshold than if such costs were aggregated with the producer's costs. Solely for purposes of applying the production period and cost thresholds, Prop. Reg. 1.263A(f)-1(e)(2)(iii) provides that the customer's production period begins on the earlier of the date the contract is executed or the customer's production costs equal 5% of the customer's estimated production costs.

Thus, a customer who contracts to have property produced may be treated as the manufacturer. For these purposes, under Prop. Reg. 1.263A(f)-1(e)(2)(ii) property is produced under a contract if the agreement to produce the specific unit of property is executed before production of that unit is completed. In the case of fungible property, property is produced under a contract if, when the contract is entered into, the contractor has insufficient inventory to satisfy the requirements of the particular

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contract, as well as all other contracts outstanding at that time.

Special rules are also provided in Prop. Reg. 1.263A(f)-1(e)(3) for improvements to existing property. All capital improvements are the production of property; incidental repairs and maintenance activities are not. Any improvement to real property-including demolition, rehabilitation, or preservation-is the construction of real property. Clearing land or drilling an oil well would be the improvement of real property.

Improvements to personal property are governed by Prop. Reg. 1.263A(f)-1(e)(3)(iii) . If the taxpayer treated the original production as within the interest capitalization rules, any subsequent capital improvement to the property is likewise subject to the rules regardless of the remaining useful life, estimated length of the production period, or estimated cost of the improvement. If the original production was not subjected to the interest capitalization rules, however, the improvement must independently satisfy the threshold tests before being subject to the interest capitalization rules.

### **CALCULATIONS**

The general approach adopted in Prop. Reg. 1.263A(f)-2(a)(1) for determining the amount to be capitalized each year is the "avoided cost" method. This requires capitalizing the interest cost that could have been avoided if the taxpayer, rather than engaging in the production activity, had used the funds invested in this activity to repay debt instead. Notwithstanding the philosophy of the avoided cost method, taxpayers may not exclude from capitalization the interest on debt that would not have been repaid if the production had not been undertaken (even where such repayment would have been prohibited by the terms of the debt agreement, e.g., interest on an industrial development bond that by its terms is not pre-payable).

To determine the interest to be capitalized with respect to a particular project for a particular tax year, the taxpayer first must capitalize interest on any "traced debt" related to the project (Prop. Reg. 1.263A(f)-2(a)(2)(i)). Traced debt for a particular project is debt-the proceeds of which have been used to pay for the production expenditures on a project-but only to the extent the debt proceeds have been used for this purpose. 10 Thus, a single debt might be part traced debt and part nontraced debt.

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The taxpayer then must determine the remaining amount that must be capitalized on the project for a particular period by applying the weighted average interest rate on the taxpayer's nontraced debt for the period to the average amount of production expenditures in excess of traced debt for the project for the particular period. (See Prop. Reg. 1.263A(f)-2(c)(1), discussed in more detail below.)

o be taken into account as either traced debt or nontraced debt, debt must be "eligible debt" ( Prop. Reg. 1.263A(f)-2(a)(4) ). Excluded are certain significant categories of debt, principally accounts payable and other non-interest-bearing debt, as well as debt owed to a related party (as defined under Section 267(b) or 707(b) ) that bears interest at less than the applicable Federal rate (AFR) under Section 1274(d) . An important exception, however, is that non-interest-bearing debt is included for determining traced debt.

The exclusion of non-interest-bearing debt from the category of eligible nontraced debt is unquestionably the most significant change made by the Proposed Regulations from the rules set forth in Notice 88-99 . Such exclusion significantly increases the weighted average interest rate on a taxpayer's debt, and therefore is likely to significantly increase the interest that must be capitalized.

Other exclusions from the eligible debt category include reserves, deferred tax liabilities, and similar liabilities that may be debt for financial accounting purposes but not for Federal income tax purposes (Prop. Reg. 1.263A(f)-2(a)(4)(vii)). Also excluded are current Federal and state income tax liabilities (Prop. Reg. 1.263A(f)-2(a)(4)(viii)). One implication of this would seem to be that noncurrent Federal and state income tax liabilities (i.e., deficiencies resulting from audit adjustments) are included in the eligible debt category.

Under Prop. Reg. 1.263A(f)-2(d), taxpayers may elect not to trace debt. If they do, however, the portion of any non-interest-bearing debt that in the absence of the election would be traced to property subject to interest capitalization is included as eligible nontraced debt, thereby reducing the effective rate at which interest is capitalized. Making or revoking an election not to trace debt is an accounting method change requiring IRS consent.

**Intercompany transactions.** As noted above, related-party debt bearing interest below the AFR is not eligible debt. Nevertheless, if interest on debt owed by one member of a consolidated return group to another member is capitalized (because, for example, the interest rate is at least the AFR or because an arm's-length rate is imputed under Section 482 ), Prop. Reg. 1.263A(f)-2(f)(5)(i) follows Notice 88-99 in

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providing an exception to the income deferral rule that would otherwise apply.<sup>11</sup> Prop. Reg. 1.263A(f)-2(f)(5)(ii), however, contains an important modification of the Notice, by limiting current income recognition to the intercompany interest income that is not greater than the deductible interest expense incurred by the group on debt owed to unrelated third parties.

**MECHANICS OF THE CALCULATION**

Prop. Reg. 1.263A(f)-2(e) requires that the taxpayer choose a "computation period" and divide each computation period into a number of "measurement periods." Taxpayers may use the full tax year as the computation period, or divide the year into two or more computation periods of equal length.<sup>12</sup>

**How many computation periods?** The advantage of dividing the year into shorter, more numerous computation periods is that the interest capitalization calculation for each computation period is essentially independent. For each computation period during a year, the taxpayer computes a separate weighted average interest rate on nontraced debt and a separate average amount of production expenditures in excess of traced debt. The weighted average interest rate for each computation period is applied only to the average production expenditures in excess of traced debt for that computation period. Thus, for example, if a taxpayer divides the tax year into two six-month computation periods and has debt outstanding only during the first six months of the year, while having production subject to interest capitalization only during the second six months, no interest will be capitalized in either period. In contrast, if a full-year computation period were used, the interest incurred during the first six months of the year would be capitalized with respect to the production activity occurring in the second six months of the year, as though the production had occurred at the same time the debt was outstanding. If debt and production were both limited to the same portion of the year, use of a shorter computation period would not be disadvantageous because the shorter computation period should not result in greater interest capitalization than would result from a full-year computation period.

The disadvantage is that shorter, more numerous computation periods compound the rate at which interest is capitalized, since under Prop. Reg. 1.263A(f)-4(b)(1) the interest capitalized for one computation period is added to accumulated production expenditures (i.e., the capitalization base) as of the first day of the following computation period. Thus, the effect of using a one-month computation period would be as though interest were compounded monthly.

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**Measurement periods.** Once the length of the computation period is chosen, Prop. Reg. 1.263A(f)-2(e)(2) requires the taxpayer to divide each computation period into measurement periods of equal length. A full-year computation period must be subdivided into at least four measurement periods. If the taxpayer has chosen two or more computation periods, each must be subdivided into at least two measurement periods. As discussed below, it generally will be advantageous for taxpayers to use shorter, more numerous measurement periods.

The last day of each measurement period is the "measurement date" for that period. As of each measurement date in the computation period, the taxpayer must determine the accumulated production expenditures, the traced debt, and the nontraced debt. The amounts in each category are, in effect, deemed to be outstanding throughout the measurement period ending on each measurement date.

Under Prop. Reg. 1.263A(f)-2(e)(1)(ii), the taxpayer's choice of a computation period is an accounting method that may not be changed without IRS consent. The choice of how many measurement periods to use for each computation period is not an accounting method, and may be varied freely from one year to the next, but Prop. Reg. 1.263A(f)-2(e)(2)(i) prohibits use of measurement periods of different lengths for different computation periods in the same tax year.

**CALCULATING THE CAPITALIZED AMOUNT**

Once the taxpayer has decided on the length of the computation period and the number of measurement periods in each, the interest capitalization calculation for each computation period is as follows:

- (1.) All of the interest incurred on traced debt for each measurement period is capitalized ( Prop. Reg. 1.263A(f)-2(b)(1) ).
- (2.) The average excess expenditures, the average nontraced debt, and the weighted average interest rate are all calculated for the computation period. Excess expenditures are the accumulated production expenditures for a project in excess of the traced debt for that project on each measurement date ( Prop. Reg. 1.263A(f)-2(c)(1) ). Average excess expenditures are the average of these amounts on all the measurement dates during the computation period ( Prop. Reg. 1.263A(f)-2(c)(5)(ii)(A) ). Average nontraced debt is computed in essentially the same fashion as average excess expenditures (Prop. Reg. 1.263A(f)-2(c)(5)(iii)(C)).

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Excess expenditures are first taken into account for a project for the measurement period during which the production period begins. The last measurement period for which excess expenditures are taken into account for a project is the measurement period during which the project's production period ends ( Prop. Reg. 1.263A(f)-2(e)(2)(iii)).

Example: A full-year computation period is subdivided into four three-month measurement periods. The production period for a particular project begins on March 28 and ends on October 2. Therefore, excess production expenditures are taken into account for all four measurement periods, even though the production period is only slightly more than six months. The balance of excess production expenditures as of March 31 is deemed outstanding from January 1 through March 31, and the balance of excess production expenditures as of October 2 is deemed outstanding from October 1 through December 31, even though the bulk of these periods falls outside the actual production period.<sup>13</sup>

The example illustrates why it generally will be to the taxpayer's advantage to choose short measurement periods and frequent measurement dates, assuming the taxpayer wishes to minimize capitalized interest. If monthly measurement periods were used above, production expenditures for the project would be deemed outstanding only for eight months, rather than 12.

The weighted average interest rate for the computation period is the total interest incurred during the computation period on nontraced debt, divided by the average nontraced debt for the computation period. For this purpose, interest incurred on nontraced debt includes interest on debt that is not reflected in average nontraced debt as a result of not being outstanding on any measurement date in the computation period, e.g., where the debt was incurred and repaid within a single measurement period (see Prop. Regs. 1.263A(f)-2(c)(5)(iii)(A) and (B)).

(3.) The last step is calculating the interest on nontraced debt that is required to be capitalized for a particular project for a particular computation period. The weighted average interest rate for the computation period is multiplied by the average excess expenditures for the project for that computation period ( Prop. Reg. 1.263A(f)-2(c)(1) ).

**SIMPLIFIED INVENTORY METHOD**

Taxpayers may elect a "simplified inventory method" under Prop. Reg. 1.263A(f)-2(f)(3) for determining the interest that must be capitalized with respect to inventory. Most typically, such interest will have to

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be capitalized where the production period exceeds two years, as for tobacco products and alcoholic beverages that undergo an aging process. It seems unlikely that many taxpayers will make the election, since the simplified inventory method will almost certainly result in greater interest capitalization than would result under a facts-and-circumstances approach.

The simplified inventory method operates by dividing each year's ending inventory into "vintages" or "layers" ( Prop. Reg. 1.263A(f)-2(f)(3)(ii)(A) uses the term "segments"), according to the number of years each segment is deemed to have been in inventory. Thus, for example, a taxpayer's ending inventory might be divided into a one-year-old segment, a two-year-old segment, and a three-year-old segment. The one-year-old segment would be assigned one year's worth of interest, the two-year-old segment would be assigned two years' worth of interest (with interest for the second year compounded), and the three-year-old segment would be assigned three years' worth of interest (with interest for the second and third years compounded).

The drawback, from a taxpayer's perspective, is that the interest assigned to each segment of ending inventory is determined on the basis of full years' interest capitalization. Thus, for example, the interest assigned to the one-year-old segment of ending inventory is an entire year's interest even though a more reasonable assumption would be that this segment has been present in inventory for six months rather than a full year (presumably, the segment would have been built up ratably over the course of the entire year, leading to an average age of six months). Similarly, a two-year-old segment of ending inventory is assigned two full years' worth of interest, even though a more reasonable estimate of the average age of the segment is presumably a year and a half. The resulting tendency is towards significant overcapitalization of interest.

The Proposed Regulations do not address the issue of how to determine the interest associated with inventory property that is to be included in cost of goods sold each year. Instead, they deal only with the question of how much interest to include in each year's ending inventory. The implication of this silence with regard to the effect on cost of goods sold may be that there is no interest inclusion in cost of goods sold. This would be a surprising result, and seems inconsistent with Temp. Reg. 1.263A-1T(a)(5)(i) , which provided that costs allocated to production activities are to be recovered as part of cost of goods sold, depreciation, basis, or otherwise at the time the property is sold or used. If the Service intended that no interest is to be included in cost of goods sold under the simplified inventory method, it would seem that this should have been made explicit.

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Apart from the simplified inventory method, the Proposed Regulations do not specifically deal with the capitalization of interest on inventory. Thus, outside of the simplified inventory method, the Proposed Regulations do not address, for example, issues that arise in applying interest capitalization in conjunction with the LIFO method. These issues include whether, for inventory with a multi-year production period, the interest capitalization base is determined solely by reference to the current year's production costs, and whether the interest rate used in that situation is solely the current year's interest rate. On this latter issue, the simplified inventory method provides for the exclusive use of the current year's interest rate, but it is not clear whether this represents a generally applicable rule. An additional issue relating to LIFO inventory that is not addressed is the relationship between the interest capitalized in ending inventory and the amount included in cost of goods sold. For purposes of the cost of goods sold inclusion, it would seem that the interest might be based on the LIFO carrying value of the inventory, whereas for purposes of determining the interest in a LIFO increment, the current-year cost of the inventory might be more relevant.

**DEFINITIONS**

Several definitions have a broad substantive effect on application of the interest capitalization rules.

**Unit of Property**

Prop. Reg. 1.263A(f)-3 defines "unit of property" for many purposes, 14 including:

- (1.) Establishing the duration of the production period, and therefore the period during which interest is capitalized.
- (2.) Applying the one-year and two-year production-period classification thresholds for tangible personal property production.
- (3.) Determining the accumulated production expenditures that are subject to interest capitalization.

In general, a functional interdependence test aggregates into a single property unit all components of a unit of property where the placing in service of one component depends on the placing in service of another component by the taxpayer or a related party ( Prop. Regs. 1.263A(f)-3(b) and (c)). In addition, for property produced for sale, all components sold as a single unit are aggregated. Thus, a multi-unit residential building may be a single property unit if it is built for sale as a rental apartment house, but the individual units may be separate property units if they are separately placed in service or held for

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sale as condominiums.

Other important principles are established in this section. With respect to real property production, Prop. Reg. 1.263A(f)-3(b)(3) states that a unit of property includes a pro rata portion of common features that are real property. A common feature includes any real property benefiting real property produced by the taxpayer or a related party that is not, itself, held for the production of income (e.g., streets, sidewalks, and other infrastructure items). This is likely to be expensive for most developers and is probably one of the more controversial features of the Proposed Regulations. A special rule provides that common features that are placed in service before the benefited real property units are placed in service are excluded from the accumulated production expenditures for the benefited units after such common features are placed in service. Thus, to the extent that large infrastructure items (such as roads, parking lots, etc.) are put into service early in a production effort, the costs of such features may effectively avoid attracting interest that otherwise would be capitalizable.

Also with respect to real property, Prop. Reg. 1.263A(f)-3(b)(5) provides that a unit of property does not include any portion of a tract held for investment or personal use. There is no guidance in these Proposed Regulations or in the UNICAP Temporary Regulations for determining when property is held for investment and when property is held instead for future development. Taxpayers should make development/investment distinctions in their records of real property holdings and adhere to internal guidelines designed to differentiate between investment properties and development properties.<sup>15</sup>

Finally, it is somewhat unclear how the functional interdependence test is applied where a personal property component becomes physically incorporated into a real property component. Nevertheless, as discussed below, it appears certain that the costs of these personal property components will be included in the accumulated production expenditures of the real property unit once the component is associated with the real property production effort.

**ACCUMULATED PRODUCTION EXPENDITURES**

Prop. Reg. 1.263A(f)-4 addresses the determination of "accumulated production expenditures," which is the relevant base for computing the interest to be capitalized. Accumulated production expenditures include all costs taken into account under a taxpayer's method of accounting and capitalized with respect to a particular unit of property, and, in certain instances, the adjusted basis of assets used to produce such unit of property. Although these rules are fairly straightforward, a few deserve special attention.

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**Transfers.** Prop. Reg. 1.263A(f)-4(a) makes clear that a taxpayer cannot avoid interest capitalization by a nontaxable transfer of partially completed production to a corporation, partnership, or other entity. The basis of such property in the hands of the transferee will continue to attract interest capitalization if the property is designated property in the hands of the transferee. A similar rule in Prop. Reg. 1.263A(f)-4(f) applies to taxable transfers. Accordingly, if a property transfer is taxable, so that profit or loss is recognized on the transfer, the transferee would have a new basis in the property and such new basis would be the relevant starting point for interest capitalization by the transferee.

**Materials and supplies.** Prop. Reg. 1.263A(f)-4(b)(2) requires the costs of raw materials, supplies, and similar items to be treated as accumulated production expenditures once they have been both incurred and dedicated to the production of a unit of property. <sup>16</sup> Dedication generally requires an affirmative act such as recordation, assignment to a job site, or physical incorporation, and thus may be something over which taxpayers will have some control. The dedication rule, however, does not apply to components or subassemblies produced by the taxpayer (or, presumably, by a related party). The costs of these items must be treated as accumulated production expenditures if such components or subassemblies are reasonably expected to be incorporated into a unit of property that is subject to the interest capitalization rule.<sup>17</sup>

**Contracts.** Prop. Reg. 1.263A(f)-4(c) contains special rules for determining accumulated production expenses when property is produced under a contract. Payments to the contractor are production expenditures by the customer. In addition, a curious rule apparently requires the customer to treat as accumulated production expenditures that portion of the contract price related to the contractor's costs incurred prior to any payment by the customer, to the extent the accrual and economic performance standards of Section 461 have been satisfied with respect to the customer. It is difficult to imagine a common situation where this rule would apply.

Corresponding to the rule treating payments by the customer to the contractor as accumulated production expenditures of the customer, the contractor is allowed to reduce its accumulated production expenditures by any cumulative payments it receives from the customer. This treatment appears to be elective, in that Prop. Reg. 1.263A(f)-4(c)(2) states that the contractor "may" make this reduction. If the contractor desires to maximize interest capitalization for resourcing or taxable income reporting purposes, this elective reduction in cost may not be preferred.

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**Basis.** Section 263A(f)(3) provides that accumulated production expenditures include the basis of property used to produce designated property. Notice 88-99 gave taxpayers an election to exclude property not used in a reasonably proximate manner to produce designated property, but Prop. Reg. 1.263A(f)-4(d) makes this exclusion automatic. This exclusion does not eliminate the requirement that depreciation on property used to produce other property be included in the basis of the property produced, as well as in accumulated production expenditures for such property.

One further amplification, however, is potentially troublesome. If an asset is used in the simultaneous production of more than one unit of designated property, the entire basis of the asset used to produce the designated property units must be apportioned among the units of property as part of the accumulated production expenditures for each such unit. Downtime and idle time do not enter into the apportionment formula, and thus downtime and idle time are apportioned to each unit of property under this rule. In contrast, if an asset is dedicated to the production of a single unit and thereafter is temporarily idle before being dedicated to produce a second unit of property, the basis of the asset while it is idle does not attract interest. Thus, the distinction between simultaneous use and seriatim use may be important under these rules.

If improvements are designated property under the rules discussed earlier, Prop. Reg. 1.263A(f)-4(e)(1) requires the adjusted basis of the existing property that is improved, or of any common feature, to be included in accumulated production expenditures if such asset or common feature must be taken out of service during the improvement activity. Prop. Reg. 1.263A(f)-4(e)(2) illustrates this rule by an example dealing with tenant improvements made by the owner of an office building. The example permits the owner to exclude the cost of the building from the interest capitalization base for the tenant improvement. It seems to assume one very important fact- i.e., that the building is a single unit of property-that may make a considerable difference to the outcome. If each floor of the building were a separate unit of property under the rules discussed above, the cost of each floor presumably would be included in the interest capitalization base for improvements on any individual floor of the building.

**PRODUCTION PERIOD**

Prop. Reg. 1.263A(f)-5 governs the production period, during which accumulated production expenses attract capitalizable interest. Consistent with the other elements of the rules, each separate unit of property has its own production period.

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The production period for a unit of real property begins on the first date that any physical production activity occurs on the site ( Prop. Reg. 1.263A(f)-5(c)(2) ). Physical production, for purposes of this rule, is broadly defined in Prop. Reg. 1.263A(f)-5(e) to include nearly all on-site activities (including clearing, grading, demolition, construction and landscaping). Planning and design and incidental repair activities are excluded, however, by Prop. Reg. 1.263A(f)-5(f).

The production period for a unit of tangible personal property begins on the first date that accumulated production expenditures, including planning and design expenditures, are at least 5% of the total estimated accumulated production expenditures for the unit ( Prop. Reg. 1.263A(f)-5(c)(3) ). Thus, in contrast to the rule for real property, actual physical production activities are irrelevant. It is difficult to understand why tangible personal property is subject to a different rule. Taxpayers will be required to maintain separate cost accounts for each unit of tangible personal property. Prior to performing any work, taxpayers must decide what the salable or functionally interdependent property unit is, and what such property unit is likely to cost. Any errors in planned use or in estimation of costs may result in audit disputes. The Proposed Regulations do not state what happens if the property unit changes in mid-production or if cost estimates are significantly changed.

Consistent with the statute, the production period for both real and tangible property ends on the date on which the property unit is ready to be placed in service or is ready to be held for sale and all production activities reasonably expected to be undertaken by the taxpayer or a related party are completed ( Prop. Reg. 1.263A(f)-5(d)(1) ). "Placed in service" is defined by reference to the investment credit rules in Reg. 1.46-3(d) . Prop. Reg. 1.263A(f)-5(d)(2) makes clear that until all reasonably expected production activities are completed, the production period does not end. Accordingly, taxpayers seeking to achieve a shorter production period will want to limit, where possible, the scope of their finishing activities relating to the production of designated property. Taxpayers seeking to capitalize more interest may be able to do so by generally undertaking more complete finishing activities relating to each unit of property.<sup>18</sup>

In an apparent concession to real estate interests, Prop. Reg. 1.263A(f)-5(g) provides for a suspension of interest capitalization where production activities with respect to a unit of property cease for 12 consecutive months. De minimis production activities are not taken into account to prevent the suspension rule from operating or from continuing, although de minimis is not defined for this purpose. Unfortunately, this suspension rule will be of limited practical use—once the production period begins,

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interest continues to be capitalized until the beginning of the 13th month following the start of the cessation period. Taxpayers seeking to avoid excessive interest capitalization should limit the scope of the unit of property definition, rather than rely on the suspension rule. In addition, given the specific statement in the Proposed Regulations that the production period of tobacco, wine, and distilled spirits includes the aging time, this suspension rule will not likely apply when suspension of production activities is required as part of the production process.

Finally, an important aspect of the production period provisions relates to the explicit recognition in the Proposed Regulations that indirect costs of carrying designated property, whether or not incurred during the production period, are nevertheless subject to capitalization generally under Section 263A(a) . Thus, for example, Prop. Reg. 1.263A(f)-5(a) expressly provides that taxes on property held for future development would be required to be capitalized as directly benefiting or as being incurred by reason of the production of property. The drafters of the Proposed Regulations apparently rejected the argument that property taxes on predevelopment real estate and delay rentals associated with a leasehold interest in minerals are incurred prior to development and production and, therefore, are exempt from the UNICAP rules until the taxpayer actually begins production activities.<sup>19</sup>

**EFFECTIVE DATES AND TRANSITION RULES**

If the property subject to interest capitalization is inventory in the hands of the producer, the Proposed Regulations apply only to tax years beginning after the date final interest capitalization Regulations are adopted. <sup>20</sup> For tax years beginning after 1986 and before the effective date of the Proposed Regulations, taxpayers may apply the interest capitalization rules based on any reasonable interpretation of the statute and legislative history. For tax years beginning after 8/17/88, taxpayers may rely on Notice 88-99 . Presumably, taxpayers could, if they so chose, also rely on the provisions of Notice 88-99 in prior years.

Taxpayers are granted automatic consent to change to a method permitted or required by the Proposed Regulations for the first tax year to which the Regulations apply, provided they are changing from a method consistent with a reasonable interpretation of the statute, legislative history, and administrative pronouncements. Alternatively, such taxpayers may apply the Proposed Regulations (when finally adopted) retroactively to any prior open year to which Section 263A(f) applies. Consent to such a change would be approved automatically, provided that all necessary amended returns are filed within 120 days after the Regulations are adopted. Regardless of whether the change is made retroactively or for the first

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year to which the final Regulations apply, taxpayers are given the choice of making the change either on a cut-off basis or with a Section 481 adjustment amortized over four years beginning with the year of change.<sup>21</sup>

**Noninventory.** If the property that is subject to interest capitalization is not inventory, the Proposed Regulations would apply on a cut-off basis to interest incurred in tax years beginning after the date the Regulations are made final. As with inventory property, taxpayers are given automatic consent to make the change to a method in compliance with the Proposed Regulations for the first year to which the Regulations apply. Likewise, taxpayers may apply the Proposed Regulations retroactively to earlier years, but only on a cutoff basis, as in the case of prospective changes.

With respect to noninventory property, costs incurred before the effective date of the UNICAP rules are included in accumulated production expenditures ( i.e., the base for interest capitalization) only if the costs were required to be capitalized under Section 263 and would have been subject to interest capitalization under old Section 189 or pursuant to a Section 266 election.<sup>22</sup> An exception applies to property used to produce non-inventory property subject to interest capitalization. The basis of such productive assets is included in accumulated production expenditures regardless of whether Sections 189 or 266 applied.

**Planning.** These transition rules provide numerous planning opportunities. For example, if the Proposed Regulations, when adopted, would increase interest capitalization in circumstances that would maximize use of foreign tax credits, a taxpayer could apply the Regulations retroactively. Conversely, where the latter approach would be disadvantageous, the taxpayer could apply the regulations prospectively.

Likewise, the choice between retroactive and nonretroactive application of the rules and the choice between a Section 481 adjustment and a cutoff transition procedure for inventory property provide extensive opportunities for taxpayers to choose the most advantageous approach from a variety of alternatives.

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1

According to these rules, interest expense that is capitalized is recharacterized as part of the taxpayer's adjusted basis in the property being constructed. Thus, as the property is depreciated or sold, the capitalized interest is recovered as depreciation or as part of gain or loss on the sale of the property. Since the source rules for interest expense differ from those applicable to depreciation and sales of

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property, many multinational corporations will find that capitalization of interest expenses increases foreign tax credits and outweighs the deferral of the deduction.

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2

A special exclusion is provided for the growing of timber and evergreen trees that are more than six years old before they are cut. See Temp. Reg. 1.263A-1T(c)(4)(ii) for a discussion of how to measure the preproductive period of crops and plants.

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3

This rule also may apply if the actual installation is performed by a party related to the taxpayer. If the contractor or subcontractor is constructing the real property for a customer, however, such activity may be governed by the long-term contract rules in Section 460 .

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4

For example, a manufacturer of central heating and air conditioning who sells such equipment to builders and also installs such equipment in customers' buildings would not be subject to the interest capitalization rules on the manufacturing process. As noted supra, however, such activities may be covered by Section 460 .

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5

See Temp. Reg. 1.263A-1T(a)(5)(iii) .

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6

This rule also would apply to produced property held by a party related to the producer under Section 267(b) or 707(b).

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7

For this purpose, progress payments by the customer are disregarded. Prop. Reg. 1.263A(f)-1(e)(2)(iii) .

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8

Id.

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9

See Temp. Reg. 1.263A-1T(a)(5)(ii) .

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10

Prop. Reg. 1.263A(f)-2(b)(2) . The tracing rules of Temp. Reg. 1.163-8T are adopted for this purpose.

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11

Regs. 1.1502-13(a)(2)(iii) , -13(c).

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12

This is an important concession to those who had complained that Notice 88-99, 1988-2 CB 422 , prevented the use of the quarterly computation period used by most taxpayers for financial reporting purposes.

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13

See Prop. Reg. 1.263A(f)-2(e)(3), Example 3 .

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14

A special elective rule in Prop. Reg. 1.263A(f)-6 applies to multi-phase development of oil and gas properties.

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15

See also Milner, "How Taxpayer's Primary Intent Affects Costs of Undeveloped Realty," .

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16

This rule is essentially the same as the comparable provision for long-term contracts in Reg. 1.451-3(d)(8)(iii)(A) .

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17

Prop. Reg. 1.263A(f)-4(b)(2) . This rule is similar to the rule found in Reg. 1.451-3(d)(6)(iv) .

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18

See Prop. Reg. 1.263A(f)-5(d)(4), Example 2 .

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19

See the discussion of this subject in Schneider and Solomon, "Application of the Uniform Capitalization Rules to the Oil and Gas Industry," 40 Oil & Gas Inst. (Matthew Bender, 1989), at §1.02 3 b .

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20

Prop. Reg. 1.263A(f)-9(a) . The cut-off transition rule does not apply to accounting method changes under Section 263A(f) , where the change is for the first taxable year to which the entire section applies. Prop. Reg. 1.263A(f)-9(c) .

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21

Prop. Reg. 1.263A(f)-9(d) . There would not be an opportunity to use a Section 481 adjustment if the change in method involves non-inventory property. Id.

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22

Prop. Reg. 1.263A(f)-9(b)(2)(i) . One of the examples of this type of cost contained in the Proposed Regulations is the cost of a mineral leasehold obtained for future drilling. Prior to 1986, a number of oil and gas companies took the position that former Section 189 was not applicable to oil and gas well drilling activities.

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