REPORT #714

TAX SECTION

New York State Bar Association

Proposed Regulations Relating to the Capitalization of Interest Costs
Under Code Section 2 63A

Table of Contents

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March 24, 1992

The Honorable Shirley D. Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Regulations Relating to the Capitalization of Interest Costs Under Code Section 2 63A[*]

Dear Commissioner Peterson:

Last August the Treasury Department issued proposed regulations (the “Proposed Regulations”) under Internal Revenue Code section 263A(f).[1] Section 263A generally requires taxpayers to capitalize or include in inventory various direct and indirect costs. Section 263A(f) requires taxpayers to capitalize interest expense paid or incurred during the production of certain kinds of real and tangible personal property.

One of the more significant aspects of section 263A(f) is that it applies the “avoided cost method” in calculating the amount of interest expense that is to be added to the basis of a constructed asset. As a result, taxpayers must capitalize not only the interest expense directly attributable to borrowings used to fund construction, but also interest expense on other borrowings not directly related to

[*] This letter was prepared by Carolyn J.L. Ichel, who served as Co-Chair of the Committee on Income from Real Property during the Tax Section's 1991¬1992 year.

[1] IA-120-86, issued August 9, 1991.

construction. In some situations, interest expense incurred by related parties also may be capitalized.[2]

The Tax Section is taking this opportunity to address briefly a number of significant issues presented by the Proposed Regulations.

1. Related Party Issues. Notice 88-99 included a number of provisions relating to consolidated groups, among them a rule regarding intercompany loans that required capitalization of interest expense but current income inclusion even where the group's “outside” indebtedness was less than the intercompany borrowings. The Proposed Regulations adopt a different rule essentially limiting the current income inclusion to the group's interest expense on nonmember indebtedness. (Prop. Reg. section 1.263A(f)- 2(f)(5)(ii).) The approach of the Proposed Regulations is considerably more equitable. We commend the Treasury for this improvement. It is hoped that a similar application of “self-charged” concepts will be reflected in future regulations' treatment of other related-party borrowings.

2. Tracing Methodology. The specific incorporation of the debt allocation rules of Regulation section 1.163-8T in identifying traced debt is most welcome. The proliferation of different administrative approaches to the allocation of indebtedness burdens the tax system with substantial complexities. We are pleased that the Proposed Regulations under section 263A are based on an existing method of allocation.

3. Comprehensive Example. The Proposed Regulations'

[2] Notice 88-99, 1988-2 C.B. 422, sets forth initial guidance on several aspects of Code section 263A(f), including the basic mechanics of the avoided cost method and various approaches to the treatment of related party borrowings.

inclusion of a “comprehensive real estate example” also is to be commended. (Prop. Reg. section 1.263A(f)-7.) This is a user-friendly approach that, through its incorporation of a number of interwoven concepts and varied facts, provides a helpful, practical illustration of the workings of the Proposed Regulations.

4. Problem Areas. There are some aspects of the Proposed Regulations that we find unduly restrictive.

a. De Minimis Rule. As has been noted in other commentary, the de minimis exception is too small to offer much relief. (Prop. Reg. section 1.263A(f)- 1(b)(3)(iii).) The exception applies only to projects that last no more than three months and cost no more than $10,000. At a 10% interest rate, the amount of interest that accrues on a $10,000 project over three months is, at most, $250. Rules such as those requiring the inclusion of an allocable portion of land in production expenditures might increase the $250 amount somewhat, but overall, in terms of the actual amount of interest expense involved, the amounts covered by the proposed de minimis exception are essentially meaningless.

In light of the significant complexities imposed by the application of the avoided cost method, which we address in greater detail below, the system can tolerate, and the Treasury Department should provide, a more meaningful de minimis rule.

In crafting a de minimis rule a number of factors should be considered. First, the tax attribute in question is the interest accruing with respect to production expenditures during the production period. Accordingly, the de minimis rule should focus on the amount of interest expense involved, rather than the cost or duration of the project.

Furthermore, interest expense can be relatively small either because production expenditures are small or because the production period is short. The conjunctive rule expressed in the Proposed Regulations, under which both expenditure and time limits apply, imposes limits on the availability of the de minimis exception that have no consistent relationship to the amount of interest expense involved.

Consideration also should be given to adopting a series of de minimis rules that apply different thresholds. At first blush this appears complicated. The goal of de minimis rules, however, is to carve out taxpayers for whom the burdens of compliance outweigh the benefits to be achieved by applying the avoided cost rules literally.

There are three natural breaks in the avoided cost method: (i) whether the interest capitalization rules apply at all; (ii) whether the avoided cost calculations must be performed; and (iii) whether related parties are implicated in the analysis. In terms of the relative burdens of complying with the avoided cost method, capitalization of interest on a taxpayer's traced debt is a fairly straightforward concept; capitalization of interest on the taxpayer's non-traced debt requires a more sophisticated analysis; and the extension of capitalization requirements to interest incurred by parties other than the taxpayer requires considerable investigation and coordination. We believe it would be appropriate to adopt different de minimis thresholds that recognize these different levels of complexity, and we think that regulations can articulate different thresholds in terms that are straightforward and readily understood.

b. Defining the Production Period. The proposals regarding the suspension and completion of a production period are unnecessarily harsh. (Prop. Reg. section 1.263A(f)-5.)

(i) Suspended Activity. The Proposed Regulations take what in some cases would be a harsh approach to the treatment of suspended production activities, as illustrated dramatically in the "comprehensive example." (Prop. Reg. section 1.263A(f)-7.) In that example the 6- month renovation of a hotel required capitalization of 27 months of interest expense. That is because, 2-$^{1/4}$ years before the hotel renovation was started, the taxpayer spent 9 months constructing a related garage facility. After the garage was completed, capitalization of interest was no longer required with respect to the garage costs, but the dormant hotel project continued to be subject to interest capitalization for another twelve months. This is unduly restrictive.

It is appropriate to provide some reasonably long testing period for ascertaining whether a project has indeed been suspended. However, where that testing period expires and there has been no substantial construction activity, the taxpayer should be permitted to cease capitalizing interest from the date that production ceased.

In suggesting revisions to this aspect of the Proposed Regulations we are mindful that a different approach might lead to uncertainties if, at the close of any taxable year, a taxpayer is unsure whether the suspension will be of sufficient duration to suspend the interest capitalization requirements. This kind of problem has been addressed in other areas of the tax law. For example, deferred like-kind exchanges must be completed no later than the due date of the taxpayer's return. Section 461(h) looks to whether economic performance occurs within 8-h months of the close of the year, a period that corresponds to the return due date, with extensions, for corporations. Indeed, there are examples of testing periods, as in Code sections 1033 and 1034, that extend beyond the return due date; in these areas taxpayers file amended returns as necessary to reflect subsequent events.

We believe that the regulations could reasonably use an 8-*s month testing period for determining whether production activities had been suspended. But whatever the mechanics for verifying the suspension of production, we believe that suspension should be treated in the same manner as completion, and that interest capitalization should cease when production activities cease.

(ii) Completion of Production. The Proposed Regulations provide that the production period does not end until “all production activities” are completed. (Prop. Reg. section 1.263A(f)-5(d)(1) (emphasis added).) As an example, the Proposed Regulations provide that a home builder who does not complete interior painting and finishing until a buyer is located has not completed construction. (Prop. Reg. section 1.263(A)(f)-5(d)(4), Ex. 2.)

In new construction there always are minor flaws and unfinished items that can require months to correct or complete. It is unrealistic to hold open the production period of the entire project simply because relatively insubstantial, often user-specific, production activities remain to be completed. Instead, the regulations should treat a production period as ending when (i) the unit is ready for sale or use and (ii) under either an objective or a subjective test, substantially all of the production activities have been completed. Where, for example, the remaining production activities represent less than five percent of overall project costs, or relate to "punch-list" items, landscaping or decor, or reflect fine-tuning and adjustments needed to perfect the finished product, it is inappropriate to continue to require the capitalization of interest expense.

Similarly, income-producing portions of a project often are completed and made ready for sale or use before related amenities are completed. It is unreasonable to hold the construction period open for separate income- producing properties that are complete and ready for use simply because a common feature, such as a swimming pool or tennis courts, is still under production. (See Prop. Reg. section 1.263(A)(f)-3(b)(6), Ex. 5.) If common features are completed before the benefited unit, the Proposed Regulations remove the costs of the completed common feature from the production expenditures base. (Prop. Reg. section 1.263A(f)-3(b)(3)(ii).) The same kind of rule should obtain when the benefited unit is completed before the common features – the costs relating to the completed property should no longer require the capitalization of interest expense.

c. <u>Complexity</u>. We have serious reservations about the complexity of the periodic calculations that the regulations would require. (See Prop. Reg. section 1.263A(f)-2(e)(2)(i).) It is fairly easy for taxpayers to identify and capitalize interest on traced debt. However, short of employing a sophisticated accounting staff, it will be difficult for many taxpayers to identify, <u>on a quarterly</u> <u>basis</u>, (i) the amount of production expenditures, (ii) the traced debt and (iii) the eligible non-traced debt of the person engaged in production. This complexity increases enormously when one considers the potential computations that may be involved with related-party borrowings.

For many producers and developers the avoided cost method is unfamiliar territory, and quarterly financial statements applying sophisticated income tax principles are rare. We appreciate that the computational approach pro-posed by the regulations is, as a financial matter, likely to produce a fairly precise estimate of the amount of interest on non-traced debt that can be attributed to production expenditures. We are concerned, however, that the price of this accuracy will be confusion, frustration and, inevitably, diminished compliance.

In enacting the avoided cost rules Congress specifically acknowledged the problems of undue complexity. The Senate Report provided that "regulations may adopt other simplifying methods and assumptions where, in the judgment of the Secretary of the Treasury, the costs and other burdens of literal compliance may outweigh the benefits."[3] The Preamble to the Proposed Regulations repeats this statement. Given this clear authority and in light of practical realities, we think it is important for the Treasury Department to develop an application of the avoided cost method that is as unintrusive and straightforward as possible.

The chief purpose of the computations in the Proposed Regulations is to impute interest expense to production costs that are financed other than by direct "traced" borrowings. The significance of these imputed interest calculations therefore relates not to the size of the taxpayer or to the size of the

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[3] S. Rep. 99-313, 99th Cong. 2d Sess. (1986) at 142.

project, but to the size of the excess expenditures. Furthermore, even where the excess expenditures are large, the dollar amount of interest attributable thereto obviously is only a small fraction of the expenditure amount. It should therefore be relatively easy to develop, at least as a safe harbor, a computational approach that achieves a fair and reasonable approximation of the amount of avoided cost interest without imposing substantial accounting burdens on taxpayers.

As an example of one simpler approach to identifying avoided cost interest, regulations could allow taxpayers to elect to use interest rates based on the applicable Federal rates obtaining during the taxable year; and then apply this interest rate to an imputed excess expenditure amount calculated by comparing (i) the average of the beginning and year-end production expenditures to (ii) the average of the beginning and year-end traced debt. This kind of approach would greatly simplify the task of complying with the avoided cost rules. While we recognize that such safe harbors will not precisely capture the indirect interest costs targeted by 263A(f), we believe that, overall, the benefits of such a simplification would more than offset the loss in financial precision.

5. Finalizing the Regulations. The Proposed Regulations under section 263A(f) have been issued at a time when, at least in the New York area, the level of construction activity is quite low. When construction activity resumes there will be many more taxpayers and practitioners actively involved in applying the avoided cost rules to actual projects. As experience with the proposed rules broadens, we expect that new problems will appear, and new approaches will need to be considered.

In general the Tax Section strongly advocates that the Treasury Department first promulgate proposed regulations, and. follow them promptly with final regulations. However, with respect to the subject matter of the proposed section 263A(f) regulations, we sense that the current level of practical experience is considerably lower than normal. Moreover, there are several important aspects of the avoided cost rules, notably the rules applicable to related-party borrowings and the treatment of interest rate swaps and caps, that have not yet been addressed in proposed regulations.

Under these unusual circumstances, we believe that the Treasury Department should either (i) issue another round of proposed regulations that incorporate substantive proposals covering the other major open points and revisions to these Proposed Regulations, or (ii) issue revisions to the Proposed Regulations as temporary regulations. On balance we would prefer the second approach. Neither of these approaches is ideal, and we do not lightly depart from our general position. However, given the current economic environment, we have concluded that it would be better to postpone finalizing the Proposed Regulations until there has been more widespread practical experience with their application.

Respectfully submitted,

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