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Proposed regulations: Interest capitalization requirements for improvements to designated property

The U.S. Treasury Department and IRS today released proposed regulations (REG-133850-13) that would:

- Remove the "associated property rule" and similar rules from Treas. Reg. § 1.263A-11(e)(1)(ii) and (iii) relating to the interest capitalization requirements for improvements that constitute the production of "designated property" under section 263A(f)
- Modify the definition of "improvement" under Treas. Reg. to § 1.263A-11(f) to clarify that Treas. Reg. § 1.263A-11(f) applies only to property purchased and further produced before it is placed in service
- Amend Treas. Reg. § 1.263A-8(d)(3) to update the definition of "improvement" so that it is consistent with the modified definition of "improvement," including the exceptions, safe harbors, and elections provided under Treas. Reg. § 1.263(a)-3

The proposed regulations are proposed to apply to tax years beginning after the date the final regulations are published in the Federal Register. However, taxpayers may choose to apply the proposed regulations for tax years beginning after May 15, 2024, and on or before the date the final regulations are published in the Federal Register.

Comments and requests for a public hearing on the proposed regulations are due by July 15, 2024.

Background

Sections 263A(a) and (b) generally require the capitalization of direct and indirect costs of real or tangible personal property produced by the taxpayer. Under section 263A(g)(1) and Treas. Reg. § 1.263A-8(d)(3), the term "produce" includes "improve."

Section 263A(f) contains rules for capitalizing interest with respect to certain property produced by the taxpayer and for determining the amount of interest required to be capitalized. In general, section 263A(f)(1) limits capitalization to interest that is paid or incurred during the production period and that is allocable to real property or certain tangible personal property produced by the taxpayer, referred to as "designated property" under Treas. Reg. § 1.263A-8(b)(1). Under section 263A(f)(2)(A), in determining the amount of interest required to be capitalized to any property, (1) interest on any indebtedness directly attributable to production expenditures with respect to the property is assigned to the property, and (2) interest on any other indebtedness is assigned to the property to the extent that the taxpayer's interest cost could have been

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reduced if production expenditures not attributable to indebtedness described in clause (1) had not been incurred (referred to as the "avoided cost method").

Treas. Reg. § 1.263A-9(a)(1) explains that, under the avoided cost method, any interest that the taxpayer theoretically would have avoided if accumulated production expenditures (as defined in Treas. Reg. § 1.263A-11) (APEs) had been used to repay or reduce the taxpayer's outstanding debt must be capitalized. Under § 1.263A-11(a), APEs generally mean the cumulative amount of direct and indirect costs described in section 263A(a) that are required to be capitalized with respect to a unit of property. Treas. Reg. § 1.263A-9(c) provides that, to the extent a taxpayer's APEs exceed traced debt (that is, debt that is allocated to APEs with respect to the unit of property), the general formula for determining the amount of interest that must be capitalized is the average excess expenditures multiplied by the weighted average interest rate on the debt during the time the production occurs. A larger base of production expenditures leads to more interest capitalized.

Treas. Reg. § 1.263A-11(e)(1)(i) provides that, if an improvement constitutes the production of designated property under Treas. Reg. § 1.263A-8(d)(3), APEs with respect to the improvement consist of all direct and indirect costs required to be capitalized with respect to the improvement. In the case of an improvement to a unit of real property qualifying as the production of designated property under Treas. Reg. § 1.263A-8(d)(3), Treas. Reg. § 1.263A-11(e)(1)(ii) provides that APEs include an allocable portion of the cost of land, and for any measurement period, the adjusted basis of any existing structure, common feature, or other property that is not placed in service, or must be temporarily withdrawn from service to complete the improvement (referred to as "associated property") during any part of the measurement period if the associated property directly benefits the property being improved, the associated property directly benefits from the improvement, or the improvement was incurred by reason of the associated property (known as the "associated property rule"). In the case of an improvement to a unit of tangible personal property qualifying as the production of designated property under Treas. Reg. § 1.263A-8(d)(3), Treas. Reg. § 1.263A-11(e)(1)(iii) provides that APEs include the adjusted basis of the asset being improved if that asset either is not placed in service or must be temporarily withdrawn from service to complete the improvement.

In *Dominion Resources, Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012), the Federal Circuit invalidated the associated property rule of Treas. Reg. § 1.263A-11(e)(1)(ii)(B) for property temporarily withdrawn from service. The court concluded that the regulation was not a reasonable interpretation of the avoided cost rule in section 263A(f)(2)(A)(ii) and that it violated the requirement under *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (S. Ct. 1983) that the Treasury Department and the IRS provide a reasoned explanation for adopting a regulation. Accordingly, the proposed regulations would remove the associated property rule at Treas. Reg. § 1.263A-11(e)(1)(ii)(B) (for improvements to real property) and Treas. Reg. § 1.263A-11(e)(1)(iii) (for improvements to tangible personal property) for property temporarily withdrawn from service. For similar reasons, the proposed regulations would remove the rule at Treas. Reg. § 1.263A-11(e)(1)(ii)(A) (APEs with respect to an improvement to real property includes an allocable portion of the cost of land).

In *Dominion Resources*, the challenge to Treas. Reg. § 1.263A-11(e)(1)(ii)(B) applied only to improvements to property "temporarily withdrawn from service" and not to improvements to property that is "not placed in service." However, the Treasury Department and the IRS have determined that the associated property rule at Treas. Reg. §§ 1.263A-11(e)(1)(ii)(B) and 1.263A-11(e)(1)(iii) for improvements to property "not placed in service" also should be removed because under Treas. Reg. § 1.263(a)-3(d), the definition of "improvement" is limited to amounts paid for activities performed after the property is placed in service. Amounts paid for activities performed prior to the date that property is placed in service are characterized as acquisition or production costs (rather than improvement costs) and are generally capitalized under Treas. Reg. § 1.263(a)-2 and section 263A. In addition, the APE rules in Treas. Reg. § 1.263A-11(f) already address a situation in which a taxpayer incurs production costs with respect to property that has not been placed in service. Accordingly, the proposed regulations would remove the associated property rule at Treas. Reg. §§ 1.263A-11(e)(1)(ii)(B) and 1.263A-11(e)(1)(iii) for improvements to property not placed in service.

However, the proposed regulations would not change the substance of the rules in Treas. Reg. § 1.263A-11(f) concerning interest capitalized with respect to property purchased and further produced before it is placed in service. Nonetheless, the proposed regulations would modify § 1.263A-11(f) to clarify that § 1.263A-11(f)

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applies only to situations in which property is purchased and further produced before the property is placed in service.

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