

Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A-9: The avoided cost method.

T.D. 9129

**DEPARTMENT OF
THE TREASURY
Internal Revenue Service
26 CFR Part 1**

Uniform Capitalization of Interest Expense in Safe Harbor Sale and Leaseback Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the capitalization of interest expense incurred in sale and leaseback transactions under the Economic Recovery Tax Act of 1981 (ERTA) safe harbor leasing provisions. The regulations affect taxpayers that provide purchase money obligations in connection with these transactions. The text of the temporary regulations also serves as the text of the proposed regulations (REG-148399-02) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin. The final regulations consist of technical revisions to reflect the issuance of the temporary regulations.

DATES: Effective Date: These regulations are effective May 20, 2004.

Applicability Dates: For dates of applicability, see §1.263A-15T(a)(3).

FOR FURTHER INFORMATION CONTACT: Grant Anderson, 202-622-4930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 263A(f) of the Internal Revenue Code (Code) relating to the treatment of certain interest expense incurred by the lessor in a sale and leaseback transaction under the ERTA safe harbor leasing provisions (former section 168(f)(8), as enacted by section 201(a) of ERTA, Public Law 97-34, 95 Stat. 214).

Section 263A (the uniform capitalization rules) generally requires the capitalization of direct costs and indirect costs properly allocable to real property and tangible personal property produced by a taxpayer.

Section 263A(f) and the regulations thereunder provide special rules for capitalizing interest to property produced by a taxpayer. In general, section 263A(f) only requires the capitalization of interest that is paid or incurred during the production period of certain property (referred to as designated property). Designated property includes all real property and certain tangible personal property. See §1.263A-8(b) of the Income Tax Regulations.

In general, interest incurred on debt that is directly attributable to production expenditures with respect to designated property (traced debt) is capitalized first. See section 263A(f)(2)(A)(i). If production expenditures with respect to designated property exceed the amount of traced debt, interest on any other debt of the taxpayer is capitalized to the extent that the interest could have been reduced if production expenditures had not been incurred. See section 263A(f)(2)(A)(ii). The amount of interest required to be capitalized under section 263A(f) is calculated by reference to eligible debt. See §1.263A-9(a)(4). Eligible debt generally includes all outstanding debt of the taxpayer. Certain types of debt (listed in paragraphs (i) to (viii) of § 1.263A-9(a)(4)), however, are

excluded from the definition of eligible debt.

The ERTA safe harbor leasing provisions were intended to permit owners of property to transfer the tax benefits of ownership (depreciation and the investment credit) to other persons. The ERTA safe harbor leasing provisions operate by guaranteeing that, for federal tax purposes, (i) a transaction meeting certain stated qualifications (a qualifying transaction) will be treated as a lease even though the qualifying transaction otherwise would not be considered a lease, and (ii) the nominal lessor will be treated as the owner of the property even though the nominal lessee is in substance the owner of the property.

Regulations issued under the ERTA safe harbor leasing provisions clarify that a qualifying transaction may be part of a sale and leaseback transaction, in which the nominal lessee sells the underlying property for Federal tax purposes to the nominal lessor for a cash payment and an interest bearing note (purchase money note), and the nominal lessor simultaneously leases the property back to the nominal lessee. See §5c.168(f)(8)-1(e) *Example 2*. Generally, the nominal lessor deducts, and the nominal lessee includes in income, the interest accruing on the purchase money note, subject to certain limitations. See §5c.168(f)(8)-7.

Explanation of Provisions

The temporary regulations provide that eligible debt under section 263A(f) does not include a purchase money obligation given by the lessor to the lessee (or a party related to the lessee) in a sale and leaseback transaction under former section 168(f)(8) as enacted by ERTA. Accordingly, these obligations are excluded from the definition of eligible debt, and the interest accruing on the obligations is not subject to capitalization with respect to designated property under section 263A(f).

The temporary regulations apply to interest incurred in taxable years beginning on or after May 20, 2004, except that, in the case of property that is inventory in the hands of the taxpayer, the temporary regulations apply to taxable years beginning on or after May 20, 2004. However, taxpayers may elect to apply the temporary regu-

lations to interest incurred in taxable years beginning on or after January 1, 1995, or, in the case of property that is inventory in the hands of the taxpayer, to taxable years beginning on or after January 1, 1995 (the general effective date of the interest capitalization regulations).

For purposes of §1.263A-15(a)(2), the exclusion of purchase money obligations given by the lessor to the lessee (or a party related to the lessee) in a sale and leaseback transaction under former section 168(f)(8) as enacted by ERTA will be considered to be a reasonable position for the application of section 263A(f) in taxable years beginning before January 1, 1995. Consequently, a taxpayer changing a method of accounting for property that is not inventory in the hands of the taxpayer to conform to the temporary regulations may elect to include interest incurred after December 31, 1986, in taxable years beginning on or after December 31, 1986 (the general effective date of section 263A), and before January 1, 1995, in the determination of its adjustment under section 481(a). A taxpayer changing a method of accounting for property that is inventory in the hands of the taxpayer to conform to the temporary regulations must revalue its beginning inventory in the year of change as if the new method of accounting had been in effect during all prior years.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Please refer to the cross-referenced notice of proposed rulemaking published elsewhere in this issue of the Bulletin for applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Grant Anderson of the Office of

Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.263A-9 is amended by revising paragraphs (a)(4)(vii), and (viii) and adding paragraph (a)(4)(ix) to read as follows:

§1.263A-9 *The avoided cost method.*

(a) * * *

(4) * * *

(vii) Reserves, deferred tax liabilities, and similar items that are not treated as debt for Federal income tax purposes, regardless of the extent to which the taxpayer's applicable financial accounting or other regulatory reporting principles require or support treating these items as debt;

(viii) Federal, State, and local income tax liabilities, deferred tax liabilities under section 453A, and hypothetical tax liabilities under the look-back method of section 460(b) or similar provisions; and

(ix) [Reserved]. For further guidance, see §1.263A-9T(a)(4)(ix).

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Par. 3. Section 1.263A-9T is added to read as follows:

§1.263A-9T *The avoided cost method (temporary).*

(a)(1) through (3) [Reserved]. For further guidance, see §1.263A-9(a)(1) through (3).

(4) *Definition of eligible debt.* Except as provided in this paragraph (a)(4), *eligible debt* includes all outstanding debt (as evidenced by a contract, bond, debenture, note, certificate, or other evidence of indebtedness). Eligible debt does not include—

(i) through (viii) [Reserved]. For further guidance, see §1.263A-9(a)(4)(i) through (viii).

(ix) A purchase money obligation given by the lessor to the lessee (or a party that is related to the lessee) in a sale and lease-back transaction involving an agreement qualifying as a lease under §5c.168(f)(8)–1 through §5c.168(f)(8)–11 of this chapter. See §5c.168(f)(8)–1(e) *Example (2)* of this chapter.

(b) through (g) [Reserved]. For further guidance, see §1.263A-9(b) through (g).

Par. 4. Section 1.263A-15T is added to read as follows:

§1.263A-15T *Effective dates, transitional rules, and anti-abuse rule (temporary).*

(a)(1) and (2) [Reserved]. For further guidance, see §1.263A-15(a)(1) and (2).

(3) Section 1.263A-9T applies to interest incurred in taxable years beginning on or after May 20, 2004, except that, in the case of property that is inventory in the hands of the taxpayer, §1.263A-9T applies to taxable years beginning on or after May 20, 2004. However, taxpayers may elect to apply §1.263A-9T to interest incurred in taxable years beginning on or after January 1, 1995, or, in the case of property that is inventory in the hands of the taxpayer, to taxable years beginning on or after January 1, 1995. A change in a taxpayer's treatment of interest to a method consistent with §1.263A-9T is a change in method of accounting to which sections 446 and 481 apply.

(b) and (c) [Reserved]. For further guidance, see §1.263A-15(b) and (c).

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

Approved May 10, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 19, 2004, 8:45 a.m., and published in the issue of the Federal Register for May 20, 2004, 69 F.R. 29066)