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Internal Revenue Service
National Office Technical Advice Memorandum

Taxpayer's name:

Taxpayer's address:

Taxpayer's EIN:

Years involved:

Date of conference:

Legend:

taxpayer =

A =

Issue: Must land be included in a unit of property's accumulated production expenditures and thereby attract interest capitalization during that unit's production period even though the land has been included in the taxpayer's rate base for ratemaking purposes and is earning income for the taxpayer prior to that production period?

Conclusion: Land must be included in the unit of property's accumulated production expenditures during the unit's production period even though the land has been included in the taxpayer's rate base for ratemaking purposes prior to that production period. The taxpayer's method of not including land in its accumulated production expenditures for any unit of property during the relevant production period is not reasonable for the years under examination because the method is contrary to the statute, legislative history, and applicable administrative guidance.

Facts: The taxpayer is an accrual-basis public utility that produces, transmits, and sells electrical energy. The taxpayer sells electrical energy at wholesale and retail principally in A. The taxpayer's business is regulated by several federal and state regulatory agencies, such as the Federal Energy Regulatory Commission (FERC), which governs the taxpayer's wholesale sales, and the state public utilities commission (PUC), which governs the taxpayer's retail sales.

The state PUC determines the rates that the taxpayer is allowed to charge its retail customers for electrical energy. The state PUC reviews the taxpayer's costs and establishes rates in a review process conducted approximately every three years. The taxpayer may adjust its rates if specific costs change without a formal review by the state PUC. The state PUC's rate structure permits the taxpayer to recover certain operating expenses and obtain a "reasonable" return on its rate base.

In conducting its business, the taxpayer buys unimproved land to accommodate projected growth. A land parcel is bought only after the taxpayer identifies a business need, budgets for that need, and locates an appropriate parcel. For example, the taxpayer may buy land for easements or where it expects to construct transmission towers, parking lots, or office buildings. The land the taxpayer buys varies in size and in cost. The taxpayer holds the parcels for varying periods of time before putting them to use in its business. The taxpayer admits that in regard to some parcels, a question exists as to whether projected construction will ever occur.

The taxpayer represents that, pursuant to the state PUC rules, the cost of all land it purchases is included in its rate base for ratemaking purposes at the time of purchase.[1] Because it is included in the taxpayer's rate base, the land begins earning income for the taxpayer shortly after purchase. Land is removed from the taxpayer's rate base when it is sold, retired from service, or is no longer used or useful. At that point, the land stops earning income for the taxpayer.

A parcel of land earns the same rate of return from the time the land is included in the taxpayer's rate base until the time the land is removed from the rate base. This constant rate of return is earned irrespective of whether any construction occurs on the land.

The taxpayer represents that land acquired for easements is depreciated in accord with the requirements specified in Rev. Rul. 72-403, 1972-2 C.B. 102. The

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[1] The taxpayer notes in passing that the FERC "treats land purchases in the same manner as the state PUC. That is, land receives rate base treatment immediately upon acquisition."

taxpayer takes depreciation beginning after this land is purchased and included in its rate base.

Because the state PUC only permits the taxpayer to include land acquisition costs in its rate base before a construction project is completed, the taxpayer marks its land acquisition work orders to clearly distinguish them from other work orders. When a construction project is completed, the taxpayer closes the appropriate construction work order and transfers the construction costs to a special operation account. Also, at that time, the taxpayer transfers the related land costs to the same special operation account. Only then, does the taxpayer include the construction costs (other than land acquisition costs) in its rate base.

During the two years at issue, 1989 and 1990, the taxpayer capitalized the acquisition costs of the parcels of land it acquired. However, when the taxpayer improved the land, the taxpayer did not include the land acquisition costs in accumulated production expenditures for the property. Therefore, the taxpayer did not capitalize any interest associated with land costs under § 263A(f) of the Internal Revenue Code.[2] In contrast, the costs of the improvement were included in accumulated production expenditures. The difference in treatment reflects that land acquisition costs were includible in the rate base from the time the land was purchased while other costs were not includible in the taxpayer's rate base until the improvement was completed.

The examiner has questioned whether the taxpayer should have included land costs in accumulated production expenditures and thus, capitalize interest associated with the land under § 263A(f) notwithstanding that the land costs had previously been included in the taxpayer's rate base for ratemaking purposes. Specifically questioned is whether the taxpayer should be required to include land costs in a unit of property's accumulated production expenditures during that unit's production period.
For the years at issue, if land costs had been included in accumulated production expenditures, accumulated production expenditures would have increased by less than ten percent.

Law and Analysis: Section 263A was enacted as part of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, 1986-3 C.B. Vol. 1. One of Congress' purposes in enacting § 263A was to match income with related expenses and thereby prevent unwarranted deferral of taxes. See H.R. Rep. No. 426, 99th Cong. 1st Sess. 625 (1985), 1986-3 C.B. (Vol. 2) 625 and S. Rep. No. 313, 99th Cong. 2d Sess. 140 (1986), 1986-3 C.B. (Vol.3) 140.

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[2] The taxpayer also represents that it did not capitalize any interest costs with regard to the land for financial or regulatory accounting purposes.

Congress intended § 263A to provide a single, comprehensive set of rules to govern the capitalization of production costs, including interest expense, subject to appropriate exceptions. See H.R. Rep. No. 426 at 625, 1986-3 C.B. (Vol. 2) at 625 and S. Rep. No. 313 at 140, 1986-3 C.B. (Vol.3) at 140. Section 263A generally requires the capitalization of direct costs and all indirect costs that directly benefit or are incurred by reason of the production of property, including real property produced by the taxpayer. Sections 263A(a)(1), 263A(a)(2), and 263A(b)(1).

Section 263A(f) contains special rules for capitalizing interest with respect to certain property produced by a taxpayer and for determining the amount of interest required to be capitalized. To determine the amount of interest that must be capitalized, § 263A(f)(2) requires the use of the "avoided cost" method. Capitalization is limited to interest that is incurred during the "production period" on debt that is allocable to the "production expenditures" of specified categories of property. See § 263A(f)(1). These categories include real property. See § 263A(f)(4)(A)(i). The term "production period" is defined in § 263A(f)(4)(B) as that period beginning on the date on which production of the property begins and ending on the date on which the property is ready to be placed in service. The term "production expenditures" is defined in § 263A(f)(4)(C) as the costs (whether or not incurred during the production period) required to be capitalized under § 263A with respect to the property.

Notice 88-99, 1988-2 C.B. 422 was published on August 16, 1988 to provide guidance in advance of proposed regulations interpreting the requirement to capitalize interest under § 263A(f). Proposed regulations were published in the Federal Register on August 16, 1991, 56 FR 40815. The preamble to the proposed regulations provided that the proposed regulations, when effective, would replace the rules contained in Notice 88-99. 56 FR 40817.

Final Income Tax Regulations for § 263A(f) were published as T.D. 8584 in the Federal Register on December 29, 1994, 59 FR 67187. The final regulations are generally effective for tax years beginning on or after January 1, 1995. These regulations require taxpayers to take reasonable positions on their federal income tax returns when applying § 263A(f) for tax years beginning before January 1, 1995. A reasonable position is a position consistent with the regulations, revenue rulings, revenue procedures, notices, and announcements concerning § 263A applicable to tax years beginning before January 1, 1995. In deciding whether a taxpayer took a reasonable position on their tax return, Notice 88-99 generally applies to tax years beginning before the effective date of the final regulations but after August 17, 1988. Section 1.263A-15(a)(2).

Section IV(A) of Notice 88-99 provides that although interest is required to be capitalized only during the "production period," the capitalization of interest applies to all accumulated production expenditures required to be capitalized under § 263A or 460.

The determination of accumulated production expenditures is made without regard to whether the expenditures are incurred during the "production period" of the property to which the costs relate. See § 263A(f)(4)(C). For example, accumulated production expenditures with respect to which interest must be capitalized include the costs of raw land acquired before the production period begins.[3]

Section IV(D) of Notice 88-99 requires a taxpayer to account for accumulated production expenditures in a manner that is consistent with the method of accounting used by the taxpayer. For example, if a taxpayer is using an overall accrual method of accounting, then the computation of accumulated production expenditures must be based on accrual method concepts. Accordingly, an accrual basis taxpayer would include billed but yet unpaid production expenditures in its calculation of its accumulated production expenditures. See also § 263A(a).

Section VI of Notice 88-99 states that subject to the rules of the notice, a taxpayer could use any reasonable method, consistently applied, in calculating the amounts of traced or avoided cost debt, the interest on such debt, and the amount of accumulated production expenditures with respect to which interest must be capitalized. An example includes raw land costs in determining accumulated production expenditures for a taxpayer constructing a building.

The taxpayer and the examiner agree that the taxpayer must capitalize land acquisition costs. What they do not agree on is whether those capitalized costs attract interest under § 263A(f) during the relevant production period. The costs that attract interest under § 263A(f) during a production period are the costs (whether or not incurred during the production period) required to be capitalized with respect to the property. Section 263A(f)(4)(C).

The taxpayer views the land it acquires as being a distinct piece of property, which is separate from any improvement later constructed on the land. This view is based on the land costs being included in the taxpayer's rate base at the time the land is purchased. The taxpayer argues that, at that point, the land is in use because the land is earning income for the taxpayer. The income earned from the land remains constant until the land is removed from the taxpayer's rate base--future improvements on the land do not alter the income earned from the land. Further, the taxpayer notes that taxpayers are required to capitalize interest under § 263A(f) only during the relevant production period, that is, the period that begins when physical activity is first

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[3] For purposes of Notice 88-99, the "production period" of real property generally began when physical activity was first performed upon the property and ended on the date the property was ready to be placed in service. See section I of Notice 88-99. See also § 263A(f)(4)(B).

performed on a unit of property and that ends when the property is ready to be placed in service. The taxpayer argues that it does not have a production period in regard to its land because the land is in service when the land acquisition costs are placed in its rate base. The taxpayer also argues that permitting the interest associated with the land to be currently deducted, and thereby offset the related income, serves one "purpose of the uniform capitalization rules--matching the deductions and related income."

The taxpayer also notes that "[n]othing in Notice 88-99 barred [it] from deducting interest costs related to land acquisitions." The taxpayer states that its method of not capitalizing the interest costs with respect to the acquired land for federal income tax purposes was consistent with the method that it used for both financial and regulatory accounting. Apparently, the taxpayer applies the rules contained in the Financial Accounting Standards Board Statement No. 34 (FAS 34) for financial accounting purposes.[4]

Additionally, even if the taxpayer's method, which it used in 1989 and 1990, of calculating the amount of accumulated production expenditures for property without including land costs was not correct, the taxpayer argues that the method should not now be changed upon examination because the method was reasonable. The applicable authority, Notice 88-99, generally allowed taxpayers to use any reasonable method, if the method was consistently applied, to calculate the amount of accumulated production expenditures that would attract interest under § 263A(f). A reasonable method is any method that is consistent with the regulations, revenue rulings, revenue procedures, notices, and announcements concerning § 263A. See § 1.263A-15(a)(2).

At issue is whether or not the taxpayer is correct in its view that the land it acquires is a distinct piece of property, which is separate from any improvement later constructed on the land. Land is not acquired by the taxpayer unless the taxpayer has identified a business need and has identified the land that is to be used to satisfy that need. Land is not acquired because of its own value but is acquired to be used as an item that, in conjunction with other items, will meet a business need. For example, a business need may exist to construct additional transmission towers and the taxpayer will acquire the necessary land upon which the towers will be built. However, the taxpayer's land is included in its rate base for ratemaking purposes at the time the land

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[4] Applying the rules of FAS 34 to its situation, the taxpayer states "that interest must be capitalized for certain qualifying assets, such as assets that are constructed or otherwise produced for an enterprise's own use. But, land that is not undergoing activities necessary to get it ready for its intended use is not a qualifying asset and the interest associated with such land is not capitalized."

is purchased and it begins, shortly thereafter, earning income for the taxpayer. A question exists whether this earning of income separates the land from the improvement done to the land and allows the land to be treated as a distinct piece of property.

Congressional intent, as the legislative history of § 263A shows, was that the costs of a project should be capitalized and then recovered as the project is sold or used in the business. See H.R. Rep. No. 426 at 625, 1986-3 C.B. (Vol. 2) at 625 and S. Rep. No. 313 at 140, 1986-3 C.B. (Vol.3) at 140. Congress' focus was on projects.

The taxpayer's projects require land to be acquired so the land can be used in conjunction with other items to complete the project. The fact that the land earns income for the taxpayer does not change the fact that the land is never purchased by the taxpayer for use other than as part of a project. Accordingly, during the production period for each project, the land acquisition costs should be treated by the taxpayer in the same fashion that the taxpayer treats the other project costs. That is, the taxpayer should include all the costs in accumulated production expenditures that attract interest under § 263A(f). There is no statutory, regulatory, or judicial exception that allows land, which is earning income, to not be included in accumulated production expenditures.

The taxpayer has noted that "[n]othing in Notice 88-99 barred [it] from deducting interest costs related to land acquisitions." The taxpayer is correct--nothing in Notice 88-99 specifically stated that the taxpayer could not deduct these interest costs. However, Notice 88-99, interpreting the interest capitalization requirements of § 263A, implements Congressional intent that generally interest costs are subject to capitalization under § 263A in cases where the interest is allocable to the production of real property. See H.R. Rep. No. 426 at 627, 1986-3 C.B. (Vol. 2) at 627 and S. Rep. No. 313 at 143-144, 1986-3 C.B. (Vol.3) at 143-144. The taxpayer is producing real property and thus, unless a specific exception applies, interest allocable to the taxpayer's production efforts, including the costs of land, must be capitalized. No exception does apply.

The taxpayer has noted that it did not capitalize the interest costs with respect to the land acquired for either financial or regulatory accounting purposes. Congress knew that the § 263A(f) avoided cost method might differ from the method required, authorized, or considered appropriate under financial or regulatory accounting principles applicable to a taxpayer. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-309 (1986). For example, the Conference Report provided that a regulated utility company must use the § 263A(f) avoided cost method even though the utility is authorized or required by FAS 34 to use a different method. Id. The need for the taxpayer to use different methods of accounting for interest capitalization illustrates a difference between tax and financial or regulatory accounting.

The taxpayer's method of not including any land acquisition costs in the accumulated production expenditures for a unit of property is not reasonable because the method is contrary to § 263A, its legislative history, and Notice 88-99, which require the capitalization of interest under § 263A that is incurred during the production period of real property.[5]

Caveat: A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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[5] While finalizing the § 263A(f) regulations in 1994, the IRS and Treasury received several comments regarding an issue similar to the one discussed in this technical advice memorandum. These commentators wanted the final § 263A(f) regulations to provide that a taxpayer could exclude certain costs from the accumulated production expenditures for a unit of property if the costs had been previously included by the taxpayer in its rate base for ratemaking purposes. The commentators suggestion, which would have allowed these costs to be excluded from the accumulated production expenditures, was not adopted. The discussion of the rationale for not providing this exception is set forth in the preamble to the final § 263A(f) regulations. 59 FR 67192.