American Institute of CPAs
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Washington, DC 20004-1081

January 4, 2017

Mr. Scott Dinwiddie
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Section 263A(f) Special Rules for Allocation of Interest to Property Produced by the Taxpayer

Dear Mr. Dinwiddie:

The American Institute of CPAs (AICPA) appreciates the opportunity to submit comments with respect to the interest capitalization regulations under Internal Revenue Code (IRC or "Code") section 263A(f)[1] and the related administrative procedures.

Final regulations under section 263A(f) were issued in 1994 and reserved on the application of the rules to related parties and pass-through entities. However, these issues were previously addressed in Notice 88-99[2] and have largely remained unchanged, although the business operations of taxpayers have undergone significant change since the notice was issued. Moreover, certain principles in Notice 88-99 require clarification and consistency to conform with aspects of the final regulations under section 263A(f).

The final section 263A(f) regulations require taxpayers to track designated property on an individual unit basis for purposes of allocating capitalized interest. In certain industries where taxpayers may have tens of thousands of units (or even more) that constitute designated property, the administrative burden and complexity of complying with the interest capitalization regulations is substantial.

The AICPA previously recommended[3] that the Department of the Treasury 2016-2017 Priority Guidance Plan include a project to clarify and simplify the interest capitalization regulations to make them more administrable. In this letter, the AICPA outlines recommendations to significantly reduce the complexity and administrative burden that taxpayers face in complying with the interest capitalization regulations.

[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.
[2] 1988-2 C.B. 422 (August 16, 1988).
[3] See AICPA Recommendations for 2016-2017 Guidance Priority List (Notice 2016-26), pages 36-37; http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-2016-2017-Priority-Guidance-Plan-List-Final.pdf.

The AICPA also recommends that the United States Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) modify Rev. Proc. 2016-29[4] (or its successor) to include all accounting method changes necessary for a taxpayer to comply with section 263A(f). Additionally, we suggest that accounting method changes made by a taxpayer to comply with section 263A(f) are, in general, made with a section 481(a) adjustment and receive audit protection for prior years.

These comments were developed by the AICPA Tax Methods and Periods Technical Resource Panel and approved by the Tax Executive Committee.

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We appreciate your consideration of our recommendations and welcome a further discussion. If you have any questions, please contact me at (408) 924-3508 or annette.nellen@sjsu.edu; or Jennifer Kennedy, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (703) 918-6951, or jennifer.kennedy@pwc.com; or Ogochukwu Eke-Okoro, Lead Technical Manager – AICPA Tax Policy & Advocacy, at (202) 434-9231, or oanokwute@aicpa.org.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: John Moriarty, Deputy Associate Chief Counsel, Income Tax & Accounting, Internal Revenue Service
Christopher Call, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury
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[4] On May 5, 2016, Treasury and the IRS issued Rev. Proc. 2016-29, which adds section 12.14 relating to changes of interest capitalization under section 263A(f). The changes apply to a taxpayer that wants to change its method of accounting from not capitalizing any interest or capitalizing interest under its book method of accounting to capitalizing interest under Treas. Reg. §§ 1.263A-8 through 14. Section 12.14 of Rev. Proc. 2016-29 does not cover accounting method changes in situations where a taxpayer is currently capitalizing some interest for tax purposes under a method that is different from its book method. Accounting method changes effected under new section 12.14 of Rev. Proc. 2016-29 are effected with a section 481(a) adjustment and receive audit protection for prior years.

AMERICAN INSTITUTE OF CPAs

Section 263A(f) Special Rules for Allocation of Interest to Property Produced by the Taxpayer

**Developed by the AICPA Tax Methods and Periods Technical Resource Panel
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January 4, 2017

AMERICAN INSTITUTE OF CPAs

Recommendations for Guidance under Section 263A(f) Regarding Interest Capitalization

I. EXECUTIVE SUMMARY

The AICPA welcomes the opportunity to comment on the interest capitalization rules and procedures in section 263A(f). The suggested modifications in this letter will allow taxpayers to determine the amount of interest to capitalize with respect to all units of designated property in a manner which reduces the current complexity and compliance burdens.

Summary of Recommendations

A. Issue Proposed Regulations Providing Related Party Rules

The AICPA recommends that the IRS and Treasury issue proposed regulations under section 263A(f) providing rules for related parties and flow-through entities, and to harmonize the concepts in Notice 88-99 with the final regulations.

Notice 88-99 provides guidance with respect to the allocation of production expenditures to related parties and flow-through entities. Notice 88-99 was issued prior to the release of the final regulations under section 263A, and certain concepts reflected in the final regulations are inconsistent with the Notice and require clarification.

Because the requirement to apply the related party rules to each unit of designated property is burdensome for taxpayers in complex organizational structures, the AICPA recommends that the IRS and Treasury allow taxpayers to elect to compute excess production expenditures that related parties[5] are required to take into account on an aggregate basis rather than at the level of each unit of designated property.

The AICPA also recommends that the IRS simplify the deferred asset method and substitute cost method to allow taxpayers to apply the methods similarly on an aggregate basis rather than a per unit basis. The AICPA includes suggested regulatory language for the proposed modification and provides examples illustrating these concepts.

Additionally, the AICPA recommends that the IRS and Treasury permit reasonable ordering rules for determining which related party's interest is capitalized first and the production expenditures of which producing taxpayer are first subject to the deferred asset method.

Further, we suggest that the IRS and Treasury clarify the procedures for electing the substitute cost method on behalf of members in a consolidated group. We propose, as a reasonable procedure for electing the substitute cost method, the capitalization of an amount of substitute

[5] Note that hereafter our reference to related parties includes flow-through entities unless otherwise specified.

costs on the return of the consolidated or parent-subsidiary controlled group that includes the member for which the substitute cost method election was made.[6]

B. Provide an Optional Safe Harbor to Follow Book or the Regulatory Interest Capitalization Method

The AICPA recommends that Treasury and the IRS include in the regulations a method similar to the historic absorption ratio election allowing taxpayers to use their book or regulatory method for capitalizing interest in cases where the amount of book or regulatory capitalized interest exceeds the amount of interest capitalized under section 263A(f) for each year of a three-year test period. Under such safe harbor, taxpayers would use their annual book or regulatory capitalized interest amount for five years and retest similar to the procedures in Treas. Reg. § 1.263A-2(b)(4).

This optional safe harbor would apply on a taxpayer, as opposed to a separate trade or business, basis. Additionally, the AICPA recommends that the IRS and Treasury permit taxpayers to effect a change to use the optional safe harbor method under the automatic consent procedures of Rev. Procs. 2015-13 and 2016-29, with the change effectuated on the cut-off method.

If the IRS and Treasury decide not to modify the regulations to provide for the optional safe harbor method, the AICPA recommends that the IRS and Treasury issue a revenue procedure providing for the optional safe harbor and automatic consent for any method changes to use the safe harbor. Allowing taxpayers to follow their book or regulatory interest capitalization method promotes administrative ease and encourages taxpayer compliance, while still ensuring interest is capitalized to the extent required under section 263A(f).

C. Permit Allocation of Capitalized Interest Among Units of Property Using a Reasonable Method

The AICPA recommends that the IRS and Treasury modify Treas. Reg. § 1.263A-9(a)(2) (and other regulations, as necessary) to allow taxpayers to use any reasonable method that is consistently applied to allocate capitalized interest to units of designated property, including inventory. We also suggest that, as part of the regulations, the IRS and Treasury include examples of reasonable allocation methods.

D. Simplify the Rules for Capitalizing Interest Related to Inventory

In order to use the simplified inventory method in Treas. Reg. § 1.263A-9(g)(3), the taxpayer's total inventory must turn over less frequently than once per year. For many taxpayers, although individual items of inventory may take longer than 24 months to produce, the taxpayer's total inventory typically turns over more frequently than once a year. In this case, the simplified inventory method is not a permissible method for a taxpayer. Moreover, taxpayers permitted to elect to use the simplified inventory method generally use the Last-in, First-out (LIFO) method to value their inventory, and the simplified inventory method operates inconsistently with the LIFO method.

[6] Similarly, we recommend that a flow-through entity effect the substitute cost method election by capitalizing an amount of substitute costs on the electing entity's return.

Accordingly, the AICPA proposes several modifications to the current rules. First, for taxpayers otherwise using the simplified production method for purposes of applying section 263A to their inventory, the AICPA recommends that Treasury and the IRS modify Treas. Reg. § 1.263A-9(g)(3) to permit the inclusion of interest expense in the simplified production method under Treas. Reg. § 1.263A-2(b).

Second, for taxpayers not using the simplified production method, we recommend that Treasury and the IRS modify Treas. Reg. § 1.263A-9(g)(3) to permit the use of any reasonable method, consistently applied, to allocate capitalized interest to inventory constituting designated property.

Under either alternative, the AICPA suggests that taxpayers using the LIFO method to value their inventory should apply a LIFO cost flow to determine capitalized interest, rather than a First-in, First-out (FIFO) cost flow.

Finally, we recommend that the IRS and Treasury allow the application of the simplified inventory method to determine inventory costs of property with a turnover period that is more frequent than once a year.

E. Provide an Election for Taxpayers to Opt Out of the *De Minimis* Safe Harbor

The AICPA recommends that the IRS and Treasury modify Treas. Reg. § 1.263A-8(b)(4) to provide taxpayers with an election to opt out of the *de minimis* rule for determining designated property. The requirement to apply the *de minimis* safe harbor under Treas. Reg. § 1.263A-8(b)(4) is administratively burdensome for taxpayers with numerous units of property. Providing an election to opt out of the *de minimis* rule will provide administrative relief to taxpayers without causing a disadvantage to the government. The election should apply to all units of property produced.

Also, we recommend that the regulations provide that revoking the election is considered a change in method of accounting requiring the consent of the Commissioner of the Internal Revenue Service ("Commissioner") under section 446(e).

F. Allow All Taxpayers to Elect to Use the Applicable Federal Rate Plus Three Percentage Points in Lieu of the Weighted Average Interest Rate

The AICPA recommends that the IRS and Treasury modify the definition of eligible taxpayer in Treas. Reg. § 1.263A-9(e)(2) to apply to all taxpayers. All taxpayers, not just small taxpayers, should have the opportunity to elect to use the highest applicable federal rate (AFR) plus three percentage points ("AFR + three").

G. Provide an Election to Not Trace Debt in the Year Traced Debt is First Incurred

The AICPA recommends that the IRS and Treasury modify Treas. Reg. § 1.263A-9(d)(1) to provide that in, or subsequent to, the first year a taxpayer has traced debt, the taxpayer may elect not to trace debt and instead treat all debt as non-traced debt for purposes of computing the weighted average interest rate. Making the election is considered the establishment of a method of accounting, rather than a change in method of accounting as currently provided in

Treas. Reg. § 1.263A-9(d)(1). Additionally, Treas. Reg. § 1.263A-9(d)(1) should provide that once a method not to trace debt is established, a revocation of that election is considered a change in method of accounting requiring the automatic consent of the Commissioner under section 446(e), as discussed below.

H. Revise the Procedures for Interest Capitalization Method Changes

The AICPA recommends that the IRS and Treasury modify Rev. Proc. 2016-29 to make all changes in the method of accounting for interest capitalization, including cases where taxpayers capitalize some interest for tax but use a method other than the avoided cost method, eligible for IRS automatic consent. Additionally, we suggest that the IRS and Treasury allow the implementation of interest capitalization method changes with a section 481(a) adjustment and audit protection for prior years.

In the case of interest capitalization method changes for flow-through entities, taxpayers should have the option to elect to implement changes on a cut-off basis for ease in administering the flow-through rules. In addition, the AICPA recommends that the IRS permit a taxpayer to make a change to follow its book or regulatory interest capitalization method using the cut-off method as well.

The AICPA commends the IRS and Treasury for modifying the current accounting method change procedures relating to interest capitalization in Rev. Proc. 2016-29.[7] In the Revenue Procedure, Treasury and the IRS added new section 12.14 which provides for automatic IRS consent for a taxpayer that wants to change its method of accounting from not capitalizing any interest or capitalizing interest under its book method of accounting, to capitalizing interest under section 263A(f). By providing automatic IRS consent, a section 481(a) adjustment and audit protection incentivizes taxpayer compliance with section 263A(f). Notably, new section 12.14 of Rev. Proc. 2016-29 does not cover accounting method changes where a taxpayer is currently capitalizing some interest for tax purposes under a method that is different from its book method. In order for the IRS to facilitate its voluntary disclosure policy for accounting method changes (i.e., "carrot and stick" approach), it needs to provide an incentive for taxpayers to initiate method changes. Providing automatic consent procedures, a section 481(a) adjustment, and audit protection for most interest capitalization method changes where the taxpayer is currently capitalizing some interest for tax but using an incorrect method, would create such an incentive.

The AICPA is confident that implementing our recommendations will promote voluntary compliance and reduce controversy by reducing the administrative complexity and burdens of complying with the section 263A(f) regulations.

[7] Issued May 5, 2016.

II. OVERVIEW OF CURRENT INTEREST CAPITALIZATION RULES

A. Section 263A(f)

Section 263A(f) requires the capitalization of interest under section 263A(a)[8] when it is paid or incurred during the production period[9] and allocable to real or tangible property produced by the taxpayer. The produced property should have: (1) a long useful life (such as real property or property with a class life of 20 years or more); (2) an estimated production period exceeding two years; or (3) an estimated production period exceeding one year and a cost exceeding $1,000,000 (referred to herein as designated property).[10]

B. Avoided Cost Method

Treasury Reg. §§ 1.263A-8 through 1.263A-15 provide rules for administering interest capitalization under section 263A(f). Taxpayers must use the avoided cost method in Treas. Reg. § 1.263A-9 to calculate the amount of interest required for capitalization under section 263A(f). The avoided cost method requires the capitalization of any interest that is avoided if accumulated production expenditures[11] (APEs) are used to repay or reduce outstanding debt.[12]

The avoided cost method requires taxpayers to determine and capitalize the traced debt amount and excess expenditure amount[13] during the production period of each separate unit of designated property. A separate unit of designated property is generally all of the components of property that are functionally interdependent.[14]

[8] Direct and indirect costs allocable to property produced by the taxpayer, including interest, are capitalized to the property as required by section 263A(a). See also Treas. Reg. §§ 1.263A-1(e)(1) and 1.263A-1(e)(3)(ii)(V).
[9] The production period with respect to property begins on the date production of the property begins, and ends on the date when the property is ready to be placed in service or held for sale. Section 263A(f)(4)(B); Treas. Reg. § 1.263A-12(c).
[10] Section 263A(f)(1); Treas. Reg. § 1.263A-8(b)(1). See also section 263A(b)(1).
[11] The term "production expenditures" refers to the costs capitalized under section 263A(a) with respect to the property. Section 263A(f)(4)(C). Accumulated production expenditures generally include the cumulative amount of direct and indirect section 263A costs which are capitalized with respect to a unit of property, including interest capitalized in prior computation periods and the adjusted bases of any assets described in Treas. Reg. § 1.263A-11(d) that are used to produce the unit of property during the period of their use. See Treas. Reg. § 1.263A-11(a). The assets listed in Treas. Reg. § 1.263A-11(d)(1) that are used in the physical construction of a unit of property include items such as assembly-line structures, cranes, bulldozers, and buildings, all of which are tangible assets. Note that the tangible nature of these assets (used to physically construct designated property) is different from the intangible commitment fees which are includable in APEs by the IRS in Chief Counsel Advice Memoranda (CCA) 201136022. The CCA applies a "but for" test to hold that there is no production activity without the commitment fees, thus the fees must relate to production and, therefore, are costs includable in APEs under Treas. Reg. § 1.263A-11(a). The IRS in CCA 201136022 provides little analysis of the different nature of the assets listed in Treas. Reg. § 1.263A-11(d)(1) versus the commitment fees at issue in the CCA.
[12] Treas. Reg. § 1.263A-9(a)(1).
[13] Treas. Reg. § 1.263A-9(a)(2).
[14] Treas. Reg. § 1.263A-10(b) and (c).

The traced debt amount is the amount of interest capitalized with respect to a unit of designated property, which is equal to the total amount of interest incurred on the traced debt during each measurement period.[15]

Taxpayers determine the excess expenditure amount, where APEs exceed traced debt with respect to a unit of designated property on any measurement date in a computation period,[16] as the product of:

> (1) the average excess expenditures for the unit of designated property for that period; and
> (2) the weighted average interest rate for that period.[17]

With respect to production expenditures of the taxpayer under applicable related person rules, the related parties must take certain excess expenditures, required to capitalize interest, into account.[18] The amount of average excess expenditures taken into account by related persons with respect to each unit of designated property is equal to the quotient of:

> (1) the amount (if any) by which the excess expenditure amount for a unit exceeds the amount of interest allocated to the unit under Treas. Reg. §1.263A-9(c)(7)(i); and
> (2) the weighted average interest rate for the computation period.[19]

With respect to the production period, taxpayers must capitalize interest to a unit of designated property for computation periods that include the production period of the unit.[20] Currently, taxpayers must determine a separate production period for each unit of property.[21] For real property, the production period begins on the first date that any physical production activity is performed with respect to a unit of real property.[22] For tangible personal property, the production period commences on the first date a taxpayer's APEs, including planning and

[15] Treas. Reg. § 1.263A-9(b)(1). On each such date, traced debt with respect to a unit of designated property is equal to the amount of outstanding eligible debt under Treas. Reg. § 1.263A-9(a)(4) that is allocated, on that date, to APEs with respect to the unit of designated property under the rules of Treas. Reg. § 1.163-8T. Non-traced debt refers to all eligible debt on a measurement date other than debt that is treated as traced debt with respect to any unit of designated property on that measurement date. Treas. Reg. § 1.263A-9(c)(5)(i).
[16] Under Treas. Reg. § 1.263A-9(f)(1)(i), a taxpayer may compute the avoided cost calculation on the basis of a full taxable year, or a shorter computation period within the taxable year. If a taxpayer uses the taxable year as the computation period, taxpayers must use measurement dates that occur at least quarterly. Treas. Reg. § 1.263A-9(f)(1)(ii). The taxpayer must use the same measurement dates for all designated property produced during a computation period, and except in cases of short taxable years, measurement dates must occur at equal intervals during each computation period that falls within a single taxable year. *Id.*
[17] Under Treas. Reg. § 1.263A-9(c)(5)(iii)(A), the weighted average interest rate for a computation period is determined by dividing interest incurred on non-traced debt during the period by average non-traced debt for the period.
[18] Treas. Reg. § 1.263A-9(c)(7)(ii).
[19] *Id.*
[20] Treas. Reg. § 1.263A-12(a).
[21] Treas. Reg. § 1.263A-12(c)(1).
[22] Treas. Reg. § 1.263A-12(c)(2). Examples of physical construction include: "(i) Clearing, grading, or excavating of raw land; (ii) Demolishing a building or gutting a standing building; (iii) Engaging in the construction of infrastructure, such as roads, sewers, sidewalks, cables, and wiring; (iv) Undertaking structural, mechanical, or electrical activities with respect to a building or other structure; or (v) Engaging in landscaping activities." Treas. Reg. § 1.263A-12(e)(2).

design expenditures, are at least 5 percent of the taxpayer's total amount of estimated APEs for the property unit.[23] For property produced for self-use, the production period generally ends on the date that the unit is placed in service and all production activities reasonably expected to be undertaken by or for the taxpayer or a related person are completed.[24] For units held for sale, the production period generally ends on the date that the unit is ready to be held for sale and all production activities reasonably expected to be undertaken by or for the taxpayer or a related person are completed.[25]

C. Per Unit Tracking

In order to comply with the current rules under the avoided cost method, taxpayers must track the following items for each unit of designated property:

- Accumulated production expenditures;
- The traced debt amount;
- The excess expenditure amount;
- The amount of excess production expenditures allocable to related parties and flow-through entities; and
- The production period for each unit of designated property (i.e., functionally related components of property).

III. DISCUSSION AND RECOMMENDATIONS

A. Issue Proposed Regulations Providing Rules for Related Parties

Summary Recommendation

The AICPA recommends that the IRS and Treasury issue proposed regulations addressing the application of the avoided cost method to related parties and flow-through entities and clarify and harmonize the concepts in Notice 88-99 with the proposed regulations.

Background and Analysis

1. Rules Covering Related Parties

Treasury Reg. § 1.263A-14, entitled *Rules for Related Persons*, indicates that taxpayers must account for average excess expenditures allocated to related persons under applicable administrative guidance. Notice 88-99 was issued prior to the final regulations under section 263A and sets forth the administrative rules for treating expenditures allocated to related persons.

Under Notice 88-99, for tax years beginning on or after January 1, 1988, a person is considered related to the producing taxpayer if the person and the taxpayer are members of the same

[23] Treas. Reg. § 1.263A-12(c)(3).
[24] Treas. Reg. § 1.263A-12(d)(1).
[25] *Id.*

consolidated group of corporations or parent-subsidiary controlled group of corporations as defined in section 1563(a)(1).[26]

In the case of related parties, Notice 88-99 provides two methods (the deferred asset method and the substitute cost method) that taxpayers may use to determine the amount of interest to capitalize with respect to excess production expenditures that are taken into account by related parties.

a. <u>Deferred Asset Method</u>

i. <u>General</u>

The deferred asset method is mandatory unless a taxpayer elects to use the substitute cost method. Under the deferred asset method, a related party is required to capitalize interest equal to an amount that the producing taxpayer would have capitalized (using the avoided cost principles) had the producing taxpayer incurred the interest on the eligible debt of the related party (related party avoided cost debt). The interest incurred by a related party is subject to these rules only if the producing taxpayer's APEs exceed the total amount of its traced and avoided cost debt (referred to as remaining production expenditures). This amount (i.e., the remaining production expenditures) is similar in concept to the average excess expenditures which are taken into account by related parties under Treas. Reg. § 1.263A-9(c)(7)(ii) for each unit of the producing taxpayer's property.[27] The term average excess expenditures is defined in the regulations for the computation period as the amount (if any) by which the excess expenditure amount for the unit exceeds the amount of interest allocated to a unit under Treas. Reg. §§ 1.263A-9(c)(7)(i) and dividing the excess by the weighted average interest rate for the period.[28]

Once the per unit interest capitalization amount has been determined, the deferred asset method requires the related party to account for the capitalized interest as an asset. This accounting is prepared in the same manner (and at the same time) that the producing taxpayer would have accounted for capitalized interest *(*i.e., as depreciation, cost of goods sold, etc.) had the interest been capitalized into the basis of the unit of property on the taxpayer's books and records as a cost of the specific unit.

ii. <u>Ordering Rules</u>

Specific to the deferred asset method, Notice 88-99 provides rules to determine the order in which interest is capitalized in consolidated groups or a parent-subsidiary controlled group. For taxable years beginning on or after January 1, 1988, if interest incurred by related parties becomes subject to the deferred asset method with respect to producing taxpayers' remaining APEs, the ordering rule for capitalizing interest is established at the parent level and applied with respect to all group members.

[26] Notice 88-99, section 8(B). Note that Treas. Reg. § 1.263A-8(a)(4)(i) provides that a person is related to a taxpayer if their relationship is described in section 267(b) or 707(b).
[27] Note that we refer to remaining production expenditures interchangeably with average excess expenditures.
[28] *Id.*

Notice 88-99 indicates that forthcoming guidance will provide additional ordering rules applicable to producing taxpayers and related parties.[29] Importantly, Notice 88-99 omits, for taxable years beginning on or after January 1, 1988, the ability of taxpayers and related parties (including flow-through entities) to use any reasonable ordering rule in determining (i) which related party's interest is first capitalized and (ii) the production expenditures of which producing taxpayer are first subject to the deferred asset method.[30]

b. Substitute Cost Method

i. General

Rather than apply the deferred asset method for the remaining APEs, taxpayers may elect to apply the substitute cost method. Substitute costs are defined in Notice 88-99 as a pro-rata amount of all the taxpayer's costs that are otherwise deductible by the taxpayer for the current taxable year (after application of all provisions of the Code). Substitute costs also include any interest expense incurred during the year on eligible debt that is not otherwise subject to capitalization.

Under the substitute cost method, the producing taxpayer must capitalize its substitute costs up to an amount equal to the additional interest that would have been capitalized by the taxpayer, had the taxpayer's eligible debt equaled the average balance of its APEs during the production period. For purposes of this method, the amount of additional interest that would have been capitalized by the taxpayer had the taxpayer's eligible debt equaled the average balance of its APEs during the production period is determined by applying: (i) the average federal long-term rate[31] in effect during the production period within the taxable year, to (ii) the average balance of the taxpayer's remaining production expenditures outstanding during such time (i.e., the excess of the taxpayer's production expenditures over the actual balances of the taxpayer's traced and avoided cost debt). Similar to the deferred asset method, the substitute cost method is applied to each unit of designated property.

ii. Election

Notice 88-99 provides that, in the case of a consolidated group of corporations or a parent-subsidiary controlled group of corporations, the election to use the substitute cost method is made at the parent level and is applied with respect to all members of the group. Further, an election to use the substitute cost method is consistently applied with respect to the production of qualified property by all members of the consolidated group or parent-subsidiary controlled group of corporations.

[29] The ordering rules for tax years beginning on or after January 1, 1988 provide: "(i) with respect to producing taxpayers organized outside of the United States, interest incurred by every related party organized outside of the United States must be capitalized before the interest of any other related party is capitalized; (ii) with respect to producing taxpayers organized in the United States, interest incurred by every related party organized within the United States must be capitalized before the interest of any other related party is capitalized." Notice 88-99, section XI(B).

[30] Under Notice 88-99, this rule only applies to taxable years beginning prior to January 1, 1988.

[31] Within the meaning of section 1274(d). Notice 88-99, section IX(B)(2).

However, Notice 88-99 does not include guidance indicating how the parent of a group is to make the election on behalf of entities in the group.

2. Recommendations Regarding Related Party Rules

a. ***Issue Related Party Regulations and Harmonize Concepts***

Recommendations

The AICPA recommends that the IRS and Treasury issue proposed regulations under section 263A(f) providing rules for related parties and flow-through entities.

Additionally, we suggest that Treasury and the IRS clarify the meaning of AFR for purposes of applying the substitute cost method and other elections in the regulations (e.g., the AFR + three election in Treas. Reg. § 1.263A-9(e)(1)). The AICPA recommends that the proposed regulations define the term "applicable" to assign a short, mid, or long-term interest rate under section 1274 based on the term of debt.

Analysis

Certain concepts in Notice 88-99, which was issued prior to the final regulations under section 263A, require clarification and consistency with the final regulations. For example, the term "remaining production expenditures" is not defined similarly to the term "excess production expenditures" that is taken into account by related parties under Treas. Reg. § 1.263A-9(c)(7)(ii). Additionally, the definition of related party is not consistent with the definition in final Treas. Reg. § 1.263A-8(a)(4)(i), which provides that a person is related to a taxpayer if their relationship is described in section 267(b) or 707(b).

Additionally, the meaning of "applicable" federal rate for purposes of applying the substitute cost method and other elections in the regulations (e.g., the AFR + three election in Treas. Reg. § 1.263A-9(e)(1)) is unclear.

b. ***Allow the Application of Deferred Asset and Substitute Cost Methods on an Aggregate Unit Basis***

Recommendations

The AICPA suggests that the IRS and Treasury permit taxpayers to elect to compute excess production expenditures of related parties on an aggregate basis rather than for each separate unit of property. The AICPA recommends modifying the current test in Treas. Reg. § 1.263A-9(c)(7)(ii) to read as follows:

> (ii) Application of related person rules to average excess expenditures. Certain excess expenditures must be taken into account by the persons (if any) required to capitalize interest with respect to production expenditures of the taxpayer under applicable related person rules. ***Taxpayers may elect to compute excess production expenditures for aggregate units rather than for each separate unit of property.*** For each computation period, the amount of average excess expenditures that must be taken into account by

such persons for each unit ***(or aggregate units)*** of the taxpayer's property is computed by –

(A) Determining, for the computation period, the amount (if any) by which the excess expenditure amount for the unit ***(or aggregate units)*** exceeds the amount of interest allocated to the unit ***(or aggregate units)*** under paragraph (c)(7)(i) of this section; and

(B) Dividing the excess by the weighted average interest rate for the period.[32]

We also suggest adding a new subparagraph (C) to Treas. Reg. § 1.263A-9(c)(7)(ii), describing the optional election to compute excess production expenditures for aggregate units rather than each separate unit of property. Taxpayers should have the ability to elect by capitalizing on a tax return, the amount of interest or substitute costs determined by computing excess expenditures on an aggregate basis.

We suggest the following regulatory language to effect these recommendations:

(C) Taxpayers may elect to compute excess production expenditures under related party regulations for aggregate units rather than separately for each unit of property. Taxpayers make this election by capitalizing on a tax return, the amount of interest or substitute costs determined by computing excess expenditures on an aggregate basis. The term "aggregate units" means for purposes of this subparagraph, the sum of a taxpayer's units of designated property, rather than each individual unit of designated property.

The AICPA also recommends that the IRS and Treasury allow taxpayers to elect to apply the deferred asset and substitute cost methods on an aggregate basis rather than separately for each unit of property.

Analysis

The current test in Treas. Reg. § 1.263A-9(c)(7)(ii) provides the following:

(ii) Application of related person rules to average excess expenditures. Certain excess expenditures must be taken into account by the persons (if any) required to capitalize interest with respect to production expenditures of the taxpayer under applicable related person rules. For each computation period, the amount of average excess expenditures that must be taken into account by such persons for each unit of the taxpayer's property is computed by –

(A) Determining, for the computation period, the amount (if any) by which the excess expenditure amount for the unit exceeds the amount of interest allocated to the unit under paragraph (c)(7)(i) of this section; and

(B) Dividing the excess by the weighted average interest rate for the period.

[32] *Id.*

The requirement to apply the related party[33] rules at each unit of designated property is burdensome for taxpayers in complex organizational structures. Often, taxpayers have hundreds of entities in a consolidated group or tiered partnership structure, and the requirement to calculate related party interest capitalization at the unit level operates as a disincentive to comply. Simplification is necessary to allow taxpayers to more easily apply the requirements of the related party rules. Taxpayers should have the option to elect to compute excess production expenditures for aggregate units rather than each separate unit of property.

Taxpayers should also have the option to elect to apply the deferred asset and substitute cost methods on an aggregate basis rather than separately for each unit of property. The requirement to track capitalized interest on a per unit basis is burdensome for taxpayers. Allowing taxpayers to make these computations on an aggregate basis is more administrable and will facilitate compliance with the related party rules. Additionally, making these computations on an aggregate basis is consistent with the AICPA's recommendation to permit taxpayers to allocate capitalized interest to units of designated property based on reasonable methods, discussed further below.

Examples 1 to 3 in the Appendix illustrate the computation of average excess production expenditures for related parties and the application of the deferred asset and substitute cost methods on an aggregate basis.

c. Ordering Rules

Recommendations

The AICPA recommends that the IRS and Treasury allow taxpayers to use any reasonable ordering rule in determining which related party's interest is first capitalized and the production expenditures of which producing taxpayer are first subject to the deferred asset method.[34]

We recommend that the IRS and Treasury provide in the proposed regulations that taxpayers may use any reasonable ordering rule established by the parent of a consolidated group of corporations or a parent-subsidiary controlled group in determining which related party's interest is first capitalized and the production expenditures of which producing taxpayer are first subject to the deferred asset method.

We suggest that the IRS add a statement, similar to the rule in Notice 88-99 for years beginning on or before January 1, 1988, to the regulations as follows:

> If interest incurred by related parties becomes subject to the deferred asset method with respect to taxpayers' remaining production expenditures, then the taxpayers and related parties may use any reasonable ordering rule in determining:
>
> (i) which related party's interest is first capitalized; and

[33] Note that our reference to related parties includes flow-through entities.
[34] Under Notice 88-99, this ability only applies to taxable years beginning prior to January 1, 1988.

(ii) the production expenditures of which producing taxpayer are first subject to the deferred asset method. In the case of a consolidated group of corporations or a parent-subsidiary controlled group, the ordering rule shall be established at the parent level and shall be applied with respect to all members of such group.

We also recommend that the IRS and Treasury implement a reasonable ordering rule for flow-through entities, similar to the rule in Notice 88-99, section XII(B)(4)(a), applicable to years beginning prior to January 1, 1988, which provides:

> For taxable years of the owner beginning before January 1, 1988, if the production expenditures of more than one flow-through entity become subject to the deferred asset method with respect to an owner, then the owner shall use any reasonable ordering rule in determining the amount of debt to allocate with respect to the remaining production expenditures of each entity.

Analysis

The IRS and Treasury included a rule in Notice 88-99 to allow taxpayers to use any reasonable ordering rule to determine which related party's interest is first capitalized and the production expenditures of which producing taxpayer is first subject to the deferred asset method for taxable years beginning on or before January 1, 1988.

However, for years beginning on or after January 1, 1988, Notice 88-99 provides that, for producing entities organized in the United States (U.S.), interest incurred by every related party organized within the U.S. is capitalized before the interest of any other related party is capitalized. Also, Notice 88-99 provides that, in the case of a consolidated group of corporations or a parent-subsidiary controlled group, the ordering rule is established at the parent level and is applied with respect to all members of the group. Treasury indicated in Notice 88-99 that forthcoming guidance would provide additional ordering rules applicable to producing taxpayers and related parties. For reasonable administration of the related party rules, we suggest that the IRS reinstate the rule.

Similarly, for the same reasons discussed above with respect to related parties in consolidated group structures, the IRS should implement a reasonable ordering rule with respect to flow-through entities. Currently, Notice 88-99, section XII(B)(4)(b), provides an ordering rule for flow-through entities as follows:

> For taxable years of the owner beginning on or after January 1, 1988, if the production expenditures of more than one flow-through entity become subject to the deferred asset method with respect to an owner, then the owner shall adopt a pro-rata ordering rule in determining the amount of debt to allocate with respect to the remaining production expenditures of each entity. Thus, the owner's debt shall be allocated with respect to its share of the remaining production expenditures of each entity based on the ratio of its share of each entity's remaining production expenditures to the aggregate amount of its share of all the entities' remaining production expenditures.

These updates are necessary to allow for reasonable administration of the deferred asset method by related parties, including flow-through entities.

d. Substitute Cost Method Election

The related party regulations should clarify how the substitute cost method election is made on behalf of members in a consolidated group. The AICPA proposes that the capitalization of an amount of substitute costs on the return of the consolidated or parent-subsidiary controlled group (that includes the member for which the substitute cost method election was made) is treated as making the substitute cost method election effective for the tax year for which such return is filed.[35]

B. Provide for an Elective Safe Harbor to Follow the Book or Regulatory Interest Capitalization Method

Recommendations

The AICPA recommends that the IRS and Treasury allow taxpayers for tax purposes to follow the method used to capitalize interest for financial statement or regulatory purposes. We also recommend that the IRS and Treasury provide a safe harbor for taxpayers to follow their book or regulatory accounting interest capitalization method under sections 263A(i) and 446.

The AICPA also suggests that the IRS and Treasury add to the regulations a method similar to the historic absorption ratio election in Treas. Reg. § 1.263A-2(b)(4). Specifically, the IRS and Treasury should permit producers with designated property to use their book or regulatory method for capitalizing interest where it results in capitalized interest in excess of tax for each year of a three-year test period.

If the IRS and Treasury permit taxpayers to follow their book or regulatory method of determining capitalized interest for tax purposes, the AICPA recommends that the IRS and Treasury update Rev. Proc. 2016-29 to allow taxpayers to file an accounting method change request under the automatic procedures to begin following their book or regulatory method to determine capitalized interest.

We suggest that Treasury and the IRS effect our recommendations by adding a new subparagraph (h) in Treas. Reg. § 1.263A-9, as follows:

> (h) *Safe harbor to use book or regulatory interest capitalization method for determining capitalized interest for tax.*
>
> > **(1) *In general.*** This paragraph (h)(1) generally permits producers with designated property to use their annual book or regulatory interest capitalization method in determining capitalized interest for tax under section 263A(f). A taxpayer may only use this safe harbor if it has capitalized interest under its book or regulatory interest capitalization method for three or more consecutive taxable years

[35] Similarly, we recommend that a flow-through entity effect the substitute cost method election by capitalizing an amount of substitute costs on the electing entity's return.

immediately prior to the year of use of the safe harbor, and has for tax purpose capitalized interest under the avoided cost method under paragraph (a)(1) of this section for its three most recent consecutive taxable years. The capitalized interest determined under a taxpayer's book or regulatory method is used in lieu of capitalized interest computed under the avoided cost method in paragraph (a)(1) of this section and is based on interest capitalized by a taxpayer for book or regulatory purposes, and tax, during its test period. If elected, the book or regulatory interest capitalization method must be used for each taxable year within the qualifying period described in paragraph (h)(2)(iii) of this section.

(2) ***Operating rules and definitions***

(i) ***Book interest capitalization method***

(A) The book interest capitalization method is the method used by a taxpayer for calculating capitalized interest for financial statement reporting purposes.

(B) The regulatory interest capitalization method is the method used by a taxpayer for calculating capitalized interest for regulatory accounting purposes.

(ii) ***Test period***

(A) ***In general.*** The test period is generally the three taxable-year period immediately prior to the taxable year that the book or regulatory interest capitalization method is used.

(B) ***Updated test period.*** The test period begins again with the beginning of the first taxable year after the close of a qualifying period. This new test period, the updated test period, is the three taxable-year period beginning with the first taxable year after the close of the qualifying period as defined in paragraph (h)(2)(iii) of this section.

(iii) ***Qualifying period***

(A) ***In general.*** A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period).

(B) ***Extension of qualifying period.*** In the first taxable year following the close of each qualifying period (e.g., the sixth taxable year following the test period), the taxpayer must compute the capitalized interest under the avoided cost method in paragraph (a)(1) of this section. If the amount of capitalized interest computed under the avoided cost method is less than the amount of capitalized interest computed under the book or regulatory interest capitalization method for this taxable year (the re-computation year), then the qualifying period is extended to include the re-computation year and the following five taxable years. In that event, the taxpayer must continue to use the book or regulatory interest capitalization method throughout the extended qualifying period. If, however, the capitalized interest computed under the avoided cost method in the re-computation year is more than the amount computed under the book or regulatory interest capitalization method for the year, then the taxpayer must use the avoided cost method beginning with the re-computation year and throughout the updated test period.

The taxpayer resumes use of the book or regulatory interest capitalization method in the year following a new three-year test period in which the taxpayer's book or regulatory method resulted in capitalized interest that exceeded interest determined under the avoided cost method, for each year of the new three-year test period.

(3) ***Method of accounting***

(i) Change to use the book or regulatory interest capitalization method. A change to use the book or regulatory interest capitalization method is a change in method of accounting. A taxpayer changing to use the book or regulatory interest capitalization method may receive deemed consent of the Commissioner to change to such method, provided the taxpayer has not obtained the Commissioner's consent to discontinue using the book or regulatory interest capitalization method within its prior six taxable years. The method change is to be effected on a cut-off basis, and thus no adjustment under section 481(a) is required or permitted. For purposes of this paragraph, the re-computation of capitalized interest under the avoided cost method during an updated test period and the change from a book or regulatory interest capitalization method to the avoided cost method by reason of the requirements of this paragraph (h)(2)(iii)(B) are not considered changes in methods of accounting under section 446(e) and do not require the consent of the Commissioner or any adjustments under section 481(a).

(ii) Discontinue use of the book or regulatory interest capitalization method. A taxpayer may only discontinue use of the book or regulatory interest capitalization method with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder.

If the IRS and Treasury permit taxpayers, for tax purposes, to follow their book or regulatory method of determining capitalized interest, we suggest modifying Treas. Reg. § 1.263A-9(g)(4) to indicate that, where the taxpayer does not make an election to follow its method of accounting for financial reporting or regulatory purposes to determine capitalized interest, then the avoided cost method is applied under this section without regard to any financial or regulatory accounting principles for the capitalization of interest.

If the IRS and Treasury decide not to modify the interest capitalization regulations to provide for a safe harbor allowing taxpayers to follow their book or regulatory interest capitalization method for tax purposes, we recommend that the IRS and Treasury issue a revenue procedure providing for such a safe harbor and automatic consent for any method changes to the safe harbor, as described above. Providing taxpayers the ability to follow their book or regulatory interest capitalization methods for tax purposes promotes administrative ease and encourages taxpayer compliance while still ensuring interest is capitalized to the extent required under section 263A(f).

Analysis

Currently, Treas. Reg. § 1.263A-9(g)(4) provides that the avoided cost method is applied without regard to any financial or regulatory accounting principles for the capitalization of interest. Thus, there is a clear mandate to determine capitalized interest for tax purposes under the avoided cost method, separate from a taxpayer's method of determining capitalized interest for financial statement or regulatory reporting purposes.

For many taxpayers, conformity between financial statement reporting and tax is important as it reduces the administrative burden associated with maintaining separate calculations. Similarly, many regulated taxpayers may seek to follow, for tax purposes, the methods of capitalizing interest for regulatory purposes to eliminate the administrative burden of maintaining separate calculations. Taxpayers may prefer the ability to forego a complex and burdensome tax calculation even though the book or regulatory method may result in a higher amount of capitalized interest than the amount capitalized under the avoided cost method.

In order to alleviate the administrative burden of maintaining a separate calculation for tax purposes based on highly complex and burdensome rules, we suggest allowing taxpayers to follow their method of capitalizing interest for financial statement or regulatory purposes. The safe harbor should apply on a taxpayer, as opposed to a separate trade or business, basis.

Making the method available where it results in an amount that equals or exceeds the amount of capitalized interest determined under the avoided cost method[36] will ensure the appropriate amount of interest is capitalized to property produced.

While section 263A(f)(2)(A) directs the use of specific interest capitalization methods for tax purposes,[37] the IRS and Treasury have the authority to provide a safe harbor for taxpayers to follow their book or regulatory accounting interest capitalization method under sections 263A(i) and 446. Under section 263A(i), Treasury is vested with the authority to issue regulations as are necessary or appropriate to carry out the purposes of section 263A. Implementing the safe harbor is appropriate to carry out the purposes of section 263A. The safe harbor will result in capitalizing costs to the extent required under section 263A (since interest is capitalized in an amount that exceeds the amount capitalized under the avoided cost method), afford taxpayers administrative ease, and promote sound tax administration. Further, the IRS and Treasury could issue the safe harbor in a revenue procedure following broad

[36] For this purpose, interest capitalized under the avoided cost method would include the amount of interest and substitute costs which are capitalized at a taxpayer level, taking into consideration the application of the related party and flow-through rules in Notice 88-99.

[37] Section 263A(f)(2)(A) provides that interest on any debt directly attributable to production expenditures with respect to such property is assigned to such property and interest on any other debt is assigned to such property to the extent the taxpayer's interest could have been reduced if production expenditures had not been incurred.

discretion vested by Treas. Reg. § 1.446-1(c)(2)(ii) to allow taxpayers to use methods of accounting not specifically described in the regulations where they clearly reflect income.

To reduce the burden of calculating the amount of interest capitalization for financial and/or regulatory accounting purposes as well as for tax purposes each year, we suggest adding to the regulations, a method similar to the historic absorption ratio election in Treas. Reg. § 1.263A-2(b)(4). Specifically, we suggest permitting producers with designated property to use their book or regulatory method for capitalizing interest where it results in capitalized interest in excess of tax for each year of a three-year test period. In that case, taxpayers would use the yearly book or regulatory capitalization amount for five years and retest, similar to the procedures in Treas. Reg. § 1.263A-2(b)(4).

Taxpayers are only able to use the book or regulatory method of capitalizing interest if they capitalize interest for book or regulatory purposes and also for tax purposes, using the avoided cost method, for the three years prior to the year the taxpayer changes to follow their book or regulatory interest capitalization method. If elected, taxpayers must use the book or regulatory capitalization method for each taxable year within a five-year qualifying period. Taxpayers would have an updated test period which would begin at the beginning of the first taxable year after the close of the qualifying period. The updated test period is the three tax-year period beginning with the first tax year after the close of the qualifying period.

The qualifying period would include each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period). A qualifying period is extended if, in the first taxable year following the close of each qualifying period (e.g., the sixth taxable year following the test period), the taxpayer's capitalized interest for book or regulatory purposes in the re-computation year exceeded the taxpayer's capitalized interest for tax purposes under the avoided cost method. In that event, the qualifying period is extended to include the re-computation year and the following five taxable years. The taxpayer is required to continue to use the book or regulatory interest capitalization method throughout the extended qualifying period. If, however, in the re-computation year the capitalized interest under the avoided cost method exceeded the capitalized interest for book or regulatory purposes, the taxpayer must use the tax avoided cost method beginning with the re-computation year and throughout the updated test period. The taxpayer could resume using the book or regulatory interest capitalization method in the year following a three-year test period in which the taxpayer's book or regulatory method resulted in interest that exceeded interest determined under the avoided cost method, for each of the three-year retest periods.

If the IRS and Treasury allow taxpayers to follow their book or regulatory method of determining capitalized interest, we suggest updating Rev. Proc. 2016-29 to permit taxpayers to file an accounting method change request under the automatic procedures, to begin following their book or regulatory method to determine capitalized interest.

The government should make the method change procedures for changing to follow the book or regulatory method of capitalizing interest similar to the procedures for use of the historic absorption ratio under Treas. Reg. § 1.263A-2(b)(4). That is, we suggest that the government effect a method change using a cut-off method and make available automatic consent under Rev. Proc. 2016-29, where a taxpayer has not obtained the Commissioner's consent to revoke the historic absorption ratio election within its prior six taxable years.

The re-computation of capitalized interest for tax purposes under the avoided cost method during an updated test period, and the change from book or regulatory capitalized interest to interest computed for tax purposes under the avoided cost method due to the retest procedures and requirements, are not changes in accounting methods and thus should not require IRS consent or section 481(a) adjustments.

The IRS and Treasury should use the non-automatic procedures in Rev. Proc. 2015-13 to permit the revocation of the election to use the book or regulatory capitalization method with IRS consent.

Example 4 in the Appendix demonstrates the operation of a change to follow a taxpayer's book interest capitalization method for tax purposes.

C. Allow Use of Reasonable Methods to Allocate Capitalized Interest to Designated Property

Recommendations

To reduce the complexity and undue burden required to capitalize interest to each unit of designated property during the production period, the AICPA recommends modifying Treas. Reg. § 1.263A-9(a)(2) (and other regulations, as necessary) to provide that taxpayers may use any reasonable method, consistently applied, to allocate capitalized interest to units of designated property, including inventory property. The AICPA also recommends including examples of reasonable allocation methods as part of the regulations.

If the IRS and Treasury permit taxpayers to use reasonable methods to allocate capitalized interest to units of designated property, we recommend updating Rev. Proc. 2016-29 to allow taxpayers to file an accounting method change request under the automatic procedures to begin using a reasonable method. We suggest allowing the taxpayer to make this change with a section 481(a) adjustment and providing audit protection for prior years.

Analysis

As previously discussed, the avoided cost method requires taxpayers to determine capitalized interest during the production period of each unit of designated property. To implement this requirement in the avoided cost method, taxpayers must separately track the following items for each unit of designated property:

- Accumulated production expenditures;
- The traced debt amount;
- The excess expenditure amount;
- The amount of excess production expenditures allocable to related parties; and
- The production period for functionally related components of property.

Tracking these items for each unit of designated property is complex and administratively burdensome for the vast majority of taxpayers, especially those taxpayers with tens of thousands of units (or more) of designated property. These current tracking requirements operate as a disincentive for taxpayers to comply with the current interest capitalization rules and requirements. The interest capitalization rules should provide simplified procedures that are reasonable for allocating capitalized interest to units of designated property.

We also suggest including examples of reasonable allocation methods. One example of a reasonable allocation method includes a taxpayer allocating aggregate capitalized interest to units of designated property based on the taxpayer's costs capitalized to the property for financial reporting purposes. Specifically, interest is allocated based on a ratio of a taxpayer's relative unadjusted book basis of each asset partially or fully produced to the total unadjusted book basis of aggregate assets partially or fully produced during the year. In applying this method, taxpayers would use a reasonable method to determine the production period for the designated property to which the aggregate capitalized interest is allocable. One example of a reasonable method includes computing an average production period for the designated property. Allowing taxpayers to use such a reasonable method to determine capitalized interest will significantly reduce administrative burden with respect to tracking designated property and thereby encourage taxpayer compliance. Further, it will approximate the correct amount of capitalized interest under section 263A(f). See Example 5 in the Appendix illustrating this recommendation.

D. Modify the Simplified Inventory Method for Easier Application

Recommendations

The AICPA recommends that the IRS and Treasury modify the simplified inventory method for easier application by taxpayers. The AICPA proposes several modifications to the current rules.

First, for taxpayers otherwise using the simplified production method, the AICPA recommends modifying Treas. Reg. § 1.263A-9(g)(3) to permit the inclusion of interest expense in the simplified production method under Treas. Reg. § 1.263A-2(b).

Second, for taxpayers not using the simplified production method, the AICPA recommends modifying Treas. Reg. § 1.263A-9(g)(3) to permit the use of any reasonable method, consistently applied, to allocate capitalized interest to inventory constituting designated property.

Finally, the AICPA recommends allowing the application of the simplified inventory method to identify inventory costs related to property with a turnover period more frequently than once a year.

Analysis

Treasury Reg. § 1.263A-9(g)(3)(i) provides a simplified inventory method for calculating interest capitalized to inventory that constitutes designated property. Under this method, a taxpayer determines the beginning and ending inventory and cost of goods sold by applying all other capitalization provisions including, for example, the simplified production method of Treas. Reg. § 1.263A-2(b), but without regard to the capitalization of interest with respect to inventory.[38] A taxpayer must establish a separate capital asset in an amount equal to the aggregate interest capitalization amount.

The weighted average interest rate is compounded annually by the number of years assigned to a particular inventory segment to produce an interest factor (applicable interest factor) for that segment. The amounts determined by multiplying the value of each inventory segment by its applicable interest factor are combined to produce a tentative aggregate interest capitalization amount.

If the tentative aggregate interest capitalization amount for a year exceeds the aggregate interest capitalization amount as of the close of the preceding year, then, for purposes of applying the rules of Treas. Reg. § 1.263A-9(c)(7), the excess is treated as an excess expenditure amount and the inventory to which the simplified inventory method applies is treated as a single unit of designated property. If, after taking these modifications into account, no interest allocation under Treas. Reg. § 1.263A-9(c)(7) is necessary (i.e., the excess expenditure amounts for all units of designated property do not exceed the total amount of interest (including deferred interest) available for capitalization), the aggregate interest capitalization amount generally equals the tentative aggregate interest capitalization amount. If, however, an interest allocation under Treas. Reg. § 1.263A-9(c)(7) is necessary, the tentative aggregate interest capitalization amount is generally adjusted to reflect the results of that allocation (i.e., the increase in the aggregate interest capitalization amount is limited to the amount of interest allocated to inventory reduced, however, by any substitute costs that are capitalized with respect to inventory under applicable related party rules).

Under the simplified inventory method, increases in the aggregate interest capitalization amount from one year to the next are generally treated as reductions in interest expense, and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold.[39] In order to apply the simplified inventory method, taxpayers must separate total ending inventory into segments equal to the total ending inventory value divided by an inverse turnover rate.[40] The simplified method assigns each inventory segment an age starting with one year and increasing by one year for each additional segment. The inverse inventory turnover rate is determined by finding the average of the beginning and ending inventory, dividing the average by the cost of goods sold for the year, and rounding the result to the nearest whole number. Beginning and ending inventory amounts are determined using total current cost of inventory for the year (rather than carrying value).

The IRS and Treasury should modify the simplified inventory method for easier application by taxpayers. Taxpayers who produce inventory property that takes longer than 24 months to produce are required to capitalize interest expense to the property produced. These taxpayers are required to use a reasonable facts and circumstances method to determine how much capitalized interest to allocate to each item of property produced and may not use the simplified production method, even if they otherwise use such method to allocate the balance of their additional section 263A costs.

[38] *Id*.
[39] Treas. Reg. § 1.263A-9(g)(3)(i).
[40] Treas. Reg. § 1.263A-9(g)(3)(ii)(A).

Moreover, the IRS interprets the requirement to use a reasonable allocation method for capitalized interest as requiring a taxpayer to physically track the holding period of each individual item of inventory and allocate a specific amount of capitalized interest to each item based on that item's own separate holding period.

As an alternative, a simplified inventory method in Treas. Reg. § 1.263A-9(g)(3) is used to allocate interest to inventory constituting designated property. However, to use the simplified inventory method, a taxpayer's total inventory must turn over less frequently than once per year. For many taxpayers, although individual items of inventory may take longer than 24 months to produce, the taxpayer's total inventory typically turns over more frequently than once a year. In this case, the simplified inventory method is not permissible. Moreover, for taxpayers that are permitted to elect the simplified inventory method, the simplified inventory method operates in a manner that is inconsistent with the LIFO method, whereas most taxpayers with aged inventory use the LIFO method.

We suggest modifying Treas. Reg. § 1.263A-9(g)(3) to permit the inclusion of interest expense in the simplified production method under Treas. Reg. § 1.263A-2(b). Allowing taxpayers to include interest as an additional section 263A cost in the simplified production method would, similar to other costs allocated under the method, approximate the correct amount of additional costs allocable to ending inventories at year-end.

We also suggest modifying Treas. Reg. § 1.263A-9(g)(3) to permit the use of any reasonable method, consistently applied, to allocate capitalized interest to inventory constituting designated property. A reasonable method may include allowing taxpayers to compute capitalized interest by aggregating the current-year cost of all inventory items that are subject to interest capitalization based on the length of the production period. In applying this method, taxpayers would use a reasonable method to determine the production period for the inventory units to which the capitalized interest is allocable. An example of a reasonable method would include computing an average turnover period or holding period of the aggregate inventory. Allowing taxpayers to use the reasonable method to determine capitalized interest will significantly reduce administrative burden of tracking inventory units constituting designated property and thereby encourage taxpayer compliance. Further, it would approximate the correct amount of capitalized interest under section 263A(f). An example of this reasonable method is provided as Example 6 in the Appendix.

Taxpayers using the LIFO method to value inventory should apply LIFO cost flow to determine capitalized interest, rather than FIFO cost flow. The current requirement to use FIFO cost flow in determining capitalized interest creates a mismatch of income and expense for LIFO taxpayers, does not clearly reflect income, and is not administrable for LIFO taxpayers.

Also, the IRS and Treasury should allow application of the simplified inventory method to inventory property with a turnover period more frequently than once a year. In this case, the simplified inventory method is permissible for inventory property meeting the long-term tangible property rules in Treas. Reg. § 1.263A-8(b)(1).

E. Allow Taxpayers to Elect Not to Apply the *De Minimis* Rule for Designated Property

Recommendations

The AICPA recommends that Treasury and the IRS modify Treas. Reg. § 1.263A-8(b)(4) to permit taxpayers to make an affirmative election to treat such property as designated property.

To effect this modification, we recommend adding a new subparagraph (iii) to Treas. Reg. § 1.263A-8(b)(4) as follows:

> (iii) A taxpayer may elect not to apply the *de minimis* rule on a taxpayer's timely filed return. The election applies to all property produced by the taxpayer. The election establishes a method of accounting and is revocable only with consent of the Commissioner under section 446(e).

Analysis

Treasury Reg. § 1.263A-8(b)(4) provides that designated property does not include property for which the production period does not exceed 90 days and the total production expenditures do not exceed $1,000,000 divided by the number of days in the production period.[41] Property meeting this exception is excluded from the interest capitalization rules.

The requirement to apply the *de minimis* safe harbor under Treas. Reg. § 1.263A-8(b)(4) creates administrative complexities for taxpayers with numerous units of property. For these taxpayers, overcapitalization of interest may outweigh the administrative burden of tracking whether each unit of designated property satisfies the *de minimis* exclusion. Providing taxpayers the ability to affirmatively elect out of the *de minimis* rule and treat all property as designated property subject to interest capitalization will provide administrative relief to such taxpayers without reducing the interest required for capitalization under section 263A(f). The regulations could provide that the election is made on the taxpayer's timely filed return and applies to all property produced by the taxpayer. Also, the regulations could provide that the election establishes a method of accounting that is revocable only with the automatic consent of the Commissioner under section 446(e).

F. Allow All Taxpayers to the Use External Rate in Lieu of the Weighted Average Interest Rate

Recommendations

The AICPA recommends that the IRS and Treasury permit all taxpayers to make the election to use the AFR + three method. To effect this change, the AICPA recommends that the IRS and Treasury strike the term "eligible" in Treas. Reg. § 1.263A-9(e)(1) and strike Treas. Reg. § 1.263A-9(e)(2) in total.

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[41] Treas. Reg. § 1.263A-8(b)(4)(i).

Analysis

Under Treas. Reg. § 1.263A-9(e), eligible taxpayers may elect to use the highest AFR under section 1274 in effect during the computation period plus three percentage points (AFR + three) as a substitute for the weighted average interest rate. Taxpayers make the election to use the AFR + three method by using the AFR + three as the weighted average interest rate.[42] Eligible taxpayers are those taxpayers with average annual gross receipts for the three previous taxable years not exceeding $10 million (the $10 million gross receipts test) where the taxpayers met the gross receipts test for all prior taxable years beginning after December 31, 1994.

The IRS and Treasury should permit all taxpayers to make the election to use the AFR + three method. All taxpayers should have the access to the simplification provided by this election. In the majority of cases, the AFR + three method results in an interest rate that is higher than a taxpayer's weighted average interest rate.

G. Provide the Election Not to Trace Debt is First Made in the Year Traced Debt is First Incurred

Recommendations

The AICPA recommends that the IRS and Treasury modify Treas. Reg. § 1.263A-9(d)(1) to provide that in, or subsequent to, the first year a taxpayer has traced debt, the taxpayer may elect not to trace debt and instead treat all debt as non-traced debt for purposes of computing the weighted average interest rate.

Additionally, Treas. Reg. § 1.263A-9(d)(1) should provide that once a method not to trace debt is established, a revocation of that election is considered a change in method of accounting requiring the consent of the Commissioner under section 446(e).

Analysis

Under Treas. Reg. § 1.263A-9(d)(1), taxpayers may elect not to trace debt and determine average excess expenditures and the weighted average interest rate by treating all eligible debt as non-traced debt. The election not to trace debt is a method of accounting that applies to the determination of capitalized interest for all designated property of the taxpayer. The making or revocation of the election is a change in method of accounting requiring the consent of the Commissioner under section 446(e).

In many cases, taxpayers may have only non-traced debt in a tax year in which they produce designated property and are subject to the interest capitalization rules. However, they may incur traced debt in the future.

[42] Any change to or from the use of the AFR + three method is a change in method of accounting requiring the consent of the Commissioner under section 446(e). Treas. Treas. Reg. § 1.263A-9(e)(1). All changes to or from the AFR + three method are currently effected on a cut-off basis. *Id.*

If a taxpayer requests a method change to appropriately apply the avoided cost method to designated property at a time when the taxpayer has only non-traced debt, the taxpayer must elect in such method change not to trace future debt or risk having to file another method change request in the future when the taxpayer has traced debt (should the taxpayer not want to trace future debt).

Taxpayers cannot analyze the impact of tracing debt versus not tracing debt until the interest rate on traced debt is known. Thus, the making of an election not to trace debt is a change in method which places taxpayers in the precarious position of having to make the election (should they not want to file another method change request) prior to having information sufficient to analyze the economic effect of the election.[43]

The IRS and Treasury should modify Treas. Reg. § 1.263A-9(d)(1) to provide that in, or subsequent to, the first year a taxpayer has traced debt, the taxpayer may elect not to trace debt and instead treat all debt as non-traced debt for purposes of computing the weighted average interest rate. Making this election should establish a method of accounting, rather than effecting a change in method of accounting as provided in Treas. Reg. § 1.263A-9(d)(1).

Taxpayers should have the option to make the election for, or in a year subsequent to, the year the traced debt is first incurred, by treating the debt as non-traced debt in the computation of the weighted average interest rate. This update is necessary to treat taxpayers fairly and prevents taxpayers from having to decide the treatment of items prior to having the information necessary to analyze the economic impact of such items.

Additionally, Treas. Reg. § 1.263A-9(d)(1) should provide that once a method not to trace debt is established, a revocation of that election is a change in method of accounting requiring the consent of the Commissioner under section 446(e).

H. Modify Rev. Proc. 2016-29, Section 12.14, to allow Taxpayers to Implement all Interest Capitalization Method Changes, a Section 481(a) Adjustment and Audit Protection with IRS Deemed Consent.

Recommendations

The AICPA recommends that the IRS and Treasury modify Rev. Proc. 2016-29 to make all changes in method of accounting for interest capitalization eligible for IRS automatic consent, including where taxpayers capitalize some interest for tax but use a method other than the avoided cost method.

The AICPA recommends that the IRS and Treasury provide that flow-through entities can elect in the new automatic procedures to effect interest capitalization method changes on a cut-off basis.[44]

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[43] In some cases, interest on traced debt may result in less capitalized interest than if the debt is treated as non-traced debt.

[44] We note that taxpayers have the option to effect accounting method changes with section 481(a) adjustments or using a cut-off basis for certain items, such as relating to changes for rolling-average cost method changes. See Rev. Proc. 2015-14, section 21.14(2).

Also, the AICPA recommends that the IRS and Treasury permit a taxpayer to make a change to follow its book or regulatory interest capitalization method using the automatic consent procedures of Rev. Procs. 2015-13 and 2016-29 using the cut-off method.

Analysis

1. General Accounting Method Change Procedure

Section 446(e) generally provides that a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes income in keeping the taxpayer's books shall, before computing taxable income under the new method, secure the consent of the United States Secretary of the Treasury ("Secretary").

Under Treas. Reg. § 1.446-1(e)(3)(i), when securing the consent for a change in method of accounting from the IRS, taxpayers must generally file a Form 3115, *Application for Change in Accounting Method*, with the IRS during the tax year in which the taxpayer desires to make the method change.

Further, Treas. Reg. § 1.446-1(e)(3)(ii) provides that the IRS may prescribe administrative procedures under which taxpayers are permitted to change their method of accounting. The terms and conditions that the IRS may prescribe may require taxpayers to effect the change in method of accounting on a cut-off basis or by an adjustment under section 481(a) that is taken into account in the taxable year or years prescribed by the IRS.

Section 481 provides rules for adjustments required by changes in method of accounting. It generally provides that in computing a taxpayer's taxable income for the year of a change in method of accounting, "there shall be taken into account those adjustments, which are determined to be necessary, solely by reason of the change, in order to prevent amounts from being duplicated or omitted.[45]"

In Rev. Proc. 2015-13, the IRS provides rules for effecting accounting method changes using a cut-off method. The IRS may determine that certain changes in methods of accounting are made without a section 481(a) adjustment (i.e., on a cut-off basis). When a change in method of accounting is made on a cut-off basis, generally only the items arising on or after the beginning of the year of change, or other operative date, are accounted for under the method of accounting for which consent is granted. Any items arising before the year of change, or other operative date, are accounted for under the taxpayer's former method of accounting.

The revenue procedure states that because no items are duplicated or omitted from income when using a cut-off method to effect a change in accounting method, then no section 481(a) adjustment is necessary. Rev. Procs. 2015-13 and 2016-29 provide the current administrative procedures for making accounting method change procedures.

Specifically, Rev. Proc. 2015-13 provides updates and revises the general procedures under section 446(e) to obtain IRS consent to change a method of accounting for federal income tax purposes. The revenue procedure provides the general procedures to obtain the advance

[45] Section 481(a).

consent of the IRS to change a method of accounting, as well as the procedures to obtain the automatic consent of the IRS to change a method of accounting described in Rev. Proc. 2016-29, which provides a list of method changes to which the automatic consent procedures apply.

2. Interest Capitalization Method Change Procedures

The IRS and Treasury recently issued Rev. Proc. 2016-29.[46] Rev. Proc. 2016-29 adds new section 12.14 that provides for automatic IRS consent for a taxpayer that wants to change its method of accounting from not capitalizing interest or capitalizing interest under its book method of accounting to capitalizing interest under section 263A(f). In order to effect the changes under section 12.14, taxpayers must make certain representations, including a representation that the taxpayer's method is in accordance with the avoided cost method under Treas. Reg. § 1.263A-9. Changes under section 12.14 are effected with a section 481(a) adjustment and with audit protection for prior years.

Additionally, Notice 88-99 provides for a standalone automatic change procedure to change from the deferred asset method to the substitute cost method and vice versa.[47]

Further, although most changes for interest capitalization are effected with a section 481(a) adjustment, certain changes for interest capitalization currently are effected on a cut-off basis, such as (1) a change from the deferred asset method to substitute cost method or vice versa,[48] and (2) a change to or from the AFR + three method under Treas. Reg. § 1.263A-9(e)(1).

Notably, section 12.14 of Rev. Proc. 2016-29 does not cover accounting method changes where a taxpayer is currently capitalizing some interest for tax purposes under a method that is different than its book method. In order for the IRS to facilitate its voluntary compliance policy for accounting method changes (i.e., carrot and stick approach), it needs to provide an incentive for taxpayers to initiate method changes. Providing automatic consent procedures, a section 481(a) adjustment, and audit protection for interest capitalization method changes where the taxpayer is currently capitalizing some interest for tax but using an incorrect method, would create such an incentive.

The new requirement in section 12.14 for taxpayers to represent that the taxpayer's method is in accordance with the avoided cost method under Treas. Reg. § 1.263A-9 will ensure that the requirements of all tax interest capitalization regulations are followed appropriately, and taxpayers are not effecting accounting method changes with only favorable numeric results. Additionally, the IRS and Treasury should implement interest capitalization method changes with a section 481(a) adjustment and audit protection for prior years.

In general, taxpayers should implement accounting method changes in order to comply with the interest capitalization rules (including, for example, changes to or from the deferred asset or substitute cost method and the AFR + three method) with a section 481(a) adjustment and also receive audit protection. Providing for a section 481(a) adjustment will prevent the significant deferred recovery of differences in capitalized amounts under the various methods

[46] Issued May 5, 2016.
[47] See Notice 88-99, section IX(C). The change is made using the cut-off method. *Id*.
[48] *Id.*

due to the extended recovery period of designated property, which may arise by implementing changes on the cut-off method.

In the case of interest capitalization method changes for flow-through entities, however, taxpayers should have the option to elect to implement changes on a cut-off basis for ease in administering the flow-through rules.

IV. CONCLUSION

The current regulatory regime for determining capitalized interest under section 263A(f) is complex and administratively burdensome. In order to alleviate the complexity and administrative burden, the AICPA recommends that the IRS and Treasury:

- Issue proposed regulations with rules covering related parties and flow-through entities, and ensure that the concepts in Notice 88-99 are clarified and made consistent with the final regulations;

- Add simplifying elections to the regulations (such as an election to follow a taxpayer's method for capitalizing interest for financial or regulatory reporting to the extent the capitalization equals or exceeds capitalization amount under the avoided cost method);

- Modify the regulations to allow taxpayers to use reasonable methods to allocate interest to units, including inventory;

- Modify the regulations to allow taxpayers to include interest as an allocable cost in the simplified production method calculation for computing capitalized inventories;

- Allow all taxpayers to elect to use the applicable federal rate plus three percentage points in lieu of the weighted average interest rate.

- Modify Rev. Proc. 2016-29 (or its successor) to provide automatic consent for all method changes to comply with section 263A(f), including generally with a section 481(a) adjustment and audit protection for prior years; provide flow-through entities the option to elect to effect interest capitalization method changes on a cut-off basis; and provide for changes to follow the book or regulatory interest capitalization method using the cut-off method as discussed above; and

- Modify the regulations with respect to the elections and other items as discussed herein.

The AICPA is confident that implementing our recommendations will make the current regulatory framework more administrable for capitalizing interest under section 263A(f), clearly reflect income, and reduce controversies between taxpayers and the IRS.

V. APPENDIX

For the consideration of the IRS and Treasury, we offer the following examples demonstrating the application of the AICPA's recommendations outlined above.

Example 1

The following example demonstrates the computation of average excess production expenditures accounted for by related parties as required under Treas. Reg. § 1.263A-9(c)(7)(ii) on an aggregate unit basis (see Section III.A. of the comments).

Excess production expenditures allocable to related parties

Taxpayer is engaged in a business in which it constructs designated property. Taxpayer is a C corporation and wholly owned subsidiary in Parent company's U.S. consolidated group. Parent is a holding company and engages in no production of designated property. There are no entities other than Taxpayer and Parent in the consolidated group. During 2014, Taxpayer incurred $200,000 of accumulated production expenditures to construct two units of designated property (units A and B). Taxpayer's units are not functionally interdependent under Treas. Reg. § 1.263A-10(b). Taxpayer has traced debt and some non-traced debt and a weighted average interest rate of 10 percent. Taxpayer uses an annual computation period and quarterly measurement dates.

At each quarterly measurement date during 2014, Taxpayer had the following total amount of accumulated production expenditures with respect to units A and B in excess of its traced debt:

Quarter 1	$ 50,000;
Quarter 2	$100,000;
Quarter 3	$150,000; and
Quarter 4	$200,000.

Under Treas. Reg. § 1.263A-9(c)(5)(ii), Taxpayer's average excess production expenditures for both units is $125,000 (i.e., the sum of ($50,000 + $100,000 + $150,000 + $200,000) divided by 4). Taxpayer's total excess expenditure amount (EEA) for units A and B as determined under Treas. Reg. § 1.263A-9(c)(1) is $12,500 (i.e., $125,000 multiplied by Taxpayer's 10 percent weighted average interest rate).

For the 2014 computation period, assume that Taxpayer's total EEA exceeds the interest allocated to units A and B under Treas. Reg. § 1.263A-9(c)(7)(i), by $10,000. Thus, for 2014, the amount of average excess production expenditures that is taken into account by Parent with respect to units A and B is $100,000 (i.e., the quotient of $10,000 divided by the 10 percent weighted average interest rate). See Treas. Reg. § 1.263A-9(c)(7)(ii).

Example 2

The following example demonstrates the computation of the deferred asset method under Notice 88-99 using a reasonable method to allocate capitalized interest to units of designated property (see Section III.A. of the comments).

Deferred asset method computed using a reasonable allocation method

Assume the same facts as *Example 1* in addition to the following facts:

During 2014, Parent has only non-traced debt and a weighted average interest rate of 10 percent. Parent has no average excess expenditures other than the $100,000 it must take into account with respect to units A and B under Treas. Reg. § 1.263A-9(c)(7)(ii).

The production period for both units A and B is four quarters. After production, the relative unadjusted book basis of unit A is $125,000 and the relative unadjusted book basis of unit B is $50,000. The difference between the $200,000 of accumulated production expenditures for tax purposes and the relative unadjusted book basis of units A and B of $175,000 is the additional section 263A costs which are included in APEs under Treas. Reg. § 1.263A-11(a).

Parent does not elect on behalf of Taxpayer to use the substitute cost method under Notice 88-99. Therefore, Parent must use the deferred asset method to compute capitalized interest on the excess expenditures for units A and B.

Parent, using a reasonable allocation method under modified Treas. Reg. § 1.263A-9(a)(2) as proposed, applies the deferred asset method on an aggregate rather than per unit basis. Parent's aggregate capitalized interest for units A and B is $10,000 (i.e., $100,000 multiplied by 10 percent weighted average interest rate). Parent's capitalized interest allocable to unit A is $7,143 (i.e., $10,000 multiplied by the fraction of ($125,000/$175,000)). Parent's capitalized interest allocable to unit B is $2,857 (i.e., $10,000 multiplied by the fraction of ($50,000/$175,000)). Parent capitalizes these amounts as deferred assets and recovers them in the same manner Taxpayer would have accounted for the capitalized interest had the interest been capitalized into the basis of the units on the Taxpayer's books and records.

Example 3

The following example demonstrates the computation of the substitute cost method under Notice 88-99 using a reasonable method to allocate capitalized interest to units of designated property (see Section III.A. of the comments).

Substitute cost method computed using a reasonable allocation method

The facts of Example 3 are similar to those of Examples 1 and 2 but with certain modifications to reflect the application of the substitute cost method on an aggregate unit basis. Taxpayer is engaged in a business in which it constructs designated property. Taxpayer is a C corporation and wholly owned subsidiary in Parent company's U.S. consolidated group. Parent is a holding company and engages in no production of designated property. There are no entities other than Taxpayer and Parent in the consolidated group.

During 2014, Taxpayer incurred accumulated production expenditures to construct two units of designated property (units A and B). Taxpayer's units are not functionally interdependent under Treas. Reg. § 1.263A-10(b). Taxpayer has traced debt, and some non-traced debt. Taxpayer uses an annual computation period and quarterly measurement dates. The production period for both units A and B is four quarters. After production, the relative unadjusted book basis of unit A is $1,000,000 and the relative unadjusted book basis of unit B is $2,000,000. Taxpayer's average balance of total remaining production expenditures for units A and B (i.e., the excess of Taxpayer's production expenditures over the actual balances of taxpayer's traced and avoided cost debt) is $4,000,000. See Notice 88-99, section IX(B)(2). Taxpayer's average applicable federal long-term rate for the period is 5 percent.

Parent elects on behalf of Taxpayer to use the substitute cost method under Notice 88-99. Taxpayer, using a reasonable allocation method under modified Treas. Reg. § 1.263A-9(a)(2) as proposed, applies the substitute cost method on an aggregate rather than per unit basis. Thus, the amount of Taxpayer's substitute costs that are capitalized in the aggregate to units A and B is $200,000 (i.e., $4,000,000 multiplied by 5 percent average applicable federal long-term rate). Taxpayer's capitalized interest allocable to unit A is $66,667 (i.e., $200,000 multiplied by the fraction of ($1,000,000/$3,000,000)). Taxpayer's capitalized interest allocable to unit B is $133,333 (i.e., $200,000 multiplied by the fraction of ($2,000,000/$3,000,000)). Taxpayer capitalizes the substitute costs with respect to units A and B and includes them in their bases for capitalization and recovery.

Example 4

The following example demonstrates changing from the avoided cost method to using the book interest capitalization method for section 263A purposes (see Section III.B of the comments). The example applies to changes to use the regulatory accounting method for determining capitalized interest as well.

4A – Taxpayer constructs designated property under Treas. Reg. § 1.263A-8(b)

In order to obtain the administrative ease of book / tax conformity, Taxpayer changes from the avoided cost method to use its book interest capitalization method for purposes of section 263A for tax year 2016. Taxpayer had the following amounts of interest capitalized for book purposes, and also capitalized for tax under the avoided cost method in Treas. Reg. § 1.263A-9(a)(1), in the test period:

2013:	
Interest Capitalized Under Book Method	$10,000,000
Interest Capitalized Under Tax Avoided Cost Method	$ 8,000,000
2014:	
Interest Capitalized Under Book Method	$10,000,000
Interest Capitalized Under Tax Avoided Cost Method	$ 8,000,000
2015:	
Interest Capitalized Under Book Method	$10,000,000
Interest Capitalized Under Tax Avoided Cost Method	$ 8,000,000

Since, in each year of the three-year test period, Taxpayer's capitalized interest using its book method resulted in more capitalized interest than is computed under the avoided cost method, Taxpayer may change to use the book capitalization method for 2016 (the year after the test period). Taxpayer continues to use its book interest capitalization method through 2020.

4B – Taxpayer's qualifying period ends with the close of its 2020 taxable year

The taxable year 2021 is a re-computation year in which Taxpayer must compute its capitalized interest under the tax avoided cost method in Treas. Reg. § 1.263A-9(a)(1). Taxpayer determines its interest capitalized under the avoided cost method for 2021 is $12,000,000, whereas the interest capitalized under its book capitalization method is $14,000,000. Since the capitalized interest for book purposes is greater than that capitalized for the tax avoided cost method, Taxpayer must continue to use its book interest capitalization method throughout an extended qualifying period, 2021 through 2026 (the re-computation year and the following five taxable years).

4C – Taxpayer's interest capitalized under avoided cost method is greater than book

If, instead, Taxpayer's interest computed under the tax avoided cost method for 2021 was $15,000,000 (i.e., more than the $14,000,000 interest capitalized for book purposes), then Taxpayer's qualifying period would end and Taxpayer is required to compute capitalized interest under the tax avoided cost method until the year following a new three-year test period in which Taxpayer's book method resulted in capitalized interest that exceeded interest determined under the avoided cost method, for each year of the new three-year test period.

Example 5

The following example demonstrates the application of a reasonable method to allocate capitalized interest to units of designated property that is not inventory (see Section III.C. of the comments).

Reasonable allocation method

Taxpayer is engaged in a business in which it constructs designated property. Taxpayer is not a member of a consolidated group or tiered partnership structure. During 2014, Taxpayer incurred $10,000,000,000 of accumulated production expenditures in order to construct 50,000 units of designated property. Taxpayer's units are not functionally interdependent under Treas. Reg. § 1.263A-10(b). Taxpayer has only non-traced debt and a weighted average interest rate of 10 percent. Taxpayer's production expenditures are less than its non-traced debt. Taxpayer uses an annual computation period and quarterly measurement dates. Using sampling, Taxpayer determines that the average production period for all units of designated property is four quarters. After production, Taxpayer's relative unadjusted book basis of unit A is $175,000 and Taxpayer's relative unadjusted book basis of all units is $9,000,000,000. The difference in the accumulated production expenditures of $10,000,000,000 and the Taxpayer's relative unadjusted book basis of all units of $9,000,000,000 is the additional section 263A costs included in APEs under Treas. Reg. § 1.263A-11(a).

Under modified Treas. Reg. § 1.263A-9(a)(2) as proposed, Taxpayer uses a reasonable allocation method to determine the amount of interest allocable to unit A. Taxpayer's average excess production expenditures are $2,500,000,000 (i.e., $10,000,000,000 divided by 4). Taxpayer's aggregate capitalized interest is $250,000,000 (i.e., $2,500,000,000 multiplied by 10 percent). Taxpayer's capitalized interest allocable to unit A is $4,861 (i.e., $250,000,000 multiplied by the fraction of ($175,000/$9,000,000,000)). Taxpayer's capitalized interest allocable to each remaining unit is each remaining unit's relative unadjusted book basis divided by the total relative unadjusted book basis of all units.

Example 6

The following example demonstrates the application of a reasonable method to allocate capitalized interest to units of designated property that is inventory (see Section III.D. of the comments).

Allocation of capitalized interest to units of inventory using a reasonable method

Taxpayer is engaged in a business in which it produces inventory constituting designated property since it is tangible property with an estimated production period exceeding two years under Treas. Reg. § 1.263A-8(b)(1). Taxpayer is not a member of a consolidated group or tiered partnership structure. During 2014, Taxpayer incurred $10,000,000 of accumulated production expenditures to produce and complete 10,000 units of inventory. Taxpayer's units are not functionally interdependent under Treas. Reg. § 1.263A-10(b). Taxpayer has only non-traced debt and a weighted average interest rate of 10 percent. Taxpayer's production expenditures are less than its non-traced debt. Taxpayer uses an annual computation period and quarterly measurement dates. Using sampling, Taxpayer determines that the average turnover period for its inventory is four times annually.

Under modified Treas. Reg. § 1.263A-9(a)(2) as proposed, Taxpayer uses a reasonable allocation method to determine the amount of interest allocable to inventory units. Taxpayer's average excess production expenditures are $2,500,000 (i.e., $10,000,000 divided by 4). Taxpayer's aggregate capitalized interest to all items of inventory is $250,000 (i.e., $2,500,000 multiplied by 10 percent). Taxpayer's capitalized interest allocable to each item of inventory produced in 2014 is $25 (i.e., $250,000 divided by 10,000 inventory units).

Applying the reasonable turnover method, Taxpayer has 2,500 units of inventory on hand at the end of 2014 (i.e., 10,000 units produced for the year multiplied by the fraction of 1/4). Interest capitalized to inventory units on hand at the end of 2014 is $62,500 (i.e., $25 multiplied by 2,500 inventory units on hand at the end of 2014). The remaining amount capitalized interest (i.e., $187,500) is capitalized to Taxpayer's inventory but allocable to cost of goods sold throughout 2014.