

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
October 25, 1999

Number: **200009004**
Release Date: 3/3/2000
Index (UIL) No.: 263A.09-00; 263A.09-02
CASE MIS No.: TAM-113231-99/CC:DOM:IT&A:B7

Chief, Examination

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

X =

B =

C =

D =

E =

F =

ISSUES:

1. Do bank customer deposit account arrangements constitute debt for purposes of section 263A(f) of the Internal Revenue Code and section 1.263A-9 of the Income Tax Regulations?
2. Is the taxpayer required to capitalize any interest in connection with expenditures it made for the production of its office facility?

CONCLUSION:

1. Bank customer deposit account arrangements fall within the scope of "eligible debt", as defined in section 1.263A-9(a)(4), and are therefore subject to application of the interest capitalization rules of section 263A(f) and section 1.263A-9.
2. The taxpayer, as a producer of property of a type subject to the requirements of section 263A(f) and section 1.263A-8, must capitalize production period interest allocable to expenditures it made for its office facility. The taxpayer must incorporate its

TAM-113231-99

debt, which includes customer deposit accounts, and associated interest into the calculations required under the avoided cost method prescribed by section 1.263A-9 to determine the amount of interest which has to be capitalized.

FACTS:

The taxpayer, X, is a banking corporation that uses an accrual method of accounting and files a return on a fiscal-year basis.

X hired an unrelated contractor to construct a new main office facility for it at a cost of approximately B. Construction took place during the period from C to D. X made periodic progress payments to the contractor throughout the construction period.

X did not obtain a separate loan to cover the cost of construction. Instead, all construction payments were made out of funds provided through the normal operation of its banking business. Customer deposit accounts were the primary source of operating funds. Interest payments were made to customers on these accounts, which included a variety of Demand, Savings and other Time Deposit arrangements.

In its tax returns for the fiscal years ending E and F, each of which included a portion of the construction period, X did not capitalize any interest associated with construction expenditures as a cost of the property constructed.

LAW AND ANALYSIS:

Section 263A(a) provides that in the case of any property to which section 263A applies, the direct costs of such property and the property's proper share of indirect costs (including taxes) part or all of which are allocable to such property shall be capitalized.

Section 263A(b)(1) provides that section 263A applies to real or tangible personal property produced by the taxpayer.

Section 263A(f)(1) provides that capitalization is required only for interest costs which are paid or incurred during the production period and allocable to real or certain tangible personal property produced by the taxpayer.

Section 263A(f)(2) provides that in determining the amount of interest required to be capitalized with respect to any property, interest on any indebtedness directly attributable to production expenditures with respect to such property shall be assigned to such property, and interest on any other indebtedness shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures (not attributable to indebtedness directly attributable to production expenditures) had not been incurred.

TAM-113231-99

Section 1.263A-8(a)(1) provides that capitalization of interest under the avoided cost method described in section 1.263A-9 is required with respect to the production of designated property.

Section 1.263A-8(a)(2) provides that interest that is capitalized is treated as a cost of the designated property and is recovered in accordance with section 1.263A-1(c)(4), which provides for recovery through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service or otherwise disposed of by the taxpayer.

Section 1.263A-8(b)(1) provides that designated property is property that is produced and that is either real property or certain types of tangible personal property.

Section 1.263A-8(c)(1) provides that real property includes land, unsevered natural products of land, buildings, and inherently permanent structures.

Section 1.263A-8(d)(2) provides that a taxpayer is treated as producing any property that is produced for the taxpayer by another party under a contract with the taxpayer or an intermediary.

Section 1.263A-9 describes the “avoided cost method” which must be used to calculate the amount of interest required to be capitalized under section 263A(f).

Section 1.263A-9(a)(1) provides that generally any interest that the taxpayer theoretically would have avoided if accumulated production expenditures had been used to repay or reduce outstanding debt must be capitalized under the avoided cost method. The application of the avoided cost method does not depend on whether the taxpayer actually would have used the amounts expended for production to repay or reduce debt. Instead, the avoided cost method is based on the assumption that debt of the taxpayer would have been repaid or reduced without regard to the taxpayer’s subjective intentions or to restrictions (including legal, regulatory, contractual or other restrictions) against repayment or use of the debt proceeds.

Section 1.263A-9(a)(2) provides that the avoided cost method requires the capitalization of the “traced debt amount” and the “excess expenditure amount” for each taxable year or shorter computation period that includes the production period.

Section 1.263A-9(a)(4) provides that “eligible debt” includes all outstanding debt (as evidenced by a contract, bond, debenture, note, certificate, or other evidence of indebtedness). Certain limited exclusions are prescribed.

Section 1.263A-9(b) provides that the “traced debt amount” is equal to the total interest incurred on outstanding “eligible debt” that is allocated to accumulated production expenditures.

TAM-113231-99

Section 1.263A-9(c) provides that the “excess expenditure amount” for a computation period equals the product of the average excess expenditures (the average amount by which accumulated production expenditures exceed traced debt at each measurement date during the computation period) by the weighted average interest rate (determined by dividing interest incurred on nontraced debt during the period by average nontraced debt for the period). Nontraced debt means all “eligible debt” on a measurement date other than any debt that is treated as traced debt.

Section 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.

The issue presented here is whether X’s customer deposit account arrangements constitute debt for purposes of section 263A(f) and section 1.263A-9. If so, interest paid or incurred during the production period which is deemed to be attributable to expenditures for the production of designated property would have to be capitalized.

The Internal Revenue Code and the Income Tax Regulations do not contain any provision which excludes banks from the capitalization requirements of section 263A. Section 263A(f) and section 1.263A-9, which provide rules for the allocation of interest to the cost of property produced by a taxpayer, make no provision for the exclusion of bank customer deposit arrangements from treatment as debt which is subject to application of the interest capitalization rules. “Eligible debt” is broadly defined in section 1.263A-9(a)(4) to include all outstanding debt, as evidenced by a contract, bond, debenture, note, certificate, or other evidence of indebtedness. Section 1.263A-9(a)(4) goes on to list certain types of debt which are not treated as eligible debt; however, bank customer deposit arrangements do not fall within the scope of any of the specified exclusions.

X’s customer deposit account arrangements qualify as a certificate or other evidence of indebtedness, and thus constitute eligible debt. This conclusion is supported by the treatment of bank deposit arrangements as other evidence of indebtedness elsewhere in the Code and Regulations. “Other evidence of indebtedness”, a term which appears in the section 1.263A-9(a)(4) definition of “eligible debt”, was defined in section 1.1275-1(d) to include certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks. Certificates of deposit are included in the definition of indebtedness in section 1275(a)(1)(A) and section 1.1275-1(d), which define a debt instrument as a bond, debenture, note, or certificate or other evidence of indebtedness, as well as any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including a certificate of deposit or a loan).

The determination that bank customer deposit account arrangements constitute

TAM-113231-99

indebtedness for purposes of the interest capitalization rules is further supported by their treatment as debt under other provisions of the Code and Regulations which deal with interest expense. First, interest paid or accrued on customer deposit accounts is deductible as interest on indebtedness under section 163(a). Specifically, section 1.163-1(c) provides that in the case of banks and loan or trust companies, interest paid within the year on deposits, such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company, may be deducted from gross income. Second, section 6049(b)(1)(B), dealing with returns regarding payments of interest, defines interest to include interest on deposits with persons carrying on the banking business. Third, interest has been defined in sections 265(b)(4)(A) and 291(e)(1)(B)(iii), dealing with interest on debt incurred to carry tax exempt obligations, to include amounts (whether or not designated as interest) paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares.

These provisions clearly indicate that bank customer deposit arrangements are treated as debt under the Code and Regulations, with the interest thereon to be accounted for accordingly. Thus, not only is the language of section 1.263A-9(a)(4), which defines “eligible debt” for purposes of interest capitalization, broad enough to encompass bank customer deposit arrangements by its terms, but consistency with other Code and Regulation provisions points to this as the correct result. Thus, X’s customer deposit accounts are “eligible debt”, subject to application of the rules of section 1.263A-9.

X would be deemed under section 1.263A-8(d)(2) to be the producer of its office facility, since the property was produced for X under contract with another party, the contractor. As a producer of property of a type designated in section 1.263A-8 as being subject to the interest capitalization requirements, section 263A(f) and section 1.263A-9 require X to capitalize production period interest allocable to the property produced, which is to be calculated by application of the avoided cost method. Pursuant to sections 1.263A-9(a)(1) and 1.263A-9(g)(4), the avoided cost method is to be strictly applied, without regard to X’s subjective intentions, restrictions (including legal, regulatory, contractual, or other restrictions) against repayment or use of the debt proceeds, or any financial or regulatory accounting principles for the capitalization of interest.

Section 1.263A-9(a)(2)(i) requires that X must capitalize interest to the extent of its “traced debt amount” and “excess expenditure amount” relative to the property produced. X has no “traced debt amount”, as it incurred no debt specifically allocable to accumulated production expenditures. However, X must calculate and capitalize its “excess expenditure amount”, which in this case would be the amount of interest it computes under section 1.263A-9(c) by multiplying its average accumulated production expenditures by its weighted average interest rate, as prescribed for the computation period. The applicable interest rate would be based on X’s average nontraced debt,

TAM-113231-99

which has to include the amount of its customer deposit accounts.

A bank's customer deposit account arrangements constitute debt which is subject to the interest capitalization requirements of section 263A(f) and section 1.263A-9.

CAVEATS:

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