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Memorandum**

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subject: Inclusion of a Commitment Fee in Accumulated Production Expenditures

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

**LEGEND**

Taxpayer =

Commitment Fee =

Property =

Year 1 =

Year 2 =

ISSUE

Is an amount incurred for a commitment fee for construction financing included in accumulated production expenditures under § 1.263A-11?

CONCLUSION

The amount incurred for a commitment fee creates an asset, the adjusted basis of which is required to be included in accumulated production expenditures under § 1.263A-11.

FACTS

Taxpayer was formed in Year 1 to design, develop, finance, and construct Property. Taxpayer entered into financing agreements with a lender to fund the construction of Property. In connection with the financing agreements, Taxpayer paid Commitment Fee to the lender on un-borrowed amounts in Year 2. A commitment fee is a charge paid for making funds available for a specified time period. Once Taxpayer borrowed these amounts, the commitment fee ceased to be paid. Taxpayer used all borrowed amounts to fund construction.

LAW AND ANALYSIS

Under section 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced or property acquired for resale.

Section 1.263A-1(e)(3) defines indirect costs as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities.

Under § 1.263A-2(a)(3), producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period.

Under § 263A(f)(1), interest costs that are capitalized are those paid or incurred during the production period and are allocable to property which has i) a long useful life, ii) an estimated production period exceeding 2 years, or iii) an estimated production period exceeding 1 year and a cost exceeding \$1,000,000.

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 in production expenditures (not attributable to indebtedness directly attributable) had not been incurred.

Section 263A(f)(3) provides that any interest on indebtedness allocable (as determined under § 263A(f)(2)) to property used to produce property to which this subsection applies to the extent such interest is allocable (as so determined) to the produced property.

Under § 263A(f)(4)(C), production expenditures means the costs (whether or not incurred during the production period) required to be capitalized under § 263A(a) with respect to the property.

Interest is capitalized using the avoided cost method described in § 1.263A-9. Under this method, any interest that the taxpayer theoretically would have avoided if accumulated production expenditures had been used to repay or reduce the taxpayer's outstanding debt must be capitalized. For each unit of designated property, the avoided cost method requires the capitalization of the traced debt amount and the excess expenditure amount. Traced debt is the outstanding eligible debt that is allocated to accumulated production expenditures with respect to the unit of designated property under the rules of § 1.163-8T. If there are accumulated production expenditures in excess of traced debt with respect to a unit of designated property on any measurement date, the taxpayer must, for the computation period that includes the measurement date, capitalize with respect to the unit the excess expenditure amount.

The preamble to the proposed regulations under § 263A(f) states that the avoided cost method assumes that debt (and the corresponding interest) is used to finance production expenditures before any other funds that may be available are used to finance those production expenditures. Capitalization of Interest, 56 Fed. Reg. 40815, 40818 (proposed Aug. 16, 1991).

Under § 1.263A-11(a), accumulated production expenditures generally means the cumulative amount of direct and indirect costs described in section 263A that are required to be capitalized with respect to the unit of property, including interest capitalized in prior computation periods, plus the adjusted bases of any assets described in § 1.263A-11(d) that are used to produce the unit of property during the period of their use.

In general, costs are taken into account in the computation of accumulated production expenditures at the time and to the extent they would otherwise be taken into account under the taxpayer's method of accounting (e.g. after applying the requirements of section 461, including the economic performance requirement of section 461(h)). Costs that have been incurred and capitalized with respect to a unit of property prior to the beginning of the production period are taken into account as accumulated production expenditures beginning on the date on which the production period of the property begins.

Under § 1.263A-11(d)(1), accumulated production expenditures include the adjusted bases (or portion thereof) of any equipment, facilities, or other similar assets, used in a reasonably proximate manner for the production of a unit of designated property during any measurement period in which the asset is so used. Examples of assets used in a reasonably proximate manner include machinery and equipment used directly or indirectly in the production process, such as assembly –line structures, cranes, bulldozers, and buildings. A taxpayer apportions the adjusted basis of an asset used in the production of more than one unit of designated property in a measurement period among such units of designated property using reasonable criteria corresponding to the use of the asset, such as machine hours, mileage, or units of production. If an asset used in a reasonably proximate manner for the production of a unit of designated property is temporarily idle (within meaning of § 1.263A-1(e)(3)(iii)(E)) for an entire measurement period, the adjusted basis of the asset is excluded from the accumulated production expenditures for the unit during that measurement period. Notwithstanding this paragraph (d)(1), the portion of the depreciation allowance for equipment, facilities, or any other asset that is capitalized with respect to a unit of designated property in accordance with § 1.263A-1(e)(3)(ii)(I) is included in accumulated production expenditures without regard to the extent of use under this paragraph (d)(1) (i.e., without regard to whether the asset is used in a reasonably proximate manner for production of the unit of designated property).

Section 1.263A-11(d)(3) provides that the adjusted bases of equipment, facilities, or other assets that are not used in a reasonably proximate manner to produce a unit of property are not included in the computation of accumulated production expenditures. For example, the adjusted bases of equipment and facilities, including buildings and other structures, used in service departments, performing administrative purchasing, personnel, legal, accounting, or similar functions are excluded from the computation of accumulated production expenditures.

Revenue Ruling 81-160, 1981-1 C.B. 312, states that a loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Loan commitment fees are required to be amortized over the term of the loan. *Id.*

The Bluebook to the Tax Reform Act of 1986 states that the purpose of the avoided cost rules is so that “any interest expense that the taxpayer would have avoided if production expenditures had been used to repay debt of the taxpayer is treated as allocable to production of property.” Staff of the Joint Committee on Taxation, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, 511 (Comm. Print 1987). Furthermore, “[t]he term ‘production expenditures’ means the cumulative production costs required to be capitalized. ... Where an asset is used in the production of property, interest on the entire cost of that asset must be capitalized as part of the production costs of that property whether or not the entire cost of the asset previously has been reflected in the property account.” *Id.* at 511-512.

Taken together, the purpose of including an asset's adjusted basis in accumulated production expenditures is so that the interest theoretically incurred on that asset, had it been purchased with debt, is included in the interest capitalization computation. For practical purposes, if the taxpayer has little non-traced debt, then it is not avoiding interest on accumulated production expenditures and assets related to production.

In this case, Commitment Fee is similar to the assets described in § 1.263A-11(d)(1). That section states that the adjusted bases of any equipment, facilities, or other similar assets, used in a reasonably proximate manner for the production of a unit of designated property is included in accumulated production expenditures. This section goes on to state that examples of assets used in a reasonably proximate manner include machinery and equipment used directly or indirectly in the production process, such as assembly-line structures, cranes, bulldozers, and buildings.

Therefore, it must first be determined if the asset is used to produce the unit of designated property. For purposes of § 263A, produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow. § 1.263A-2(a)(1)(i). A cost to produce a unit of property can be either a direct cost or an indirect cost. § 1.263A-1(c). Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. § 1.263A-1(e)(3)(i). Producers are required to capitalize direct and indirect costs properly allocable to property produced even though production has not begun. § 1.263A-2(a)(3)(ii).

The regulations provide a non-exhaustive list of indirect costs that are required to be capitalized in § 1.263A-1(e)(3)(ii). Additionally, in *Von-Lusk v. Commissioner*, 104 T.C. 207, 215 (1995), the Tax Court held that "meeting with government officials, obtaining building permits and zoning variances, negotiating permit fees, performing engineering and feasibility studies, drafting architectural plans, and appealing development conditions" constituted production activities and costs.

Additionally, the Service recently proposed regulations for the treatment of sales-based royalties under § 263A. Sales-Based Royalties and Vendor Allowances, 78 Fed. Reg. 78940 (proposed Dec. 17, 2010). The preamble to the proposed regulations describes royalties as the costs associated with the right to use intellectual property, such as copyrighted works or patented inventions. The preamble states that "[i]f the use of those rights directly benefits or is incurred by reason of production activities, then the cost to secure those rights do as well." *Id.* at 78941.

Here, Commitment Fee was incurred before production began for the purpose of maintaining access to funds to continue construction activities. The asset created by Commitment Fee is therefore similar to the indirect costs required to be capitalized in that it directly benefits or was incurred by reason of the performance of production activities. The right secured by the asset, access to funds, directly benefits the

construction activities, and therefore the asset is used to produce a unit of designated property.

Next, Commitment Fee must be used in a reasonably proximate manner to the production of designated property. Commitment Fee is paid to ensure access to funds at agreed upon terms for the sole purpose of continuing production. If the Commitment Fee is not paid, Taxpayer may be unable to access credit markets or find credit terms too unfavorable to continue producing the designated property. Therefore, Commitment Fee is used in a reasonably proximate manner to the production of property because it is incurred solely for the purpose of the production of designated property and to allow production to continue by maintaining access to credit.

Section 1.263A-11(d)(3) describes equipment, facilities, and other assets that are not used in a reasonably proximate manner to produce a unit of designated property. Examples of these assets include buildings and other structures used in service departments performing administrative, purchasing, personnel, legal, accounting, or similar functions. Section 1.263A-1(e)(4)(i)(B) defines service departments as administrative, service, or support departments that incur service costs. The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. Service costs are a type of indirect cost that can be identified specifically with a service department or function that directly benefit or are incurred by reason of a service department or function.

In general, service costs that are incurred in the production of designated property will be included in accumulated production expenditures if they are capitalized under § 263A(a). Section 1.263A-11(d)(3) only states that the adjusted bases of buildings and other structures that house service departments are not included in accumulated production expenditures. These assets are not used in a reasonably proximate manner to the production of designated property.

The asset created by Commitment Fee is intangible while the assets described in § 1.263A-11 are tangible (whether included or excluded from accumulated production expenditures). This does not mean Commitment Fee is not an "other similar asset." In order to produce the designated property, Taxpayer incurred Commitment Fee, creating an asset that is amortized over the life of the loan. Similarly, a taxpayer may purchase a bulldozer to produce designated property. Both a commitment fee and a bulldozer are assets that are used in a reasonably proximate manner to produce a unit of designated property. A building that houses a taxpayer's service departments is not used in the same manner as the bulldozer or a commitment fee with respect to the production of a unit of designated property.

The principles of the avoided cost method require the capitalization of interest that could theoretically be avoided if the taxpayer used its capital to reduce debt rather than produce property. The amounts incurred for Commitment Fee could have been used to reduce Taxpayer's debt. Rather, it was used in a reasonably proximate manner to the

production of designated property. Similarly, a taxpayer could choose to rent a bulldozer and incur a capitalizable cost under § 263A(a), rather than purchase a bulldozer and include the cost in accumulated production expenditures (and only depreciation for purposes of § 263A(a)).

Here, Taxpayer incurred Commitment Fee for the purpose of ensuring access to funds to produce the unit of designated property. This created an asset for Taxpayer. This asset is used in a reasonably proximate manner to the production of the unit of designated property. Therefore, the adjusted basis of this asset, i.e. the amount of Commitment Fee, must be included in Taxpayer's accumulated production expenditures under § 1.263A-11.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 622-4970 if you have any further questions.