Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

(Large Business & International)

from: Martin Scully Jr.
Senior Counsel, Branch 6
(Income Tax & Accounting)

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subject: Capitalization of costs to improve leased real property incurred by a lessee subject to § 263A

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

LEGEND

Lessee	=
Lessor	=
Party X	=
Party Y	=
Party Z	=
Year 1	=
Year 2	=
Year 3	=
A	=
B	=

ISSUE

Whether costs incurred to construct real property leased by the Lessee are properly capitalizable under § 263A of the Internal Revenue Code to the basis of property produced by the Lessee.

CONCLUSION

Costs (including the portion of the $B related to indirect costs) incurred by the Lessee associated with the construction of the leased property owned by the Lessor must be capitalized by the Lessee as leasehold improvements under § 263(a) and § 1.162-11(b) (as amended in 2000) of the Income Tax Regulations and may not be capitalized under § 263A to the basis of property produced and owned by the Lessee.

FACTS

The Lessee is a limited partnership that owns and operates a
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The Lessor is a public funded by the "Party X," Party Y" and "Party Z."

The Lessee entered into a sublease and construction agreement (the "Agreement") with the Lessor. The Agreement provided that the Lessee would lease certain real property and improvements thereon. The Agreement also provided that the Lessee would construct a (the " ") on the leased property and lease the from the Lessor after it was constructed.

Under the Agreement, the Lessor provided an allowance to the Lessee of $A to construct the on the leased property. The Lessee used the $A provided by the Lessor plus $B of its own funds to construct the . The Agreement provided that the Lessor would own all of the real property and most of the improvements constructed and the Lessee would own all the personal property and some of the real property improvements constructed.

In addition, the Agreement specifically required the Lessee to incur certain indirect costs associated with the construction of the real property and improvements owned by the Lessor. The Agreement did not provide that the costs incurred by the Lessee associated with the construction of the leased property owned by the Lessor were a substitute for rent.

In Year 1, Year 2, and Year 3, the Lessee took the position on its tax returns that the portion of the $B related to indirect costs associated with the construction of the leased property owned by the Lessor was capitalizable under § 263A to the basis of the property produced and owned by the Lessee.

Large Business & International (LB&I) contends that § 263A permits the Lessee to capitalize only the costs that relate to the property produced and owned by the Lessee. Accordingly, LB&I questions whether the portion of the $B that relates to indirect costs associated with the construction of the leased property owned by the Lessor, but incurred by the Lessee, may be capitalized under § 263A to the basis of property produced and owned by the Lessee. LB&I and the Lessee have agreed, for federal income tax purposes, that ownership will be determined pursuant to the terms of the Agreement.

LAW AND ANALYSIS

Sections 263A(a) and 1.263A-1(a)(3)(ii) provide, in part, that taxpayers that produce real or tangible personal property must capitalize (1) all direct costs of producing the property and (2) the property's properly allocable share of indirect costs.

Section 1.263A-2(a)(1)(ii) clarifies that a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles.

Section 1.263A-1(c)(1) provides that taxpayers must allocate or apportion costs to various activities, including production activities. After § 263A costs are allocated to production activities, the costs are generally allocated to the items of property produced during the taxable year and capitalized to the items that remain on hand at the end of the taxable year.

Section 1.263A-1(e)(3)(i) provides, in part, that “indirect costs” are all costs other than direct material costs and direct labor costs (in the case of property produced), and that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities.

Section 1.263A-1(e)(3)(i) also specifically provides that taxpayers subject to § 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or permanent improvements made to increase the value of any property.

For the taxable years at issue, § 1.162-11(b) (as amended in 2000) provides that the cost to a lessee of erecting buildings or making permanent improvements on property leased by the taxpayer is a capital investment and is not deductible as a business expense.[1]

In *Gladding Dry Goods Co.*, 2 B.T.A. 336 (1925), the court reasoned that payments made by a lessee for improvements upon a lessor’s premises represent an investment of capital for improvements which will inure to the benefit of the lessee for the term of the lease or the term of the useful life of the improvements. *See also Mayerson v. Commissioner*, 47 T.C. 340, 350 (1966).

[1] For taxable years beginning on or after January 1, 2012, § 1.162-11T(b) (2011) provides a similar rule, and cross-references § 1.263(a)-3T(f)(1) (2011), which generally provides that a taxpayer lessee is required to capitalize amounts paid to improve a unit of leased property.

Similarly, in *McGrath v. Commissioner,* T.C. Memo. 2002-231, *aff'd*, No. 03-60273 (5th Cir. 2003), the Tax Court held that the petitioner lessee's costs of improvements to leased property were capital expenditures of the lessee under § 263(a). The Court stated that where the owner of real property enters into a long-term lease requiring the lessee to construct, at its own cost, a building on the lessor's property, the lessee, not the lessor, is entitled to recover its cost through the depreciation deductions associated with the building.

In Year 1, Year 2, and Year 3, the Lessee took the position on its tax returns that the portion of the $B related to indirect costs associated with the construction of the leased property owned by the Lessor was capitalizable under § 263A to the basis of the property produced and owned by the Lessee.

If a lessee makes a leasehold improvement that is not a substitute for rent, then the lessee is generally required to capitalize the cost of the improvement under §§ 263(a) and 1.162-11(b) (as amended in 2000). A lessee is required to capitalize the amounts it incurs for a leasehold improvement under § 263(a) regardless of whether the lessee is considered the owner, and therefore the producer, of the property under § 1.263A-2(a)(1)(ii) for purposes of § 263A. Accordingly, the Lessee must capitalize the portion of the $B incurred to construct the leased property owned by the Lessor as leasehold improvements.

Further, §§ 263A(a) and 1.263A-1(a)(3)(ii) provide that taxpayers that produce real or tangible personal property must capitalize the property's properly allocable share of indirect costs. Section 1.263A-1(e)(3)(i) provides that indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of the production activities. Only the indirect costs that directly benefit or that are incurred by reason of the performance of the production of the property produced and owned by the Lessee may be charged to the basis of such property. Accordingly, the Lessee may not allocate costs that do not directly benefit or that are not incurred by reason of the production of the property it produced and owned to the basis of such property.[2] Indirect costs incurred by the Lessee that relate to both the property produced and owned by the Lessee and the leased property owned by the Lessor must be allocated between the property produced and owned by the Lessee and the leased property constructed by the Lessee but owned by the Lessor.

Similarly, § 1.263A-1(e)(3)(i) specifically requires that taxpayers subject to § 263A make a reasonable allocation of indirect costs between production, resale, and other activities. The Lessee's method of allocating indirect costs associated with the construction of the leased property owned by the Lessor to the production of property produced and owned by the Lessee is not a reasonable allocation method.

[2] Section 1.263A-1(j)(2) provides an election to capitalize certain indirect period costs that do not directly benefit or that are not incurred by reason of the production of property. However, the Lessee has not made an election under § 1.263A-1(j)(2)(i), and the costs at issue are not capitalizable under § 1.263A-1(j)(2)(ii).

In summary, costs (including the portion of the $B related to indirect costs) incurred by the Lessee associated with the construction of the leased property owned by the Lessor must be capitalized by the Lessee as leasehold improvements under §§ 263(a) and 1.162-11(b) (as amended in 2000) and may not be capitalized under § 263A to the basis of property produced and owned by the Lessee.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

We have not been asked, nor have we addressed, whether the parties are in fact the owners for federal income tax purposes of the property as specified under the Agreement, or whether the Agreement is properly treated as a lease for federal income tax purposes.

Please contact Christopher Call at (202) 622-4970 if you have any further questions.