Office of Chief Counsel
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Memorandum

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to: Associate Issue Counsel
(LMSB, Heavy Manufacturing & Transportation, Associate Area Counsel – Cincinnati (Group 2),CC:LM:HMT:CIN:2)

from: Senior Counsel, Branch 7
(Income Tax & Accounting)

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subject: POSTF-120641-08; Unit of Property for Interest Capitalization

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

LEGEND

Taxpayer	=	
Company Y	=	
Company Z	=	
Complex	=	
Location C	=	
Date a	=	
Date b	=	
Date c	=	
Date d	=	
Date e	=	
Date f	=	
Date g	=	
$x	=	
State A	=	
State Agency	=	
State Statute B	=	
State Statute C	=	

State Statute D	=	
State Statute E	=	
State Statute F	=	
State Statute G	=	
State Admin. Code H	=	
State Statute J	=	

ISSUES

Whether certain real property components are considered a single unit of property for purposes of § 1.263A-10(b)?

FACTS

Taxpayer is a limited liability company with two equal members, Company Y and Company Z. Taxpayer owns and operates the Complex in Location C.

In Date a, Taxpayer began construction of the Complex. The Complex includes a - story hotel tower with guest rooms, a square foot casino with slot machines and table games, and a parking garage. The Complex also includes several restaurants, a spa, meeting rooms, exercise rooms, and an indoor pool. In Date b, construction of the Complex was completed at a total construction cost of approximately $x.

On Date c, the State Agency granted a casino license to the Taxpayer for the Complex, effective upon the issuance of a certificate of operations for the Complex. On or about Date d, the Commission conditionally approved an operations certificate for the Complex pending successful completion of a test period. The test period, during which the Complex was open for limited hours, was conducted on Date e and on Date f. On Date g, the Complex opened for 24 hour-a-day operations.

Under the law of State A, a casino means

in accordance with the provisions of State Statute B. State Statute C.

State Statute D.

State Statute E and State Statute F.

In addition, under the law of State A, no casino may operate unless all necessary licenses and approvals have been obtained. State Statute G.

State Admin. Code H. Notwithstanding the issuance of a casino license, no casino may be open to the public without a valid operations certificate. State Statute J.

During its construction of the Complex, Taxpayer capitalized interest on the indebtedness attributable to the construction costs of the Complex under § 263A(f). Taxpayer took the position that each hotel room and the casino were separate units of property. For purposes of the interest capitalization computation, Taxpayer grouped the hotel rooms by floor, concluding that the rooms on one floor had contemporaneous production periods. Taxpayer stopped capitalizing interest with respect to a hotel room once it deemed a hotel floor to be completed (*i.e.*, available for use) as reflected in its "capitalized interest workpapers." Where appropriate, Taxpayer resumed capitalizing interest with respect to completed hotel rooms when it began the construction of common features.

LAW AND ANALYSIS

Section 263A(a)(1) provides that in the case of any property to which § 263A applies, any costs described in § 263A(a)(2) shall be included in inventory costs (in the case of property which is inventory in the hands of the taxpayer), or shall be capitalized (in the case of property that is not inventory in the hands of the taxpayer).

Section 263A(a)(2) provides that the costs described by such paragraph with respect to any property are (i) the direct costs of such property; and (ii) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.

Section 263A(b)(1) provides that, except as otherwise provided, § 263A applies to real or tangible personal property produced by the taxpayer.

Section 263A(f)(1) provides that § 263A(a) shall apply only to interest costs which (i) are paid or incurred during the production period, and (ii) are allocable to property which is described in § 263A(b)(1) and which has a long useful life, an estimated production period exceeding 2 years, or an estimated production period exceeding 1 year and a cost exceeding $1,000,000.

Section 263A(f)(4)(A) provides that, for purposes of § 263A(f), property has a "long useful life" if such property is real property, or property with a class life of 20 years or more (as determined under § 168).

Section 263A(f)(4)(B) provides that, for purposes of § 263A(f), the term "production period" means, when used with respect to any property, the period beginning on the

date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or is ready to be held for sale.

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

Section 1.263A-8(b)(1) provides that, except as provided in §§ 1.263A-8(b)(3) and 1.263A-8(b)(4), "designated property" means any property that is produced and that either is (i) real property; or (ii) tangible personal property that meets certain requirements.

Section 1.263A-8(d)(1) provides that "produce" is defined as provided in §§ 263A(g) and 1.263A-2(a)(1)(i). Section 263A(g)(1) provides that, for purposes of § 263A, the term "produce" includes construct, build, install, manufacture, develop or improve. Section 1.263A-2(a)(1)(i) provides that, for purposes of § 263A, "produce" includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

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(c)(3) provides that "inherently permanent structures" include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former § 48(a)(1)(B) and § 1.48-1. Any property not otherwise described in § 1.263A-8(c)(3) that constitutes other tangible property under the principles of former § 48(a)(1)(B) and § 1.48-1(d) is treated for the purposes of § 1.263A-8 as an inherently permanent structure.

Section 1.263A-12(c)(1) provides that a separate production period is determined for each unit of property defined in § 1.263A-10.

Section 1.263A-10(b)(1) provides that a unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property even though the common feature does not meet the functional interdependence test. When the production period begins with respect to any functionally interdependent component or any common feature of the unit of real property, the production period has begun for the entire unit of real property.

Section 1.263A-10(b)(2) provides that components of real property produced by, or for, the taxpayer, for use by the taxpayer or a related person are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of property produced for sale, components of real property are functionally interdependent if they are customarily sold as a single unit. For example, the real property components of a single-family house (e.g., the land, foundation, and walls) are functionally interdependent. In contrast, components of real property that are expected to be separately placed in service or held for resale are not functionally interdependent. Thus, dwelling units within a multi-unit building that are separately placed in service or sold (within the meaning of § 1.263A-12(d)(1)) are treated as functionally independent of any other units, even though the units are located in the same building.

In Example 3 of § 1.263A-10(b)(6), D is in the trade or business of developing real property. D owns a tract of land on which D intends to build a shopping center and a parking lot. D intends to complete the shopping center in phases and expects that each store within the shopping center will be placed in service independently of the other stores. Example 3 concludes that each store is a separate unit of real property.

In Example 5 of § 1.263A-10(b)(6), X, a real estate developer, begins a project to construct a 10-story condominium and a swimming pool for the benefit of the condominium. Each story of the building is occupied by a single condominium and each condominium is sold as a separate unit. Example 5 concludes that each condominium is a separate unit of real property. See also § 1.263A-10(b)(6)(Ex. 7) (implying that, where X intends to lease rather than sell the condominiums, the unit of property determination is the same as in Example 5).

Section 1.263A-12(c)(2) provides that the production period of a unit of real property begins on the first date that any physical production activity (as defined in § 1.263A-12(e)) is performed with respect to a unit of real property. Section 1.263A-12(e)(1) provides that the term “physical production activities” includes any physical activity that constitutes production within the meaning of § 1.263A-8(d)(1).

Section 1.263A-12(d)(1) provides, in general, that the production period for a unit of property produced for self use 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. The production period for a unit of property produced for sale ends on the date the unit is ready to be held for sale and all production activites reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed.

Section 1.263A-8(a)(4)(ii) provides that, for purposes of §§ 1.263A-8 through 1.263A-15, placed in service has the same meaning as set forth in § 1.46-3(d) (providing rules relating to the qualification of property investments for the investment tax credit).

Section 1.46-3(d)(1) provides that property shall be considered placed in service in the earlier of (i) the taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or (ii) the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function.[1] Section 1.46-3(d)(2) provides that, in the case of property acquired by the taxpayer for use in his trade or business (or in the production of income), the following are examples of cases where property shall be considered in a condition or state of readiness and availability for a specifically assigned function: (i) parts are acquired and set aside during the taxable year for use as replacements for a particular machine (or machines) in order to avoid operational time loss, (ii) operational farm equipment is acquired during the taxable year and it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following year, and (iii) equipment is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects. However, materials and parts acquired to be used in the construction of an item of equipment shall not be considered in a condition or state of readiness and availability for a specifically assigned function.

In general, the placing in service of one component asset is dependent upon the placing in service of another component asset – that is, the assets are considered functionally interdependent – when the assets "functionally form a single property." Hawaiian Independent Refinery, Inc. v. United States, 697 F.2d 1063, 1069 (Fed. Cir. 1983). When all of the component assets, properly fitted together, form an operational unit capable of serving its intended purpose, the assets are considered a single unit of property. Public Service Co. of N.M. v. United States, 431 F.2d 980, 984 (10th Cir. 1970) Stated differently, "individual components will be considered a single property for tax purposes when … each component is essential to the operation of the project as a whole and cannot be used separately to any effect." Armstrong World Industries, Inc. v. Commissioner, T.C. Memo. 1991-326, *aff'd*, 974 F.2d 422, 434 (3rd Cir. 1992).

In contrast, component assets are considered discrete units of property when they can "function as planned in a wholly independent manner." Armstrong World Industries, 974 F.2d at 434 (emphasis omitted). This may occur, for example, when an acquired asset is intended to replace an existing, functional asset. Northern States Power Co. v. United States, 151 F.3d 876 (8th Cir. 1998), *aff'g in part*, *rev'g in part*, 952 F.Supp. 1346 (D.Minn. 1997). Examples 3, 5 and 7 of § 1.263A-10(b) further indicate that, where the taxpayer is constructing a real property asset, each individual unit of the real property that is intended to be sold (or leased) separately (*e.g.*, a store within a shopping center or a condominium within a condominium building) is considered a distinct unit of property.

[1] Because of the depreciation conventions under § 168, the taxable years in (i) and (ii) are the same for property subject to depreciation under § 168.

In Piggly Wiggly Southern, Inc. v. Commissioner, 84 T.C. 739 (1985), *aff'd*, 803 F.2d 1572 (11th Cir. 1986), the taxpayer claimed depreciation deductions and the investment tax credit in the taxable year in which it purchased new equipment for use in the operation of new, relocated, and remodeled stores. The equipment for the remodeled stores was installed, operating, and in use in these stores in the year of purchase. The equipment for the new and relocated stores was placed in stores that were not open for business in the year of purchase. The court held that the equipment for the remodeled stores was placed in service in the year of purchase but the equipment for the new and relocated stores was not placed in service in the year of purchase.

For purposes of this advice, we assume (and Taxpayer does not dispute) that each component asset (the rooms of the hotel and the casino) are "real property" within the meaning of § 1.263A-8(c).

Based on the facts presented, the purpose of the hotel and casino construction project was the production of a within the meaning of the law of State A. None of the facts indicate that the hotel was intended to operate for the production of income without the casino having also been approved and operating. Furthermore, there is no indication that the casino or the hotel was intended to be used in conjunction with existing assets. Moreover, under the law of State A, no casino may operate unless the casino is within an

Taxpayer argues that each individual hotel room is a distinct unit of property for purposes of § 263A(f). Taxpayer represents that each room is intended to be separately "leased" or held out for the production of income. In support of its position, Taxpayer relies upon Examples 3, 5, and 7 of § 1.263A-10(b)(6).

In our view, a room in the hotel (or, for that matter, a floor in the hotel) is distinct from the multiple units of property described in the Examples. In Example 3, the shopping center was completed in phases and each store was found to be a distinct unit of property because each store was intended to be leased separately. A similar conclusion is implied in Examples 5 and 7. These Examples illustrate the principle found in the last sentence of § 1.263A-10(b)(2) that dwelling units within a multi-unit building that are separately placed in service or sold (within the meaning of § 1.263A-12(d)(1)) are treated as functionally independent of other units in the same building.

In this case, although Taxpayer may "lease" an individual hotel room to each customer, Taxpayer is not able to "lease" any rooms before construction of the entire hotel is completed and the hotel has been granted an operations certificate by State Agency. The hotel, therefore, is not comparable to the multi-unit shopping center or condominium building described in the regulations. In the Examples in the regulations, the taxpayer intended to sell or lease each unit in the shopping center or condominium, and each unit could be made available for sale prior to completion of the entire shopping center or condominium. On the other hand, in the instant case, Taxpayer's intended purpose for each room in the hotel was to "lease" each room to customers in

the ordinary course of operating the Complex. Because the hotel could not legally operate until an operations certificate had been obtained, no individual room could be available for its intended purpose (*i.e.*, placed into service) to "lease" to customers until the operations certificate was obtained, even if construction of an individual room may have been completed prior to the completion of the entire hotel. See *Piggly Wiggly Southern*, 84 T.C. at 748-49. Thus, the rooms within the hotel may not be properly characterized as distinct units of property within the meaning of § 1.263A-10.

In addition,

, the placing in service of the casino is dependent upon the placing in service of the hotel.

Therefore, we conclude that the casino and all rooms of the hotel are functionally interdependent and comprise a single unit of real property for purposes of § 1.263A-10.

In addition, we conclude that the production period for the Complex ended, within the meaning of § 1.263A-12(d)(1), no earlier than Date f, the date the test period for the operations certificate was completed. Prior to this date, the Complex was not in a condition or state of readiness and availability for its assigned function because Taxpayer was not legally allowed to operate the Complex as a casino hotel.

We express no opinion regarding whether any component asset relating to construction of the Complex constitutes a common feature within the meaning of § 1.263A-10(b)(3).

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.

Please call (202) 622-4930 if you have any further questions.

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