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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, PORTLAND

FROM: Associate Chief Counsel (Passthroughs & Special Industries)
CC:PSI

SUBJECT: Capitalization of Taxes and Interest Under I.R.C. § 189

This Field Service Advice responds to your memorandum dated May 1, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND

Taxpayer =
 A =
 B =
 C =

ISSUES

Whether machinery and equipment affixed to improved “real property” constitutes “real property” for purposes of Section 189 of Internal Revenue Code of 1954.

CONCLUSIONS

Virtually all the property in issue will constitute real property given its inherently permanent status for purposes of former section 189 of the Internal Revenue Code of 1954.

FACTS

The Service disallowed deductions for interest and taxes incurred during construction of certain of taxpayer’s facilities on the grounds that Section 189, which requires capitalization of real property taxes and interest incurred during construction, required these items to be capitalized and amortized.

The facilities in question are an A Unit, a B Plant , which produces power for the A Unit, and a C Unit, which assists in production of the taxpayer’s manufacturing activities.

The focus of this request is the A unit. The facts concerning this facility are fully developed. The legal questions concerning the interpretation and application of section 189 are essentially the same for all three facilities.

The A Unit is a maze of pipes, valves, pumps and meters whose purpose is to aid in the production of taxpayer’s manufacturing activities. The Unit takes up more than a city block and at its highest point extends about 100 feet into the air. The labyrinth of pipes and vessels is located on a concrete platform to which the components are bolted.

Taxpayer contends that for purposes of analysis under section 189, its facilities must be broken down into their constituent parts. Taxpayer argues that section 189 must be separately and independently applied to the countless nuts, bolts,

switches, belts etc. which comprise its facilities because all of these parts can be disassembled, moved, or replaced.

LAW AND ANALYSIS

Section 189, prior to its repeal in 1986 provided, in pertinent part, that “no deduction shall be allowed for real property construction period interest and taxes.” The present issue is the scope of the term “real property” for the purposes of this provision. This term is not specifically defined in the statute, and regulations were never promulgated. Thus, the common law meaning of “real property” together with the legislative history to section 189 should be utilized in determining whether taxpayer’s self-constructed machinery and equipment are subject to the interest and tax capitalization requirement.

In general, all property rights are classified in accordance with the nature of the object concerning which the rights are claimed. Thus, immovables (land and those things permanently attached to land) are generally classified as real property and movables (commonly designated in the law as chattels) are classified as personal property.

[T]he distinction . . . drawn in the common law between real and personal property is that between rights in land and rights in chattels . . . [T]hese words “real” and “personal” . . . in their origin denoted not the difference between the objects of property rights but . . . between the forms of action by which rights were vindicated.

Brown, *The Law of Personal Property* § 1.7 (3rd Ed. 1975).

The Internal Revenue Code utilizes the concepts of “real” and “personal” property in sections 1250 and 1245 without defining those terms with more specificity. In addition, section 1245 introduces the term “other property” which relates loosely to the common law concept of “fixtures”, *i.e.*, a movable chattel that by reason of affixation to or association with use with land is treated in law as realty. Brown, *The Law of Personal Property* § 16.1.

The legislative history of section 189 clearly demonstrates that use of the term “real property” included both buildings and other permanent improvements to land, as well as machinery and equipment permanently affixed thereto. Thus, when originally enacted in 1976, the Joint Committee Summary indicated that the capitalization requirements applied with respect to “the construction of a building or other improvement.” Summary of the Tax Reform Act of 1976, Joint Committee Staff (Oct. 4, 1976); 1976-3 C.B. Part I at 426.

In 1982, when section 189 was extended to all corporations, the Conference Committee Report, H.Rept. No. 97-760, 97th Cong. 2nd Sess., (Aug. 17, 1982), 1982-2 C.B. 600, 608-609, in discussing transition rules, clearly indicated that the term “real property” included both real property improvements and permanently affixed machinery and equipment:

[I]f a taxpayer plans to construct a facility to produce sheet metal from iron ore, then both the **blast furnace** and the **rolling mill** . . . are part of the same integrated facility . . . because both properties are necessary to produce sheet metal from iron ore . . .

Although **improvements**, such as **parking lots, access roads,** and **utility hook-ups** may be part of an integrated facility, the start of construction of such property (which can be used in connection with any type of facility) is not considered the start of construction . . . for purposes of the effective date of [amended section 189].

(Emphasis supplied).

Colloquies between senators on the Senate floor also indicate that fixtures, such as oil pipelines (including the Alaska Pipeline), were subject to the interest and tax capitalization requirements of section 189.¹ For this reason, the effective date provision, previously referred to, specifically excluded the Alaska Pipeline from section 189. Notably, the exclusion of the Alaska Pipeline extended to “related facilities (e.g. compressor stations and conditioning plants)”. 1982-2 C.B. 600, 608.

Additionally, the General Explanation, for an unrelated amendment in 1984, states that for purposes of section 189 “real property includes certain property that is treated as personal property for purposes of the investment tax credit and depreciation.” General Explanation; H.R. 4170, 98th Cong; P.L. 98-369 p. 293, n. 13. To the same effect, the Senate Finance Committee Report related to the 1984 provision, states that “real property includes certain sec. 1245 property and certain ‘section 38 property’ described in section 48(a)(1).” Deficit Reduction Act of 1984, as approved by the Senate Finance Committee on March 21, 1984, § 72; Sen. Print 98-169, Vol. I (April 2, 1984) pp. 280-81.

¹Although a Treasury Official testified that the statute only applied to buildings and not to “structures affixed to the ground, such as farm implement sheds, [and] pipelines” (128 Cong. Rec. S8977 (daily ed. July 22, 1982)) later colloquies between Senators Dole and Bentsen, and Metzenbaum and Dole indicated that this was an error and that pipelines were in fact governed by section 189. Id. S8981-82.

With the enactment of section 263A of the Internal Revenue Code of 1986, the less comprehensive interest and tax capitalization rules of section 189 were repealed. The background memorandum accompanying the proposed regulations to section 263A(f) states that

[t]he legislative history under former section 189 . . . suggests an expansive definition of real property, encompassing both buildings **and** improvements. Similarly, when Congress extended the scope of former section 189 to C corporations, it was apparent that Congress contemplated that former section 189 applied to pipelines and other land improvements.

1991-2 C.B. 1000.

The background memorandum to the final regulations also makes clear that Congress did not intend to adopt a definition of real property any less comprehensive than the definition appropriate for section 189 purposes. See Background Memorandum accompanying the final regulations under section 263A(f), 1995-1 C.B. 24 - 25. Accordingly, the regulatory definitions promulgated for section 263A(f) purposes are useful in establishing the types of assets subject to the interest and tax capitalization rules of section 189.

Thus, Treas. Reg. § 1.263A-8(c)(1), defines real property, in part, as “land . . . buildings, and inherently permanent structures. . . . Real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property.” (Emphasis supplied).

Treas. Reg. § 1.263A-8(c)(3), in turn, defines “inherently permanent structures” as including “property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time” giving as examples, among other things, special foundations, fences, inherently permanent outdoor lighting facilities, power generation facilities and transmission facilities, oil and gas pipelines, broadcasting towers, derricks and storage equipment, grain storage bins and silos. Property falling within the definition of “other tangible property” for purposes of 48(a)(1)(B) and Treas. Reg. § 1.48-1(d) also is treated as an inherently permanent structure (and thus “real property”) “for the purposes of this section.”

Finally, Treas. Reg. § 1.263A-8(c)(4) provides that, although “machinery” by itself is not an inherently permanent structure, property in the nature of machinery is real property if it is a building or part of a structural component that is part of a building or inherently permanent structure.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

2 [REDACTED]

3 [REDACTED]



Please call if you have any further questions.

Associate Chief Counsel

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