INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director
Natural Resources

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

State X =

State Y =

State Z =

Project 1 =

Project 2 =

A =

B =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Amount 6 =

Amount 7 =

Amount 8 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

ISSUES:

1. Should Taxpayer have included the adjusted bases of the functionally interdependent components of a unit of real property that was temporarily withdrawn from service for improvement in the accumulated production expenditures (APEs) of such unit to compute the amount of interest that it was required to capitalize under § 263A(f) of the Internal Revenue Code?

2. When is a unit of real property "temporarily withdrawn from service" for purposes of Treas. Reg. § 1.263A-11(e)(1)(ii)?

3. Under the circumstances of this case, is Taxpayer's method of determining the adjusted bases of the functionally interdependent components that were withdrawn from service appropriate?

CONCLUSIONS:

1. Taxpayer should have included the adjusted bases of the functionally interdependent components of a unit of real property that was temporarily withdrawn from service for improvement in the APEs of such unit when it computed the amount of interest that it was required to capitalize under § 263A(f).

2. A unit of real property is "temporarily withdrawn from service" when the property is removed from its condition or state of readiness and availability for a specifically assigned function.

3. Under the circumstances of this case, Taxpayer's method of determining the adjusted bases of the functionally interdependent components that were withdrawn from service was inappropriate.

FACTS:

Taxpayer owns and operates electrical power generation, transmission and distribution assets in State X, State Y, and State Z. During the years at issue, Taxpayer conducted a number of construction projects that improved its electrical power generation, transmission, and distribution properties. The issues in this case concern the amount of interest that Taxpayer is required to capitalize under § 263A(f) with respect to these improvement projects. However, Taxpayer and the Examination Division have agreed that the facts of two of Taxpayer's projects, Project 1 and Project 2, are representative of all of Taxpayer's improvement projects and that advice rendered with respect to these two projects can be applied to all of Taxpayer's improvement projects. The facts of Project 1 and Project 2 are discussed below.

Project 1

A is an electrical generating plant that contains three 550-megawatt coal fired units that were built in Year 1, Year 2, and Year 3. Each of these units contains a boiler, which is essentially a furnace that burns coal to produce heat. The heat that is generated in each of these boilers is used to convert water to steam. In turn, the steam rotates the blades of a turbine, which runs a generator that produces electricity. Each of the boilers contains a number of burners that are basically jets that spew powered coal into the furnaces.

Pursuant to the Clean Air Act of 1990, Pub. L. No. 101-549, 104 Stat. 2399 (codified at 42 U.S.C. §§ 6921 to 7671 (1994)), Taxpayer was required to replace the existing burners with new burners that produced less nitrous oxide (NOx). In accordance with this requirement, Taxpayer's project authorization for Project 1 states

that the purpose of the project was to install new low NOx burners in unit 3 of A (unit 3). In addition to the installation of the new low NOx burners, the project also involved integrating unit 3's instrumentation and controls with the planned station distributed control system and the system requirements for the continuous emission monitoring system. For purposes of this technical advice memorandum, the Examination Division and Taxpayer have agreed that Project 1 constituted an improvement to unit 3, rather than an incidental maintenance or repair to unit 3.

To complete Project 1, unit 3 had to be shut down between Date 1 and Date 2. Prior to the start of the project, Taxpayer had estimated that the total cost of Project 1 would be Amount 1. Taxpayer's actual cost to complete Project 1, without regard to the adjusted bases of the functionally interdependent components of unit 3, was Amount 2. Taxpayer has represented that this amount includes all of the project's direct and indirect costs, except for interest. Taxpayer included Amount 2 in APEs to calculate the amount of interest that it was required to capitalize with respect to the project under § 263A(f).

The Examination Division asserts that, in addition to Amount 2, Taxpayer is required to include the adjusted bases of the functionally interdependent components of unit 3 in APEs to calculate the amount of interest that is required to be capitalized with respect to the project. The Examination Division and Taxpayer also disagree on how to determine the adjusted bases of the functionally interdependent components of unit 3.

Project 2

B is a nuclear power electricity generating plant that was built in Year 4. In Year 5, Taxpayer replaced a safety relief valve in the pressurizer of B during a shutdown of the entire nuclear facility. Project 2 required B to be shut down between Date 4 and Date 5. For purposes of this example, the Examination Division and Taxpayer have agreed that Project 2 was a capital improvement to B, rather than an incidental maintenance or repair to B.

Before the start of Project 2, Taxpayer estimated that the cost of the project would be Amount 3. Taxpayer's actual cost to complete Project 2, without regard to the adjusted bases of any of the functionally interdependent components of B, was Amount 4. Taxpayer included Amount 4 in the project's APEs to calculate the amount of interest that it was required to capitalize with respect to the project under § 263A(f).

The Examination Division asserts that, in addition to Amount 4, Taxpayer is required to include the adjusted bases of the functionally interdependent components of B in APEs to compute the amount of interest that Taxpayer was required to capitalize with respect to the project. Assuming the Examination Division's argument is correct, the Examination Division and Taxpayer disagree on how to determine the adjusted bases of the functionally interdependent components of B.

LAW AND ANALYSIS:

Issue 1. Should Taxpayer have included the adjusted bases of the functionally interdependent components of a unit of real property that was temporarily withdrawn from service for improvement in the accumulated production expenditures (APEs) of such unit to compute the amount of interest that it was required to capitalize under § 263A(f)?

For purposes of this technical advice memorandum, the Examination Division and Taxpayer have agreed that Project 1 and Project 2 constitute the production of real property and that Taxpayer is required to capitalize interest under § 263A(f) with respect to these projects. However, the Examination Division and Taxpayer disagree on the amounts that must be included in APEs with respect to these projects and, therefore, the amount of interest that Taxpayer is required to capitalize. The Examination Division contends that the APEs for each project must include both the direct and properly allocable indirect costs of the improvement and the adjusted bases of real property components that are functionally interdependent with the units of real property being improved. In comparison, Taxpayer contends that the APEs for each project should only include the direct and properly allocable indirect costs of the improvement.

Section 263A (UNICAP) generally requires a taxpayer to capitalize the direct costs and an allocable share of the indirect costs of the real or tangible personal property that it produces. See § 263A(a). A taxpayer "produces" property when it constructs, builds, installs, manufactures, develops, or improves property. See § 263A(g). The direct costs of property produced by a taxpayer include direct materials and direct labor costs. See Treas. Reg. § 1.263A-1(e)(2)(i). The indirect costs of produced property are all costs other than direct material costs and direct labor costs. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. See Treas. Reg. § 1.263A-1(e)(3). Interest on debt incurred or continued during the production period to finance the production of real property or tangible personal property to which § 263A(f) applies is an indirect cost that is capitalized under UNICAP. See Treas. Reg. § 1.263A-1(e)(3)(ii)(V).

Nonetheless, § 263A(f) limits the amount of interest that is required to be capitalized under UNICAP to the amount of interest that is allocable to certain specified property (referred to in Treas. Reg. § 1.263A-8(b) as "designated property") and that is paid or incurred during the property's production period. The interest capitalization rules under UNICAP reflect Congress's intention to match interest incurred to finance an asset's production with the income that is generated by such asset. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, page

508. See also Von-Lusk v. Commissioner, 104 T.C. 207, 218 (1995). Moreover, Congress expected the UNICAP rules to be applied from the acquisition of property, through the time of its production, until the time of its disposition. See Von-Lusk v. Commissioner, supra at 215.

When a taxpayer is required to capitalize interest under UNICAP, it must use the avoided cost method. See Treas. Reg. §1.263A-9; see also § 263A(f)(2). The avoided cost method provides a system for relating liabilities and interest to the APEs of designated property. The premise underlying this method is that money is fungible and that any interest that the taxpayer theoretically would have avoided if the money that was used for APEs had been used to repay or reduce the taxpayer's outstanding debt must be capitalized. See Treas. Reg. § 1.263A-9(a)(1). 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. See id.

More specifically, the avoided cost method requires a taxpayer to capitalize interest to a unit of designated property by allocating to such unit (i) the interest on any indebtedness that is directly attributable to the APEs of the unit, and (ii) the interest on any other indebtedness to the extent that the taxpayer's interest costs could have been reduced if the APEs of the unit (other than APES directly attributable to interest described in (i)) had not been incurred. See § 263A(f)(2)(A); Treas. Reg. § 1.263A-9(a)(2). Therefore, to determine the amount of interest that must be capitalized with respect to a production activity, a taxpayer must determine, among other things, the unit of property that is produced, the production period of the unit of property, and the APEs of the unit of property.

In this case, the Examination Division and Taxpayer disagree upon the amount of APEs that relate to each improvement project.

APEs generally include the cumulative amount of direct and indirect costs that are required to be capitalized under § 263A with respect to a unit of property, including interest capitalized in prior computation periods, plus the adjusted bases of any assets that are used to produce the unit of property during the period of their use. See Treas. Reg. § 1.263A-11(a). See also §§ 263A(f)(4)(C) and 263A(f)(3).

When an improvement to designated property constitutes the production of designated property, the regulations provide a specific rule to determine APEs. Treasury Regulation § 1.263A-11(e) provides:

> (e) Improvements - (1) General rule. If an improvement constitutes the production of designated property under § 1.263A-8(d)(3), accumulated production expenditures with respect to the improvement consist of -

(i) All direct and indirect costs required to be capitalized with respect to the improvement,

(ii) In the case of an improvement to a unit of real property -

(A) An allocable portion of the cost of land, and

(B) For any measurement period, the adjusted basis of any existing structure, common feature, or other property that is not placed in service or must be temporarily withdrawn from service to complete the improvement (associated property) during any part of the measurement period if the associated property directly benefits the property being improved, the associated property directly benefits from the improvement, or the improvement was incurred by reason of the associated property. See, however, the de minimis rule under paragraph (e)(2) of this section that applies in the case of associated property.

(iii) In the case of an improvement to a unit of tangible personal property, the adjusted basis of the asset being improved if that asset either is not placed in service or must be temporarily withdrawn from service to complete the improvement.

Based upon this regulation, the Examination Division argues that Taxpayer is required to include the adjusted bases of the functionally interdependent components of unit 3 and B in APEs to compute the amount of interest that is required to be capitalized with respect to Project 1 and Project 2. The Examination Division further argues that the functionally interdependent components of a unit of real property are temporarily withdrawn from service to complete an improvement when the unit of real property is temporarily withdrawn from service for improvement. Moreover, the Examination Division contends that the functionally interdependent components of a unit of real property directly benefit the unit of real property.

Taxpayer disagrees and argues that Treas. Reg. § 1.263A-11(e)(1)(ii) cannot require it to include the adjusted bases of unit 3 and B in APEs because § 263A(f) only requires the capitalization of interest during the production period of a unit of designated property. Taxpayer further argues that the production period of unit 3 and B ended when each facility was placed in service and, therefore, interest is no longer required to be capitalized with respect to these facilities. Taxpayer also contends that under the avoided cost method it is only required to capitalize interest that corresponds to the interest that could have been avoided or reduced if the improvements had not been incurred. In this regard, Taxpayer argues that the adjusted basis of existing

property should not be included in the APEs because unit 3 and B would have continued as corporate assets even if the improvements had not been performed. Lastly, Taxpayer asserts that requiring it to include the adjusted basis of existing property in APEs would have the effect of requiring it to capitalize the same interest twice. Based upon these arguments, Taxpayer contends that it is only required to include in APEs the direct costs and indirect costs of the improvements.

We agree with the Examination Division. The functionally interdependent components of a unit of property must be included in APEs when the unit of real property is temporarily withdrawn from service for improvement. Treasury Regulation § 1.263-11(e)(ii) specifically requires the adjusted basis of any existing property to be included in APEs when (1) the existing property is temporarily withdrawn from service to complete an improvement and (2) the existing property directly benefits the unit of real property being improved.

The functionally interdependent components of a unit of real property are temporarily withdrawn from service to complete an improvement when the unit of real property they are a part of is temporarily withdrawn from service for improvement. A unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent. See Treas. Reg. § 1.263A-10(b)(1). 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. See Treas. Reg. § 1.263A-10(b)(2). Therefore, it follows that the functionally interdependent components of a unit of real property comprise one single indivisible unit of property and the functionally interdependent components of the unit are temporarily withdrawn from service when the unit is temporarily withdrawn from service. Moreover, logically the functionally interdependent components of a unit of real property must also directly benefit the unit of property they make up. This position is supported by Treas. Reg. § 1.263A-10(b)(5), which in describing the treatment of costs when a common feature is included in a unit of real property defines “benefitted property” as including the functionally interdependent components.

Taxpayer’s positions are fundamentally flawed because they ignore the definition of the term “unit of property,” which is the foundation of UNICAP’s interest capitalization rules. Generally, the starting point in determining the amount of interest that must be capitalized under § 263A(f) is to ascertain the “unit of property” being produced. A taxpayer uses the “unit of property” to determine both the APEs and the beginning and end of the production period. See Treas. Reg. § 1.263A-10(a). To determine APEs, a taxpayer must first define the “unit of property” because APEs generally consist of the cumulative amount of direct and indirect costs that are required to be capitalized with respect to a unit of property. See Treas. Reg. § 1.263A-11(a). Likewise, to determine the beginning of the “production period” a taxpayer must first determine the “unit of property” because the production period begins on the date that

production of the unit of property begins. See Treas. Reg. § 1.263A-12(c). Moreover, the production period for a unit of property produced for self use ends on the date the unit of property is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See Treas. Reg. §1.263A-12(d)(1).

UNICAP defines "produce" to include the term "improve." See § 263A(g). Therefore, an improvement to designated property generally constitutes the production of designated property. See Treas. Reg. § 1.263A-8(d)(3). However, improvements do not generally create separate units of property, but instead only add value, or substantially prolong the useful life, of existing property or adapt property to a new or different use. See. Treas. Reg. § 1.263(a)-1(b).

Taxpayer has argued that unit 3's and B's production period ended when each facility was placed in service and, therefore, subsequent to this time interest is no longer required to be capitalized with respect to the adjusted basis of these facilities. We disagree with Taxpayer's position because it fails to recognize that improvements are always directed toward an existing unit of property (i.e., the unit of property being improved) and interest relating to the existing unit's production expenditures may be required to be capitalized during the production/improvement period of the unit.[1]

Neither the Code nor the regulations directly define the "production period." Instead, only the beginning and end of the production period are described. The production period of a unit of real property begins on the first date that any physical production activity is performed with respect to a unit of real property. See Treas. Reg. § 1.263A-12(c)(2). 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. See Treas. Reg. § 1.263A-12(d)(1). Read together it can be discerned that the production period of a unit of real property that is produced for self use includes any period of time that occurs after physical production of the unit has begun and the unit is not in service. Accordingly, an existing unit of real property is in a production period after physical improvement of the unit has begun and the unit is withdrawn from service to complete the improvement.

Taxpayer has also argued that it is not required to capitalize interest with respect to the adjusted basis of unit 3 and B because under the avoided cost method it is only required to capitalize interest that could have been avoided. In this regard, Taxpayer further agues that the adjusted basis of existing property should not be included in

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[1]An exception to this general rule is provided by the de minimis rule contained in Treas. Reg. § 1.263A-11(e)(2). The application of this rule to this case is addressed below in Issue # 3.

APEs because unit 3 and B would have continued as corporate assets even if improvements to them had not been made. Again, we disagree with Taxpayer's position.

Under the avoided cost method, a taxpayer is required to capitalize interest to the extent that the taxpayer's interest costs could have been reduced if the APEs of the property (not attributable to directly traced indebtedness) had not been incurred. The APEs of a unit of property include all of the property's production expenditures, including the production expenditures that were incurred before the production period. See § 263A(f)(4)(C); Treas. Reg. § 1.263A-11(b)(1). Accordingly, the adjusted basis of a unit of real property being improved (the unit's production expenditures that were incurred prior to the present production period) is included in APEs when the unit of real property is temporarily withdrawn from service for improvement.

Taxpayer's position would also produce untenable results because it would only capitalize interest with respect to the production expenditures of a fraction of the unit of real property, rather than the entire unit. Stated differently, if Taxpayer's rational were followed, the unit of property would be split and interest would not be capitalized with respect to the individual components of the unit once the individual components were completed. In effect, Taxpayer's position would distort the definition of APEs depending upon whether a taxpayer's production activity involved creating an asset from "scratch" or purchasing an "old asset" and "improving" it. The following example illustrates this point.

Assume that Company A buys an existing operating power plant that has a turbine in need of capital improvement from an unrelated party for $100 million. After acquiring the plant, Company A shuts it down and performs the necessary capital improvement to the turbine. The cost of the improvement to the turbine is $10 million. According to Taxpayer's position, Company A is only required to capitalize interest on the $10 million cost of the improvement. Next, assume that Company B chooses to construct an identical power plant from "scratch" and that the cost of constructing the new plant is $110 million. Company B would be required to capitalize interest on $110 million.

According to Taxpayer's position, Company A and Company B would capitalize interest on different amounts even though Company A's and Company B's power plants are identical and the cumulative capitalizable costs incurred by each company to acquire or produce the plants, aside from interest, was the same. Nevertheless, we agree that Company B may be required to capitalize more interest with respect to its plant than Company A because the production period to construct a plant from scratch presumably would be longer than the period to improve an existing plant. However, any difference in amount of interest that would be capitalized could not be due to any difference in the amount of the APEs because the APEs incurred by each company to acquire or construct their plants are identical.

Lastly, contrary to Taxpayer's position, capitalizing interest with respect to a unit of property's APEs during two different production periods does not result in the same interest being capitalized twice. For tax purposes, interest is defined as the amount one has contracted to pay for the use of borrowed money and as the compensation paid for the use or forbearance of money. See Deputy v. DuPont, 308 U.S. 488 (1940); Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932). Accordingly, interest is a fee that is calculated and charged for the use of money for a specified time period. Therefore, interest calculated and charged for the use of money during one period does not constitute the same expense as interest calculated and charged for the use of the money during a prior period.

Based upon the above, it is clear that Treas. Reg. § 1.263A-11(e) provides generally that the adjusted bases of the functionally interdependent components of a unit of real property are included in APEs when an improvement is made to such property and the property is temporarily withdrawn from service to complete the improvement.

Issue 2. When is a unit of real property "temporarily withdrawn from service" for purposes of Treas. Reg. § 1.263A-11(e)(1)(ii)?

Alternatively, Taxpayer contends that it does not need to include the adjusted bases of the functionally interdependent components in APEs for either improvement project because no existing structure, common feature, or other property was "temporarily withdrawn from service" to complete the improvements. In this regard, Taxpayer contends that an existing structure, common feature, or other property should only be considered "temporarily withdrawn from service" if such property has been taken out of service for depreciation purposes. Taxpayer further argues that Treas. Reg. § 1.263A-11(e)(1)(ii) must be read in light of Treas. Reg. § 1.263A-8(a)(4)(ii), which provides that the phrase "placed in service" has the same meaning as set forth in Treas. Reg. § 1.46-3(d). Taxpayer further argues that "§ 47 provided for the recapture of the credit when property ceased to qualify as § 38 property ... [and] the temporary idling of property was never an event leading to recapture."

Taxpayer's position is contrary to both the specific language of the regulation and the explanatory language contained in the preamble to the regulation. The regulation specifically provides that the adjusted basis of an existing structure, common feature, or other property that is not placed in service or must be temporarily withdrawn from service to complete the improvement must be included in APEs if such property directly benefits the property being improved. See Treas. Reg. § 1.263A-11(e)(1)(ii). Taxpayer's position is contrary to this language because it effectively eliminates temporarily from the phrase "temporarily withdrawn from service" and instead requires property to be permanently withdrawn from use in the trade or business before it is considered withdrawn from service. Moreover, the preamble to the UNICAP regulations also clearly indicates that Taxpayer's position fails to comport with the regulation:

> Commentators indicated that sometimes property must be temporarily disconnected or otherwise taken out of service for health, safety or regulatory reasons in order to make certain improvements (e.g., a power generating facility must be taken out of service in order to make capital improvements). Commentators suggested that the regulations provide that property is taken out of service only if the property is taken out of service for depreciation purposes.
>
> The final regulations do not adopt the suggestion concerning when property should be taken out of service.

See T.D. 8584, 1995-1 C.B. 21, 26. Therefore, Taxpayer's position with regard to the meaning of the phrase "temporarily withdrawn from service" is clearly incorrect. However, Taxpayer's position is correct to some extent because Treas. Reg. § 1.263A-8(a)(4)(i) does shed some light on the meaning of the phrase "temporarily withdrawn from service." The regulation defines when property is "in service." Under this section, property is generally "placed in service" when the property is placed in a condition or state of readiness and availability for a specifically assigned function. See also Treas. Reg. § 1.46-3(d)(ii). Therefore, from this section it can be discerned that property is temporarily withdrawn from service when it is removed from a condition or state of readiness and availability for a specifically assigned function.

In the present case, unit 3 and B had to be shut down when Taxpayer began Project 1 and Project 2, respectively. During these shutdowns, unit 3 and B were clearly not in a condition or state of readiness and availability for their specifically assigned functions because they were unable to generate electricity. Therefore, Taxpayer is required to include the adjusted bases of the functionally interdependent components of unit 3 and B in APEs for the measurement period during which Taxpayer had to withdraw unit 3 and B from service to complete the improvements.

Issue 3. Under the circumstances of this case, is Taxpayer's method of determining the adjusted bases of the functionally interdependent components that were withdrawn from service to complete the improvements appropriate?

With respect to Project 1 and Project 2, the Examination Division determined that Taxpayer temporarily withdrew from service functionally interdependent components with adjusted bases of Amount 5 and Amount 6

Taxpayer's position is that if the adjusted basis of associated property is included in APEs, the amounts included in APEs for Project 1 and Project 2 should be Amount 7 and Amount 8, respectively. Taxpayer estimated the adjusted bases of the functionally interdependent components of unit 3 by first calculating a ratio of its total unadjusted book bases of all its fossil-fuel assets to its total unadjusted book bases of all its fossil-fuel plants. Taxpayer then multiplied this ratio by the total adjusted tax bases of all its fossil-fuel plants. Taxpayer estimated the adjusted bases of the functionally interdependent components for B in a manner similar to the method it used to determine the adjusted basis of unit 3.

Taxpayer also contends that "If the [Examination Division] is correct that the adjusted basis of property as a consequence of a capital project must be taken into consideration in computing capitalized interest, it is not free to pick and choose a few items, regardless of how conservative and Taxpayer favorable this selection allegedly may be. Instead, under the circumstances of this case the entire adjusted basis of idled property must be considered." Taxpayer also argues that the Examination Division's selection of a relatively small adjusted bases for the functionally interdependent components of B results in the capitalization of additional interest because if the adjusted bases of all of B's idled property were included in APEs the de minimis rule provided by Treas. Reg. § 1.263A-11(e)(2) applies.

The de minimis rule contained in Treas. Reg. § 1.263A-11(e)(2) provides as follows:

> For purposes of paragraph (e)(2)(ii) of this section, the total costs of all associated property for an improvement unit (associated property costs) are excluded from the accumulated production expenditures for the improvement unit during its production period if, on the date the production period of the unit begins, the taxpayer reasonably expects that at no time during the production period of the unit will the accumulated production expenditures for the unit, determined without regard to the associated property costs, exceed 5 percent of the associated property costs.

The amount that Taxpayer is required to include in APEs regarding Project 1 and Project 2 is a question of fact. Hence, its resolution is beyond the scope of the technical advice process. While we often consider such factual issues in considering the underlying technical issue, it is more appropriate for the Examination Division to resolve these sorts of issues because of its more proximate involvement. Therefore, we limit our analysis to whether Taxpayer's methodology in determining the amounts included in APEs due to Project 1 and Project 2 is reasonable.

Based upon the above facts, we find that Taxpayer's methodology was unreasonable.

First, Taxpayer's methodology incorrectly assumes that each of its power generating plants has the same combination of assets, improvements, and vintage year costs. Undoubtedly, all of the Taxpayer's fossil-fuel and nuclear power generating plants are not identical. Moreover, a simple averaging of these differences will not result in a reasonable estimate of the adjusted bases of the functionally interdependent components of unit 3 and B.

Taxpayer's method is also flawed because it grossly overstates the number of assets that were temporarily withdrawn from service to complete Project 1 and Project 2. In other words, Taxpayer's method incorrectly assumes that 100% of unit 3's and B's assets were temporarily withdrawn from service to complete the projects. This is not accurate.

For example, when unit 3's boiler was shut down and was unable to generate electricity, many assets related to unit 3 were not withdrawn from service. Most notably, the various buildings that are related to unit 3 remained in service while Taxpayer completed Project 1. These buildings were not temporarily withdrawn from service when the boiler was shut down because the buildings continued to serve in their specifically assigned functions (i.e., the buildings continued to shelter the machinery and equipment that was housed within them). Moreover, the buildings and the machinery and equipment contained inside them cannot be considered one single unit of property because the placing in service of the buildings was not dependent upon the placing in service of the machinery and equipment. See Treas. Reg. § 1.263A-10(b); See also Rev. Rul. 76-238, 1976-1 C.B. 55 (a building that houses machinery and equipment may be placed into service prior to the machinery and equipment being placed in service.)

In any event, we agree with Taxpayer to some extent. The proper application of the de minimis rule contained in Treas. Reg. § 1.263A-11(e)(2) requires that the adjusted bases of all functionally interdependent components of the unit of real property being improved be considered when the unit of real property is temporarily withdrawn from service to complete the improvement. Therefore, to apply the de minimis rule the Examination Division must take into account the adjusted bases of all of the functionally interdependent components of the units of real property being improved. However, we do not address the manner by which the Examination Division must make this determination. Nor do we address whether Taxpayer's records enable the Examination Division to determine the adjusted bases of all of the functionally interdependent components of unit 3 and B. This factual determination is best left to the discretion of the Examination Division because of its proximate involvement.

CAVEAT(S)

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