DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (NATURAL RESOURCES)
CC:LM:NR:PNX

FROM: ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES) CC:PSI

SUBJECT: SELF-CONSTRUCTED TRANSITION PROPERTY RULE FOR THE INVESTMENT TAX CREDIT

This Chief Counsel Advice responds to your memorandum dated December 11, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer:

Public Utility:

Plant:

Unit A:

Unit B:

ISSUE

Whether Taxpayer may combine the replacements of two steam reheat lines to meet the requirements of the self-constructed transition property rule under section 203(b)(1)(B) of the Tax Reform Act of 1986 (TRA of 1986).

CONCLUSION

Taxpayer may not combine the replacements of two steam reheat lines to meet the requirements of the self-constructed transition property rule under section 203(b)(1)(B) of the TRA of 1986 because they are separate units of property. Each replacement must independently meet the requirements of the self-constructed transition property rule to be eligible for the investment tax credit (ITC).

FACTS

Taxpayer files a consolidated income tax return including Public Utility, its subsidiary. Public Utility is primarily engaged in the production, purchase, transmission, distribution, and sale of electricity. Public Utility is subject to regulation by the Federal Energy Regulatory Commission (FERC).

Public Utility operates Plant, consisting of five units including Unit A and Unit B. Each unit consists of a generator, turbine, and boiler system. Public Utility owns a minority interest in both Unit A and Unit B.

In 1985, a steam reheat line similar to the steam reheat lines on Unit A and Unit B failed. Inspections in 1985 indicated that the steam reheat line on Unit A was defective and that the steam reheat line on Unit B was not defective. Further inspections in 1986 indicated that the steam reheat line on Unit B was also defective.

A work order was initiated in 1985 to replace the defective steam reheat line on Unit A. More than 5 percent of the cost of the replacement was incurred by December 31, 1985. The replacement of the steam reheat line was placed in service in 1986. During the period that Unit A was not operating due to the replacement, Unit B and the other three units continued to operate.

A work order was initiated in 1986 to replace the defective steam reheat line on Unit B. Public Utility began actual physical construction on the replacement in 1987. No part of the cost of the replacement was incurred or committed by December 31, 1985. The replacement of the steam reheat line was placed in service in 1987. During the period that Unit B was not operating due to the replacement, Unit A and the other three units continued to operate.

The FERC accounting rules required Taxpayer to treat each replacement of the steam reheat lines as a separate unit of property. On its consolidated income tax return for 1986, Taxpayer treated the replacement of the steam reheat line on Unit A as transition property under section 203(b) of the TRA of 1986 and claimed ITC and depreciation under the Accelerated Cost Recovery System (ACRS). Taxpayer did not treat the replacement of the steam reheat line on Unit B as transition property and did not claim ITC or depreciation under ACRS. Taxpayer claimed depreciation for the replacement of the steam reheat line on Unit B under the new Modified Accelerated Cost Recovery System (MACRS).

In 1999, Taxpayer, at the urging of its accounting firm, made a claim for ITC regarding the replacement of the steam reheat line on Unit B. Taxpayer now insists that the replacements of the two steam reheat lines were one property for purposes of the transition rules under section 203 of the TRA of 1986.

We assume without deciding that the replacement of the steam reheat line on Unit A is transition property.

LAW

Repeal of the Investment Tax Credit

Section 211(a) of the TRA of 1986 added section 49 to the Internal Revenue Code. Section 49 provides for the repeal of the regular ITC.

Section 49(a) provides the general rule that for purposes of determining the amount of ITC determined under section 46, the regular percentage shall not apply to any property placed in service after December 31, 1985.

Section 49(b)(1) provides an exception to the general rule of section 49(a) for property that is transition property (within the meaning of section 49(e)).

Section 49(e) provides that the term “transition property” means any property placed in service after December 31, 1985, and to which the amendments made by section 201 of the TRA of 1986 do not apply, except that in making such determination–

(A) section 203(a)(1)(A) of the TRA of 1986 shall be applied by substituting “1985" for “1986,” and
(B) sections 203(b)(1) and 204(a)(3) of the TRA of 1986 shall be applied by substituting “December 31, 1985" for “March 1, 1986."

Section 201 of the TRA of 1986 replaced ACRS with MACRS. In general, the recovery periods for depreciation under MACRS are longer than under ACRS.

Section 203 of the TRA of 1986 provides the effective dates and the general transitional rules for ACRS/MACRS and ITC.

Section 203(a) of the TRA of 1986 provides the general effective dates. Section 203(a)(1)(A) provides that except as provided in sections 203, 204, and 251(d), the amendments made by section 201 shall apply to property placed in service after

December 31, 1986 (December 31, 1985, for ITC), in taxable years ending after such date.

Transitional Rules

Section 203(b) of the TRA of 1986 provides the general transitional rule. Section 203(b)(1) provides that the amendments made by section 201 shall not apply to–

> (A) any property that is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract that was binding on March 1, 1986 (December 31, 1985, for ITC),
>
> (B) property that is constructed or reconstructed by the taxpayer if–
>
>> (i) the lesser of (I) $1,000,000, or (II) 5 percent of the cost of such property has been incurred or committed by March 1, 1986 (December 31, 1985, for ITC), and
>>
>> (ii) the construction or reconstruction of such property began by such date, or
>
> (C) an equipped building or plant facility if construction has commenced as of March 1, 1986 (December 31, 1985, for ITC), pursuant to a written specific plan and more than one-half of the cost of such equipped building or facility has been incurred or committed by such date.

Section 203(b)(2)(A) of the TRA of 1986 provides that sections 203(b)(1) and 204(a) shall not apply to any property unless such property has a class life of at least 7 years and is placed in service before the applicable date. In the case of property with a class life of at least 7 years but less than 20 years the applicable date is January 1, 1989. In the case of property with a class life of 20 years or more the applicable date is January 1, 1991.

Section 204 of the TRA of 1986 provides the additional transitional rules for ACRS/MACRS and ITC.

Section 204(a)(5) of the TRA of 1986 provides special rules for property included in master plans of integrated projects. Section 204(a)(5) provides that the amendments made by section 201 of the TRA of 1986 shall not apply to any property placed in service pursuant to a master plan that is clearly identifiable as of March 1, 1986, for any project described in any of the following 25 subparagraphs of this paragraph.

H.R. Rep. No. 99-841, at II-62 (1986), in discussing the additional transitional rules, states that “[t]he conference agreement also provides other special transitional rules of limited application.”

H.R. Rep. No. 99-841, at II-53 through II-66 (1986), provides an extensive discussion of the transitional rules, including self-constructed property:

Self-constructed property

The conference agreement does not apply to property that is constructed or reconstructed by the taxpayer, if (1) the lesser of $1 million or five percent of the cost of the property was incurred or committed, (i.e., required to be incurred pursuant to a written binding contract in effect) as of March 1, 1986 (December 31, 1985, for purposes of the investment tax credit) and (2) the construction or reconstruction began by that date. For purposes of this rule, a taxpayer who serves as the engineer and general contractor of a project is to be treated as constructing the property. For purposes of this rule, the construction of property is considered to begin when physical work of a significant nature starts. Construction of a facility or equipment is not considered as begun if work has started on minor parts or components. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, researching, or developing.

For purposes of the rule for self-constructed property, in the context of a building, the term "property" includes all of the normal and customary components that are purchased from others and installed without significant modification (e.g., light fixtures).

Equipped buildings

Under the conference agreement, where construction of an equipped building began on or before March 1, 1986 (December 31, 1985, for purposes of the investment tax credit), pursuant to a written specific plan, and more than one-half the cost of the equipped building (including any machinery and equipment for it) was incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) the entire equipped building project and incidental appurtenances are excepted from the bill's application.[1] Where the costs incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) do not equal more than half the cost of the equipped building, each item of machinery and equipment is treated separately for purposes of determining whether the item qualifies for transitional relief.

Under the equipped building rule, the conference agreement will not apply to equipment and machinery to be used in the completed building, and also incidental machinery, equipment, and structures adjacent to the building (referred to here as appurtenances) which are necessary to the planned use of the building, where the following conditions are met:

(1) The construction (or reconstruction or erection) or acquisition of the building, machinery, and equipment was pursuant to a specific written plan of a taxpayer in existence on March 1, 1986 (December 31, 1985, for the investment tax credit); and

(2) More than 50 percent of the adjusted basis of the building and the equipment and machinery to be used in it (as contemplated by the written plan) was attributable to property the cost of which was incurred or committed by March 1, 1986 (December 31, 1985, for the investment tax credit), and construction commenced on or before March 1, 1986 (December 31, 1985, for the investment tax credit).

The written plan for an equipped building may be modified to a minor extent after March 1, 1986 (December 31, 1985, for the investment tax credit) and the property involved may still come under this rule; however, there cannot be substantial modification in the plan if the equipped building rule is to apply. The plan referred to must be a definite and specific plan of the taxpayer that is available in written form as evidence of the taxpayer's intentions.

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1. For example, if property with a class life of less than 7 years is incorporated into an equipped building, then such property would not independently need to satisfy the placed-in-service requirements. Instead, such property would qualify for transition relief as part of the equipped building--as long as the equipped building is placed in service by the prescribed date.

ANALYSIS

Purpose of the Transitional Rules

"It has been said many times that provisions granting special tax exemptions are to be strictly construed." Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46, 49 (1940) (footnote omitted). This maxim of strict construction has been applied to the transitional rules of the TRA of 1986. See, e.g., United States v. Commonwealth Energy System and Subsidiary Companies, 235 F.3d 11, 16 (1st Cir. 2000) (construing section 204(a)(3) of the TRA of 1986); United States v. Kjellstrom, 916 F. Supp. 902, 905 (W.D. Wis. 1996), aff'd, 100 F.3d 482 (7th Cir. 1996) (construing section 204(a)(7) of the TRA of 1986).

"Transition rules were intended to provide limited exemptions for certain taxpayers who would be affected adversely by a new law because they had relied on the old law to their detriment." Kjellstrom, 916 F. Supp. at 907. "In the Tax Reform Act of 1986, Congress included 'transition rules,' which provided specified exemptions from designated provisions of the new tax laws to a very, very few specified favored taxpayers." Apache Bend Apartments, Ltd. v. United States, 987 F.2d 1174, 1175 (5th Cir. 1993). "[A]nd although we must extend them to all qualifying taxpayers, we need not broaden our interpretation so that entities that did not detrimentally rely on the old rule benefit from the transition exemption." Commonwealth Energy System, 235 F.3d at 16 (citations omitted).

There was no detrimental reliance by Taxpayer. Both steam reheat lines had to be replaced without regard to ITC or ACRS because they were both defective. Taxpayer did not even know until 1986 that the steam reheat line on Unit B was defective and needed to be replaced. Taxpayer did not claim ITC or ACRS on the replacement of the steam reheat line on Unit B and did not raise the possibility for more than 10 years.

Definition of "Property"

The repeal of ITC does not apply to "transition property." Under section 203(b)(1)(B) of the TRA of 1986, the term "transition property" includes property that is constructed or reconstructed by the taxpayer if–(i) the lesser of (I) $1,000,000, or (II) 5 percent of the cost of such property has been incurred or committed by December 31, 1985, and (ii) the construction or reconstruction of such property began by such date. In addition, under section 203(b)(2)(A) of the TRA of 1986, property with a class life of 20 years or more must be placed in service before January 1, 1991.

To be "property," the property must be functionally interdependent and placed in service concurrently. Hawaiian Independent Refinery, Inc. v. United States, 697 F.2d 1063, 1069 (Fed. Cir. 1983); Armstrong World Industries, Inc. v. Commissioner, 974 F.2d 422, 432 (3rd Cir. 1992). See also Treas. Reg. §§

1.46-5(e)(3)(ii), 1.263A-10(c), and 1.167(a)-11(d)(2)(vi)(g) of the Income Tax Regulations.

Hawaiian Independent Refinery, Inc. v. United States, construing the transitional rules under a prior repeal of the investment tax credit, held that an offshore tanker-mooring facility, an oil refinery, and the pipelines were one property because they "functionally form a single property" and were "placed in operation concurrently." Hawaiian Independent Refinery, 697 F.2d at 1069.

Armstrong World Industries, Inc. v. Commissioner, construing the safe-harbor leasing rules of former section 168(f)(8), stated that "a number of courts have agreed in other contexts that component assets constitute a single property when those components have no independent utility in the taxpayer's trade or business prior to the time that all of the components are completed and available for use in the intended manner." Armstrong World Industries, 974 F.2d at 432 (footnote omitted) (emphasis added).

Treas. Reg. § 1.46-5(e)(3)(ii), concerning ITC for Qualified Progress Expenditures, provides:

> Property is part of an integrated unit only if the operation of that item is essential to the performance of the function to which the unit is assigned. Property essential to the performance of the function to which the unit is assigned includes property the use of which is significantly connected to that function and which effects the safe, proper, or efficient performance of the unit. Generally, property must be placed in service at the same time to be considered part of the same integrated unit. Properties are not an integrated unit, however, solely because they are to be placed in service at the same time. (Emphasis added.)

Treas. Reg. § 1.263A-10(c), concerning capitalization of certain expenses, provides:

> Components of tangible personal property are a single unit of property if the components are functionally interdependent. Components of tangible personal property that are 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. (Emphasis added.)

Treas. Reg. § 1.167(a)-11(d)(2)(vi)(g), concerning repairs and additions to certain depreciable property, provides that:

> a unit of property generally consists of each operating unit (that is, each separate machine or piece of equipment) which performs a discrete function and which the taxpayer customarily acquires for original installation and retires as a unit. (Emphasis added.)

Taxpayer's replacements of the steam reheat lines of Unit A and Unit B are not functionally interdependent and were not placed in service concurrently. Unit A and Unit B function independently to generate electricity. There are five functionally independent units, including Unit A and Unit B, generating electricity at Taxpayer's Plant. While Unit A was shut down for the replacement of its steam reheat line, Unit B and the other three units continued to operate independently. And while Unit B was shut down for the replacement of its steam reheat line, Unit A and the other three units continued to operate independently. Taxpayer placed the replacement of the steam reheat line on Unit A in service in 1986 and the replacement of the steam reheat line on Unit B in 1987.

"Property" does not mean "Project"

"As a general rule, a statute should be construed so that each part is given effect and no part is rendered inoperative or superfluous." Commonwealth Energy System, 235 F.3d at 15. See also Reiter v. Sonotone Corp., 442 U.S. 330, 339 (1979); Bell Atlantic Corporation v. United States, 224 F.3d 220, 224 (3rd Cir. 2000) (construing section 204(a)(3) of the TRA of 1986).

Section 203(b)(1)(A) and (B) of the TRA of 1986 refer to "property." Section 203(b)(1)(C) refers to "plan," and section 204 refers to "project" numerous times. If, as Taxpayer contends, "property" in section 203(b)(1)(B) means "plan" or "project," then section 203(b)(1)(C) and section 204 are rendered superfluous. When Congress used the term "property," Congress meant "property." When Congress wanted to use the broader terms "plan" and "project," Congress did so.

Under section 203(b)(1)(C) of the TRA of 1986, the term "transition property" includes "an equipped building or plant facility if construction has commenced as of March 1, 1986 [December 31, 1985, for ITC], pursuant to a written specific plan and more than one-half of the cost of such equipped building or facility has been incurred or committed by" December 31, 1985. (Emphasis added.)

H.R. Rep. No. 99-841, at II-56 (1986), states that "[w]here the costs incurred or committed before March 2, 1986 (January 1, 1986, for the investment tax credit) do not equal more than half the cost of the equipped building, each item of machinery and equipment is treated separately for purposes of determining whether the item qualifies for transitional relief." (Emphasis added.) In other words, if a taxpayer fails to meet the equipped building rule of section 203(b)(1)(C), then each individual unit of property must independently meet the binding written contract rule of section 203(b)(1)(A) or the self-constructed property rule of section 203(b)(1)(B) to be transition property. Each individual unit of property cannot be independently tested under section 203(b)(1)(B) if, as Taxpayer contends, "property" in section 203(b)(1)(B) means "plan."

Section 204 of the TRA of 1986 provides the additional transitional rules for ACRS/MACRS and ITC.

Section 204(a)(3) of the TRA of 1986 provides that "[t]he amendments made by section 201 shall not apply to any property which is readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease, which was binding on March 1, 1986 [December 31, 1985, for ITC]." (Emphasis added.) H.R. Rep. No. 99-841, at II-60 (1986), states that "[t]his rule does not provide transitional relief to property in addition to that covered under a contract described above, which additional property is included in the same project but does not otherwise qualify for transitional relief." (Emphasis added.) In section 204(a)(3), Congress used the term "property," and Congress made it clear in the conference report that the term "property" does not mean all property included in the same project.

Section 204(a)(5) of the TRA of 1986 provides special rules for property included in master plans of integrated projects. Section 204(a)(5) provides that "[t]he amendments made by section 201 shall not apply to any property placed in service pursuant to a master plan which is clearly identifiable as of March 1, 1986, for any project described in any of the following [25] subparagraphs of this paragraph." (Emphasis added.) H.R. Rep. No. 99-841, at II-62 (1986), states that the additional transitional rules of section 204 are of "limited application." It is obvious that if Congress had wanted the term "property" in section 203(b)(1)(B) to mean, as Taxpayer contends, any property placed in service pursuant to a plan or project, then Congress clearly knew how to say that.

If the term "property" in section 203(b)(1)(B) of the TRA of 1986 includes any and all property pursuant to a taxpayer's "plan" or "project," then "the transition rule exception would swallow the rule eliminating the ITC." United States v. Zeigler Coal Holding Company, 934 F. Supp. 292, 295 (S.D. Ill 1996) (construing section 204(a)(3) of the TRA of 1986).

Under the statute, the conference report, case law, and the FERC accounting rules, the replacement of each steam reheat line is a separate unit of property, and Taxpayer treated them as such for both ACRS/MACRS and ITC transition rule purposes.

Other Requirements of the Self-constructed Property Transition Rule

(1) Self-constructed

Under section 203(b)(1)(B) of the TRA of 1986, the property must have been constructed or reconstructed by the taxpayer. "For purposes of this rule, a taxpayer who serves as the engineer and general contractor of a project is to be treated as constructing the property." H.R. Rep. No. 99-841, at II-56 (1986). The conference report refers to a taxpayer serving as the engineer and general contractor of a "project." Every business has projects and plans. Still it is each "property" that must qualify under section 203(b)(1)(B).

Public Utility itself constructed the replacement of the steam reheat line on Unit B. Therefore, it appears that Taxpayer met this requirement with respect to the replacement of the steam reheat line on Unit B.

(2) Cost Incurred or Committed

Under section 203(b)(1)(B)(i) of the TRA of 1986, the lesser of $1,000,000 or 5 percent of the cost of the property must have been incurred or committed by December 31, 1985. The term "committed" means "required to be incurred pursuant to a written binding contract in effect" as of December 31, 1985. H.R. Rep. No. 99-841, at II-56 (1986).

No part of the cost of the replacement of the steam reheat line on Unit B was incurred or committed by December 31, 1985. Therefore, Taxpayer failed to meet this requirement with respect to the replacement of the steam reheat line on Unit B.

(3) Beginning Construction

Under section 203(b)(1)(B)(ii) of the TRA of 1986, the construction or reconstruction of the property must have begun by December 31, 1985. H.R. Rep. No. 99-841, at II-56 (1986) states the following:

> For purposes of this rule, the construction of property is considered to begin when physical work of a significant nature starts. Construction of a facility or equipment is not considered as begun if work has started on minor parts or components. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, researching, or developing.

Public Utility began actual physical construction on the replacement of the steam reheat line on Unit B in 1987. Therefore, Taxpayer failed to meet this requirement with respect to the replacement of the steam reheat line on Unit B.

(4) Placed in Service

Under section 203(a)(1)(A) of the TRA of 1986, the property must have been placed in service after December 31, 1985, in a taxable year ending after such date. In addition, under section 203(b)(2)(A) of the TRA of 1986, property with a class life of 20 years or more must have been placed in service before January 1, 1991.

Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under section 167(m) (determined without regard to section 167(m)(4) and as if the taxpayer had made an election under section 167(m)). Former section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation allowance was based on the class life prescribed by the Secretary of the Treasury that reasonably reflected the anticipated useful life of that class of property to the industry or other group. Under Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b), which provides rules for classifying property under former section 167(m), property is included in the asset guideline class for the activity in which the property is primarily used. The class lives of property subject to depreciation under section 168 are set forth in Rev. Proc. 87-56, 1987-2 C.B. 674. Asset class 49.13 (Electric Utility Steam Production Plant) includes assets used in the steam power production of electricity for sale. The class life is 28 years.

The replacement of the steam reheat line on Unit B was placed in service in 1987. Therefore, it appears that Taxpayer met this requirement with respect to the replacement of the steam reheat line on Unit B.

CONCLUSIONS

Accordingly, we conclude that the replacements of the steam reheat lines on Unit A and Unit B cannot be combined for purposes of the self-constructed property rule in section 203(b)(1)(B) of the TRA of 1986. Because the replacements of the steam reheat lines on Unit A and Unit B are separate units of property, then each replacement must independently meet the requirements of the self-constructed property rule of section 203(b)(1)(B) of the TRA of 1986.

The replacement of the steam reheat line on Unit B is not self-constructed property within the meaning of section 203(b)(1)(B) of the TRA of 1986 because the lesser of $1 million or 5 percent of the cost of the replacement on Unit B was not incurred or committed by December 31, 1985, and because physical work was not begun on the replacement on Unit B by December 31, 1985. Accordingly, we also conclude that the replacement of the steam reheat line on Unit B is not transition property under section 49(e) and is not eligible for ITC under section 46.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We believe that our case is very strong.

In developing the case, you should consider the following:

1. When Taxpayer and the other owner(s) of Unit A and Unit B originally placed them in service, did Taxpayer and the other owner(s) treat each as a separate unit of property? If Unit A and Unit B were originally treated as

separate units of property, how could replacements be a single unit of property?

2. Did the other owner(s) of Unit A and Unit B treat the replacements of each steam reheat line as a separate unit of property? If the other owner(s) treated the replacements as separate units of property, how can Taxpayer, a minority owner of the Units, treat the replacements as a single unit of property?

3. How has Taxpayer treated the other three units at the plant: as a single unit of property or as three separate units of property?

4. Did construction begin as defined above on the replacement of the steam reheat line on Unit A by December 31, 1985? If not, then linking the replacements of the steam reheat lines on Unit A and Unit B will not benefit Taxpayer.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

By: /s/ Harold E. Burghart
HAROLD E. BURGHART
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