INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

June 5, 2002

Number: **200239002**
Release Date: 9/27/2002
Index (UIL) No.: 49.05-06 R 90
CASE MIS No.: TAM-117187-02/CC:PSI:B5

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference: The Taxpayer's authorized representative declined a conference.

LEGEND:

Taxpayer:

Substation:
City:
X:
Year:
Affidavit:

Date 1:
Serial Number 1:
Serial Number 3:
Serial Number 5:

ISSUE:

Whether the Substation met the self-constructed property transitional rule under section 203(b)(1)(B) of the Tax Reform Act of 1986 (TRA of 1986) and is therefore entitled to the investment tax credit (ITC).

CONCLUSION:

Because the Taxpayer had not begun construction of the Substation by December 31, 1985, as required by section 203(b)(1)(B)(ii) of the TRA of 1986, the Substation did not meet the self-constructed property transitional rule. Therefore, the Taxpayer is not entitled to ITC for the Substation.

FACTS:

The Taxpayer, a public utility, files a consolidated income tax return with its parent. The Taxpayer is primarily engaged in the production, purchase, transmission, distribution, and sale of electricity. The Taxpayer is subject to regulation by the Federal Energy Regulatory Commission (FERC).

Because of increasing demand for electricity, the Taxpayer began before January 1, 1986, to plan for a new substation in the downtown area of City. In 1985, the Taxpayer ordered five transformers from X, including transformers with Serial Number 3 and Serial Number 5. The transformers were similar to other transformers already placed in service in the Taxpayer's transmission and distribution system.

The Taxpayer did not acquire the land on which the Substation is located until after December 31, 1985. The Taxpayer did not begin actual physical construction work at the site until after December 31, 1985. The transformers with Serial Number 3 and Serial Number 5 were installed in the Substation.

The Substation was placed in service in Year, a year after December 31, 1985. On its consolidated income tax return for Year, the Taxpayer did not treat the Substation as transition property and did not claim ITC or depreciation under the Accelerated Cost Recovery System (ACRS). The Taxpayer claimed depreciation for the Substation under the new Modified Accelerated Cost Recovery System (MACRS).

In 1999, the Taxpayer made a claim for ITC regarding the Substation. The Taxpayer now insists that the Substation is self-constructed property for purposes of the transitional rule under section 203(b)(1)(B) of the TRA of 1986.

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.

The Conference Report, H.R. Rep. No. 99-841, at II-53 through II-66 (1986), provides an extensive discussion of the transitional rules. The Conference Report at II-56 describes the self-constructed property transitional rule as follows:

> ***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).

The Conference Report at II-57 through II-58 describes the plant facility transitional rule as follows:

> ***Plant facilities***
>
> The conference agreement also provides a plant facility rule that is comparable to the equipped building rule (described above), for cases where the facility is not housed in a building. For purposes of this rule, the term "plant facility" means a facility that does not include any building (or of which buildings constitute an insignificant portion), and that is a self-contained single operating unit or processing operation–located on a

single site–identifiable as a single unitary project as of March 1, 1986.

If pursuant to a written specific plan of a taxpayer in existence as of March 1, 1986 (December 31, 1985, for the investment tax credit), the taxpayer constructed, reconstructed, or erected a plant facility, the construction, reconstruction, or erection commenced as of March 1, 1986 (December 31, 1985, for the investment tax credit), and the 50-percent test is met, then the conference agreement will not apply to property that makes up the facility. For this purpose, construction, etc., of a plant facility is not considered to have begun until it has commenced at the site of the plant facility. (This latter rule does not apply if the facility is not to be located on land and therefore, where the initial work on the facility must begin elsewhere.) In this case, as in the case of the commencement of construction of a building, construction begins only when actual work at the site commences; for example, when work begins on the excavation for footings, etc., or pouring the pads for the facility, or the driving of foundation pilings into the ground. Preliminary work such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings), does not constitute the beginning of construction, reconstruction or erection.

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 the Taxpayer. The Substation had to be built without regard to ITC or ACRS because of the increasing demand for electricity in City. Taxpayer did not claim ITC or ACRS on the Substation when the Taxpayer filed its consolidated income tax return for Year and did not raise the possibility for more than 10 years after the Substation was placed in service.

BEGINNING CONSTRUCTION

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.

Regarding beginning construction, the Conference Report at II-56, under the heading "Self-constructed property," provides 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.

Regarding beginning construction, the Conference Report at II-58, under the heading "Plant facilities," provides the following:

> For this purpose, construction, etc., of a plant facility is not considered to have begun until it has commenced at the site of the plant facility. (This latter rule does not apply if the facility is not to be located on land and therefore, where the initial work on the facility must begin elsewhere.) In this case, as in the case of the commencement of construction of a building, construction begins only when actual work at the site commences; for example, when work begins on the excavation for footings, etc., or pouring the pads for the facility, or the driving of foundation pilings into the ground. Preliminary work such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings), does not constitute the beginning of construction, reconstruction or erection.

Both excerpts refer to a "facility." The Substation is a facility. The Conference Report at II-57 states the following:

> For purposes of this rule, the term "plant facility" means a facility that does not include any building (or of which buildings constitute an insignificant portion), and that is a self-contained single operating unit or processing operation–located on a single site–identifiable as a single unitary project as of March 1, 1986.

The taxpayer argues that because the requirement of actual work at the site appears under the heading "Plant facilities," the requirement only applies to the equipped building/plant facility transitional rule of section 203(b)(1)(C) of the TRA and not the self-constructed property transitional rule of section 203(b)(1)(B).

We disagree. We believe that the requirement applies to self-constructed property as well. The statute requires beginning construction by December 31, 1985, for both the self-constructed property transitional rule under section 203(b)(1)(B) and the equipped building/plant facility transitional rule under section 203(b)(1)(C). We believe the requirement to begin construction by December 31, 1985, means the same thing in both section 203(b)(1)(B) and section 203(b)(1)(C).

In addition, we believe the headings in the Conference Report are merely for convenience. It would be unreasonable to expect the same requirement to be repeated under all three headings: "Self-constructed property," "Equipped buildings," and "Plant facilities."

We can think of no reason why Congress would require taxpayers to begin actual physical construction at the site to meet the equipped building/plant facility transitional rule of section 203(b)(1)(C) of the TRA for a facility to be located on land and not require taxpayers to begin actual physical construction at the site to meet the self-constructed property transitional rule of section 203(b)(1)(B).

"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).

The Taxpayer cites an example in the General Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation, JCS-10-87 (May 4, 1987) (the "Blue Book"), as support for its claim for ITC under the self-constructed property transitional rule of section 203(b)(1)(B) of the TRA. The Blue Book at 114, under the heading of "Self-constructed property" provides the following example:

> *Example*.–Prior to January 1, 1986, an aircraft manufacturer entered into binding contracts with third parties for the construction of aircraft subassemblies to be included by the manufacturer in the construction of

the completed aircraft. The cost to the aircraft manufacturer of these subassemblies is approximately $300,000, which the manufacturer had incurred or was required to incur pursuant to a written binding contract on December 31, 1985, exceeds 5 percent of the cost of the aircraft. These subassemblies were designed for this model of aircraft, were specifically ordered for the aircraft and are essential to its operation, and include wing trailing edges, ailerons and tabs, and rudders and tabs. The subcontractors commenced physical construction of these subcomponents prior to January 1, 1986. Prior to the date the aircraft is placed in service, the manufacturer will transfer it to its wholly-owned subsidiary that is included in the same consolidated tax return as the manufacturer.

The aircraft qualifies for the investment tax credit under the transitional rule for self-constructed property. Construction of the aircraft would be considered to have begun by the aircraft manufacturer when the subcontractors commenced physical construction of the subassemblies on behalf of the manufacturer pursuant to the binding written contract.[7]

[7] Floor statement by Senator Packwood, Cong. Rec. S 13955-56 (September 27, 1986); Floor Statement by Mr. Rostenkowski, Cong. H 8360 (September 25, 1986).

This example can easily be distinguished on the following bases:

First, the Blue Book is not legislative history. E.g., Flood v. United States, 33 F.3d 1174, 1178 (9th Cir. 1994) (The Blue Book is not properly characterized as legislative history because it was written after passage of the legislation and therefore did not inform the decisions of the members of Congress.)

Second, an aircraft is personal property. The Substation consists of land and land improvements, which are real property. To meet the beginning construction requirement for facilities to be located on land, the Conference Report at II-58 requires actual work at the site. The Conference Report acknowledges that the requirement of actual work at the site does not apply to facilities not to be located on land. The Substation is located on land. Therefore, the requirement of actual work at the site applies to the Substation.

Third, the subassemblies were designed for this model of aircraft and were specifically ordered for the aircraft. The Taxpayer ordered five transformers, two of which were eventually installed in the Substation. The transformers could have been installed at any similar substation in the Taxpayer's transmission and distribution system. See Affidavit. The Taxpayer has offered no contemporaneous written evidence that the two

transformers eventually installed at the Substation were specifically ordered for the Substation.

Even assuming that the example in the Blue Book could apply to a facility to be located on land, the Taxpayer has failed to show its compliance with the example. The example requires that the subcontractor begin actual physical construction on the subcomponents before January 1, 1986. The Taxpayer is unable to show that X began before January 1, 1986, actual physical construction of the two transformers that were installed in the Substation. All the Taxpayer can show is that before January 1, 1986, X ordered numerous parts to be installed in the transformers.

By letter dated Date 1, the Taxpayer provided a statement that "[X's] records indicate winding began for the first unit, [Serial Number 1], on December 11, 1985. Winding is usually the first step in transformer manufacturing. Subsequent units were produced through 1986."[1] The transformer with Serial Number 1 was not installed at the Substation.

Winding of the coils for the transformers with Serial Number 3 and Serial Number 5, which were installed at the Substation, began some indeterminate time after December 11, 1985. The nameplate on the transformer with Serial Number 5 indicates that it was "Made in USA 1986." The nameplate on the transformer with Serial Number 3 provides no date.

Other Requirements of the Self-constructed Property Transitional Rule

Because we believe our conclusion regarding beginning construction is dispositive, we are not addressing any of the other requirements of the transition property rules. Specifically, we are not addressing the following:

1. Whether the facility was constructed by the Taxpayer as required by section 203(b)(1)(B) of the TRA of 1986;

2. Whether the lesser of $1,000,000 or 5 percent of the cost of the facility was incurred or committed by the Taxpayer before December 31, 1985, as required by section 203(b)(1)(B)(i);

3. Whether the facility met the placed in service requirements of section 203(a)(1)(A) and section 203(b)(2)(A); or

[1] Subsequently, the Taxpayer provided a statement saying that non-local production activities may precede winding, but the Taxpayer did not provided specifics on the transformers installed at the Substation.

4. Whether the acquisition of the five transformers met the requirements of the binding written contract transitional rule under section 203(b)(1)(A).

CONCLUSION:

All the evidence submitted by the Taxpayer shows prior to January 1, 1986, mere "preliminary activities such as planning or designing, securing financing, exploring, researching, or developing." Conference Report at II-56.

In addition, the Taxpayer did not acquire the land on which the Substation is located until after December 31, 1985. The Taxpayer did not begin "actual work at the site" (Conference Report at II-58) until after December 31, 1985.

Accordingly, we conclude that the Taxpayer had not begun construction of the Substation by December 31, 1985, as required by section 203(b)(1)(B)(ii) of the self-constructed property transitional rule. Therefore, the Taxpayer is not entitled to ITC with respect to the Substation.

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