INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-150483-02/CC:PSI:B6

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer =

State =

City A =

City B =

Substation 1 =

Substation 2 =

Substation 3 =

Substation 4 =

Substation 5 =

Substation 6 =

Area X =

Utility Y	=	
Date 1	=	
Year a	=	
Year b	=	
Year c	=	
Year d	=	
Year e	=	
Year f	=	
Year g	=	
Year h	=	
Year i	=	
Year j	=	
Year k	=	
A	=	
B	=	
C	=	
D	=	
E	=	
F	=	
G	=	
H	=	

I =

J =

K =

ISSUE:

Under the facts set forth below, is the Taxpayer as a matter of law entitled to the Investment Tax Credit (ITC) under the self-constructed property transition rule of section 203(b)(1)(B) of the Tax Reform Act of 1986 (TRA of 1986).

CONCLUSION:

Because each asset is a functional, independently operational unit, treated as a separate asset for depreciation purposes and placed in service at a separate time, the Taxpayer may not as a matter of law aggregate the assets placed in service prior to January 1, 1986, with the assets placed in service after December 31, 1985, to treat the overall projects as a single property for purposes of the self-constructed property transition rule.

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) and State.

In Year k, the Taxpayer made a claim for ITC relating to the years Year d through Year h, recognizing the tax effect in the Year i taxable year. The Taxpayer claims that the assets involved in each situation constitute self-constructed property for purposes of the transition rule under section 203(b)(1)(B) of the TRA of 1986. The Taxpayer categorized its claim into thirty-five separate “projects,” consisting of various functional, independently operational assets. Five of these factual situations have been selected for purposes of this Technical Advice Memorandum. The Taxpayer claims that for each of its “projects,” the assets should be aggregated and treated as a single property for purposes of the self-constructed property transition rule.

For all of the following factual situations, different assets were placed in service for financial and tax accounting purposes during the years Year a through Year h. These assets were placed in service and depreciation was begun, for financial and tax accounting purposes, on the date and in the year in which the asset was actually placed in service in the Taxpayer’s system. The Taxpayer treated some of these assets as ITC property or ITC transition property by reference to federal income tax returns as filed, but did not treat some assets placed in service in Year d or later as ITC property or ITC transition property. The Taxpayer now claims that each of the latter assets should be aggregated with at least one of the former assets as part of an overall "project" and considered a single property for purposes of the self-constructed property transition rule.

Additionally, the Taxpayer has always defined an asset as the work done on a single Taxpayer work order. The Taxpayer's Accounting Codes Manual describes a work order as "a document which: 1) specifies the work to be performed, 2) projects an estimated cost, 3) estimates the number of man hours of labor which will be required, and 4) projects the beginning and completion dates." Each work order is assigned a unique work order number and is reviewed by at least a concurring engineer, the user, and a budget officer. No actual construction in the field can begin until the various approvals are secured. The Taxpayer's Transmission and Distribution Division planning department has the authority to initiate the procurement and to enter into contracts for items which have long lead times, that is, equipment which generally takes more than six months to construct, in order to have essential equipment on hand when construction commences. In Year j and Year k, the Taxpayer conducted an extensive review of its fixed asset accounting for tax accounting for the years Year d through Year h. The Taxpayer has not adjusted its fixed asset accounting system for financial accounting to make changes to the definition of what is an asset, consistent with what the Taxpayer proposes for tax accounting purposes.

First Factual Situation: Customer Service, Year d

The Taxpayer's system of delivery of power from the generating station to the commercial or residential user consists of transmission, distribution, and customer service. Customer service involves the actual hookups of customers from the utility pole to the business or residence, and includes the electric meters. Costs for any one customer service hookup are typically less than A, and the time involved to complete a given hookup or series of hookups may vary from a few days to three or four months. Customer service hookups are going on more or less continuously.

Because of the large number of jobs of relatively small dollar value, the Taxpayer does not give a formal work order to any one job. Instead, a blanket work order is assigned for all costs of a certain type over the course of one month. At the end of the month all costs accumulated during the month are transferred to the fixed asset system.

The Taxpayer now claims that each of the Customer Service hookups in Year d should be aggregated and considered a single property for purposes of the self-constructed property transition rule.

Second Factual Situation: Transmission and Distribution Expansion Project

The Taxpayer underwent capital improvements to improve its transition and distribution facilities in the City A, State area. The improvements were made to Substation 1, Substation 2, and Substation 3, three distinct substations in the greater City A, State area. The Taxpayer refers to these improvements collectively as the City A Expansion Project ("The City A Project").

The City A Project consists of the assets placed in service to fulfill eighteen separate work orders. The first work order was approved in Year b, and the asset was placed in service for depreciation purposes in Year c. ITC was claimed and was allowed. The second work order was placed in service for depreciation purposes in Year d. ITC was claimed and was allowed.

The third through eighteenth work orders were approved between Year c and Year e, and the assets were placed in service for depreciation purposes between Year d and Year f. The Taxpayer claimed ITC on two of these assets. For both assets, the IRS disallowed the ITC on audit and the Taxpayer agreed to the disallowance by executing an agreement to a Notice of Proposed Adjustment on Date 1. The Taxpayer claimed no ITC on the other sixteen assets.

The Taxpayer now claims that each of the above assets in The City A Project should be aggregated and considered a single property for purposes of the self-constructed property transition rule.

Third Factual Situation: Substation Area X

The Taxpayer operated Substation Area X, a transmission and distribution substation, at all times under a joint operating agreement between the Taxpayer and Utility Y Project. Prior to Year c, the Taxpayer was allowed to utilize excess capacity that Utility Y Project had at its substation. The Utility Y Project is located on property adjacent to property owned by the Taxpayer. The Utility Y Project substation consisted of one 230-69kV transformer, two 69kV lines, a transformer breaker, and a tie breaker to the Taxpayer's yard.

The Substation Area X Project consists of the assets placed in service to fulfill seven separate work orders. The first work order was approved in Year a, and authorized the construction of Switchyard Area X, a switchyard consisting of one 69kV bus with circuit breakers. This equipment operated using power purchased from Utility Y Project and distributing that power over the Taxpayer's system. The switchyard was placed in service for depreciation purposes in Year c. ITC was claimed and allowed.

The second work order was approved in Year c, and authorized the transfer and connection of a 69kV feeder line from the Utility Y Project to Switchyard Area X. The work performed under this work order was placed in service for depreciation purposes in Year d. More than 5% of the costs of this work order were incurred prior to

January 1, 1986, and physical construction had begun by that date. ITC was claimed and allowed.

The third work order authorized an environmental study for a 230kV line from Substation 4 to Switchyard Area X. The work performed under this work order was placed in service for depreciation purposes in Year f. More than 5% of the costs of this work order were incurred prior to January 1, 1986, and physical construction had begun by that date. ITC was claimed and allowed.

The fourth work order was approved in Year h, and authorized preliminary engineering and survey work for a 230kV distribution line from Substation Area X to Substation 5.

Actual costs incurred prior to January 1, 1986 were B and total depreciable costs were C. It is not in dispute that ITC was claimed and allowed.

The fifth work order was initiated in Year e and approved in Year e, and authorized the conversion of Switchyard Area X to a substation by adding a transformer, bus, and circuit breaker. The work performed under this work order was placed in service for depreciation purposes in Year g. Estimated cost for the work order was D. Actual costs incurred prior to January 1, 1986 were E and total depreciable costs were F. The Taxpayer claimed no ITC on these assets.

The sixth work order was initiated in Year c and approved in Year c, and authorized the construction of a single 230kV feeder line from Substation 4 to Switchyard Area X. The line was built to accommodate a second line in the future. The work performed under this work order was placed in service for depreciation purposes in Year g. Estimated cost for the work order was G. Actual costs incurred prior to January 1, 1986 were H, and total depreciable costs were I. The Taxpayer claimed no ITC on this asset.

The seventh work order was initiated in Year e and approved in Year e, and authorized the installation of a 230kV bay and circuit breaker on the feeder line from Substation 4 to Switchyard Area X. The work performed under this work order was placed in service for depreciation purposes in Year g. Estimated cost for the work order was J. No costs were incurred prior to January 1, 1986, and total depreciable costs were K. The Taxpayer claimed no ITC on this asset.

The Taxpayer now claims that each of the above assets in The Substation Area X Project should be aggregated and considered a single property for purposes of the self-constructed property transition rule.

Fourth Factual Situation: Substation 6

The Taxpayer operated Substation 6, a transmission and distribution substation, near the City B downtown area. The Substation 6 Project consists of the assets placed in service to fulfill six separate work orders. The first work order was initiated in Year d and approved in Year d, and authorized the construction of a substation with three 69kV circuit breakers, two 41 MVA transformers, and a switchgear. The work performed under this work order was placed in service for depreciation purposes in Year f. The Taxpayer claimed no ITC on these assets.

The second work order was initiated in Year d and approved in Year e, and authorized the construction of two 69kV transmission lines for Substation 6. The work performed under this work order was placed in service for depreciation purposes in Year f. The Taxpayer claimed no ITC on these assets.

The third work order was initiated in Year d and approved in Year f and authorized the construction of two ties for the radial feeders constructed under the second work order and for reconducting of distribution lines from Substation 6. The work performed under this work order was placed in service for depreciation purposes in Year f. The Taxpayer claimed no ITC on these assets.

The fourth work order was initiated in Year d and approved in Year d, and authorized the installation of duct and cable to provide six 12kV network feeders to customers. The work performed under this work order was placed in service for depreciation purposes in Year g. The Taxpayer claimed no ITC on these assets.

The fifth work order was initiated in Year d and approved in Year d, and authorized the installation of communication cable, terminator equipment, and associated hardware to render supervisory control and energy management communications at Substation 6. The work performed under this work order was placed in service for depreciation purposes in Year h. The Taxpayer claimed no ITC on these assets.

The sixth work order was initiated in Year e, and approved in Year e, and authorized the installation of a duct bank system for two new radial feeders and for three future feeders. The work performed under this work order was placed in service for depreciation purposes in Year g. The Taxpayer claimed no ITC on these assets.

The Taxpayer now claims that each of the above assets in The Substation 6 Project should be aggregated and considered a single property for purposes of the self-constructed property transition rule.

Fifth Factual Situation: Customer Service, Year e through Year h

As stated above in the first factual situation, the Taxpayer’s system of delivery of power from the generating station to the commercial or residential user consists of transmission, distribution, and customer service. Customer service involves the actual hookups of customers from the utility pole to the business or residence, and includes the electric meters. Costs for any one customer service hookup are typically less than A, and the time involved to complete a given hookup or series of hookups may vary from a few days to three or four months. Customer service hookups are going on more or less continuously.

Because of the large number of jobs of relatively small dollar value, the Taxpayer does not give a formal work order to any one job. Instead, a blanket work order is assigned

for all costs of a certain type over the course of one month. At the end of the month all costs accumulated during the month are transferred to the fixed asset system.

The Taxpayer now claims that the costs of Customer Service hookups from Year e through Year h should be aggregated and that a percentage of the total Customer Service costs for each taxable year should be aggregated and considered a single property for purposes of the self-constructed property transition rule. The Taxpayer requests that the percentage of qualifying costs for Customer Service hookups in each taxable year be determined by the ratio of transmission and distribution projects for each taxable year on which ITC is claimed to the total transmission and distribution projects for each taxable year.

LAW:

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.

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).

ANALYSIS:

“Provisions granting special tax exemptions are to be strictly construed.” Helvering v.

Northwest Steel Rolling Mills, 311 U.S. 46, 49 (1940). This tax principle has been applied in interpreting the transition rules of the TRA of 1986, including the ITC transition rules. See United States v. Commonwealth Energy Systems, 235 F.3d 11 (1st Cir. 2000); Bell Atlantic Corp. v. United States, 224 F.3d 220 (3rd Cir. 2000); United States v. Kjellstrom, 916 F. Supp. 902, 905 (W.D. Wis. 1996), aff'd, on other grounds, 100 F.3d 482 (7th Cir. 1996); Apache Bend Apartments, Ltd. v. United States, 987 F.2d 1174 (5th Cir. 1993). "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." Id. at 1175. "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. "[A]lthough 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). The Taxpayer did not detrimentally rely on the old rule. Rather, the Taxpayer's factual situations involved the improvement and expansion of its system of delivery of power without regard to ITC, to meet growing power needs in the area. The Taxpayer did not claim ITC in its factual situations when the Taxpayer filed its consolidated income tax returns for the years in question and did not raise the possibility for years after the assets were placed in service.

In seeking the refund claim, the Taxpayer argues that for purposes of the self-constructed property rule, Congress did not intend the term "property" as used in the self-constructed property transition rule to be synonymous with the word "asset." The Taxpayer has conceded that if each asset is analyzed based upon when it was placed in service for depreciation purposes, the assets will not meet the eligibility criteria under the self-constructed property rule. However, the Taxpayer claims that the meaning of the term "property" as used in the self-constructed property transition rule is more akin to the word "project," and that therefore, transition property may have multiple placed-in-service dates for the various functional, independently operational assets constituting transition property. As each of the taxpayer's "projects" includes independently operational assets placed in service prior to January 1, 1986, as well as the collection of various independently operational assets placed in service during the transition period, the taxpayer argues that the costs of the assets placed in service prior to January 1, 1986, should be aggregated with the costs of the assets placed in service after December 31, 1985, and treated as a single property for purposes of the self-constructed property transition rule. In making this argument, the Taxpayer largely relies on the single use of the word "project" in the Conference Report at II-56, which states: "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."

We disagree with the Taxpayer's argument. "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 Systems, 235 F.3d at 15. See also Reiter v. Sonotone Corp., 442 U.S. 330, 339 (1979); Bell Atlantic Corporation, 224 F.3d at 224 (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 claims, "property" in section 203(b)(1)(B) means "project," then section 204 is rendered superfluous. When Congress used the term "property," Congress meant "property." The single use of the word "project" at that point in the Conference Report does not support the taxpayer's contention that Congress intended "property" to refer to multiple independently operational assets with different placed in service dates. This passage of the Conference Report was intended to clarify whether property, constructed by a taxpayer who serves as the engineer and general contractor but uses the services of subcontractors, was constructed by the Taxpayer as required by section 203(b)(1)(B). Our interpretation is supported by the next paragraph of the Conference Report, which further clarifies that in the context of a building, for the purposes of the self-constructed property transition rule, "the term 'property' includes all of the normal and customary components that are purchased from others and installed without significant modifications (e.g., light fixtures)." Thus, the Conference Report merely reaffirms that taxpayers need not literally construct the entire property in order to qualify under the self-constructed property transition rule.

The Taxpayer also cites as authority an unpublished opinion, Steelcase, Inc. v. United States, 95-2 U.S.T.C. ¶ 50,336 (W.D. Mich. 1995), aff'd, 165 F.3d 28 (6th Cir. 1998). In Steelcase, the taxpayer began construction of a new office building with a projected cost of $35 million before the applicable date. Subsequently, the design of the building was modified leading to the construction of a building costing $100 million. The district court concluded that the modified building qualified for ITC under the self-constructed property transition rule. The court reasoned:

> From the beginning, Steelcase set out to construct an innovative research and development building that would enhance the creative process by promoting interaction between the marketing, research and development departments. Steelcase's design concept never changed. The building placed in service fulfilled those goals. The building was in the same location, was the same size, housed the same departments, housed the same laboratories, housed the same people, performed the same function, and was created according to the same concept as the building Steelcase originally began construction on in the fall of 1985. What Steelcase wanted on day one it achieved. The finished project is evidence of the integrity of Steelcase's initial philosophy, even though the implementation of that philosophy may have required some trial and error.
>
> (95-2 U.S.T.C. at 89,046).

However, Steelcase is distinguishable from the Taxpayer's factual situations. In Steelcase, the asset in question was a building comprised of a shell and structural components functioning as a single interdependent unit. The test for whether component assets will be considered as a single property is whether the component parts are functionally interdependent where each component is essential to the operation of the project as a whole and cannot be used separately to any effect. See Armstrong World Industries, Inc. v. Commissioner, 974 F.2d 422, 434 (3rd Cir. 1992). See also Hawaiian Independent Refinery, Inc. v. United States, 82-1 U.S.T.C. ¶ 9183

(Ct. Cl. Trial Div. 1982) (all components to a facility that are essential to a facility constitute a single property), aff'd, 697 F.2d 1063 (Fed. Cir. 1983) (trial court's approach was particularly reasonable since the complex was conceived, designed and constructed as a unit, the three components being placed in operation concurrently). In this case, each of the separate assets is a functional, independent unit and treated as a separate asset for depreciation purposes and placed in service at separate times. Therefore, we conclude that this case is factually distinct from Steelcase.

We would also distinguish the building involved in Steelcase from the Taxpayer's factual situations. In Steelcase, the taxpayer had a definitive design concept that never changed. In contrast, the Taxpayer's factual situations involved an ongoing effort which the Taxpayer flexibly altered in scope and duration to meet the growing power needs of the area. We therefore find that the reasoning in Steelcase inapplicable to the Taxpayer's claim that multiple functional, independently operational assets constitute a single interdependent asset like a building for purposes of the self-constructed property transition rule.

Our conclusion is that the Taxpayer may not aggregate multiple functional, independently operational assets as a single property for purposes of the self-constructed property transition rule. We are not addressing any of the other requirements of the self-constructed property transition rule. Specifically, we are not addressing:

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 assets was incurred or committed by the Taxpayer before December 31, 1985, as required by section 203(b)(1)(B)(i);

3. Whether the construction of the assets began by such date, as required by section 203(b)(1)(B)(ii); or

4. Whether the assets met the placed in service requirements of section 203(a)(1)(A) and section 203(b)(2)(A).

CONCLUSION:

Because each asset is a functional, independently operational unit, treated as a separate asset for depreciation purposes and placed in service at a separate time, the taxpayer may not as a matter of law aggregate the assets placed in service prior to January 1, 1986, with the assets placed in service after December 31, 1985, to treat the overall projects as a single property for purposes of the self-constructed property transition rule.

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.