Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Area Counsel (Natural Resources: Houston)

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subject: Section 29(g): Placed in Service requirement for credit
POSTN-167143-02

This memorandum is in response to your request of December 11, 2002, regarding the meaning of "placed in service," as used in Internal Revenue Code section 29(g)(1) in connection with a facility for the production of qualified fuels described in section 29(c)(1)(C).

DISCLOSURE STATEMENT

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Issue

When is a facility that produces solid synthetic fuel from coal "placed in service" for purposes of section 29?

Conclusions

For purposes of section 29, a facility is placed in service when, based on all relevant facts and circumstances, it is in a condition or state of readiness and availability for its specified function, e.g., to produce commercially usable synfuel. Lack of production, or of less than designed capacity is not the sole determining factor for a placed in service determination. In addition, a taxpayer must have commenced a trade or business as of the cut-off date to be considered placed in service for purposes of section 29.

Background

Guidance has been requested guidance regarding the requirements for the section 29 credit for production of qualified solid synthetic fuel from coal. Some facilities under examination were either not producing the synthetic fuel prior to July 1, 1998 (the cut-off date for section 29(g)), or were not producing at or near intended or rated capacity as of that date. Exam has questioned whether such facilities meet the placed in service requirements under section 29.

Exam has argued that the commencement of a trade or business is inherent to a placed in service determination for purposes of depreciation or for the section 29 credit. Many of these facilities did not have contracts for the delivery of synthetic fuel, nor an inventory on hand to sell a customer as of the cut-off date. Without inventory or current production, Exam has questioned whether the taxpayer was engaged in a trade or business as of the cut-off date. If not so engaged, Exam argues that the facility would not be currently used in a trade or business and, thus, would not be placed in service.

Law & Analysis

In general, section 29 provides a credit for the production of solid synthetic fuel from coal. Section 29(g)(1) (added by P.L. No. 104-188 (1996)) provides a tax credit for the sale of qualified fuels that are sold through the end of 2007 and produced from a facility that was originally placed in service after December 31, 1992, and before July 1, 1998, pursuant to a binding written contract that was in effect before January 1, 1997. No regulations have been promulgated under section 29. Thus, we look to other published guidance of the Service and other analogous Code sections to interpret the meaning and scope of that section, in particular the meaning of placed in service.

In general, property is placed in service in the taxable year the property is placed in a condition or state of readiness and availability for a specifically designed function. See, Treas. Reg. sections 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i). Placed in service is construed by the Service as having the same meaning for purposes of the investment tax credit under section 46 and depreciation under section 167, in Rev. Proc. 2001-30, 2001-1 C.B. 1163 and in private letter rulings. Section 1.46-3(d)(2) provides examples of when property is in a condition of readiness and availability. One of those examples is equipment that is acquired for a specifically assigned function and is operational but undergoing tests to eliminate any defects. See also Rev. Proc. 79-40, 1979-1 C.B. 13, where machinery and equipment were placed in service in the year critical tests (with appropriate materials) and operational tests were completed. Another example in section 1.46-3(d)(2) involved operational farm equipment acquired and placed in service in a taxable year even though it was not practical to use such equipment for its specifically designed function in the taxpayer's business of farming until the following year.

Several Tax Court cases have addressed placed in service questions in the context of electric power plants. In Olgethorpe Power Corp. v. Commissioner, T.C. Memo. 1990-505 and Consumers Power Co. v. Commissioner, 89 T.C. 710 (1987) facilities can be deemed placed in service upon sustained power generation near rated capacity. However, if the facility operates on a regular basis but does not produce the projected output, it may still be considered placed in service. Sealy Power, Ltd v. Commissioner, 46 F.3d 382 (5th Cir. 1995), nonacq. 1996-1 C.B. 6. In the Action on Decision for Sealy Power, the Service stated that at a minimum, the property would have to have been in a state of readiness sufficient to produce electricity on a sustained and reliable basis in commercial quantities. AOD 1995-010. And in Rev. Rul. 84-85, 1984-1 C.B. 10, a solid waste facility that was experiencing operational problems such that it was unable to operate at its rated capacity was considered to have been placed in service since it was being operated on a regular basis and saleable steam was being produced. But if a facility is merely operating on a test basis, it is not placed in service until it is available for service on a regular basis. Consumers Power v. Commissioner, 89 T.C. at 710.

The above-referenced cases and rulings, which address electric generating facilities, provide some parallels in evaluating a placed in service issue for section 29 facilities. The following factors common to both power plants and synfuel plants in determining placed in service are:

(1) approval of required licenses and permits;
(2) passage of control of the facility to taxpayer;
(3) completion of critical tests; and
(4) commencement of daily or regular operation.

A fifth factor that was noted, synchronization, applies only to power plants. See generally, Rev. Rul. 76-256, 1976-2 C.B. 46 and Rev. Rul. 76-428, 1976-2 C.B. 47.

In Rev. Rul. 84-85, 1984-1 C.B. 103, the Service found that reaching the design capacity was not a prerequisite to a determination that a facility was placed in service. In that ruling, the Service looked to daily operation of the facility to determine the placed in service date. In Valley Natural Fuels v. Commissioner, 62 TCM 229, the court required an ethanol plant to be producing ethanol of the quality for which the plant was designed prior to being placed in service. Finally, Armstrong World Industries, Inc. v. Commissioner, TCM 1991-326, provides an extensive overview of the various placed in service cases.

The focus in determining a placed in service date should be on ascertaining from the relevant facts and circumstances the date the unit begins supplying product in such a manner that it is routinely available and is consistent with the unit's design. It is necessary to examine relevant factors occurring both before and after the claimed placed in service date so that the date can be verified. However, a facility does not have to achieve full design output to be placed in service as long as it is in the process of ramping up its production levels. Subject to exceptions that are beyond the taxpayer's control, the Service has generally required actual operational use as a prerequisite for an asset to be deemed placed in service. For this reason, it is critical to

know when the facility began producing synfuel, and whether this production continued to be "ramp-up" or ceased until significant problems with the facility were corrected.

Regarding facilities that are not operating as of the cut-off date, the focus should be on the facilities readiness and availability to produce, on a regular basis, commercial quantities of synfuel rather than the actual production of such synfuel. In addition, subsequent production should reflect the same ramp-up to facility capacity. However, if the facility never operates at a significant production level, or in the same or next tax year shut down for any significant period of time to correct production problems, the earlier activity is likely in the nature of start-up and testing, and the facility has not been placed in service.

In general, business operations must have begun for the subject property to be considered placed in service. See, Piggy Wiggly Southern, Inc. v. Commissioner, 84 T.C. 739, 748 (1985), nonacq. on another issue. 1988-2 C.B. 1, aff'd on another issue, 803 F.2d 1572 (11th Cir. 1986). Sporadic activity may be merely start-up activity. The property cannot be placed in service until the trade or business begins. Wall v. Commissioner, T.C. Memo. 1992-321; Richmond Television Corp. v. U.S., 345 F.2d 901, 909 (4th Cir. 1965), vacated and remanded on another issue, 382 U.S. 68 (1965), on remand, 354 F.2d 410 (4th Cir. 1965), overruled on other grounds.

Section 167 requires property to be used in a trade or business or for the production of income. However, activities that constitute a trade or business are not defined in the regulations under 167, so we look to similar provisions under section 162. Section 162(a) provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. To qualify as a deduction allowable under section 162(a), an expenditure must: (1) be paid or incurred during the taxable year, (2) be for carrying on any trade or business, (3) be an expense, (4) be necessary, and (5) be ordinary. Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 352 (1971). The instant issue concerns the interpretation of the second requirement.

Neither the Code nor the Income Tax Regulations provide any explicit definition of the term "carrying on any trade or business" for purposes of section 162. The Supreme Court has stated that to be engaged in a "trade or business" for purposes of section 162 the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987). Determining whether a taxpayer is carrying on a trade or business for purposes of section 162 requires an examination of the facts in each case. 480 U.S. at 36.

In Richmond Television Corporation v. United States, supra, NCNB Corporation v. United States, 684 F.2d 285 (4th Cir. 1982), the Fourth Circuit addressed the issue of what point in time did the taxpayer's business begin. After reviewing other cases to see the evidentiary bases on which factual determinations were made, the court stated the following rule: "[E]ven though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money in preparation for

entering that business, he still has not 'engaged in carrying on any trade or business' within the intendment of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it was organized." 345 F.2d at 907 (footnote omitted). See also Jackson v. Commissioner, 864 F.2d 1521 (10th Cir. 1989), aff'g 86 T.C. 492 (1986); Hardy v. Commissioner, 93 T.C. 684 (1989), aff'd on this issue and remanded on other issue, 1990 U.S. App. LEXIS 19670 (10th Cir. Oct. 29, 1990), on remand, T.C. Memo. 1991-187; Bybee v. Commissioner, T.C. Memo. 1993-232, aff'd on this issue and vacated in part and remanded on other issue without published opinion, 29 F.3d 630 (9th Cir. 1994), 74 AFTR2d 5487, on remand, T.C. Memo. 1996-411, aff'd without published opinion, 129 F.3d 124 (9th Cir. 1997), cert. denied, 525 U.S. 1069 (1999). In Jackson, 864 F.2d at 1526 n.7, the Tenth Circuit discussed the case of Kennedy v. Commissioner, T.C. Memo. 1973-15, which held that a pharmacy did not begin to function as a going concern until the date it first opened its doors to the public. The Tenth Circuit explained that, although sales presumably followed, this holding properly focused on the taxpayer's "opening its doors" to attempt to make a sale, and not on the taxpayer's success at selling. In any analysis, it is important to consider whether the taxpayer is actually entering a new business or is only beginning to use a new method of carrying on an old business. See Colorado Springs National Bank v. United States, 505 F.2d 1185 (10th Cir. 1974); First Security Bank of Idaho, N.A. v. Commissioner, 63 T.C. 644 (1975), aff'd, 592 F.2d 1050 (9th Cir. 1979).

In light of the above, an analysis of the relevant facts and circumstances is necessary to determine whether a particular taxpayer is engaged in a trade or business as of the cut-off date for purposes of the section 29 credit. The lack of current contracts, or of an available inventory of synfuel is not determinative, provided the taxpayer has "opened his doors," is actively soliciting contracts and has a facility ready and available to produce, on a regular basis, commercial quantities of synfuel.

If you have any further questions, please contact at