INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
March 1, 2002

Number: **200225007**
Release Date: 6/21/2002
Index (UIL) No.: 0049.00-00
CASE MIS No.: TAM -160007-01/CC:PSI:B5

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer =

Area A =

State B =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

ISSUE:

Whether Taxpayer's replacement transformers in the aggregate or each replacement transformer constitute the unit of property for purposes of determining eligibility under the self-constructed property transition rule under section 203(b)(1)(B) of the Tax Reform Act of 1986 (Act)?

CONCLUSION:

Each of Taxpayer's replacement transformers constitutes a unit of property for purposes of determining eligibility under the self-constructed transitional rule.

FACTS:

The Taxpayer is an electric utility and is principally engaged in the production, purchase, transmission, distribution and sale of electricity to residential, commercial, and industrial customers. The Taxpayer's electric service territory covers Area A of State B.

The Taxpayer has filed refund claims for additional transition investment tax credit. Specifically, the Taxpayer is seeking investment tax credit for the replacement of certain components of the taxpayer's transmission and distribution network which occurred in a through b under the self-constructed property transition rule of section 203(b)(1)(B) of the Tax Reform Act of 1986, Public Law No. 99-514.

When the Taxpayer originally constructed its transmission and distribution network, it utilized equipment containing polychlorinated biphenyls ("PCBs") such as transformers (device which increase or decrease voltage) and pole-mounted capacitors (device for the short-term storage of electricity). Because of the environmental hazards caused by PCBs, the Environmental Protection Agency ("EPA") issued regulations requiring the removal of capacitors containing PCBs. Pursuant to these regulations, the Taxpayer began removing such capacitors in c . In anticipation of similar regulations governing transformers, the Taxpayer also began in c replacing transformers and auxiliary equipment (protectors, cables, meters).

In July of 1985, the EPA issued regulations (40 CFR Part 761) which required the removal of certain types of transformers. The regulations stated in part:

> (a)(1)(ii). As of October 1, 1990, the use of network PCB Transformers with higher secondary voltages (secondary voltages equal to or greater than 480 volts, including 480/277 volt systems) in or near commercial buildings is prohibited.
> ***
> (a)(1)(iv). As of October 1, 1990, all radial PCB Transformers, in use or near commercial buildings, and lower secondary voltage network PCB Transformers not located in sidewalk vaults in or near commercial buildings (network transformers with secondary voltages below 480 volts), that have not been removed from service as provided in paragraph (a)(1)(iv)(B) of this section, must

be equipped with electrical protection to avoid transformer ruptures caused by high current faults.

(A) Current-limiting fuses or other equivalent technology must be used to detect sustained high current faults and provide for the complete deenergization of the transformer (within several hundredths of a second in the case of higher secondary voltage radial PCB Transformers and within tenths of a second in the case of lower secondary voltage network PCB Transformers), before transformers rupture occurs...

(B) All lower secondary voltage network PCB Transformers not located in sidewalk vaults (network transformers with secondary voltages below 480 volts), in use in or near commercial buildings, which have not been protected as specified in paragraph (a)(1)(iv)(A) of this section by October 1, 1990, must be removed from service by October 1, 1993.
***
(D) As of October 1993, all lower secondary voltage network PCB Transformers located in sidewalk vaults (network transformers with secondary voltages below 480 volts) in use near commercial buildings must be removed from service.

Based on these regulations, the Taxpayer's engineering department prepared a d budget request and accompanying document estimating a total of e transformers to be replaced through j. In f, the Taxpayer interpreted the EPA regulations to require the replacement of a greater number of transformers and auxiliary equipment. As a result, the Taxpayer expanded its replacement program from an estimated e transformers in g to over h transformers. The replacement of transformers was completed in i.

The Taxpayer concedes each transformer is a functional, independent unit and treated as a separate asset for depreciation purposes and placed in service at separate times. However, the Taxpayer's position is that the replacement of separate transformers and units of auxiliary equipment should be aggregated and deemed a single property for purposes of the self-constructed property transition rule.

The Taxpayer would also have the Service take into account replacement costs of transformers and auxiliary equipment already installed and operating by December 31, 1985, as incurred toward the $1 million or 5 percent cost requirements of the self-constructed property transition rule.

In contrast, the revenue agent asserts that each component (i.e., transformer) should be evaluated separately as to the requirements of the self-constructed rule to determine transition rule eligibility rather than the Taxpayer's aggregation approach. The revenue agent notes that the Taxpayer has consistently treated each transformer as a separate unit of property for purposes of depreciation and internal accounting purposes.

LAW AND ANALYSIS:

The Tax Reform Act of 1986 ("Act") eliminated the investment tax credit ("ITC")

and the Accelerated Cost Recovery System ("ACRS") depreciation method. In making the change, Congress recognized that the repeal of the credit would work a hardship on some companies that had relied to their detriment on the old law. Therefore, the repeal was accompanied by transitional rules which a taxpayer could still qualify for the ITC and the ACRS depreciation under the old rules if certain requirements were met. The three transitional rules, known as the binding contract rule, the self-constructed property rule, and the equipped building/plant facility rule, enabled taxpayers already committed to the acquisition or construction of certain property to qualify for the continued ITC and ACRS depreciation (P.L. 99-514, §§ 203(b)(1)(A-C) and 211(a)).

Section 49(a) of the Code, which was added by section 211 of the Act, states that, for purposes of determining the amount of the investment credit determined under section 46, the regular percentage (10 percent) does not apply to any property placed in service after December 31, 1985. Section 49(b)(1), however, provides, that section 49(a) does not apply to transition property as defined in section 49(e), subject to the general limitations in sections 49(c) and (d).

Section 49(e)(1) of the Code defines the term "transition property" as any property which was placed in service after December 31, 1985, and to which the amendments made by section 201 of the Act (relating to the modification of the accelerated cost recovery system) generally do not apply. For purposes of the investment credit transition rules, section 49(e)(1)(B) substitutes "December 31, 1985" for "March 1, 1986" (the date generally applicable to the accelerated cost recovery transitional rules).

Section 203(b)(1)(B) of the Act known as the "self-constructed property" exception, provides that the repeal of the of the ITC and ACRS shall not apply to:

(B) property which 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.

As a preface to our discussion, we note the well-established precedent that "provisions granting special tax exemptions are to be strictly construed." Helvering v. Northwest Steel Rolling Mills, 311 U.S. 46, 49 (1940). This oft-quoted tax principle has been applied in interpreting tax transition rules in the Reform Act, including those involving the phase-out of the investment tax credit, 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); Apache Bend Apartments, Ltd. v. United States, 987 F.2d 1174 (5th Cir. 1993); 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). As noted in Apache Bend, 987 F.2d at 1175, the transition rules were enacted to provide relief "to a very, very few specified favored taxpayers," and although they must extend to all qualifying taxpayers, their interpretation is not to be broadened so that entities that did not detrimentally rely on the old rule benefit from the transition exemption. See

Commonwealth, 235 at F.3d at 16. Beginning from this well established tax principle of strict construction and detrimental reliance in assessing claims for transition rule relief, we will analyze Taxpayer's arguments.

In seeking the refund claim, Taxpayer argues that the entire replacement "project" should be considered a single unit of property for determining eligibility under the self-constructed transition rule. The Taxpayer maintains that its program of replacing PCB transformers began in c and completed in i was a long-term project to reconstruct the affected portions of the Taxpayer's transmission and distribution system. The Taxpayer analogizes the replacement transformers in the aggregate to a separately identifiable asset such as a heating and cooling system in a building. The Taxpayer 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 investment tax credit 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, emphasis added).

We would first distinguish the building involved in Steelcase from the Taxpayer's transformers. In contrast to a building comprised of a shell and structural components functioning as a single interdependent unit, the Taxpayer's transformers are functionally independent equipment that do not rely on interaction with other replaced transformers for functional operation. Indeed, each separate transformer can be replaced without disrupting electrical power in the entire electrical system. The Taxpayer treated each separate transformer as a separate unit of property for both depreciation and internal budgetary purposes.

Second, in contrast to the existence of a definitive design concept in Steelcase, the Taxpayer's replacement transformer program was an ongoing replacement effort which the Taxpayer flexibly altered in scope and duration to encompass a greater number of individual transformers to fulfill EPA requirements. In fact, as greater numbers of individual transformers needed to be replaced, Taxpayer's own budget

plans and supporting documents reveal an evolving replacement program in both scope of transformers (e to h) and in time duration (b to i). In summary, we thus find the reasoning of Steelcase inapposite to the Taxpayer's assertion that a multitude of individual transformers and auxiliary equipment replaced over a period of k years constitutes a single interdependent asset like a building for purposes of the self-constructed transition rule.

The issue of whether property is considered to be a single unit of property or a component part of a single unit of property was considered in Armstrong World Industries, Inc. v. Commissioner, 974 F.2d 422 (3rd Cir. 1992); and Hawaiian Independent Refinery, Inc. v. United States, 82-1 U.S.T.C. ¶ 9183 (Ct. Cl. Trial Div. 1982), aff'd, 697 F.2d 1063 (Fed. Cir. 1983). The specific issue in Armstrong World was whether property placed in service with respect to safe harbor leasing qualified for investment tax credits and depreciation deductions if property was leased within three months of being placed in service. Nine agreements for the sale and leaseback of railroad property were entered into between Armstrong World and Conrail.

The agreements were for various construction activities of Conrail. For illustrative purposes, one project will be discussed. The determinations by the court are similar for the other projects. Conrail was experiencing delays in the movement of traffic on 76 miles of track. Two parallel tracks allowed trains to operate in only one direction, and the various interlockings along the route were controlled by human operators in control towers. During 1977, the Board of Directors approved a project to upgrade the 76 miles of track to include an electronic traffic control system. One or more work orders were assigned to the project by Conrail's accounting department in order to monitor costs.

The project was described on a work order as follows: (1) install a traffic control signaling system (TCS) on the Pittsburgh-Chicago main line between Orville and Colsan, Ohio and on the Cleveland-Indianapolis main line between Crestline and Galion, Ohio; (2) downgrade the parallel Akron-Galion main line; (3) convert to remote control interlockings; (4) improve connections at Crestline, Ohio, from the Pittsburgh-Chicago main line to the Cleveland-Indianapolis main line; and (5) construct a connection at Mainsfield, Ohio, from the Pittsburgh-Chicago main line to the Brady Lake-Galion main line.

The project was to permit two way traffic movement of trains on each of the parallel tracks. When new signals, connections, wiring and necessary track work was completed in a segment, such segment would be "cut over" i.e., turned over by construction crews to local crews for actual train operation. Eleven segments were completed over a period of 2-1/2 years. The computer was not able to make prioritizing decisions along the route until the final segment was placed in service.

Many aspects of the project were already under construction prior to any discussion of the tax act. The lease was entered into near the completion of the last segment after the passage of the tax act. The taxpayer requested the Tax Court to conclude that the whole project should be placed in service as a single unit of property, when the last segment was placed in service.

The Tax Court reasoned that where the completion of a component is integral to the availability and readiness of a project for its specifically assigned function, then no one component/part of a project is considered placed in service until the whole project is placed in service. In the Tax Court's view of the evidence, the safe harbor leases involved projects consisting of components or sub-projects. The Tax Court determined that the use of a segment (sub-project) after it was cut over reveals the independent character of the segment in relation to the other segments. The individual segments were not necessary to the whole project but, rather, were independent sub-projects. Accordingly, the Tax Court decided only the final segment met the 3-month window for the safe harbor lease.

In affirming the Tax Court, the court of appeals stated:

> In sum, courts appear to agree that individual components will be considered as a single property for tax purposes when 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. The converse, thus, should be equally valid in this case. Accordingly, if a project has component parts which can function as planned in a wholly independent manner, then a court may find that each component is a 'property ...placed in condition of readiness and availability for a specifically assigned function' (emphasis added, 974 F.2d at 434).

In Hawaiian Independent Refinery, Inc. v. United States, 82-1 U.S.T.C. ¶ 9183 (Ct. Cl. Trial Div. 1982), aff'd, 697 F.2d 1063 (Fed. Cir. 1983), the court of appeals considered the question of what was single property for purposes of applying the construction exception to the restoration of the investment tax credit in 1971. In Hawaii Independent, the taxpayer argued that a refinery, marine terminal, and product pipelines were separate properties for purposes of applying the transition rule. In order to qualify for the transition rules of this act, the taxpayer desired separate dates for beginning construction later than that of the project as a whole. However, the Court of Claims concluded that the refinery, marine terminal, and pipelines, constituted a single property. In reaching this conclusion, the Court of Claims reasoned that all components of a facility that are essential to the operation of the facility constituted a single property. In affirming the decision, the court of appeals concluded that the trial court's approach was reasonable "particularly since the refinery complex, was conceived, designed and constructed as a unit, the three components being placed in operation concurrently" Hawaii Independent, 697 F.2d at 1069.

Applying the test found in Armstrong World Industries and Hawaiian Independent Refinery for determining whether components will be considered as a single property, we conclude that each of Taxpayer's individual replacement transformer is a unit of property for purposes of the self-construction provision in section 203(b)(1)(B) of the Tax Reform Act of 1986. Each replacement transformer could function as soon as it was placed in service independent of any replacement transformer that had not yet been installed because the distribution system of which the replacement transformer became a part was already in place. Since each replacement transformer is a functional unit, the Taxpayer cannot aggregate the replacement transformers and treat

them as a single unit of property for purposes of the transition rule. This would be inconsistent with the functional interdependence required by the courts in Armstrong and Hawaii Independent to establish a single unit of property. Indeed, we note that the courts' rationale for determining a unit of property is entirely consistent with the investment tax credit and depreciation provisions of sections 1.46-3(d)(1) and 1.167(a)-11(d)(2)(vi)(g) of the Income Tax Regulations. Thus, the Taxpayer simply cannot establish that the multitude of transformers constitute a single property for investment tax credit qualification in view of the well-established legal precedent.

We also disagree with Taxpayer's position that they can count the costs of transformers and auxiliary equipment already replaced prior to December 31, 1985, as counting toward satisfying the requirement that the lesser of $1 million or 5 percent of the cost of transition property be incurred or committed by December 31, 1985. We conclude that the to the extent property has already been placed in service prior to December 31, 1985, such property no longer can qualify as transition property and, therefore, cannot provide the foundation necessary to qualify transition property placed in service after December 31, 1985. In other words, if the $1 million or 5 percent in property costs used by the Taxpayer to meet the self-constructed rule threshold relates to costs of pre-transition property already placed in service and for which regular investment tax credit has already been claimed, the self-constructed property transition rule is not met.

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.

-END-