INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Date of Communication: Not Applicable

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Team Manager,

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

Legend:

State:
Authority:
Facility 1:
Facility 2:
Facility 3:
Location 1:
Location 2:
Date 1:
Date 2:
Date 3:
Tax Years at Issue:

ISSUE

Were the Facilities at issue placed in service by the Taxpayer prior to July 1, 1998?

CONCLUSION

The Facilities at issue were placed in service by the Taxpayer prior to July 1, 1998.

FACTS

Taxpayer contracted for construction of three facilities to produce synthetic fuel from coal using Process. The Taxpayer received certificates of substantial completion for the facilities on Date 1 for Facility 1 and Facility 3, and on Date 2 for Facility 2, at which point control of the facilities was passed to the Taxpayer. All three facilities are located in State; Facility 1 and Facility 2 are located at Location 1, and Facility 3 is located at Location 2.

On Date 3, Authority issued temporary permits allowing Taxpayer to operate the facilities. In late 1998, Taxpayer was fined for exceeding the allowable discharge from the facilities; however, Authority did not withdraw or suspend the existing permits for operation. The Taxpayer voluntarily slowed commercial production at the Facilities to investigate the causes of, and reduce the discharge from, the Facilities to permitted limits. Discharges were reduced by limiting the amount of air forced over the drying synthetic fuel and this was accomplished without significant change to the Facilities. By early 1999, the Facilities were operating and discharges were within permitted limits.

Taxpayer's president and senior vice president made sales and marketing calls to prospective customers, largely in the utility and manufacturing sectors prior to June 1998. In late June 1998, the Taxpayer hired a full-time sales and marketing manager. This sales and marketing manager continued in that position until late 2001. Further, Taxpayer had a workforce of 32 persons in place prior to July 1, 1998, that had been trained in the operation of the Facilities. Roads adequate to allow trucks to transport the synthetic fuel to customers were present at both Location 1 and Location 2.

Prior to July 1, 1998, all three facilities were producing synthetic fuel and all of the fuel produced was ultimately sold to unrelated customers. There were occasional operational problems at the facilities but these problems necessitated only repairs and adjustments to the facilities. Due to a lack of demand, the facilities did not always operate daily. However, beginning in early June 1998, and continuing through early August, both the amount produced by the Facilities and the hours of operation steadily increased. For example, Facility 3 averaged approximately 10 hours of operation daily from July 17 through August 11, 1998. During this period, Facility 3 produced an average of more than 600 tons of synthetic fuel.

LAW AND ANALYSIS

Section 29 of the Internal Revenue Code provides a credit for the sale, to unrelated parties, of qualified synthetic fuel produced in a facility originally placed in service after December 31, 1992, and before July 1, 1998.

Section 1.46-3(d)(1)(ii) of the Treasury regulations provides generally that property is placed in service when it is placed in a condition or state of readiness and availability for

a specifically assigned function. This definition of placed in service has been extensively analyzed in revenue rulings and court cases under both section 46 and section 167.

In order to determine when a facility has reached a condition or state of readiness and availability for a specifically assigned function, all facts and circumstances must be considered. The Service has generally looked to a number of factors to determine when a facility is in a condition or state of readiness and availability for a specifically assigned function. They 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.

See generally, Rev. Rul. 76-526, 1976-2 C.B. 46; Rev. Rul. 76-428, 1976-2 C.B. 47; Rev. Rul. 84-85, 1984-1 C.B. 103.[1] These factors are not exclusive – they are used as guideposts to determine whether, looking at the totality of the facts and circumstances, a facility has been placed in service.

It is important to note that a facility need not have reached design capacity to be considered placed in service. Rev. Rul. 84-85. However, a facility must be able to produce on a sustained and reliable basis in commercial quantities. To the factors used by the Service, courts have generally also required that the taxpayer be engaged in a trade or business. See, e.g., 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 F2d 1572 (11th Cir. 1986). While neither the Code nor the regulations defines when a taxpayer is carrying on trade or business, the Supreme Court has stated that 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. 345, 352 (1971). Each of these requires that all of the relevant facts and circumstances be taken into account in determining whether the taxpayer has placed the facility in service as well as whether the taxpayer is in a trade or business.

Because section 29 requires that the Facilities be placed in service prior to July 1, 1998, we must examine the facts as they existed at that time. However, one cannot simply take a "snapshot" at a moment in time, as events before and after the key date must be considered to determine whether the facilities at issue here were placed in service prior to July 1, 1998. We shall first consider the four factors.

[1] The revenue rulings using these factors involve power plants but the four factors listed above are also useful in analyzing other types of facilities. A fifth factor, synchronization to the power grid, is useful only in the context of power plants.

The first factor is whether the Taxpayer had secured approval of all required licenses and permits. All licenses and permits necessary for operation of the facilities were secured by the Taxpayer prior to July 1, 1998. While the facilities did, in fact, violate the existing temporary environmental permit, the Authority did not revoke the operating permit and require the facilities to cease operation. Instead, the Authority fined the Taxpayer. At no time subsequent to June 30, 1998, was the Taxpayer prevented from operating the Facilities by failure to have the required permits. Had the Authority revoked the temporary permit, rather than issue the final permit, we may have concluded that the facilities were not yet in a "condition or state of readiness and availability for a specifically assigned function" as of July 1, 1998.

The second factor, whether control of the facility had passed to Taxpayer prior to July 1, 1998, is also satisfied by the Taxpayer. Taxpayer received certificates of substantial completion from the building contractor prior to July 1, 1998, and Taxpayer was in control of the premises and the facilities. The contractor returned to perform repairs and adjustments after that date, but these were minor and did not interfere with the Taxpayer's control and operation of the Facilities.

The third factor, completion of critical tests, is also in the Taxpayer's favor. The facilities were operational by early June 1998, and the Taxpayer trained its workforce on the machinery and made necessary adjustments during this period. These adjustments were consistent with the principles of section 1.46-3(d)(2)(iii)that permits property acquired for a specifically assigned function to be placed in service notwithstanding that it is still undergoing minor, non-critical, testing to eliminate defects.

The fourth factor, commencement of daily or regular operation, has also been satisfied. Prior to July 1, 1998, as well as after that date, the facilities produced significant quantities of salable synthetic fuel. Daily operations is considered to have begun when a facility begins continuous operations at progressively increasing output consistent with minor testing to eliminate defects. While the facilities did not always operate daily, the increased production beginning in early June and continuing through mid-August, 1998, demonstrate that the Facilities had commenced regular operation prior to July 1, 1998. In general, the Facilities operated when demand was sufficient to require it. Thus, the facilities were ready and able to produce commercial quantities of synthetic fuel prior to July 1, 1998.

Finally, Taxpayer had an adequate number of employees trained to operate the Facilities. Senior executives and later, a sales and marketing manager, regularly solicited potential customers for the synthetic fuel in the utility and manufacturing industries. Further, while acceptance of this new product was initially slow, all synthetic fuel produced by Taxpayer was eventually sold to unrelated entities. The Taxpayer had sufficient capacity to produce the synthetic fuel when necessary and adequate ingress and egress was available at both locations to allow customers to transport the synthetic fuel. Thus, the Taxpayer was in a trade or business prior to July 1, 1998.

Thus, after a review of all the relevant facts and circumstances, including, but not limited to, the facts expressly referenced in the applicable cases and revenue rulings, we have determined that the Facilities were placed in service prior to July 1, 1998.

CAVEAT(S):

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