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to: Keith M. Jones, Industry Director
Natural Resources and Construction
(Large & Mid-Size Business Division)

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subject: Generic Legal Advice for Section 48A/ PRENO-147074-07

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

For purpose of determining the qualified investment for the qualifying advanced coal project credit under § 48A of the Internal Revenue Code, which property described below would constitute eligible property under §48A(c)(3), and which expenditures would be subject to capitalization under §§ 263 and 263A into the basis of eligible property?

CONCLUSIONS

1. For qualifying advanced coal projects using an integrated gasification combined cycle (IGCC), the "eligible property" under § 48A(c)(3)(A) means any property that is a part of the qualifying project and is necessary for the gasification of coal.

2. For qualified advanced coal projects using advanced coal technologies other than IGCC, the "eligible property" under § 48A(c)(3)(B) means any property that is a part of the qualifying project. The eligible property includes steam turbines, generators,

foundations for generators, foundations for the power trains, silos for storage of coal, blending facilities for coal, control boards for the plant, assets necessary for steam generation, and assets necessary for emission control.

3. The amounts incurred in the qualifying advanced coal project generally must be capitalized under §§ 263 and 263A. Please note that the treatment of costs incurred to acquire tangible property is the subject of a pending guidance project. Proposed regulations under § 263 concerning the treatment of tangible assets were published on August 21, 2006. Any change in these regulations when they are finalized might affect our analysis and conclusions.

4. The qualified progress expenditures provisions of former § 46(d) only apply to expenditures that are for eligible property. Thus, to the extent an expenditure is for an item of eligible property or for a cost that is capitalized into the basis of eligible property under §§ 263 and 263A, the expenditure qualifies for treatment as a qualified progress expenditure if the conditions of former § 46(d) are met. The amounts treated as a qualified progress expenditure in a particular year are described in former § 46(d)(3)(A), in the case of self-constructed property, and are described in former § 46(d)(3)(B), in the case of non-self-constructed property.

FACTS

In building, or acquiring, qualifying advanced coal projects described in § 48A, taxpayers incur expenditures for (1) the items of machinery and equipment, (2) the planning and design activities, and (3) the various types of financing, listed below:

- Steam turbines
- Generators and foundations for generators
- Transmission lines
- Rights of way or easements for transmission lines
- Foundations for the power train
- Assets that are necessary for both the power train and the gasification train.
- Planning costs, such as engineering reports, architectural fees, feasibility studies, and environmental studies, for the new coal plant or unit
- Costs in obtaining necessary permits for construction of the new coal plant or unit
- Section 263A expenses, such as capitalized interest, financing of the new coal plant or unit, overhead, and construction contingency costs.
- Employee health and safety plans
- Silos for storage of coal
- Blending facilities for coal
- Transportation facilities for coal
- Control boards for plant,
- Assets used both for pre-existing unit and for new unit (dual-purpose assets).
- Assets necessary for steam generation, and

- Assets necessary for emission control.

LAW AND ANALYSIS

Section 48A provides that the qualifying advanced coal project credit for any taxable year is an amount equal to 20 percent of the qualified investment for such taxable year for IGCC projects and 15 percent of the qualified investment for such taxable year for projects that use other advanced coal-based generation technologies.

Section 48A(b)(1) provides that the qualified investment for any taxable year is the basis of eligible property placed in service by the taxpayer during such taxable year that is part of a qualifying advanced coal project.

Section 48A(c)(1) defines a qualifying advanced coal project as a project that meets the requirements of §48A(e). Section 48A(e) provides the minimum requirements for a project to be certified as a qualifying advanced coal project are:

- (A) That the project uses an advanced coal-based generation technology to power a new electric generation unit or to retrofit or repower an existing electric generation unit (including an existing natural gas-fired combine cycle unit);
- (B) That the fuel input for the project, when completed, is at least 75 percent coal;
- (C) That the project, consisting of one or more electric generation units at one site, will have a total nameplate generating capacity of at least 400 megawatts;
- (D) That the applicant provides evidence that a majority of the output of the project is reasonably expected to be acquired or utilized;
- (E) That the applicant provides evidence of ownership or control of a site of sufficient size to allow the proposed project to be constructed and to operate on a long-term basis; and
- (F) That the project will be located in United States.

Section 48A(c)(3)(A) defines the “eligible property” for qualifying advanced coal project using IGCC as any property that is a part of such project and is necessary for the gasification of coal, including any coal handling and gas separation equipment.

Section 48A(c)(3)(B) provides that for any other qualifying project, eligible property is any property that is a part of such project (emphasis added).

Section 48A(b)(3) provides that rules similar to the rules of § 46(c)(4) and § 46(d) (as in effect on the day before the enactment of the Revenue Reconciliation Act of 1990) shall apply for purposes of this section.

Under former § 46(d), a taxpayer may elect to increase the taxpayer’s amount of the qualified investment for the taxable year by an amount equal to the aggregate of the applicable percentage of each qualified progress expenditure for the taxable year with respect to progress expenditure property. Qualified progress expenditures are defined under former § 46(d)(3)(A) as the amounts that are properly chargeable (during such

taxable year) to capital account with respect to the self-constructed property. Section 46(d)(3)(B) provides that in the case of non-self-constructed property, the term qualified progress expenditure means the lesser of (1) the amount paid during the taxable year to another person for the construction of the property, or (2) the amount that represents that proportion of the overall cost to the taxpayer of the construction by such other person that is properly attributable to that portion of such construction that is completed during such taxable year.

Definition of eligible property

In your request for generic legal advice, you asked for guidance on which items in the list of properties for which the credit is claimed constitutes “eligible property.”

IGCC Projects

For IGCC projects, only the property, including any coal handling and gas separation equipment that is a part of qualifying IGCC project and that is necessary for the gasification of coal is eligible property. Therefore, any property that is used in the qualifying IGCC project after the gasification of coal is completed is not an eligible property. Furthermore, any property that is used prior to the completion of the coal gasification must be necessary for the gasification in order to be an eligible property.

Accordingly, the assets that are necessary for the gasification train (including any necessary gas separation equipments to clean, and to separate out components of, the synthesis gas prior to combustion of the gas in the gas turbine) are part of qualifying IGCC project. These assets are eligible property. The blending facilities for coal and the silos for storage of coal may qualify as eligible property but only to the extent that such blending and storing of coal at the project site are necessary for the gasification of coal.

Any transportation facilities that are used to transport the coal to the project site from another location are neither part of the project nor necessary for the gasification of coal. Therefore, such transportation facilities are not eligible properties. However, the coal handling facilities directly necessary for the IGCC projects such as facilities for feeding coal into the gasifier may qualify as eligible property.

Other properties such as the steam turbine and generators that are part of the qualifying IGCC project do not qualify as eligible properties because they are not necessary to the gasification of coal. The transmission lines also are not eligible properties because they are not part of a qualifying advanced coal project, as explained further below.

Other than IGCC Projects

For advanced coal projects other than IGCC, the statute provides a broader definition of eligible property. Under § 48A(c)(3)(B), the eligible property is any property that is a part of qualifying advanced coal project. Section 48A(c)(1) defines the term “qualifying advanced coal project” as a project that meets the requirements of § 48A(e). Section 48A(e)(1)(C) describes a qualifying project as consisting of one or more electric generation units. Under § 48A(e)(D), the applicant must provide evidence that a majority of the output of the project is reasonably expected to be acquired or utilized. Thus the qualifying project is the project for the production of electricity. The qualifying project does not encompass the transmission of the electricity produced by the project. Therefore, any property used beyond the property used for generation of electricity is not eligible property for purposes of § 48A(c)(3). For example, transmission lines and rights of way or easements for transmission lines are not eligible property.

As explained earlier, any transportation facilities that are used to transport the coal to the project site from another location are not eligible properties because transporting coal to the project site is not part of a qualifying project. However, any part of the transportation facilities that is used directly for purposes of meeting the requirements of § 48A(e) may qualify as eligible property.

Consequently, the eligible property for other than IGCC projects includes the following:

- Steam turbine;
- Generators and foundations for generators;
- Foundations for the power train;
- Assets that are necessary for the power train;
- Silos for storage of coal;
- Blending facilities for coal;
- Control panels related to the qualified project;
- Assets necessary for steam generation: and
- Assets necessary for emission control.

Applicability of the capitalization rules under §§ 263 and 263A

The list of various expenditures that are incurred in the qualifying project require the analysis of capitalization rules under §§ 263 and 263A to determine how, and to what extent, these costs should be capitalized and allocated to the property to which they relate.

Amounts incurred to acquire property generally must be capitalized under § 263. Section 263(a)(1) provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)-2(a) provides that an example of a capital expenditure includes the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. See also Prop. Reg. § 1.263(a)-2(d)(1).

Section 263A generally requires a taxpayer to capitalize the direct costs and an allocable share of the indirect costs of the real or tangible personal property that it produces. Under § 263A(g), a taxpayer “produces” property when it constructs, builds, installs, manufactures, develops, or improves property. The direct costs of property produced by a taxpayer include direct materials and direct labor costs under § 1.263A-1(e)(2)(i). The indirect costs of produced property are all costs other than direct material costs and direct labor costs. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities under § 1.263A-1(e)(3).

Section 1.263A-2(a)(3)(ii) provides that if property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property even though production has not begun.

Section 263 requires that amounts incurred to construct a qualifying project be capitalized. These capitalizable costs include planning costs such as engineering reports, architectural fees, feasibility studies, and environmental studies. See § 1.263(a)-2(d); Louisiana Land & Exploration Co. v. Commissioner, 7 T.C. 507 (1946), *affd.* 161 F.2d 842 (5th Cir. 1947) (developmental expenses must be capitalized and treated as an adjustment to the taxpayer’s basis in the property); See also Prop. Reg. § 1.263(a)-2(d)(3). In addition, amounts expended to obtain any necessary permits for construction of the project must be capitalized. Rev. Rul. 2002-9, 2002-1 C.B. 614. Therefore, amounts incurred to acquire the following properties for the qualifying project should be capitalized:

- Steam turbines;
- Generators and foundations for generators;
- Transmission lines;
- Foundations for the power train;
- Blending facilities for coal;
- Control boards for a plant;
- Assets that are necessary for both the power train and the gasification train;
- Assets necessary for steam generation: and
- Assets necessary for emission control.

Section 1.263A-1(e)(3)(ii)(H) lists, as one of the indirect costs required to be capitalized under § 263A, storage costs, which include the costs of carrying, storing, and warehousing property. Section 1.263A-3(c)(5) provides that storage costs are capitalized to the extent they are attributable to the operation of an off-site storage or warehousing facility. Therefore, the costs incurred for the following should be capitalized:

- Silos for storage of coal;
- Transportation facilities for coal; and
- Blending facilities for coal.

The list of expenditures also includes costs incurred for assets used for both a pre-existing unit as well as for a new unit. The general rule of § 263 requiring capitalization of amounts to acquire assets has certain limitations and exceptions. For example, § 1.162-4 provides that the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, generally may be deducted. See also Prop. Reg. § 1.263(a)-3(d). Accordingly, amounts expended for acquired assets might be deductible if used to repair an existing unit.

If, however, the costs incurred for the assets used for both a pre-existing unit and a new unit are subject to capitalization because the limitations and exceptions do not apply, then the costs of the assets should be appropriately allocated to each unit. Similarly, the costs incurred for assets that are necessary for both the power train and the gasification train should be appropriately allocated to the property. Furthermore, the costs incurred for assets that are necessary for both the eligible property and noneligible property should be appropriately allocated to each property.

Under § 1.263A-2(a)(3)(ii), even though production has not begun, taxpayers holding property for future production must still capitalize direct and indirect costs allocable to such property. Consequently, the items below that directly benefit or are incurred by reason of the performance of production activities would likely be subject to capitalization under § 263A:

- Engineering reports, architectural fees, feasibility studies, environmental studies, and other planning costs for the new coal plant or unit, and
- Costs in obtaining necessary permits for construction of the new coal plant or unit.

By definition, § 263A expenses such as capitalized interest, financing of the new coal plant or unit, overhead, and construction contingency costs, would be subject to capitalization under § 263A, and allocated to the property to which they relate.

Section 1.263A-1(e)(3)(ii)(D) lists, as one of the indirect costs required to be capitalized under § 263A, employee benefit expenses, which specifically include “premiums on health and life insurance, and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc.” Consequently, the costs for employee health and safety plans would likely be subject to capitalization.

Note, however, that although under § 263 and § 263A certain costs (such as, costs allocable to transmission lines, rights of way and easements for transmission lines, and, in the case of projects using IGCC, costs allocable to machinery and equipment beyond the gasification step) must be capitalized, these costs are not allocable to qualified investments in eligible property and are not treated as qualified progress expenditure payments.

I hope this is helpful to you. If you have any further questions, please call Jaime Park at (202) 622-3110.