INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 01, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 29.04-00
CASE-MIS No.: TAM-150356-05
Number: **200621019**
Release Date: 5/26/2006
Director, Field Operations,
Heavy Manufacturing and Transportation - LMSB

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No

Year(s) Involved:
Date of Conference:

Legend:

State:
Authority:
Former Owner:
Facility 1:
Facility 2:

Facility 3:
Facility 4:
Location:
Mine:
Power Company:
Contract:
Amount 1:
Amount 2:
Date 1:
Date 2:
Date 3:
Date 4:
Date 5:
Date 6:
Tax Years at Issue:

ISSUE

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

CONCLUSION

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

FACTS

Former Owner contracted for construction of four facilities to produce synthetic fuel by combining coal with a binding agent. The Former Owner received certificates of substantial completion for the facilities on Date 1, at which point control of the facilities was passed to the Former Owner. All of the facilities are located at Location in State. Location is close to Mine. Under the provisions of Contract, Former Owner agreed to purchase coal from Mine. An independent engineering firm inspected the facilities prior to July 1, 1998, including observing each facility operating, and concluded that each facility was capable of operating 24 hours per day, 365 days per year, except for downtime for normal maintenance and repairs.

On Date 2, Authority issued an air quality waiver to Former Owner, for the four facilities, permitting aggregate production of Amount 2 for a period ending on Date 4. That waiver was extended to Date 5 by Authority. On Date 3, Authority temporarily modified the existing Land Quality Permit applying to Mine to include the activities of the four facilities. On Date 6, that modification was extended, allowing production of up to 5 million tons of synfuel at the Location.

Under Contract, the owner of Mine or, under certain circumstances, Power Company, agreed to purchase Amount 1 of synfuel from Former Owner. Power Company agreed to use its best efforts to conduct a "test burn" of the synfuel as part of this contract to assist Former Owner in marketing its synfuel. Prior to July 1, 1998, all four facilities produced synfuel and all of that fuel was ultimately sold and burned by Power Company, except for a small amount that became mixed with soil whilst stored and became unusable. Production, however, did not reach Amount 1.

The nature of the coal from Mine made the synfuel produced by the facilities crumble with handling, making it difficult to transport. This problem made the synfuel produced by Former Owner at Location economically unviable. The facilities were sold to Taxpayers on Date 6. The facilities were moved to new locations and, using new coal feedstocks, produced economically viable synfuel. The same independent engineer that evaluated the facilities at Location concluded that the facilities as relocated were identical to the facilities at Location.

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.[1]

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.[2] These factors are not exclusive – they are used as

[1] Thus, while the Former Owner actually placed the facilities in service, it is the Taxpayers that have claimed the credit for the production of synfuel by these facilities, and the Taxpayers are the persons to whom the determination of whether the facilities were placed in service is relevant.

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 a 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 a 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.

With respect to the first factor, all licenses and permits necessary for operation of the facilities were secured prior to July 1, 1998. While an air qualify waiver of limited duration was originally issued prior to July 1, 1998, that waiver was extended for an additional period. This is sufficient for this factor.

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

The third factor, completion of critical tests, has also been satisfied. The facilities were operational by late June 1998, and the Former Owner 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.

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[2] 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 fourth factor, commencement of daily or regular operation, is more complex. Prior to July 1, 1998, as well as after that date, the facilities produced significant amounts of synfuel, but this production was not sufficient to fulfill the Contract. In addition, the synfuel produced was not able to be transported over long distances and therefore was of limited commercial utility. However, the reason for the limited commercial production was not due to an operating defect in the machinery itself, but rather due to the nature of the coal feedstock from Mine. Section 1.46-3(d)(1)(ii) provides that property is placed in service when it is placed in a condition or state of readiness and availability for a specifically assigned function. When property is ready and available for use, even if its actual use is limited, that property is placed in service. See, e.g., Yellow Cab Company of Pittsburgh v. Driscoll, 24 F. Supp. 993 (D. Penn. 1938) (Taxicabs stored in garage by owner without gasoline, water, or batteries considered available for use even though they were warehoused due to economic conditions). By contrast, when a defect in the property is the reason for the lack of actual use, such property is not placed in service. See, e.g., Valley Natural Fuels v. Commissioner, 62 T.C.M. 229 (1991) (Ethanol distillation plant unable to produce ethyl alcohol of 198.2 proof as intended by taxpayer due to lack of molecular sieve not placed in service until the molecular sieve installed and operational.) Here, the actual machinery was in a condition or state of readiness for the intended use of producing synfuel from coal; all that was necessary was a feedstock without the inherent defects of that from Mine. Although production was limited, it was sufficient to demonstrate that the reason for the limited production was not in the machinery itself but in the feedstock. Thus, the facilities were ready and able to produce synthetic fuel prior to July 1, 1998.

Finally, the Former Owner had an adequate number of employees trained to operate the facilities. The Contract provided a customer for synfuel produced. The facilities had sufficient capacity to produce synthetic fuel when necessary and adequate ingress and egress was available at Location to allow customers to transport the synthetic fuel. Thus, the Former Owner was in a trade or business prior to July 1, 1998.

Accordingly, 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 Facilities 1, 2, 3, and 4 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.