General Counsel Memorandum 37449, 03/06/1978, IRC Sec(s). 46

UIL No. 0046.05-00; 0167.18-00

CC:I-353-77

Br:JDCox

March 6, 1978

Memorandum to:

JOHN L. WITHERS

Assistant Commissioner (Technical)

Attention: Director, Corporation Tax Division

In a memorandum (T:C:E:A) dated September 9, 1977, the Director, Corporation Tax Division requested our concurrence or comment concerning a proposed revenue ruling (Control No. 77-6-25927).

ISSUE
Whether certain machinery and equipment acquired and placed in a production facility are"first placed in service"for depreciation and investment credit purposes in the year the preliminary tests are completed.

CONCLUSION
The proposed revenue ruling concludes that the machinery and equipment acquired and placed in a production facility in preparation to operate the facility, which has not become operational and has never been operated in the taxpyer's business because of economic conditions, has not been placed in service for depreciation and investment credit purposes. While we agree that machinery and equipment that are not operational are not"first placed in service" we have certain problems with your conclusion based on the facts in this case.

FACTS
The facts presented by the propsed revenue ruling are as follows. The taxpayer completed a production facility that will be inactive until the taxpayer determines that competitive prices for the product will economically justify its operation. The taxpayer operates several similar facilities. The machinery and equipment are completely installed and have gone through a series of preliminary tests using steam and water; however, the machinery and equipment were not tested under actual operating conditions and no raw materials were processed to obtain the desired actual products. Steam and water were used in the preliminary tests because the product itself would have a corrosive effect on the machinery and equipment that could not be eliminated by cleaning prior to leaving it

inactive. These preliminary tests with steam and water, however, are not sufficient to establish that the machinery and equipment will perform satisfactorily under operating conditions when the raw materials are introduced into the system. The completed facility is in the control of the taxpayer with all legal attributes of ownership such as title, risk of loss, and liability. The machinery and equipment are depreciable and the taxpayer has elected the Class Life Asset Depreciation Range (CLADR) system for its machinery and equipment. The machinery and equipment have a useful life in excess of three years.

ANALYSIS

I.R.C. § 38 allows a credit against Federal income tax for qualified investment in "section 38 property" Section 46(c) defines the term "qualified investment" with respect to any taxable year, as the aggregate of-

(A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus
(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service by the taxpayer during such taxable year.

Treas. Reg. § 1.46-3(d)(1)(ii) provides that property is placed in service in:

The taxable year in which property is placed in a condition or states of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or a personal activity.

Treas. Reg. § 1.46-3(d)(2) provides that in the case of property acquired by a taxpayer for use in his trade or business, the following examples are cases when property shall be considered in a condition or state of readiness and availability for a specifically assigned function:
(ii) Operational farm equipment is acquired during the taxable year and it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following year.
(iii) Equipment is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects.
Section 167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business, or of property held for the production of income.

Treas. Reg. § 1.167(a)-10(b) provides that the period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. Treas. Reg. § 1.167(a)-11(e)(1)(i) provides that:

The term "first placed in service" refers to the time the property is first placed in service by the taxpayer, not to the first time the property is placed in service. Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. In general, the provisions of paragraph (d)(1)(ii) and (d)(2) of § 1.46-3 shall apply for the purpose of determining the date on which property is placed in service. ...

I

The fact that property has not actually been used in the taxpayer's business is of no consequence in determining whether the property has been placed in service. As indicated in the following analysis, devotion to a trade or business requires (1) a trade or business and (2) a condition or state of readiness and availability for a specifically assigned function.

The question of when property was "used in a trade or business' has been at issue in several cases. In Kittredge v. Commissioner, 88 F.2d 632 (2d Cir. 1937), the court determined that once property was devoted to the trade or business, depreciation was allowable even though the property remained idle. Similarly, the court in P. Dougherty Co. v. Commissioner , 159 F.2d 269 (4th Cir. 1946), aff'g, 5 T.C. 791 (1945), held that tugs and barges that lay idle for protracted periods but were nevertheless kept in usable condition and were ready for use should the occasion arise were devoted to the trade or business and thus subject to depreciation. In both cases, the property was actually used in the trade or business prior to the inactive period.

In cases in which the issue was when was the property first placed in service, the courts have usually determined the issue based on the rationale of Kittredge and Dougherty unless the taxpayer was not in a trade or business. Thus, in Jephson v. Commissioner, 37 B.T.A. 1117 (1938) (which relied upon Kittredge) and Kent v. Commissioner, No. 37332 (T.C.M. 1953), the Tax Court, or Board of Tax Appeals as the case may be, held that certain structures were placed in service and depreciable even though not operating in such year because they were in a state of readiness and the taxpayer was in a trade or business for which the property was purchased.

In contrast, in Nulex, Inc. v. Commissioner, 30 T.C. 769 (1958) and Hillcone Steamship Co. v. Commissioner, T.C.M. 1963-1096, the Tax Court concluded that property was not placed in service primarily because the taxpayer was not yet in the business for which the depreciable assets had been purchased. In addition, the property was not in a state of readiness. In Hillcone Steamship Co., the rock crushing equipment in issue remained in an unassemblied state and was not available for operation. In Nulex, Inc., the boat was not available for operation because a license needed to operate the boat as a commercial charter vessel could not be obtained.

The Hillcone Steamship Co. and Nulex, Inc. cases were distinguished by the court of appeals in Sears Oil Co. v. Commissioner, 359 F.2d 191 (2d Cir. 1966). In Sears Oil Co. , the court held that the barge at issue was first placed in service in December, 1957, because it was then ready for charter or for use in taxpayer's business even though the barge was not put in actual use until 1958 because it was frozen in the water. See also Twentieth Century-Fox Film Corp. v. Commissioner, 372 F.2d 281 (2d Cir. 1967), aff'g, 45 T.C. 137 (1965) in which the lack of use was more voluntary in nature.

The Service evidently concurs in the rationale of the Sears Oil Co. case. In Rev. Rul. 76-238, 1976-1 C.B. 56, the Service, citing Sears Oil Co., held that a building was first placed in service on July 31, 1972, because on that date it was in a condition or state of

readiness and availability to perform the function for which it was built even though the manufacturing process could not be carried out in it until nearly a year later because of the installation and testing of machinery and equipment necessary for the production line process. Further, in Rev. Rul. 76-428, 1976-2 C.B. 47, the Service held that a nuclear electric generating unit was first placed in service on December 23, 1975, when fully operational even though it was shutdown on December 24, 1975, due to an abundance of hydro-generated electricity rather than to any problems concerning the unit. See also Treas. Reg. § 1.46-3(d)(2)(ii) and Treas. Reg. § 1.167(a)-11(e)(1)(i).

Pursuant to the precedents set forth above, we believe that any reliance by the proposed revenue ruling on the fact that the facility, including machinery and equipment, has not actually been used in the taxpayer's trade or business is misplaced. The taxpayer has been for some years in the trade or business for which the facility was constructed. Therefore, under Sears Oil Co. , the taxpayer would not be required to actually use the facility for it to be considered placed in service for investment credit and depreciation purposes. This leads us to the more difficult question: whether the facility is operational.

II

The regulations, though allowing property to be deemed to be "placed in service" when in a condition or state of readiness and available for a specifically assigned function, require that the property be operational to meet these conditions and availability. See Duvin Coal Co. v. Commissioner, 16 B.T.A. 194 (1929). Nevertheless, neither the Code nor regulations define the term "operational"

The test of operability may be met by the act of simply completing construction. For example, Treas. Reg. § 1.167(a)-11(e)(1)(i) and Rev. Rul. 76-238, 1976-1 C.B. 56, imply that a building, which functions by providing enclosed shelter, is operational when the construction is completed. With more complicated machinery and equipment, extensive testing and synchronization into existing systems may be required before such property is considered operational. See Rev. Rul. 76-428, 1976-2 C.B. 47; Rev. Rul. 76-256, 1976-2 C.B. 46. At the very least, property must be capable of producing an acceptable product or performing an acceptable function. Rev. Rul. 76-238, 1976-1 C.B. 56; Rev. Rul. 73-518, 1973-2 C.B. 54. Thus, the property must be capable of producing income before it will be considered placed in service. See G.C.M. 37272, *** in which this Office concluded that casing and associated downhole equipment is not placed in service until the well is completed and capable of production; Treas. Reg. § 1.46-3(d)(2), which concludes that fruit-bearing trees and vines shall not be considered in a condition or state of readiness and availability for a specifically assigned function until they have reached an income-producing stage. With the possible exception of these fruit trees, the regulations make it equally clear, however, that the property is placed in service when operational even though undergoing testing to eliminate any defects. Treas. Reg. § 1.46-3(d)(2)(iii); Rev. Rul. 76-256, 1976-2 C.B. 46.

A recent Tax Court opinion, Noell v. Commissioner, 66 T.C. 718 (1976), nonacq. as to the issue of placed in service, 1977-38 L.R.B. 5, is inconsistent with these principles. In holding that a runway, even though being used, was not operational because construction

was not completed and the runway could not be used permanently, the court required "full service." As pointed out in Milton J. and Adelaide Noell, A.O.D. (Aug. 9, 1977), operability implies capability to perform a specifically assigned function and not that property must be up to "full service" before it is placed in service for investment credit and depreciation purposes. In Noell, the fact that airplanes were using the runway should have been sufficient to prove operability.

In the instant case, both the proposed revenue ruling and underlying ruling letter conclude that the facility in issue is not operational because there is not a clear correlation between pretesting with steam and water and the processing of raw materials. We have great difficulty agreeing with this conclusion.

The production machinery at issue has been installed and tested. Although the actual production process has not been run because of the corrosive effect it would have on the machinery and equipment, preliminary testing has been run, and apparently, at least to the satisfaction of the taxpayer, establishes that the equipment is operational. The various systems and components of the facility are similar to the systems and components of a present operating facility in *** According to the engineering report provided in the underlying file, actual production can be "closely simulated" in terms of fluids, temperatures, and pressures using water and steam. The close simulation and the similarity between the new facility and an already operating facility should be sufficient to show operability. Moreover, the taxpayer has done all it can, short of actual operation, to prove that the machinery is operational.

A conclusion concerning operability necessarily requires a facts and circumstances examination in each individual case. While in this case we express doubt as to your conclusion concerning operability, we cannot say that you are incorrect. If this or a similar case should reach court, it would probably become a battle of engineers as to whether or not the machinery and equipment are operational. We do believe that publication of the proposed ruling with its present set of facts may cause some problems for the Service. It could be read as inconsistent with existing rulings and regulations, which do not require "full service" or actual operation. In addition, the proposed ruling might also be interpreted as inconsistent with the Service's nonacquiescence in the Noell case. In order to avoid inconsistent Service positions, we, therefore, recommend that certain facts be changed to clearly indicate lack of operability. For your consideration, we have attached a revised proposed revenue ruling consistent with this recommendation.

STUART E. SEIGEL

Chief Counsel

By:

RICHARD P. MILLOY

Chief, Technical Branch No. 1

Tax Court Litigation Division

Attachments:

Administrative file

Revised proposed

revenue ruling

Control Number 77-6-25927

PART I

SECTION 46.-AMOUNT OF CREDIT

26 CFR 1.46-3: Qualified investment.

(Also Section 167; 1.167(a)-11)

REV. RUL.
Advice has been requested whether machinery and equipment acquired and placed in a production facility are placed in service for depreciation and investment tax credit purposes under the circumstances described below.

*** the taxpayer installed machinery and equipment in an existing building. The machinery and equipment while completely installed and partially tested with substitute materials had not had any critical tests performed with appropriate materials until early *** when such tests and adjustments were completed. The taxpayer plans to use the machinery and equipment in its production process. The building and installed machinery and equipment are in the control of the taxpayer with all legal attributes of ownership such as title, risk of loss, and liability. The machinery and equipment are depreciable and the taxpayer has elected the Class Life Asset Depreciation Range (CLADR) system for its machinery and equipment. The machinery and equipment have a useful life in excess of three years.

Section 38 of the Internal Revenue Code of 1954 allows a credit against Federal income tax for qualified investment in"section 38 property"

Section 48(a)(1) of the Code provides that the term"section 38 poperty"means tangible personal property or other tangible property (not including a building and its structural components) but only if such other property is used as an integral part of certain specified activities, including manufacturing. In order to qualify as section 38 property, the property must be depreciable and have a useful life of 3 or more years.

Section 46(c) of the Code defines that the term "qualified investment" with respect to any taxable year, as the aggregate of-

(A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus
(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service by the taxpayer during such taxable year.
Section 1.46-3(d)(1)(ii) of the Income Tax Regulations provides, for purposes of the investment tax credit, that property is placed in service in the taxable year in which it is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business or for the production of income.

Section 1.46-3(d)(2)(iii) of the regulations provides that equipment is considered in a condition or state of readiness and availability for a specifically assigned function if it is acquired for a specifically assigned function and is operational but undergoing testing to eliminate any defects.

Section 167 of the Code provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income shall be allowed as a depreciation deduction.

Section 1.167(a)-11(e)(1)(i) of the regulations provides that property is first placed in service when it is first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, or in the production of income. In general, the provisions of section 1.46-3(d)(1)(ii) and (d)(2) shall apply for the purpose of determining the date on which the property is placed in service.

Held: To meet the requirements of sections 1.46-3(d)(2)(iii) and 1.167(a)-11(e)(1)(i), machinery and equipment must first be operational. Under the facts in this case, the machinery and equipment were not operational until early *** when the critical tests with the appropriate materials and operational testing was completed. It was then determined that the entire system was able to perform the function for which it was designed, even though some testing to eliminate defects that affected its production capacity was performed subsequently. Accordingly, the machinery and equipment are not placed in service for depreciation and investment credit purposes in