

Private Letter Ruling 8324013

Mar. 9, 1983

Issue

Whether various elements of a snowmaking system, added to a ski area, qualify as "section 38 property" eligible for the investment credit.

Facts

The taxpayer operates a skiing facility in connection with which it also owns and operates an extensive snowmaking facility. The major elements of the system are as follows:

1. Water intake pipe. This is the piping that takes water from a source (such as a pond or stream) for conveyance to the pumphouses. Generally, all elements are underground because of safety or insulation considerations.
2. Transformers, pumps, compressors, etc. This is the machinery necessary to operate the system. This machinery and the structures that shelter some or all of it are not at issue.
3. Electrical lines. These are high voltage lines that transmit electricity from its point of purchase to the pump and compressor shelters. Generally, they are buried so as to conform to the building and safety regulations imposed by the State of
4. Distribution system. This is the system of welded steel pipes that transport water and air from pumps and compressors to the ski slopes. The pipes are either laid on top of the ground or are buried. Pipe is buried for one or more of three reasons: (a) insulation (least expensive way is burying); (b) safety -- for example, where pipes run across or parallel and adjacent to skiing surfaces; and (c) aesthetic considerations -- keeping the slopes in their natural state. Where the pipe is buried, it is generally 2 to 4 feet deep, depending on the terrain.
5. Air and water hydrants. These are a separate set of pipes and valves that tap into the air and water pipes at regular intervals along the ski slopes. The hydrants are attached by threaded pipe to the main lines.
6. Guns and hoses. Flexible hoses connected to the hydrants at each takeoff point deliver the air and water to a single gun through which (at the appropriate ambient temperature) the air and water are ejected together to form the snow.

All snow made by this system is laid along the slopes and trails that are part of this taxpayer's skiing facility; no snow is sold to other parties. The taxpayer claims investment tax credit on the costs of all components except for the pumphouses.

Applicable LAW:

Section 38 of the Internal Revenue Code allows a credit against federal income tax for qualified investment in “section 38 property”. The determination of what property qualifies as “section 38 property” is made in accordance with the rules provided in section 48 of the Code.

Section 48(a)(1) of the Code provides that the term “section 38 property” includes: (1) tangible personal property, and (2) other tangible property (not including a building and its structural components) if such property is used as an integral part of one of certain specified activities among which are manufacturing and production.

Section 1.48-1(c) of the Income Tax Regulations states that the term “tangible personal property” means any tangible property except land and improvements to the land, such as buildings or other inherently permanent structures. The term includes all property (other than structural components) that is contained in or attached to a building. Also, all property that is in the nature of machinery (other than structural components of a building or other inherently permanent structures) shall be considered tangible personal property even though located outside a building.

Section 1.48-1(d)(1) of the regulations provides that among the other tangible properties that may qualify as section 38 property is property that is used as an integral part of manufacturing or production.

Section 1.48-1(d)(2) of the regulations provides that, for investment tax credit purposes, the terms “manufacturing” and “production” include the construction, reconstruction, or making of property out of scrap, salvage, or junk material, as well as from new or raw material, by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles.

H.R. Rep. No. 1447, 87th Cong., 2nd Sess. 12 (1962), 1962-3 C.B. 405, 416, and S. Rep. No. 1881, 87th Cong., 2nd Sess. 16 (1962), 1962-3 C.B. 707, 722, the committee reports prepared when the investment credit was first enacted, mention oil and gas pipelines as examples of real property. Because they are analogous to oil and gas pipelines, extensive systems of underground piping are considered inherently permanent improvements to land and not tangible personal property.

In *JOHN J. JOHNSTON V. UNITED STATES*, (District Court unreported) 80-1 USTC 9199 (D. Mont. 1979), the court held that underground piping of the water and sewage systems of a trailer park was in the nature of land improvements and not tangible personal property. Similarly, Rev. Rul. 66-269, 1966-2 C.B. 13, rules that the electrical and plumbing hookups installed at a trailer park are in the nature of land improvements. In Rev. Rul. 69-273, 1969-1 C.B. 30, the underground water pipes and valves in a golf course sprinkler system are found to be “other tangible property” within the meaning of section 1.48-1(d) of the regulations that is not used as an integral part of one of the qualifying activities. The court and the two rulings all rely on the oil and gas pipeline analogy.

H.R. Rep. No. 1447, 87th Cong., 2nd Sess. 112 (1962), 1962-3 C.B. 405, 516, and S. Rep. No. 1881, 87th Cong., 2nd Sess. 153 (1962), 1962-3 C.B. 707, 859, state that (for purposes of section 48(a)(1) of the Code) the terms “manufacturing” and “production” are to be given their commonly accepted meaning.

Rev. Rul. 66-299, 1966-2 C.B. 14, and Rev. Rul. 69-558, 1969-2 C.B. 4, conclude that the electrical wiring and plumbing located in the immediate vicinity of, and inside, the building that houses the machinery to which they are connected are considered part of the machinery and equipment and, thus, tangible personal property.

Rev. Rul. 81-66, 1981-1 C.B. 19, states:

Activities involving the sale of merchandise, food and other items to the general public for personal or household consumption, and the rendering of services incidental to the sale of goods are considered to be retail activities rather than manufacturing within the commonly accepted meaning of the term. Processing incidental or subordinate to selling is often conducted at retail stores. For example, drug stores prepare prescriptions, restaurants prepare meals, and meat markets cut meat.

The operation of a cafeteria, like the operation of a restaurant or cafe, is considered in the trade to be a retail activity rather than a manufacturing activity. The food and drink prepared by the cafeteria employees is for direct sale to and for the consumption by the general public. The food preparation activity is incidental or subordinate to the selling of the prepared meals and is not considered to be similar to any of the activities encompassed by the definition of manufacturing provided by section 1.48-1(d)(2) of the regulations.

Rationale

The snow guns and flexible hoses are in the nature of machinery and thus considered tangible personal property even though they are located outside a building. Similarly, the transformers, pumps, compressors, related control equipment, and plumbing and wiring in and around the pumphouses are in the nature of machinery and thus are tangible personal property. The other components of the system -- the air and water distribution pipes, the hydrants, the electrical transmission lines, and the water intake pipe -- may also qualify as section 38 property if they are either tangible personal property or are used as an integral part of manufacturing or production.

The water intake pipe and electrical transmission lines of the snowmaking system are located outside the pumphouse and buried underground. Therefore, those components are not tangible personal property, but are inherently permanent property not in the nature of machinery or equipment.

The air and water distribution pipes and hydrants of the snowmaking system are similar to the types of property involved in the above authorities in that all consist of extensive systems of underground piping connected to machinery or equipment. Accordingly, the

air and water distribution pipes and hydrants are not tangible personal property, but are inherently permanent improvements to land.

Although none of the components in question are tangible personal property, they may be section 38 property if used as an integral part of manufacturing or production.

Interpreting the term “manufacturing” in its usual sense, Rev. Rul. 81-66 concludes that the operation of a cafeteria is a retail activity, not a manufacturing activity within the meaning of section 48(a)(1) of the Code, and that leasehold improvements to the cafeteria facility that are not tangible personal property do not qualify as section 38 property. The ruling determines that in common parlance the term “manufacturing” does not include incidental or subordinate activities occurring in a retail context.

Similarly, the terms “manufacturing” and “production” in their customary sense do not embrace activities that are incidental or subordinate to the provision of recreational services, such as snowmaking by the operator of a ski resort. Accordingly, the air and water distribution pipes, hydrants, electrical transmission lines and the water intake pipe of the taxpayer's snowmaking system are not used as an integral part of manufacturing or production.

Conclusion

The guns and hoses, transformers, pumps, compressors, and related control equipment, and plumbing and wiring interconnections in and around the pumphouses are tangible personal property and qualify as section 38 property.

The air and water distribution pipes, hydrants, water intake pipe, and electrical transmission lines do not qualify as “section 38 property.”