Rev. Rul. 79-98, 1979-1 CB 103 -- IRC Sec. 167

Depreciation; first placed in service; nuclear electric generating unit.

ISSUE
Is a nuclear electric generating unit first placed in service by a public utility when it becomes operational or when the utility formally accepts the unit from the contractor?

FACTS
The taxpayer, a regulated public utility company, files its federal income tax returns on a calendar year basis. For depreciation purposes, the taxpayer elected the Class Life Asset Depreciation Range (CLADR) system and adopted the modified half-year convention under section 1.167(a)-11 of the Income Tax Regulations.

In 1971, the taxpayer and X, a contractor, entered into an agreement under which X agreed to build for the taxpayer a nuclear electric generating unit on property owned by the taxpayer. Under the terms of the contract, X had full responsibility for the technical direction of the construction of the unit, including all testing. The testing was actually carried out by the employees of the taxpayer. Title to all material and equipment incorporated in the unit passed to the taxpayer at the time of delivery at the plant site. However, the risk of loss of all such material and equipment remained with X until plant acceptance. X agreed to maintain property insurance, applicable to occurrences at the site, prior to unit acceptance covering equipment, materials, and supplies furnished by X. X also agreed to provide nuclear property insurance covering taxpayer's property until unit acceptance. The taxpayer agreed to obtain property insurance applicable to all nonnuclear occurrences at the site, and to obtain nuclear liability insurance and an agreement of indemnification as required by 42 U.S.C. section 2210 (1977), concerning financial protection for public liability claims in connection with construction of nuclear power plants under licenses issued by the United States. Further, the taxpayer was required to obtain all licenses and permits, including the construction permit required by statute (42 U.S.C. section 2235).

X was required to provide the taxpayer with information, reports, and data concerning X's progress. The taxpayer participated in the decisional process during construction. X was not liable under the contract for failure or delay, including labor difficulties, in securing necessary materials, service, or facilities beyond X 's reasonable control. The taxpayer agreed to accept the unit upon the completion of the unit, acquisition of an operating license, the successful completion of all necessary pre-operational, fuel loading, and startup tests, and a continuous 100-hour demonstration run.

The construction contract did not provide for fuel payments during the construction period. Pursuant to a supplementary agreement, X agreed to pay the taxpayer for the fuel used during the testing period, and the taxpayer agreed to pay X for the electricity generated by X during the testing period and sold by the taxpayer to its customers.<Page 104>

Construction on the unit began in 1971. Due to delays in construction beyond X's reasonable control, the nuclear electric generating unit did not achieve criticality until December 8, 1973. By February 20, 1974, all necessary permits and licenses to operate the generating unit had been obtained by the taxpayer. On March 4, 1974, the unit was synchronized into the taxpayer's transmission and distribution system. By May 25, 1974, all critical tests were completed and the unit was able to operate at its rated capacity without failure even though undergoing testing to eliminate any defects and to demonstrate reliability. On July 9, 1974, the nuclear electric generating unit was accepted by the taxpayer from X.

LAW AND ANALYSIS

Section 167 of the Internal Revenue Code of 1954 provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in a trade or business, or of property held for the production of income.

Section 1.167(a)-10(b) of the regulations provides that the period of depreciation of an asset shall begin when the asset is placed in service. Section 1.167(a)-11(c)(2)(ii) provides for the modified half-year convention, which allows a full year's depreciation deduction for assets placed in service during the first half of the taxable year and no depreciation deduction for the taxable year for assets placed in service during the second half of the year.

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

Section 1.46-3(d)(1) of the regulations provides that for purposes of the investment credit allowed by section 38 of the Code, property shall be considered placed in service in the earlier of the following taxable years: (i) the taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or (ii) the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function.

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

Rev. Rul. 76-256, 1976-2 C.B. 46, states that a coalfired electric generating unit was in a condition or state of readiness or availability for a specifically assigned function when the necessary permits and licenses had been approved, the critical tests for the various components were completed, synchronization was achieved, and daily operation of the unit begun, notwithstanding that the generating unit would undergo further testing to eliminate any defects.

See also Rev. Rul. 76-428, 1976-2 C.B. 47, that states that a nuclear electrical generating unit was fully operational and “placed in service” on December 23, 1975, even though it is still undergoing testing to eliminate any defects and to demonstrate reliability.

With respect to whether a facility is “placed in service” when the facility is owned or in the control of the taxpayer, Rev. Rul. 76-256 and Rev. Rul. 76-428 provide that a facility is “placed in service” when all the critical tests are successfully achieved and a “state of readiness and availability for a specifically assigned function”, such as “daily operation”, has been demonstrated even though subsequent testing may be performed to eliminate any defects. Similarily, in this case all critical tests were completed and the facility was able to operate at its rated capacity without failure by May 25, 1974, even though subsequent testing was performed to eliminate any defects.

HOLDING

The public utility had control of the nuclear electric generating unit when the unit became operational because the public utility had ownership of the facility during the construction period. Therefore, the unit was first placed in service by the utility when the unit became operational, which occurred May 25, 1974, because synchronization was then achieved, all critical tests were completed, and the unit was able to operate at its rated capacity without failure, rather than the date of the utility's formal acceptance of the unit from the contractor. Thus, since the unit was placed in service before July 1, 1974, under the modified half-year convention used by the utility, a full year's depreciation deduction was allowable for the unit for the taxable year 1974.