

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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Date:

To:

Team Coordinator [ ]

From:

Associate Area Counsel  
Large Business & International Division

Subject:

I.R.C. § 168(e)(3)(B)(vi)(II)

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## ISSUES

1) Whether a cogeneration facility, as defined by 16 U.S.C. § 796(18), can also be a “qualifying small power production facility” for purposes § 168(e)(3)(B)(vi)(II).<sup>1</sup>

2) Whether XYZ’s power facility is a “qualifying small power production facility” and thus the equipment used in the facility is “5-year property” pursuant to § 168(e)(3)(B)(vi)(II).

## SUMMARY OF CONCLUSIONS

1) A cogeneration facility can also be a “qualifying small power production facility” for purposes of § 168(e)(3)(B)(vi)(II).

2) XYZ’s power facility is a “qualifying small power production facility” and thus the equipment used in the facility is “5-year property” pursuant to § 168(e)(3)(B)(vi)(II).

## FACTS

The taxpayer, XYZ, is a Business. The taxpayer produces A of Product a Period, which is approximately B of all of the Product produced in Location. In producing such C of Product, the taxpayer relies on its power production assets to generate electricity and steam used in its refining operations.

In the early 1980s, the taxpayer used D Industrial turbine generators in its power operation which produced a total of E Megawatts. On Date 1, the taxpayer filed a “self-certification” with the Federal Energy Regulatory Commission (hereinafter the “FERC”) that its power operation was a qualified small power production facility within the meaning of 16 U.S.C. § 796(17)(C). To date, the taxpayer has not filed any subsequent certifications.

The taxpayer began replacing the original Industrial turbine generators in Year 2. In Year 3, the taxpayer also replaced a boiler in its power operation that increased the plant’s steam capacity. By Year 4, the taxpayer had completely replaced all D of its original turbine generators, its boiler, and all of its other equipment related to its power operation.

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<sup>1</sup> All statutory references are to provisions of the Internal Revenue Code unless otherwise expressly stated in this memorandum.

The taxpayer's power plant is, and has been, fueled from a Product F material called Fuel. The process begins when Product is brought into the plant where it is Refined. The Product F (the "Fuel") is combusted in the boilers and used to create steam. High pressure steam is then channeled from the boilers to the generators and is used to turn the turbines. The turbines create the electricity used in the operation. Low pressure steam from the same boilers is channeled to evaporators which are used to Refine. When the steam from the evaporator condenses, it is channeled back to the boilers as water and is subsequently boiled again. The system is what is referred to as a "closed loop system."

The power operation serves two purposes: (1) to generate electricity, and (2) Refinement. While the taxpayer produces its own power, the taxpayer is connected to the power company's grid so that it can draw power to run its operations if needed. The taxpayer sells any excess power production from its operation back to the power company grid.

Since Year 2, the taxpayer has depreciated its power plant equipment and associated assets under Asset Class 20.2 of Rev. Proc. 87-56, 1987-2 C.B. 674. That asset class provides a 18-year class life, and a 10-year recovery period under the general depreciation system, for assets used in the production of raw sugar, syrup, or finished sugar cane or sugar beets. Exam reviewed the taxpayer's power production operation and issued a Notice of Proposed Adjustment (a "NOPA") that the power production plant and associated assets should be depreciated under Asset Class 00.4 of Rev. Proc. 87-56 which provides a 22-year class life and a 15-year recovery period, under the general depreciation system, for assets used in "industrial steam and electric generation and/or distribution systems." After Exam asserted its position in its NOPA, the taxpayer changed its position and notified Exam that it was in fact entitled to classify the power plant equipment and associated assets under § 168(e)(3)(B)(vi)(II), which provides for a 5-year property classification with a 5-year recovery period under the general depreciation system.

An IRS Engineer determined that the Fuel used in the power facility met the definition of "biomass property" pursuant to § 48(l)(15) (1990). The IRS engineer also studied the taxpayer's power facility and opined that the power facility was a "cogeneration facility" within the meaning of 16 U.S.C. § 796(18). A cogeneration facility is defined as "a facility which produces (i) electric energy, and (ii) steam or forms of useful energy (such as heat) which are used for industrial, commercial, heating or cooling purposes." 16 U.S.C. § 796(18)(A). A qualified cogeneration facility is a facility that the FERC determines, by rule, meets such requirements (i.e. minimum size, fuel use, and fuel efficiency) as the FERC prescribes, by rule. 16 U.S.C. § 796(18)(B).

The taxpayer agrees that the facility is a cogeneration facility, but claimed that it is also a qualified small power production facility. The taxpayer suggests that the two definitions are not mutually exclusive. The taxpayer claims that the type of fuel used in its power operation, combined with the size of the electricity output, make the facility a

small power production facility. The taxpayer adds that the self-certification filed with the FERC in October of 1984 makes the facility “qualified.” Therefore, in determining whether § 168(e)(3)(B)(vi)(II) applied, Exam questioned whether the power facility could be, and was, a “qualified small power production facility” within the meaning of 16 U.S.C. § 17(C).

### LAW AND ANALYSIS

Section 167(a) allows as a deduction, “a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income.” Section 168 is used to determine the amount and timing of the depreciation deduction. § 167(b). Section 168(e)(3)(B)(vi)(II) provides that “5-year property” includes any property which is described in § 48(l)(15) (as in effect before the date of the enactment of the Revenue Reconciliation Act of 1990) and is a qualifying small power production facility within the meaning of section 16 U.S.C. 3(17)(C), as in effect on September 1, 1986. The relevant part of § 48(l)(15) (1990) (*amended by* the Revenue Reconciliation Act of 1990) defines Biomass Property as an organic substance that is any synthetic solid fuel, which does not include coal (including lignite) or any product of such coal.

Fuel, is an organic substance other than coal and is therefore property described in paragraph § 48(l)(15) (1990) (*amended by* the Revenue Reconciliation Act of 1990). The first requirement of § 168(e)(3)(B)(vi)(II) is thus satisfied. The next requirement is that the property be part of a qualifying small power production facility within the meaning of 16 U.S.C. § 796(17)(C).

A qualifying small power production facility means a small power production facility that the FERC determines, by rule, meets such requirements (including requirements respecting fuel use, fuel efficiency, and reliability) as the FERC may, by rule, prescribe. 16 U.S.C. § 796(17)(C). In other words, to be a qualified small power production facility the taxpayer’s facility must be (1) a small power production facility and (2) must be qualified by the FERC. The first part of the definition is clearly explained in parts (A) and (B) of 16 U.S.C. § 796(17).

A small power production facility is a generating facility of 80 megawatts or less whose primary energy is renewable (hydro, wind or solar), biomass, waste, or geothermal resources. 16 U.S.C. § 796(17)(A). The primary energy source is the fuel used for the generation of electric energy. 16 U.S.C. § 796(17)(B). Fuel is a type of biomass and the taxpayer’s operation is a generating facility of less than 80 megawatts. Accordingly, the taxpayer’s facility appears to be a small power production facility.

As to the qualification requirements, the FERC promulgated regulations that provide a small power production facility is a qualifying facility if (1) the power production capacity is less than 80 megawatts, (2) the primary energy source of the facility is biomass, waste, renewable resources, or any combination thereof, and (3) the facility files a notice of self-certification with the FERC or files an application with the FERC for “Commission Certification.” 18 C.F.R. §§ 292.203(a); 292.204. The owner of

the facility can self-certify with the FERC by submitting a Form with the FERC. 18 C.F.R. § 292.207. The taxpayer submitted its self-certification form in Date 1. At that time, the taxpayer's facility met all of the above requirements to be a qualified small power production facility.

Between Year 2 and Year 4, the taxpayer replaced all the equipment in the self-certified facility. Despite the replacement, a change in facts from those presented in a notice of self-certification or an application for Commission certification does not mean that the facility is no longer a qualified facility. Mesquite Lake Associates, Ltd., 63 FERC ¶ 61,351 (June 30, 1993). Whether the facility will continue to be certified after a change in facts depends on whether the facility continues to satisfy the ownership and technical requirements for qualifying status found in the statute and the Commission's regulations. Id. Despite the replacement, the taxpayer's facility continued to satisfy the ownership and technical requirements for qualifying status set forth in 18 C.F.R. §§ 292.203; 292.204.<sup>2</sup>

[REDACTED] A cogeneration facility produces electricity and steam or forms of useful energy (such as heat) which are used for industrial, commercial, heating, or cooling purposes. 16 U.S.C. § 796(18)(A). A qualifying cogeneration facility is a cogeneration facility that the FERC determines, by rule, meets the requirements the FERC prescribed. 16 U.S.C. § 796(18)(B). The taxpayer agrees that its power operation is a qualified cogeneration facility, however, the taxpayer disagrees that it is not also a qualified small power production facility.

There is no rule in either 16 U.S.C. § 796 or the associated regulations which, expressly or impliedly, states that if a facility is a cogeneration facility it is excluded from the definition of a small power production facility. In fact, in a 1996 Order concerning certification the FERC ruled that, based on the facts presented, a facility could be both a qualified small production facility and a qualified cogeneration facility. Burney Forest Products, 76 FERC ¶ 62,263 (September 30, 1996). The facility at issue in the Order consisted of two wood-fired boilers and an extraction/condensing steam turbine generator. Id. The thermal output of the facility was used to dry lumber as well as create electricity. Id. The wood used in the facility was considered biomass and the maximum net electric power production capacity of the facility was 31.5 megawatts. Id. Since the fuel was a biomass and the size of the power production capacity was less than 80 megawatts, the facility met the definition of a small power production facility. Id. Since the thermal output both created electricity and dried the lumber, it was also a cogeneration facility. Id.

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<sup>2</sup> [REDACTED]

The definitions themselves suggest that the classifications are not mutually exclusive. The crux of the definition of a qualified small power production facility is the size of the facility (based on power output) and the type of fuel used. The crux of the definition of a qualified cogeneration facility is the method in which the electricity is produced and the efficiency standards of that method. Thus, a plain reading of 16 U.S.C. § 796(17) and (18) suggests that a facility could be both a qualified small power production facility and a qualified cogeneration facility.<sup>3</sup> In fact, the FERC has certified numerous facilities that have satisfied the criteria of both definitions.<sup>4</sup>

### CONCLUSION

The taxpayer uses Fuel, a type of biomass, for fuel in its power facility. Its facility produces less than 80 megawatts of electricity. The taxpayer's facility is within the definition of a small power production facility. The taxpayer self-certified in Year 1 and therefore the small power production facility is qualified. Accordingly, the equipment used in the taxpayer's qualified small power production facility is "5-year property" pursuant to § 168(e)(3)(B)(vi)(II).

Please call LB&I Attorney Signing at Telephone if you have any further questions. Section 6110(k)(3) provides that this memorandum may not be used or cited as precedent.

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By: \_\_\_\_\_  
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