DEPARTMENT OF STATE REVENUE

40-20140245.LOF

Letter of Findings: 40-20140245
Utility Receipts Tax
For the Years 2010 and 2011

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUE

I. Utility Receipts Tax - Resource Recovery Depreciation Deduction.

Authority: IC § 6-2.3-1-7; IC § 6-2.3-5-3; I.R.C. § 167; I.R.C. § 168(a); I.R.C. § 168(g); I.R.C. § 168(k); I.R.C. § 167(m); I.R.C. § 179; Treas. Reg. 1.167(a)-11(b)(4)(iii)(b); Rev. Rul. 2014-17; Rev. Rul. 2003-81.

Taxpayer argues that the Department erred in disallowing its resource recovery depreciation deduction.

STATEMENT OF FACTS

Taxpayer is a public utility company which provides electric services to residential, commercial, and industrial customers in Indiana. Taxpayer owns and operates Indiana coal fired power plants. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's Utility Receipts Tax ("URT") returns. The audit resulted in the assessment of additional URT. Taxpayer disagreed with the additional assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Utility Receipts Tax - Resource Recovery Depreciation Deduction.

DISCUSSION

During 2010 and 2011, Taxpayer claimed a deduction on its URT returns for "Depreciation on Resource Recovery Systems." The Department's audit concluded that three tests must be satisfied before Taxpayer could qualify for the resource recovery deduction provided by IC § 6-2.3-5-3. As set out in the audit report, the three tests are:

- The utility must be allowed a federal depreciation deduction for resource recovery property (asset class 49.5) for the property in question. The IRS has a "primary use" test to classify the assets.

- The utility must use the property to dispose of solid waste or hazardous waste; and

- The property must convert the solid waste or hazardous waste into energy or other useful products.

The audit concluded that Taxpayer failed to satisfy the first of the three tests. According to the audit report, I.R.C. § 167 (Section 1.167(a)-11(b)(4)(iii)(b)) "sets out the asset classification by placing the assets in groups **by primary activity of use."** Further, "Property is included in the **asset guideline class for the activity in which the property is primarily used**." (Emphasis in original).

The audit report explained:

> Accordingly, while it is correct that there is not a "predominate use" requirement in Indiana law, there is under federal depreciation rules a "primarily use" requirement that a taxpayer put the assets in the asset class for which the property is primarily used when figuring its depreciation deduction.

The audit found that Taxpayer did not take depreciation deductions for its precipitators and scrubbers in accordance with I.R.C. § 167 because "[t]he claimed Resource Recovery Depreciation Deduction does not meet the primary use test requirement under IRC 167." Based on that determination, the audit made two adjustments. As explained in the audit report:

1. "An adjustment is made to disallow Section 168(k) Bonus depreciation deduction on the URT return since

the amount of depreciation deduction is generally equal to the amount of tax depreciation allowed under Sections 167 and 179 of the federal tax code . . . "
2. "An adjustment is made to disallow the resource recovery depreciation deduction since it was not depreciated under asset class 49.5 'Waste Reduction and Resource Recovery Plant' with a 7 year recovery period under MACRS but rather asset class 49.13."

Taxpayer maintains that both of these adjustments were erroneous.

A. Resource Recovery System:

A "Resource Recovery System" means "tangible tangible personal property directly used to dispose of solid waste or hazardous waste by converting it into energy and other useful products." IC § 6-2.3-1-7.

Taxpayer's power plants employ "Resource Recovery Systems." Taxpayer's "Resource Recovery System" consists (1) of "electrostatic precipitators . . . used to remove . . . fly ash particle[s] from the flue gas using the force of an induced electrostatic charge." Some of the fly ash is used in the production of concrete. According to the audit report, "The remainder of the fly ash is either land filled or incorporated in [a] slurry mixture used for the production of synthetic gypsum."

Taxpayer's "Resource Recovery System" also consists of (2) a "flue gas desulfurization . . . scrubbing process ["Scrubbers"] at its coal-fired power plants." The scrubbing process removes sulfur dioxide emissions from the power plants' flue gas. The scrubbing process produces calcium sulfate which Taxpayer calls "synthetic gypsum." The synthetic gypsum is sold to an unrelated third-party wallboard manufacturer.

As explained in the audit report, "The [T]axpayer claimed a depreciation deduction related to fly ash and synthetic gypsum which they state are usable products created with the generating plants."

B. Depreciation Deduction:

The depreciation deduction at issue here includes IC § 6-2.3-5-3, which provides.

(a) Except as provided in subsection (b), if:
(1) for federal income tax purposes a taxpayer is allowed a depreciation deduction for a particular taxable year with respect to a resource recovery system; and
(2) the resource recovery system processes solid waste or hazardous waste;
the taxpayer is entitled to a deduction from the taxpayer's gross receipts for that same taxable year. The amount of the deduction equals the total depreciation deductions that the Taxpayer is allowed, with respect to the system, for that taxable year under Sections 167 and 179 of the Internal Revenue Code.
(b) A taxpayer is not entitled to the deduction provided by this section for a particular taxable year with respect to a resource recovery system that is directly used to dispose of hazardous waste if during that taxable year the taxpayer:
(1) is convicted of any criminal violation under IC 13, including IC 13-7-13-3 (before its repeal) or IC 13-7-13-4 (before its repeal); or
(2) is subject to an order or consent decree based upon a violation of a federal or state rule, regulation, or statute governing the treatment, storage, or disposal of hazardous wastes that had a major or moderate potential for harm. (Emphasis added).

C. Taxpayer's Basis for Claiming the Deduction:

For federal income tax purposes, Taxpayer claimed a depreciation deduction for its resource recovery system equipment pursuant to I.R.C. § 167(a) in an amount determined under I.R.C. § 168(a) and I.R.C. § 168(k).

I.R.C. § 168(a) is "regular" depreciation, and I.R.C. § 168(k) is "bonus" depreciation.

The implementation of the depreciation deduction is explained at Rev. Rul. 2003-81 which provides in part:

Section 167(a) of the Internal Revenue Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business or held for the production of income. The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) the

alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed deprecation method, recovery period, and convention.

D. Audit's Report:

The Department's audit disallowed the deduction because it determined the deduction was not taken under I.R.C. § 167 and I.R.C. § 179 as required under IC § 6-2.3-5-3 and failed to meet one of the requirements under the "three-part" test.

As explained in the audit report:

> A review of the . . . [T]axpayer's Resource Recovery Deduction work papers revealed the [T]axpayer took a Resource Recovery Depreciation Deduction from URT that was Bonus Depreciation under IRC Section 168(k).
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> . . . .
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> An adjustment is made to disallow Section 168(k) Bonus depreciation deduction on the URT return since the amount of depreciation deduction is generally equal to the amount of tax depreciation allowed under Sections 167 and 179 of the federal tax code, with respect to the resource recovery property . . . .

In addition, the audit report found that, "An adjustment is made to disallow the resource recovery depreciation deduction since it was not depreciated under asset class 49.5 . . . ." (Emphasis added).

E. Asset Classification:

"Asset Class" as it relates to the depreciation scheme is explained in Rev. Rul. 2003-81 which states in part:

> For purposes of either § 168(a) or § 168(g), the applicable recovery period is determined by reference to class life or by statute . . . . Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former § 167(m) as if it were in effect and the taxpayer had made an election under that section. Prior to its revocation, § 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary that reasonably reflects the anticipated useful life of that class of property to the industry or other group.
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> Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations provides rules for classifying property under former § 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.
>
> Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowances under § 168. Rev. Proc. 87-56 establishes two categories of depreciable assets: (1) asset classes 00.11 through 00.4 which consists of specific assets used in all business activities (asset categories); and (2) asset classes 01.1 through 80.0 which consists of assets used in specific business activities (activity categories) based on broadly defined industry classifications. The same item of depreciable property may be described in both an asset category and an activity category, in which case the item is classified in the asset category unless specifically excluded from the asset category or specifically included in the activity category.

See also Rev. Rul. 2014-17.

For example, asset class 00.11 includes "furniture and fixtures that are not a structural component of a building" such as "desks, files, safes, and communication equipment." Id Asset class 00.3 "includes improvement directly to or added to land" such as sidewalks, sewers, canals, or transmitting towers. Rev. Rul . 2003-81.

In particular, asset class 49.13 "includes assets used in the steam power production of electricity for sale, combustion turbines operated in a combined cycle with a conventional steam unit and related land improvements. This asset class also includes package boilers, electric generators and related assets such as electricity and steam distribution systems as used by a waste reduction and resource recovery plant if the steam or electricity is normally for sale to others." Id. (Emphasis added).

The audit disallowed the resource recovery depreciation deduction since it was not depreciated under asset class 49.5, "Waste Reduction and Resource Recovery Plants," with a seven-year recovery period under MACRS but rather asset class 49.13. The audit concluded that, "The claimed Resource Recovery Depreciation Deduction does not meet the primary use test requirement under IRC 167."

F. Audit's Analysis:

The Department's audit set out a three-part test pursuant to IC § 6-2.3-5-3 "that must be met to [qualify] for the resource recovery deduction from URT." The audit report's three-part test provided:

> 1. The utility must be allowed a federal depreciation deduction for resource recovery property (asset class 49.5) for the property in question. The IRS has a "primary use" test to classify the assets.
> 2. The utility must use the property to dispose of solid waste or hazardous waste[] and
> 3. The property must convert the solid waste or hazardous waste into energy or other useful products.

See also IC § 6-2.3-1-7; IC § 6-2.3-5-3.

The audit report cited to Treas. Reg. 1.167(a)-11(b)(4)(iii)(b) explaining that the regulation:

> [S]ets out the asset classification by placing assets in groups by primary activity of use. Property is included in the asset guidelines class for the activity in which the property is primarily used. Property is classified according to its primary use even though the activity in which such property is primarily used is insubstantial to all the activities of the taxpayer. (Emphasis in original).

The audit report further explained:

> Accordingly, while it is correct that there is not a "predominate use" requirement in Indiana law, there is under federal depreciation rules a "primarily use" requirement that a taxpayer put the assets in the asset class for which the property is primarily used when figuring its depreciation deduction.

The audit report found that Taxpayer had misclassified its "electrostatic precipitators" and its "flue gas desulfurization scrubbing" equipment explaining that "Waste Recovery Property" (Class 49.5) as defined under I.R.C. § 167 means that the asset must be "used in the conversion of refuse or other solid waste or biomass to heat or to a solid, liquid, or gaseous fuel."

G. Audit's Conclusion:

The audit report concluded that:

> An adjustment is made to disallow the resource recovery depreciation deduction since it was not depreciated under asset class 49.5 "Waste Reduction and Resource Recovery Plants" with a 7 year recovery period under [modified accelerated cost recovery system (MACRS)] but rather asset class 49.3. The claimed Resource Recovery Deduction does not meet the primary use test requirement under IRC 167.

In other words, the Department concluded that for federal purposes Taxpayer's equipment falls within asset class 49.3 and is properly depreciated at the federal level, but because Taxpayer's equipment is not "directly used to dispose of solid waste or hazardous waste by converting it into energy and other useful products," it does not meet the Indiana definition of a depreciable Resource Recovery System as defined in IC § 6-2.3-1-7. The Department agrees that the equipment produces "other useful products" (recovered fly ash and synthetic gypsum) but it does not agree that the precipitators and scrubbers convert "hazardous waste" (unrecovered fly ash and sulfur dioxide) into energy or other useful products.

Taxpayer disagrees stating that:

> [T]he Auditor's conclusion that resource recovery property means only property that is depreciated under asset class 49.5 is incorrect as a matter of law, because (1) utilities are required by federal law to depreciate their resource recovery assets under asset class 49.13 and (2) the Legislature provided a deduction for all resource recovery property depreciated under Section 167 without regard to any specific asset class.

Asset Class 49.13 - which Taxpayer used to classify its equipment including the "electrostatic precipitators" and its "flue gas desulfurization scrubbing equipment" - provides as follows:

Includes assets used in the steam power production of electricity for sale, combustion turbines operated in a combined cycle with a conventional steam unit and related land improvements. Also includes package boilers, electric generators and related assets such as electricity and steam distribution systems as used by a waste reduction and resource recovery plan if the steam or electricity is normally for sale to others. Rev. Rul. 2006-81.

H. Conclusion:

Taxpayer is correct because, under federal law, utilities such as Taxpayer are required to depreciate resource recovery assets under asset class 49.13 and because IC § 6-2.3-5-3 provides a deduction for resource recovery property depreciated under I.R.S. § 167 without regard to any particular asset class.

As explained in Rev. Rul. 2003-81 and Rev. Rul. 2014-17 the amount of depreciation deduction provided under I.R.C. § 167 for tangible personal property placed in service at 1986 is generally determined under I.R.C. § 168. I.R.C. § 168 prescribes two accounting methods for depreciation allowance: (1) the general depreciation allowed in I.R.C. § 168(a); and (2) the alternative depreciation scheme allowed under I.R.C. § 168(g). Under either provision, the depreciation deduction is computed using a prescribed depreciation method, recovery period, and convention.

For purposes of both I.R.C. § 168(a) or I.R.C. § 168(g), the recovery period is determined by class life or by statute. I.R.C. § 168(i)(1) provides that the term "class life" means the class life - if any - that would apply to property as of January 1, 1986, under former I.R.C. § 167(m)(repealed) as if I.R.C. § 167(m) were still in effect and as if the taxpayer had made an election under that provision. Treas. Reg. 1.167(a)-11(b)(4)(iii)(b) provides the rules for classifying property under former I.R.C. § 167(m). Under these rules, property is included in the asset class for the activity for which the property is primarily used (the "primary use" test).

Asset class 49.5 (Waste Reduction and Resource Recovery Plants) includes assets used in the conversion of refuse or other solid waste or biomass to heat or to a solid, liquid, or gas fuel. The audit's conclusion that only assets depreciated for federal purposes under class life 49.5 is not correct because 49.5 applies exclusively to assets whose "primary" use of the resource recovery plant's assets are to make heat or fuel which is not what IC § 6-2.3-5-3 provides.

Taxpayer correctly depreciated the resource recovery assets under asset class 49.13 (Electric Utility Steam Production Plant) which includes assets used in the steam powered production of electricity for sale, combustion turbines operated with conventional steam units and related land improvements. Asset class 49.13 also includes package boilers, electric generators and related assets such as electric and steam distribution system as used by a waste reduction and resource recovery plant if the steam or electricity is normally for sale to others. Taxpayer's precipitators and scrubbers were properly included in this asset class because the primary purpose of all the assets in Taxpayer's plants was to generate electricity for sale.

Any resource recovery plant property can be included in either asset class 49.5 or 49.13 depending on the primary purpose for which that property is used. In this case, Taxpayer produces electricity for sale and not heat or fuel; Taxpayer was required to include its assets - including the precipitators and scrubbers - in asset class 49.13.

In addition, if the Indiana Legislature intended to limit the scope of the resource recovery deduction in IC § 6-2.3-5-3 to only those assets depreciated under asset class 49.5, it would have said so. IC § 6-2.3-5-3 is not written as narrowly as the audit suggests; under IC § 6-2.3-5-3, the resource recovery deduction applies to any assets depreciated under I.R.C. § 167 without regard to asset class.

FINDING

Taxpayer's protest is sustained.

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