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IN THE UNITED STATES DISTRICT COURT FOR THE
DISTRICT OF UTAH, CENTRAL DIVISION

UNITED STATES OF AMERICA, Plaintiff, vs. RAPOWER-3, LLC, INTERNATIONAL AUTOMATED SYSTEMS, INC., LTB1, LLC, R. GREGORY SHEPARD, NELDON JOHNSON, and ROGER FREEBORN, Defendants.	Civil No. 2:15-cv-00828-DN-EJF **DEFENDANTS' MEMORANDUM REGARDING "PLACED IN SERVICE" AND "USED IN TRADE OR BUSINESS"** Judge David Nuffer Magistrate Judge Evelyn J. Furse

Defendants RaPower-3, LLC, International Automated Systems, Inc., LTB1, LLC., R. Gregory Shepard, and Neldon Johnson (hereinafter collectively "Defendants") respectfully submit this memorandum regarding the issue of "placed in service" and its confluence with customers' carrying on a "trade or other business."[1] Each issue is addressed in turn.

I. The Fresnel Lenses are Solar Equipment and Qualify as Equipment Placed in Service in the Year Customers Purchased the Lenses.

[1] Doc. 378.

Before a taxpayer may take a tax credit under 26 U.S.C.S §§ 46 or 48 or claim a depreciation expense under 26 U.S.C.S. § 36, the energy property must be "placed in service" during the taxable year for which the credit is claimed. Under Section 48, solar energy property means "any equipment which uses solar or wind energy to generate electricity, to heat or cool or provide hot water for use in a structure, or **to provide solar process heat**." (Emphasis added.) In the context of alternative energy production, courts have applied a less stringent "placed in service" test when determining whether a tax payer is entitled to credits or depreciation expenses.

In *Sealy Power v. Commissioner*, the IRS challenged a company's claims to investment tax credits and depreciation expenses under 26 U.S.C.S. §§ 36, 46, and 48. The 5th Circuit Court of Appeals overturned the Tax Court's decision to apply an "unduly restrictive 'placed in service' test that requires regular operation as measured by the amount generated." Instead, the 5th Circuit determined that "[t]he appropriate method for determining the year that an electric generating facility is placed in service is to analyze a taxpayer's fact situation, using a common-sense approach in the context of the policy behind the investment tax credit, the Treasury Regulations defining 'placed in service,' and the Revenue Ruling Factors."[2]

A. Legislative History Supports a Liberal Interpretation of Placed in Service.

In *Sealy*, the 5th Circuit explored the meaning of "placed in service" by examining the legislative history related to the investment credit. It dismissed the Tax Court's interpretation of the "placed in service" requirement as too stringent in requiring a "regular achievement of anticipated production levels" when Congress created the credit. [3] "Congress enacted the

[2] *See Sealy Power v. Commissioner*, 46 F.3d 382, 393 (5th Cir. 1995)
[3] *Id.* ("These regulations do not require that property entitled to depreciation and credits must first meet expected output goals before it may be deemed to have been placed in service; to the contrary, these regulations reveal that defectively or disappointingly performing property may still be considered to have been placed in service.")

investment tax credit to stimulate the economy by encouraging investment in machinery, equipment, and certain other property."[4] It went on to say:

> These credits provide an incentive to acquire property such as machinery and equipment by lowering the effective after-tax acquisition cost of the qualified property, which in turn increases the rate of return on these assets. The legislative history dealing with the investment tax credit noted that the increased cash flow would be particularly important for new and smaller firms, like Sealy, which did not have ready access to the capital markets. The credit would lower the profit risk that these firms faced in starting out a new venture and therefore would facilitate their investment decisions.
>
> Courts have often recognized the notion that the "investment tax credit should be construed liberally in light of its purposes." The Tax Court's reading of "specifically assigned function" as achieving ideal or near ideal production levels, however, demands a hindsight approach to the success of a taxpayer's investment expenditures which undermines the very focus of the credits' incentive, the initial investment decision. Further, the Commissioner's own interpretations of the statute in the relevant Regulations support a less restrictive examination of the contribution of property to the business for the "placed in service" determination. This common-sense approach stops short of requiring a new business to achieve a certain level of production in order to qualify for the credit. In defining "placed in service," Treasury Regulation 1.46-3(d)(1)(ii) neither states nor implies that the property must produce an anticipated or projected amount before it may be considered ready and available for a specifically assigned function. Neither do the examples in Treasury Regulation § 1.46--3(d)(2)(ii) and (iii) -- illustrating when property acquired for use in a trade or business or for the production of income is placed in service -- support the Tax Court's unduly strict construction of the statute.[5]

The Court examined a Regulation example[6] of property placed in service for a taxable year relating to operational farm equipment as support for its less stringent approach. The Regulation example stated that operational farm equipment shall be considered in a condition or state of readiness and availability the year it was acquired even if the equipment is not used that year where it is not practical to use the equipment until the following year.

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[4] *Id.* (citing S. Rep. No. 529, 95th Cong., 2d Sess. 1, 6-11 (1978), *reprinted in* 1978 U.S.C.C.A.N. 7942, 7945-49.)
[5] *Sealy*, 46 F.3d at 393-94.
[6] 26 C.F.R. § 1.46-3(d)(ii)(2)(ii) ("In the in case of property acquired by a taxpayer for use in his trade or business (or in the production of income), the following are examples are cases where property shall be considered in a condition or state of readiness and availability for a specifically assigned function: 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.")

> "This example does not imply that the farming operation has to produce crops at or near its expected level in order for the equipment to be placed in service. To the contrary, this example contemplates that it may not be practicable to use some assets acquired for the farming business if the business' output does not present a need for the additional equipment at the present time."

Additionally, the court noted another example in support of its approach. This example identified equipment acquired for a "specifically assigned function which is operational but is undergoing testing to eliminate any defects."[7] "This example acknowledges that defective performance -- presumably performance below that which was anticipated or projected -- does not bar an asset's 'placed in service' designation."[8]

b. The Fresnel Lenses, as Component Parts, are "Placed in Service" When in a Condition or State of Readiness and Available for a Specifically Assigned Function.

The 8th Circuit Court of Appeals has also held that "placed in service" is not synonymous with "used."[9] Specifically, the court in *Northern States Power Co.* held that fuel assemblies that were "placed in service" the year they were acquired despite not being used until a later date because they were "in a condition or state of readiness and availa[ble] for a specifically assigned function" of the greater power plant. The court also relied on examples from 26 C.F.R. § 1.46-3(d)(ii)(2)(i)-(iii) to support its reasoning that property need not be conducting electricity to qualify as "placed in service" under the code.[10] Other circuits have similarly held.[11]

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[7] *See Sealy*, 46 F.3d at 94 (citing 26 C.F.R. § 1.46-3(d)(ii)(2)(iii).)
[8] *Id.*
[9] *N. States Power Co. v. United States*, 151 F.3d 876, 880 (8th Cir. 1998) (holding that fuel assemblies were "placed in service" the year they were "first placed in a condition or state of readiness and availability for a specifically assigned function.")
[10] *Id.*at 882-83.
[11] *Conn. Yankee Atomic Power Co. v. United States*, 38 Fed. Cl. 721, 729 (1997) (Fuel assemblies available for use the year they were received, not the year they were actually used.); *accord Waddel* ***v.*** *Commissioner*, 86 T.C. 848, 897 (1986), *aff'd*, 841 F.2d 264 (9th Cir. 1988) ("For an asset to be 'placed in service' for purposes of depreciation and the [ITC], it is not necessary that the property actually be used during the taxable year in the taxpayer's profit motivated venture."); *c.f., Cooper v. Commissioner*, 88 T.C. 84, 116 (1987) ("We reject respondent's argument, however, that the lack of a completely functional system precludes a finding that the equipment was energy property.")

In this case, Defendants are entitled to the benefit of a liberal standard for the "placed in service" test because the equipment at issue is alternative energy production.[12] Applying this test, the Fresnel lenses leased to RaPower-3 customers were in a condition or state of readiness and available for a specifically assigned function. Thousands of lenses were mounted onto steel frames for installation on IAS towers. Throughout the years, Defendants have continually used the lenses for research and development purposes to further develop the IAS solar energy system. As a result, Defendants have continually advanced toward the goal of generating electric power using solar energy to lower cost. Further, even though development continues to advance toward production of electric power, the lenses have nonetheless continually been and are being used to create solar process heat.

II. Defendants' Believed Customers were in the "Trade or Business."

Plaintiff asserts that Defendants knew or should have known that its customers were not in in the "trade or business" because Defendants' customers were not conducting "bona fide or ongoing businesses" and that the "'leasing businesses only existed on paper and would never produce income." There is no evidence before this court demonstrating that every RaPower-3 customers' business does not qualify as carrying on trade or business, and testimony from witness Robert Rowbotham that he was paid five years' rent and engaged in an ongoing profitable business on which he paid income taxes contradicts this claim. (Trial TR p. 954:3-9.)

It is well settled that taxpayers are free to structure their transactions so as to decrease or eliminate their taxes by any means which the law permits.[13] The law is also well settled that to constitute the carrying on of a trade or business, the activity must be engaged in with an "actual

[12] *See Sealy*, 46 F.3d at 393-94.
[13] *Gregory v. Helvering*, 293 U.S. 465, 469 (1935*); Gordon v. Commissioner*, 85 T.C. 309, 326 (1985*).*

and honest objective of making a profit."[14] Although a reasonable expectation of profit is not required, the activity must "be entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom."[15] The issue of whether the requisite profit objective exists is one of fact to be resolved on the basis of all the evidence in the case.[16]

Section 1.183-2(b) of the Income Tax Regulations enumerate a nonexclusive list of factors to be considered in determining whether an activity is engaged for profit:

(1) The manner in which the taxpayer carries on the activity;

(2) the expertise of the taxpayer or his advisors;

(3) the time and effort expended by the taxpayer in carrying on the activity;

(4) the expectation that assets used in the activity may appreciate in value;

(5) the success of the taxpayer in carrying on other similar or dissimilar activities;

(6) the taxpayer's history of income or losses with respect to the activity;

(7) the amount of occasional profits, if any, which are earned;

(8) the financial status of the taxpayer; and

(9) any elements indicating personal pleasure or recreation.

No one factor is conclusive; the importance of each factor must be evaluated in the context of the particular case.[17]

In this case, the Court would need to hear evidence on every customers' unique situation to determine whether they individually are in the "trade or business" and can consequently benefit

[14] *Dreicer v. Commissioner*, 78 T.C. 642, 644 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); *Capek v. Commissioner*, 86 T.C. 14, 36 (1986); *Fuchs v. Commissioner*, 83 T.C. 79, 98 (1984).

[15] *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963).

[16] *Cooper* v. Commissioner, 88 T.C. 84, 108 (1987) (citing *Sutton v. Commissioner*, 84 T.C. 210 (1985)).

[17] *Dunn*, 70 T.C. at 720.

from the depreciation expenses and tax credits under the code. Plaintiff's attempt to categorically dismiss each customer as not engaging in a "bona fide and ongoing business" because Defendants knew that the "'leasing business' existed only on paper and would never produce income'" without providing evidence of each individual's unique situation falls short of satisfying its evidentiary burden. On the contrary, the customers Plaintiff intends to call have testified or are expected to testify that each expected that they would eventually earn a profit through their leases. If any one of the Defendants' customers qualify under the code then Plaintiff's claim must fail. So far, Robert Rowbotham's testimony contradicts the government's theory and demonstrates that he qualifies as a business owner entitled to claim he was engaged in a trade or business:

> Q. Mr. Rowbotham, what income, if any, have you received from your lenses?
>
> A. I have received a monthly check from RaPower3 for the last three, four or five years.[18]

(Trial TR p. 933, l. 19-22.)

He paid taxes on the money he received:

> Q. Have you paid taxes on all the money that you have received from the sale of solar lenses or relating to these lenses --
>
> A. Yes, I have.
>
> Q. Excuse me. -- for the last five years?
>
> A. Yes. (Tr. TR p. 954, l. 3-9.)

And further testified that he viewed this transaction as a legitimate business intended to produce a profit:

> Q. Okay. When you purchased the lenses, did you think a profit was possible from your lens?

[18]

A. I thought so, yes.

Q. Did you understand that there were market risks when you purchased your lenses?

A. Absolutely.

Q. Did you actually pay for your lenses?

A. Yes.

Q. Was your purchase of those lenses at arm's length?

A. Will you say that again, please?

MR. MORAN: Objection; mischaracterizes the evidence.

THE COURT: Overruled. If he has a clue what that means.

Q. BY MR. GARRIOTT: Do you understand what an arm's length transaction is?

A. Yes.

Q. Okay. What is your understanding of an arm's length transaction?

A. That it's basically separate of the existing organization that I'm in.

Q. Okay. And did you understand that your purchase of the lenses was an arm's length transaction?

A. Yes.

(Tr. TR p. 952, l. 17-p. 953, l. 15.)

The IRS apparently agrees, because his claimed deduction for an energy credit involving multiple lens purchases have not been challenged or audited. Although the government identified Rowbotham as an individual who took these deductions, and deposed him in this case, they have accepted his claimed deductions. As Rowbotham testified:

Q. And none of those credits were ever audited by the IRS; correct?

A. That is correct.

(Tr. TR p. 955, l. 18-20; see also p. 944, l. 5-13 to the same point.)

The same CPA firm the government elicited testimony from (Mantyla, Reynolds) to criticize and suggest the lenses do not qualify for solar tax incentives were the people who prepared the tax returns for Rowbotham and determined he was entitled to claim the solar tax incentives:

Q. Who's your tax person?

A. Dave Mantyla.

Q. Dave Mantyla?

A. Yes.

Q. Do you know the name of his company?

A. At the time it was Mantyla McReynolds, I believe, and he is currently an independent now.

Q. Okay. How long did Mr. Mantyla do your taxes?

A. Don Mantyla was Dave's dad, and we started with him, I'd say the late '90s.

Q. Does he still do your taxes?

A. Dave does, yes. (Tr. TR p. 945, l. 3-14.)

Q. Okay. And did he do taxes for you, do your taxes in the years 2006 through 2010?

A. I'm pretty sure he did, yes.

Q. I think those were the years that you testified that you took tax credits for the solar energy. Does that --

A. That is correct.

Q. That's correct?

A. Yeah. (Tr. TR. P. 946, l. 2-9.)

Mr. Rowbothom, as a customer of RaPower-3 identified by the Plaintiff, believes he is in a trade or business and has conducted himself accordingly. This is likely the best evidence the Court will receive on the matter.

III. Conclusion.

This Court is required to take a liberal interpretation of "placed in service" when making its determination about solar energy development. Although the lenses do not need to be used in the year they are "placed in service", and do not need to be a part of an operating system, they have been used not only to further the research and development of the solar energy system, but also to create solar process heat both for the research and development and for the system itself. The lenses qualify as "placed in service."

Although there are numerous factors to consider in whether or not the customers held the subjective belief they were in a trade or business, the most compelling answer comes from the owner-witness the Court has already heard. The activity must be engaged in with an "actual and honest objective of making a profit." Mr. Rowbothom had that objective and believed he was in a trade or business. He expected to receive profit. He did receive profit from it. He paid for the lenses. He paid taxes on the income he received from his business. The best evidence this Court has received demonstrates a purchaser of the lens qualified under the language of the code written by Congress. The lenses are a part of a trade or business.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing **DEFENDANTS' MEMORANDUM REGARDING "PLACED IN SERVICE" AND "USED IN TRADE OR BUSINESS"** was sent to counsel for the United States in the manner described below.

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