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April 8, 2004

The Honorable George E. Pataki
Governor of the State of New York
State Capitol
Albany, New York 12224

The Honorable Michael R. Bloomberg
Mayor of the City of New York
City Hall
New York, New York 10007

Re: Use of Liberty Bonds to Finance Power Plant in Queens

Dear Governor Pataki and Mayor Bloomberg:

In the aftermath of the tragedy of September 11, the President of the Association of the Bar of the City of New York established a Special Task Force on Downtown Redevelopment to inform the legal and institutional processes to be followed by the City, State and Federal agencies involved with the rebuilding of the World Trade Center ("WTC") and the revitalization of Lower Manhattan. This letter is submitted on behalf of the Task Force concerning the legality of the New York Liberty Development Corporation's plan to issue Liberty Bonds for the purpose of financing a merchant power plant in Queens.

Some of the activities undertaken by the Task Force include the issuance of two reports regarding the appropriate environmental and land use review procedures to be followed by public agencies for decisions relating to downtown redevelopment and submission of detailed comments on the Scope for the World Trade Center

Redevelopment's Environmental Impact Statement, prepared by the Lower Manhattan Development Corporation.

It has now come to our attention that the Liberty Development Corporation, established by the State and the City to administer the Congressionally enacted New York Liberty Bond Program, is preparing to sell up to $600 million dollars of Liberty Bonds to finance the construction of a new 1000-megawatt gas-fired electric generating facility in Astoria, Queens. The plant will be privately owned by Astoria Energy, LLC. The State Board on Electric Generation Siting and the Environment approved the construction of the plant on November 21, 2001. Construction of the plant has been delayed due to financing difficulties. The Task Force takes no position regarding the appropriateness of this facility; however, a review of the Federal legislation governing the Liberty Bonds indicates that the use of the bond program to assist with the financing of this plant is unlawful. Therefore, we believe it to be prudent for the State and the City to consider the following legal analysis before any action is taken by the Liberty Development Corporation to issue the bonds for the purpose of financing the Astoria Energy plant. We respectfully submit this analysis to ensure that the bond program will be used as intended by the legislation and assist the State and the City in avoiding the potential for litigation.

In March 2002, Congress passed the "Job Creation and Worker Assistance Act of 2002" (the "Act") which, among other things, authorized New York's Governor and New York City's Mayor to issue $8 billion of low-cost tax-exempt private activity bonds to revitalize Lower Manhattan and assist New York City in recovering from the damage caused by the terrorist attacks of September 11, 2001. The Act provides for the financing of qualifying commercial, residential, and utility projects within a designated area – the New York Liberty Zone ("Liberty Zone") – and for the financing of certain commercial projects outside of the Liberty Zone, but within New York City. *See* Internal Revenue Code ("IRC"), Section 1400L.

The Liberty Zone covers lower Manhattan, south of Canal Street. Up to $2 billion of the $8 billion total may be used for projects within the City outside the Liberty Zone. The Act provides that Liberty Bonds may **only** be used outside the Liberty Zone to finance: "... the cost of acquisition, construction, reconstruction, and renovation of **nonresidential real property** (including fixed tenant improvements associated with such property)... if such property is part of a project which consists of **at least 100,000 square feet of usable office or other commercial space** located in a single building or multiple adjacent buildings." *See* IRC, Section 1400L(d)(4)(B) (*emphasis added*). The question researched by the Task Force was whether the Astoria Energy plant would qualify for the Liberty Bond program. After extensive evaluation, the Task Force believes that the Astoria Energy plant does not qualify as "nonresidential real property" which is "part of a project which consists of at least 100,000 square feet of usable office or other commercial space...." While government assistance with financing energy facilities in this difficult market may be a laudable goal, it is, in our view, contrary to the legislative intent to divert funds from a program that was earmarked to compensate for the losses experienced by the City because of the September 11th tragedy.

In January 2004, after this controversy was brought to the attention of the Task Force, we received a copy of a September 2002 legal memorandum prepared by the law firm of Winston & Strawn for the New York City Industrial Development Agency, purportedly to support issuance of Liberty Bonds to finance the Astoria Energy plant. With respect, it is the opinion of this Task Force that the memorandum falls short in its analysis and reaches the wrong conclusion. We would be happy to forward a copy if you are not familiar with the memo.

Astoria Energy is proposing to build a 1000-megawatt gas-fired electric generating plant on Steinway Street in Astoria, Queens, outside the Liberty Zone. The plant will comprise 347,500 square feet of space, the principal components of which will be an administration building (18,000 square feet); pump houses and electrical equipment (11,500 square feet); two combustion turbine/heat recovery units (162,000 square feet); a gas compressor (unspecified size); and a boiler (156,000 square feet).

The Astoria Energy plant is not "real property" for purposes of IRC Section 1400L. Section 1400L does not specifically define the term within the section, but refers to the meaning under IRC Section 168. Section 168 refers to Section 1250 which in turn refers to Section 1245 for definitions. These sections read together define real property as a building or its structural components, excluding tangible personal property or other tangible property that is used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services. *See* IRC Sections 1400L(d)(4)(A), 168(e)(2)(B), 1250(c), and 1245(a)(3).

The Internal Revenue Service ("IRS") regulations promulgated under IRC Section 1245 define "building" and "structural component" in Treas. Reg. §1.48-1:

> 1.48-1(e)(1): The term "building" generally means any structure or edifice enclosing a space within its walls, and ... does not include (i) a structure which is essentially an item of machinery or equipment...
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> 1.48(e)(2): The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefore such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

In Revenue Ruling 69-412, 1969-2 C.B.2 (1969), the IRS ruled the structure enclosing a 750-megawatt electric generating plant was not a building under Treas. Reg. §1.48-1(e). The IRS found that, although the structure contained small partitioned areas

for washrooms, a control room, shops, and necessary personnel areas, its primary purpose was to protect the machinery and equipment from the weather, and that "by the nature of the specific interrelationship of the design and operation of the basic components, the useful economic lives of all are common to each other and it is anticipated that each component will be retired, replaced, or abandoned contemporaneously with one another." Thus, the IRS held that because the structure was so closely related to the equipment, it was not a building under Treas. Reg. §1.48-1(e). The IRS found that an attached structure that provided workspace for plant clerical and operating personnel did constitute a building.

In Fort Howard Paper Company v. Commissioner, 36 T.C.M. 1711 (1977), the tax court found that two structures housing electric generating turbines at a paper mill were not buildings under Treas. Reg. §1.48-1(e). The court found that, because the structures were specifically designed for the turbines, with a special foundation and pilings, it would not be economically practicable to use the structure for anything else upon retirement or removal of the turbines.

In applying the reasoning of these cases, it is clear that the planned Astoria Energy structures housing the equipment (but not the administration building) are not buildings under Treas. Reg. §1.48-1(e) because (1) their primary purpose is to protect the equipment, and not to provide work space for employees, (2) their function as buildings is strictly incidental to their function as part of the equipment, and (3) they are so closely interrelated with the equipment that they would be expected to be retired or replaced upon retirement or replacement of the equipment.

The Winston memorandum cites three cases to support the conclusion that the enclosures for the proposed plant are buildings under Treas. Reg. §1.48-1(e): IRS Private Letter Ruling 8018013 (1980), in which the IRS found that the building enclosing a turbine driven electric generating plant at a brewery, except for the pedestal type foundation, was a building under Treas. Reg. §1.48-1(e); In the Matter of James M. Samis, 76 T.C. 609 (1981), in which the tax court held that a concrete structure housing an electric generating plant was a building under Treas. Reg. §1.48-1(e); and Star Farms, Inc. v. U.S., 447 F. Supp. 580 (W.D. Ark 1977), in which the court held that a chicken coop was a building under Treas. Reg. §1.48-1(e).

The decisions cited in the Winston memorandum are clearly distinguishable from the circumstances before us. In both PLR 8018013 and James M. Samis, the structures at issue not only enclosed the power generating equipment, but also provided significant, finished, habitable space, including offices, conference rooms, and restrooms, which could be used for activities unrelated to the generation of electricity. The IRS noted that the foundation of the turbine could not be considered part of the building as it was designed specifically for the equipment. With the Astoria Energy plant, the only building that will provide similarly habitable workspace is the administration building. Also, the Winston memorandum mischaracterizes the holding in Star Farms. Just a year later, in Walter Sheffield Poultry Co., Inc. v. Commissioner, 37 T.C.M. 1282 (1978), the tax court examined another chicken coop and determined that it was not a building, but in fact

tangible property because it was not designed to provide workspace for employees and was used as an integral part of poultry production activities.

Nor does the equipment to be used in the Astoria Energy plant to generate electricity constitute "structural components" under IRC §1400L since it is designed for the production of electrical energy, and not for the operation of the building. *See* Treas. Reg. §1.48-1(e)(2), *supra.* In fact, the turbines, boilers, etc. are tangible property under IRC Section 1245.

Regulations promulgated under section 1245 define "tangible personal property" and "other tangible property" in Treas. Reg. §1.48-1:

> 1.48-1(c): [T]he term "tangible personal property" means any tangible property except land and improvements thereto... Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property...Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building.
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> 1.48-1(d)(1): [The term] other tangible property [means property] used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service...

The equipment to be used in the proposed Astoria Energy plant (pumps, turbines, compressors, boilers, etc.) is explicitly contemplated by the language of Treas. Reg. §1.48-1(c) and §1.48-1(d)(1). *See* Sealy Power, Ltd., v. Commissioner, 46 F.3d 382, 389 (5th Cir. 1995) (components of an electric generating facility were all tangible personal property within the meaning of Treas. Reg. §1.48-1(c)).

Winston & Strawn suggests that if Astoria Energy were to go through the process of leasing the plant to a separate entity (presumably a subsidiary of itself) for less than 80% of the expected life of the plant, then perhaps the energy production equipment might be considered "fixed tenant improvements" for purposes of IRC Section 1400L. The Winston memorandum cites to Tobias v. Commissioner, 40 T.C. 84 (1963), but that case involved solely a determination that equipment may become fixtures under property law if agreed to under the terms of a lease.

Although the term "fixed tenant improvement" is not defined in IRC §1400L(d), it may be construed in light of similar language in IRC §1400L(c) regarding depreciation of

certain leasehold improvements. IRC §1400L(c)(2) defines "Qualified New York Liberty Zone leasehold improvement property" as defined in section 168(k)(3)). IRC §168(k)(3) defines the term, in relevant part, as: "any improvement to an interior portion of a building which is nonresidential real property made under or pursuant to a lease, and placed in service more than 3 years after the date the building was first placed in service." Therefore, the electric generating equipment at the Astoria Energy plant could not be considered "fixed tenant improvements" under any scenario.

As clearly set forth above, the equipment slated for the Astoria Energy plant does not constitute "structural components" of a building or "fixed tenant improvements." Further, the building itself has no independent function beyond the incidental enclosure of the equipment, and therefore does not constitute a building at all.[1] Winston & Strawn puts forth a circular argument that the equipment may somehow be removed from the facility at the end of the life cycle and the building reused for another purpose to show that the structures are in fact buildings. Even if true, this would result only in the conclusion that the building **as a shell** might qualify as nonresidential property for purposes of the Liberty Bond legislation.

Even if the Astoria Energy plant were considered nonresidential real property under IRC Section 1400L, IRC §1400L(d)(4)(B) requires that for projects outside of the Liberty Zone to qualify for Liberty Bond financing, they must be "part of a project that consists of at least 100,000 square feet of usable office or other commercial space." Even if the proposed administrative building is considered office space, it only comprises 18,000 square feet - well short of the required 100,000. Thus, in order for the plant to qualify for funding, the space created by the component structures must be considered "usable commercial space." Because "commercial space" is not defined in IRC Section 1400L, it should be interpreted in light of the following considerations.

Congress created IRC §1400L in order to assist New York in rebuilding Lower Manhattan, and recovering from the September 11, 2001 attacks that destroyed the World Trade Center and adjoining property. Although there is no legislative history directly related to IRC Section 1400L," there is some evidence of what Congress intended. When the Liberty Bond program was announced, Senator Schumer stated, "We lost over 20 million square feet of office space on September 11, and every day we wait to replace it is another day we lose business to New Jersey and other states."[2] Additionally, the goals of the program, as described, were to:

- repair and replace damaged and destroyed commercial space,
- improve lower quality commercial space,
- create multifamily residential rental and complementary retail development,
- provide modern office space for displaced and decentralized businesses in central business districts throughout the city,

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[1] When it was announced that the Consolidated Edison facility at First Avenue and 39th Street in Manhattan was being retired, there was no discussion of reusing the buildings in any way and we have not found any example of the reuse of a structure whose only purpose was to enclose a power plant.

[2] *See* Press release, "Governor Pataki, Mayor Bloomberg Launch NY Liberty Bonds," August 7, 2002.

- attract new residents and employers to New York City, and
- encourage environmentally responsible design and construction.[3]

Moreover, on November 18, 2003, Congressmen Houghton and Rangel introduced H.R. 3508 to amend IRC §1400L(d)(4)(B) in order to permit the financing of power plants outside of the Liberty Zone precisely because power plants outside of the Liberty Zone do not currently qualify for Liberty Bond financing. The proposed amendment, rejected by House Ways and Means Committee, would have allowed the issuance of Liberty Bonds for the "(ii) acquisition, construction, and installation of real and personal property for one or more electric generation facilities with an installed capacity of no more than 300 megawatts each." Given the events precipitating the passage of the law, and the expressed goals of the Liberty Bond program, the law as currently written was intended to finance the type of commercial space that was lost when the World Trade Center was destroyed, i.e., office, retail, personal service establishments, and public service establishments, not merchant power plants.

Furthermore, commercial property has always been distinguished from industrial property in the application of planning, environmental and zoning laws. Under New York Zoning Resolution, Article III, Commercial District Regulations, commercial uses include: retail space, wholesale space, office space, personal service establishments, public service establishments, clubs, restaurants, amusements, parking, and light manufacturing. NYC Zoning Resolution, §31 et al. Commercial uses do not include power plants, which are considered "heavy manufacturing," because they "involve considerable danger of fire, explosion or other hazards to public health or safety, or cannot be designed without appreciable expense to conform to high performance standards with respect to the emission of objectionable influences." NYC Zoning Resolution, §42-15.

Finally, what constitutes "usable" space must also be considered. If the electric generating equipment, which takes up virtually all of the almost 350, 000 square feet of space, is so intricately entwined with the enclosing structure so as to constitute part of the building for purposes of IRC Section 1400L, the amount of space available for use, regardless of the definition of "commercial," is a mere 18,000 square feet of office space.

In sum, the use of New York Liberty Bonds to finance the construction of an electric generating facility in Astoria would appear to violate IRC §1400L(d)(4) since the structures that will house the plant equipment are not nonresidential real property under IRC §1400L; the plant equipment and machinery are not nonresidential real property or fixed tenant improvements under IRC §1400L; and a power plant is not usable office or other commercial space under IRC §1400L.

[3] *Id.*

The Task Force on Downtown Redevelopment urges that the decision of the Liberty Development Corporation to issue Liberty Bonds to finance the Astoria Energy plant be reconsidered for potential violation of applicable law. The Task Force stands ready to discuss this important matter further.

Respectfully,

Philip Weinberg, Chair
Downtown Redevelopment Task Force

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