Taxpayer could claim bonus depreciation by filing accounting method change

April 16, 2013

In brief

A recent IRS private letter ruling (PLR 201313012) permitted the taxpayer to claim 'bonus depreciation' by filing Form 3115, *Application for Change in Accounting Method*. The reasoning of the PLR focused on the taxpayer's having met the acquisition rule for bonus depreciation — in particular, the "10-percent safe harbor" — and the taxpayer's having filed only one federal income tax return with respect to the property at issue at the time the taxpayer requested the PLR.

In detail

Background

Bonus depreciation

The special depreciation allowance under Section 168(k) (commonly referred to as bonus depreciation) generally provides four requirements for property to be eligible for 50-percent bonus depreciation:

- The depreciable property must be of a specified type (qualified property);
- The original use of the depreciable property must commence with the taxpayer after December 31, 2007 (original use);
- The depreciable property must be acquired by the taxpayer after December 31, 2007, and before January 1, 2013; and
- The depreciable property must be placed in service before January 1, 2013 (or January 1, 2014, for longer production period property (as described in Section 168(k)(2)(B)(i)) and certain aircraft).

Reg. sec. 1.168(k)-1(b) provides guidance on the four bonus depreciation requirements. With respect to the acquisition requirement, the regulations provide two separate rules — one for acquired property and one for self-constructed property.

Self-constructed property

The bonus depreciation regulations provide, in general, that if a taxpayer manufactured, constructed, or produced (hereafter, constructed) property for its own use, the date the property is considered acquired is the date construction begins. Property that is constructed for the taxpayer by another person under a written binding contract that is entered into before construction of the property begins is considered to be constructed by the taxpayer.

For purposes of the self-constructed property acquisition rule, the bonus depreciation regulations generally provide that construction of property begins when physical work of a significant nature begins. The determination of when physical work of a significant nature begins and that this determination depends on the facts and circumstances.

Alternatively, the bonus depreciation regulations provide an elective safe harbor — the 10-percent safe harbor rule — for taxpayers to determine when physical work of a significant nature begins for self-constructed property. Pursuant to this safe harbor, physical work of a significant nature will not be considered to begin before the taxpayer incurs (in the case of an accrual-basis taxpayer) more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching).

When property is constructed for the taxpayer by another person, this safe harbor test must be satisfied by the taxpayer. Construction is deemed to begin when the taxpayer has incurred more than 10 percent of the total cost of the property. A taxpayer may elect to apply this safe harbor "by filing an income tax return for the placed-in-service year of the property that determines when physical work of a significant nature begins."

Adopting a method of accounting

Consistent, but erroneous, treatment of a material item constitutes a method of accounting. In general, a method of accounting is adopted and used consistently if the method either is permissible and used on one federal income tax return, or is impermissible and used on two consecutively filed tax returns. See Rev. Rul. 90-38. Use of an impermissible method of accounting on one federal income tax return does not constitute adoption of a method of accounting. A taxpayer in this situation that desires to use a correct method of accounting generally should amend its return to use a permissible method of accounting on that return.

Rev. Proc. 2011-14, which provides the automatic procedures for a taxpayer to change its method of accounting, states in Appendix Section 6.01(1)(a)(i) the general rule for depreciation under Section 168, which follows the rules under Rev. Rul. 90-38. However, Appendix Section 6.01(1)(b) of Rev. Proc. 2011-14 provides an exception to the general rules for changing from an impermissible method of determining depreciation to a permissible method of determining depreciation. Specifically, for a taxpayer that places in service and begins depreciating property in Year 1 and uses an improper method of accounting for depreciation on that Year 1 return (one-year depreciable property), the taxpayer may correct the improper method used on the Year 1 return and use a proper depreciation method of accounting by either amending the Year 1 return prior to filing the immediately succeeding, Year 2 federal income tax return, or filing a Form 3115 for Year 2.

PLR 201313012

In PLR 201313012, the IRS first determined whether the taxpayer met (among the other bonus depreciation requirements) the acquisition requirement for its facility, a solid-fuel generation plant, which included "Section 1245 property." As noted earlier, self-constructed property is acquired for bonus depreciation purposes when construction of the property begins, i.e., generally when physical work of a significant nature begins. Under the 10-percent safe harbor, physical work of a significant nature will not be considered to begin before an accrual-basis taxpayer "incurs" more than 10 percent of the total cost of the property.

In the PLR, the taxpayer represented that under its current method of accounting, economic performance occurred as the property was accepted by the taxpayer. The IRS determined that the taxpayer incurred a liability under Section 461 on the turnover date, and concluded that if the taxpayer chooses to apply the 10-percent safe harbor, that date applies for determining when the taxpayer began construction of its facility. The IRS therefore ruled that the taxpayer did not incur costs attributable to the contract prior to the turnover date.

PLR 201313012 also concludes that the taxpayer could claim the additional first-year depreciation deduction (bonus depreciation) on the self-constructed Section 1245 property by filing a request for an automatic change in method of accounting.

Observations

PLR 201313012 is consistent with PLRs 201210004 and 201214002 with respect to the appropriate analysis for determining when costs are incurred for the 10-percent safe harbor (the all-events test and economic performance under section 461). This ruling also is consistent with the position that many taxpayers have taken with respect to such analysis.

In this instance, the taxpayer had a self-constructed facility meeting the requirements of bonus deprecation, but the taxpayer did not deduct bonus depreciation under Section 168(k) for the facility in the year placed in service. The taxpayer also did not elect out of bonus depreciation for any class of qualified property placed in service during the year. The IRS permitted the taxpayer to apply the 10-percent safe harbor rule by filing Form 3115.

The IRS explicitly noted that the facility was one-year depreciable property as defined in section 6.01 of the Appendix to Rev. Proc. 2011-14, and that the taxpayer did not make an election out of bonus depreciation for the placed-in-service year. As a result, the IRS ruled that the taxpayer "may

choose" to apply the 10-percent safe harbor by changing its method of accounting by filing Form 3115 to claim bonus depreciation for the Section 1245 property of the facility.

To illustrate the method of accounting conclusion reached in the PLR, assume the taxpayer was a calendar-year taxpayer that placed the property at issue in service in 2011 (i.e., Year 1). The PLR concludes that the taxpayer may claim the omitted 2011 bonus depreciation by filing Form 3115 with the taxpayer's 2012 (i.e., Year 2) federal income tax return and reporting the omitted 2011 bonus depreciation on the 2012 return through a Section 481(a) adjustment.

Using the example above, the taxpayer in the PLR requested that it be permitted to claim the omitted 2011 bonus depreciation by filing Form 3115 for its 2012 year and claiming the bonus depreciation in its 2012 federal income tax return. However, the one-year depreciable property rule permits the taxpayer to claim the omitted 2011 bonus deprecation by either amending its 2011 federal income tax return or filing a Form 3115 with its 2012 federal income tax return. Accordingly, if the taxpayer instead had requested to amend, prior to filing its 2012 federal income tax return, its 2011 federal income tax return to claim the omitted 2011 bonus depreciation, it appears the taxpayer would have been permitted to do so pursuant to the one-year depreciable property rule.

The takeaway

The PLR does not address whether a taxpayer would be permitted the choice to amend or file Form 3115 to apply the 10-percent safe harbor in the event that a taxpayer had filed two or more consecutive returns for property for which the taxpayer had not claimed bonus depreciation. Accordingly, although the bonus depreciation regulations provide that a taxpayer chooses to apply the 10-percent safe harbor by filing an income tax return for the placed-in-service year of the property, the facts of the PLR did not appear to apply to this situation.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Federal Tax Services Depreciation Team

Annette Smith
(202) 414-1048
annette.smith@us.pwc.com

George Manousos
(202) 414-4317
george.manousos@us.pwc.com

James Liechty
(202) 414-1694
james.f.liechty@us.pwc.com

Sara Logan
(202) 414-1417
sara.l.logan@us.pwc.com

Rick Farley
(646) 471-4084
richard.c.farley@us.pwc.com