WNTS Insight

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IRS rules favorably on key bonus depreciation issue

In a recently issued private letter ruling (PLR 201214003), the IRS concluded that certain self-constructed property qualifies for the 50-percent additional first-year depreciation deduction (bonus depreciation) under section 168(k)(1) and that some components of the property may qualify for 100-percent bonus depreciation if a proper election is made. Most notable in the PLR is the analysis of when a taxpayer "incurs" costs for purposes of applying the 10-percent safe harbor rule in Reg. sec. 1.168(k)-1(b)(4)(iii)(B)(2) (the 10-percent safe harbor).

Observation: The recent PLR follows PLR 201210004, which also addressed, among other things, the analysis of the section 461 standards for purposes of applying the bonus depreciation 10-percent safe harbor.

Numerous issues arise in application of the bonus depreciation provisions. For prior discussion of these issues, see WNTS Insight, "IRS addresses key issues in bonus depreciation guidance," March 30, 2011; and WNTS Insight, "Key issues under temporary 100-percent expensing and extended 50-percent bonus depreciation provisions of 2012 Act," January 24, 2011.

Background

Section 168(k)(1)(A) provides that a taxpayer may claim bonus depreciation on qualified property in the tax year in which such property is placed in service by the taxpayer.

For purposes of the current applicable 50-percent bonus depreciation period, property generally must be acquired and placed in service by the taxpayer after December 31, 2007, and before January 1, 2013. Similarly, for purposes of the applicable 100-percent bonus depreciation period, property generally had to be acquired and placed in service by the taxpayer after September 8, 2010, and before January 1, 2012.

Two separate standards apply for meeting the acquisition rules --one for "self-constructed" property and another for "acquired" property. Self-constructed property includes property that a taxpayer manufactures, constructs, or produces by itself for its own use as well as property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into before the manufacture, construction, or production of the property begins. All other property is characterized as acquired property for bonus depreciation purposes.

Acquired property is considered to be acquired when the taxpayer pays or incurs the cost of the property, Self-constructed property is considered to be acquired when manufacture, construction, or production of the property begins or when "physical work of a significant nature" begins. A taxpayer may choose to determine when "physical work of a significant nature" begins under either a facts-and-circumstances approach or via the 10-percent safe harbor. Under this 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 (excluding certain preliminary construction costs such as planning and designing).

Observation: The regulations' use of the phrase "paid or incurred" is to be interpreted based on the taxpayer's overall method of accounting (cash or accrual, respectively). Accrual-method taxpayers incur a liability when the all-events and economic performance tests are met. Accordingly, as discussed more fully below, payment to another party often does not result in an incurred liability.

PLR 201214003

Facts

In the new PLR, a taxpayer entered into a written binding contract with another party under which the other party was to construct -- on a lump sum, fixed-price, turnkey basis -- two electric generating units (separately referred to as Unit 1 and Unit 2). The contract was entered into before any construction began on Units 1 and 2. The contract was signed and construction of the property began prior to January 1, 2008. Pursuant to the terms of the contract, the taxpayer made payments in accordance with the payment schedule based on payment events. The contract was subject to numerous change orders, one of which resulted in the parties entering into a settlement agreement regarding the contract price and turnover dates for the units.

The taxpayer represented that the property was for the taxpayer's original use, that Unit 1 was placed in service after December 31, 2007, and before September 9, 2010, and that Unit 2 was placed in service after September 8, 2010, and before January 1, 2012. The taxpayer also represented that regarding Units 1 and 2, assuming that no costs were incurred with respect to the contract until turnover, the costs (including capitalized interest) that were incurred as of January 1, 2008, were 10 percent or less of the final tax basis of each unit as of the original placed-in-service date. However, with respect to Unit 2, the taxpayer further represented that, assuming that no costs were incurred with respect to the contract until turnover, the costs (including capitalized interest) that were incurred as of September 9, 2010, were probably more than 10 percent of the final tax basis of the unit as of the original placed-in-service date.

The taxpayer requested that the IRS rule on whether Unit 1 and Unit 2 qualify for bonus depreciation under section 168(k).

IRS analysis

For purposes of applying the bonus depreciation provisions, the IRS first examined whether the property was self-constructed property. The IRS concluded that the units were self-constructed property because the taxpayer entered into a written binding contract under state law before construction of the units commenced. Although the contract was subject to a number of change orders, the IRS concluded that the changes were insubstantial to the terms of the contract, so the contract continued to be binding at all pertinent times for purposes of section 168(k).

The IRS then turned to whether the taxpayer met the acquisition requirement for such property. As noted earlier, self-constructed property is acquired for bonus depreciation purposes when the manufacture, construction, or production of the property begins or 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.

The IRS noted that because the term "incurred" is neither defined nor given any special meaning in section 168(k), the regulations thereunder, or the legislative history, the determination of when an accrual-basis taxpayer has "incurred" more than 10 percent of the total cost of the property is made in accordance with section 461. Specifically, Reg. sec. 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the tax year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability.

The taxpayer represented that under its current method of accounting, economic performance occurred as the property was accepted by the taxpayer. Thus, the taxpayer incurred a liability under section 461 on the turnover date, as defined under the contract, which was after December 31, 2007. Therefore, the IRS ruled that the taxpayer did not incur costs attributable to the contract prior to January 1, 2008, because such costs were not incurred under the taxpayer's current method of accounting, for purposes of section 461, until after such date.

In addition to costs directly attributable to the contract, the taxpayer incurred a small amount of costs for the construction of the facility for items such as permitting, project development, project design, and interest required to be capitalized under section 263A(f). The IRS acknowledged that for purposes of the safe harbor, the total cost of the property excludes the cost of any land and preliminary activities. However, the IRS did not consider interest required to be capitalized under section 263A(f) to be a preliminary activity; rather, the IRS concluded that such interest must be included as a cost of the property for purposes of the safe harbor. Based on the taxpayer's representations that the costs incurred as of January 1, 2008, were 10 percent or less of the total cost of the property, the IRS ruled that if the taxpayer chooses to apply the 10-percent safe harbor, the taxpayer began construction of Unit 1 and Unit 2 after December 31, 2007, and therefore satisfies the requirements of the acquisition rule for purposes of claiming bonus depreciation.

Because Unit 1 met all the bonus depreciation requirements and was placed into service after December 31, 2007, and before September 9, 2010, the IRS ruled that the unit was eligible for 50-percent bonus depreciation. Unit 2 was placed in service after September 8, 2010, and before January 1, 2012. However, because the costs that were incurred as of September 9, 2010, were represented by the taxpayer as probably being more than 10 percent of the final tax basis of the unit as of the original placed-in-service date, the 10-percent safe harbor was met prior to September 9, 2010, so Unit 2 was not eligible for 100-percent bonus depreciation, but nonetheless was eligible for 50-percent bonus depreciation.

In addition, for purposes of determining whether components of Unit 2 were eligible for 100-percent bonus depreciation, the IRS considered the application of the limited election in Revenue Procedure 2011-26. This revenue procedure provides that a taxpayer may elect to treat any acquired or self-constructed component of the larger self-constructed property to which such component relates as being eligible for 100-percent bonus depreciation if the component is qualified property and is acquired or self-constructed by the taxpayer after September 8, 2010, and before January 1, 2012. The IRS ruled that if a proper election is made, any component of Unit 2 (i.e., the larger self-constructed property) may qualify for 100-percent bonus depreciation because the original use of Unit 2 commenced with the taxpayer after September 8, 2010, and the taxpayer placed the unit into service after September 8, 2010, and before January 1, 2012.

Observation: PLR 201214003 confirms the position that many taxpayers have taken with respect to the appropriate analysis for determining when costs are incurred for the 10-percent safe harbor and the component rule (i.e., the all-events test and economic performance under section 461).

The determination of whether a contract is for the provision of property or the provision of services is a critical factor in determining when economic performance occurs under section 461. The regulations under section 461 provide that if a liability arises out of the provision of services or property to the taxpayer by another person, economic performance occurs as the property or services are provided.

For a contract under which services are to be provided to a taxpayer, economic performance generally occurs as the services are provided. For construction services that are provided to a taxpayer, this may result in a taxpayer incurring costs as the construction services are provided throughout the contract. Alternatively, if a contract is for the provision of property, then economic performance occurs as the property is provided to the taxpayer, which may occur when the property is delivered or accepted by the taxpayer, or when the taxpayer takes title to the property, based on the terms of the contract and in accordance with the taxpayer's method of accounting for determining when economic performance occurs.

Observation: Taxpayers should analyze their construction contracts to determine whether each contact is for the provision to the taxpayer of services, property, or a combination of both. This determination is key to computing the 10-percent safe harbor, because a taxpayer may incur costs with respect to services earlier than with respect to property provided to the taxpayer.

Actionable Insights

Taxpayers that did not claim bonus depreciation on otherwise qualifying self-constructed property in a prior year because they did not believe they met the requirements of the 10-percent safe harbor or component rule may wish to revisit their analysis in light of the IRS ruling in PLR 201214003.

Specifically, taxpayers that began construction of property before January 1, 2008, and placed such property in service during the applicable bonus depreciation period, but failed to claim bonus depreciation, may be able to amend the prior year return or file a Form 3115, *Application for Change in Accounting Method*, as applicable, to claim the missed bonus depreciation.

A change in method of accounting for missed bonus depreciation generally is an automatic accounting method change under Revenue Procedure 2011-14. As an automatic accounting method change, the Form 3115 must be attached to a timely filed federal income tax return, including extensions, and a copy must be filed with the IRS in Ogden, UT, in lieu of the IRS National Office, no later than the filing of the tax return.

Observation: Potential opportunities to claim missed bonus depreciation may exist for taxpayers that had property constructed for them by a third-party contractor whereby construction of the property physically began prior to a bonus depreciation period (e.g., prior to January 1, 2008) but title or acceptance of the property occurred after such date. Taxpayers with this fact pattern may have failed to analyze the 10-percent safe harbor because construction physically began prior to the bonus depreciation period, and thus may not have claimed bonus depreciation on such property. Taxpayers with this fact pattern should re-evaluate their overall facts and construction contracts to determine whether an opportunity exists to claim missed bonus depreciation.

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