

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

LB&I:RFTH Group #

from:

Senior Attorney ()
(Large Business & International)

subject: Whether Taxpayer is Entitled to Bonus Depreciation
UIL: 168.00-00; 461.00-00

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|------------|---|
| Taxpayer | = |
| Hotel | = |
| City | = |
| State | = |
| A Building | = |
| C Building | = |
| Year 1 | = |
| Year 2 | = |
| Year 3 | = |
| Year 4 | = |
| Year 5 | = |
| Year 6 | = |
| N1 | = |
| N2 | = |

| | |
|---------------------------|---|
| N3 | = |
| N4 | = |
| Date 1 | = |
| Date 2 | = |
| Date 3 | = |
| Date 4 | = |
| Date 5 | = |
| Date 6 | = |
| Date 7 | = |
| Date 8 | = |
| Date 9 | = |
| Date 10 | = |
| Month 1 | = |
| Month 2 | = |
| Month 3 | = |
| Month 4 | = |
| Amount 1 | = |
| Amount 2 | = |
| Amount 3 | = |
| Amount 4 | = |
| Amount 5 | = |
| Amount 6 | = |
| Amount 7 | = |
| Amount 8 | = |
| Consultant | = |
| Architect | = |
| Contractor | = |
| Taxpayer's Representative | = |

Issues:

1. Under the following facts and circumstances, what are the properties that should be analyzed to determine whether the additional first year (bonus) depreciation is applicable under IRC § 168(k)?
2. Under the following facts and circumstances, which of the above properties are subject to additional first year (bonus) depreciation under IRC § 168(k)?
3. Is Taxpayer entitled to bonus depreciation under the facts of this case?

Conclusions:

1. Taxpayer is required to separately identify the properties associated with the project to determine which assets constitute "qualified property". Taxpayer has identified the properties herein through a cost segregation study.
2. Taxpayer has the burden of proof to show that properties are subject to bonus depreciation and taxpayer has not met its burden under the facts of this case.

3. Taxpayer is not entitled to bonus depreciation as it has failed to demonstrate when costs were incurred for each property.

Facts:

Taxpayer owns and operates Hotel complex in City, State, which consists of several adjacent buildings including a casino, a hotel, a restaurant and convention center building, and above-ground parking structures. Taxpayer opened the casino complex in Year 2. Before opening the complex, Taxpayer acquired the former A Building, now called the C Building, located on the site and entirely renovated the building to construct restaurant and food service areas for the casino complex. From Year 3 through Year 6, Taxpayer completed four separate construction projects involving four existing buildings at the Hotel complex. One of these projects was the renovation and expansion of the C Building (the Project). The other three projects completed at the complex during this time period are not discussed in this memorandum as the parties have agreed to use the C Building Project as representative of the projects at issue.

A. The Project

Prior to the Project, the C Building was a two-level, N1 square foot, brick and concrete structure. Per the project scope included in The Agreement for Architectural / Engineering Services ("Architectural Agreement"), the Project consisted of the renovation and expansion of the C Building portion of the casino complex in accordance with Taxpayer's development agreement and the building plans therefore as approved by the City. The Project included the complete renovation of the existing restaurant and food service areas in the original N1 square foot portion of the building. Also included in the Project was construction of a new, two-level, N2 square foot addition along one side of the existing structure to provide space for additional uses, including offices, lounges, bars, conference/convention rooms, ballroom, and a theater.

The property constructed in the Project includes, in general:

- Land improvements associated with the building (sidewalks, paving, landscaping)
- The building structure (foundations, concrete, masonry, structural steel, roofing), exterior building finishes, doors and windows and building systems, including elevators, building mechanical (HVAC, plumbing, fire protection) systems, building electrical systems (power, lighting, communications), fire alarm and security systems

- Personal property items, including carpet, business signage and decorative items, kitchen, food service and bar equipment and hook-ups, and specialty property for the theater (stage, stage equipment, lighting, sound).

B. Design Phase

Taxpayer engaged Architect in Month 1, Year 3 as the Project architect, initially under an original oral contract and later under the Agreement for Architectural Engineering Services executed on Date 1. Taxpayer submitted the completed construction documents (drawings and specifications) prepared by Architect for permitting by the local authorities.

Architect provided and billed for services for the Project in three phases:

Phase I (fee of \$Amount 1) consisted of the design development for the restaurants, convention space and theater portions of the building.

Phase II (fee of \$Amount 2) consisted of the design and preparation of construction documents for the Project including site, architectural, structural, mechanical, electrical and lighting.

Phase III (fee of \$Amount 3) consisted of contract administration including permitting, shop drawing review and field review of the construction work completed by the contractors.

C. Construction Phase

In Year 4, the construction phase of the Project began. Taxpayer engaged Contractor in Month 2, Year 4 to complete the initial work with respect to the C Building. Taxpayer engaged Contractor to perform the construction services for the entire Project under The Agreement Between Taxpayer and Contractor (“Contractor Agreement”) which was executed on Date 2. Both parties acknowledged that the work performed prior to the execution of the Contractor Agreement was retroactively covered by and subject to the terms of the Contractor Agreement. The Project was completed and placed into service in Month 4, Year 6.

D. The Parties

The three primary actors involved in the Project (“Project Team”) were Taxpayer, Architect and Contractor. Architect and Contractor have separate contractual relationships directly with Taxpayer. There is no contractual relationship between Architect and Contractor. Each member of the Project Team had specific and defined

responsibilities with regard to the Project.

Taxpayer

Taxpayer is the owner of the C Building and paid for the design and construction of the Project. Taxpayer was involved throughout the Project from initial conception through completion. During construction of the Project, Taxpayer's agent, the on-site Taxpayer's Representative, acted on its behalf. Taxpayer's Representative is an employee of Taxpayer and had no relationship with either Architect or Contractor. Article 2 of the General Conditions of the Contracts for Design and Construction ("Contract General Conditions") dated Date 3 designates Taxpayer's Representative.

Architect

Architect provided the overall architectural, structural, mechanical and electrical design for the Project, coordinated the designs of the specialty consultants with the overall architectural and engineering designs, and performed construction administration services during the construction phase. Architect was involved throughout the project from design through construction. The Architectural Agreement executed on Date 1 between Architect and Taxpayer details the services provided by Architect to Taxpayer on the Project. In addition to the Architectural Agreement, the services provided by Architect are also subject to and bound by the terms of Contract General Conditions.

As a part of the design project, numerous consultants were used. The consultants used include the following:

- Structural Engineer
- Mechanical Engineer
- Electrical Engineer
- Civil Engineer
- Code Consultant
- Elevator Consultant
- Acoustic Consultant
- Lighting Consultant
- Theatre Consultant
- Interior Designer

With the exception of the interior designer, which was separately engaged by Taxpayer, all other consultants were hired and engaged by the Architect. None of these consultants had any contractual relationship with either Taxpayer or Contractor.

Contractor

Contractor is a construction firm providing general contracting and construction management services. Contractor was not engaged in the design portion of the

Project. Rather, Contractor was involved only with the construction phase of the Project. The Agreement between Taxpayer and Contractor (“Contractor Agreement”) was executed on Date 2 between Contractor and Taxpayer. The Contractor Agreement details the services provided by Contractor to Taxpayer on the Project. In addition, the services provided by Contractor to Taxpayer are also subject to and bound by the terms of the Contract General Conditions dated Date 3.

Contractor performed and managed the construction of the renovations and addition to the C Building. Contractor engaged a number subcontractors and suppliers who, under contract with it, performed much of the actual construction work or supplied construction materials on the Project. These firms were under contract with Contractor and had no contractual relationships with either Taxpayer or Architect.

E. Agreements

As mentioned previously, Taxpayer had separate contracts with Architect and Contractor for distinct services: the contract with Architect was for design and construction administration services and the contract with Contractor was for construction services for the Project. While Architect and Contractor had an informational relationship, there was no contractual relationship between the two parties. In summary, the operating agreements related to the Project are:

1. Architectural Agreement
2. Contractor Agreement
3. Contract General Conditions

F. Key Terms of the Agreements:

1. Architectural Agreement:

The scope of services provided by the Architect included the following:

Phases I and II

- Architectural Design
- Structural Engineering
- Mechanical Engineering
- Electrical Engineering
- Civil Engineering
- Landscape Architecture
- Back-of-House Interior Design
- Vertical Transportation
- Life Safety/Code
- Way-finding Signage
- Theater Design

- Acoustical Consulting
- Audio Visual
- Lighting Design
- Costing
- Surveillance Design
- Providing Power and Conduit for Surveillance, Security and Information Technology Systems Design by Others
- Food Services

Phase III

- Construction Administration Services

Per the terms of the Architectural Agreement, the Architect coordinates all architectural and engineering design services and administers all contracts with the Architectural sub-consultants. While providing construction administration services, Architect is present on site on a daily basis and makes inspections, but is not required to “make exhaustive or continuous on-site inspections to check quality or quantity of the Work.” On the basis of these inspections, Architect informs Taxpayer of the progress of the Work and immediately notifies Taxpayer’s Representative if any Work is found not to be in accordance with the Project Documents. At times, Architect may be asked by Taxpayer to review the Contractor’s Payment Application. In summary, Architect is involved in the administration of the construction agreement to the extent that it has the responsibility to keep track of the progress and to monitor the quality of the Project and has the responsibility to inform Taxpayer when it finds that Contractor has not met its obligations on the Project. However, Architect does not have authority to stop work on the site even it finds that work does not conform to the Project Documents.

2. Contractor Agreement

The scope of services provided by Contractor included the following:

- Build, bring online, and maintain management team
- Coordinate and supply management personnel
- Coordinate and supply management personnel and attend all meetings with utilities
- Coordinate and supply management personnel and attend all meetings with City and other agencies
- Coordinate and supply management personnel and attend all construction related meetings with State and ensure that contracting and construction activities regarding the Project meet State requirements
- Coordinate and supply management personnel and attend all meetings with Taxpayer’s accounting department and compliance department personnel to establish appropriate procedures

- Coordinate and supply management personnel and attend all meetings with Taxpayer's construction/development department personnel to develop and implement appropriate procedures and provide construction scheduling, estimating and budgeting services
- Coordinate and supply management personnel and attend all meetings with Taxpayer's construction/development department personnel and Taxpayer's insurance carriers and insurance broker to develop and implement appropriate procedures and provide appropriate services regarding Taxpayer Controlled Insurance Program
- Coordinate and supply management personnel and attend all meetings with subcontractors regarding budgets, design, and means and methods related to a fast track scheduling program
- In coordination with the design team prepare subcontractor bid packages
- Draft, negotiate, and finalize subcontracts (inclusive of a mutually acceptable contract for FF&E) for the Project
- Obtain/provide required insurance for the Project
- Review Drawings and Specifications as prepared by Architect

In summary, the Contractor provided construction services for the Project and had no responsibility for any design or development on the Project. The Development Agreement is already in place and the drawings and specifications have been completed by Architect.

3. Contract General Conditions

The Contract General Conditions establishes the terms and conditions that will govern the design and construction of the Project. The General Conditions are incorporated by reference in both the Architectural Agreement and the Contractor Agreement.

A. Key Terms Related to Taxpayer and Taxpayer's Representative

Taxpayer authorized Taxpayer's Representative to act on its behalf with respect to the Project. Taxpayer designated Taxpayer's Representative as its agent to act on its behalf. Architect and Contractor were to rely on the direction and decisions of Taxpayer's Representative on the behalf of Taxpayer. Taxpayer administers the contracts.

B. Key Terms Related to Architect

Article 4 – Payments, of the Architectural Agreement provides the schedule of values for Architect's services during the different phases of the Project and details the process for Architect to submit applications for payment for these services. As of Date 2, when the Contractor Agreement was executed, Architect had completed 100% of the Phase I services and the majority of the Phase II services on the Project.

C. Key Terms Related to Contractor

- In accordance with Article 11 - Payments and Completion, of the General Conditions: to be paid for its work, Contractor submits an Application for Payment to Taxpayer's Representative on a monthly basis. The first Application for Payment shall be submitted by the 1st day of the calendar month following the completion of the first month of the Work and each following Application for Payment by the 1st day of the following month. Title to all work covered by a Payment Application passes to Taxpayer no later than the time of payment by Taxpayer. Contractor warrants that upon submittal of a Payment Application, all work for which Certifications for Payment have been previously issued and payments have been received from Taxpayer is free and clear of liens, claims, security interests or encumbrances in favor of Contractor, subcontractors, and sub-subcontractors.
- The Progress Payment Amounts are computed by taking "that portion of the Contract Sum properly allocable to completed Work as determined by multiplying the percentage of completion of each portion of the Work by the share of the Contract sum allocated to that portion of the Work in the schedule of values, less retainage of 10%." Thus, the amount of each progress billing is based on the actual amount of the Work completed by Contractor in the period covered by the Application for Payment.¹ Pursuant to this billing method, the amount of the liability incurred by Taxpayer is accurately established with each progress payment.
- Within twenty days after the receipt of the Application for Payment and Architect's certificate for payment, Taxpayer's Representative shall issue a Certificate for Payment, with a copy to Contractor, for such amount, if any as Taxpayer's Representative determines is properly due.
- The issuance of a Certificate for Payment by Taxpayer's Representative constitutes a representation by Taxpayer's Representative to Taxpayer that the relevant work has progressed to the point indicated and the quality of the work is in accordance with the Project Documents. The issuance of the Architect's certificate for payment and Taxpayer's Representative's Certification for Payment further constitutes a representation and certification by them to Taxpayer that Contractor is entitled to payment in the amount approved.
- Within ten days after Taxpayer's Representative has issued a Certificate for Payment, Taxpayer shall make payment to Contractor of the amount specified in the Certificate for Payment, less all applicable retentions.

In summary, Contractor submits an Application for Payment according to the requirements set forth in the General Conditions. Taxpayer's Representative issues a

¹ This differs from a "milestone payment" where the contractor is paid for the work only when it has reached a certain stage or level of completion which is often referred to as a "milestone".

Certificate for Payment within 20 days of receiving this Application for Payment for the amount properly due Contractor. This certification constitutes a representation that Contractor is entitled to the amount approved. Taxpayer then pays Contractor within ten days of the date of the Certificate for Payment and title for the work covered by the Application for Payment passes to Taxpayer.

Under the facts in this case, Contractor submitted progress payment billings for the construction work they and their subcontractors completed on the Project. Progress payments normally covered a period of one month, but a few covered periods longer than this. The progress payment amounts were based on the actual physical progress of the work and were determined in accordance with the General Conditions.

The first progress billing submitted by Contractor was for work completed in Month 3, Year 4. This work was completed pursuant to an oral contract between Taxpayer and Contractor that was in force prior to the execution of the Contractor Agreement. From that point, progress billings continued for the Project based on the actual physical work completed as construction progressed pursuant to the terms of the Contractor Agreement.

As previously discussed, Contractor submitted Applications for Payment (“pay applications”) for the Work it completed on the Project in the previous period. In this case, pay applications were normally submitted on a monthly basis at the beginning of the month following the end of the work period. The pay applications indicate the total amount of the Work on the Project that had been completed by Contractor as of the Application. While the pay applications show the construction costs, they do not identify the costs related to the delivery of the underlying properties. The applications begin with Application No. 1 dated Date 5 for Work on the Project completed in the period Date 6 to Date 4. Per Application No. 1, the total amount of the Work completed was \$Amount 4. Application for Payment No. 23 dated Date 7 was for Work on the Project completed in the period Date 8 to Date 9. Per Application No. 23, the total amount of the Work on the Project completed by the Contractor was \$Amount 5. The final Project cost, as shown on Taxpayer’s fixed assets records, was \$Amount 6. This total Project cost includes the Contractor costs as well as all allocated indirect costs such as the Architect fees.

F. The Cost Segregation Study

After the completion of the Project, Consultant performed a cost segregation study to classify the various items of property constructed within the Project under I.R.C. §168(e) and Rev. Proc. 87-56 for depreciation purposes. The study, dated Date 10, segregated the construction costs of the Project and classified them as either 15-year, 7-year, or 5-year property under MACRS or as nonresidential real property (39-year recovery period). The cost segregation study allocated the total cost of each identified asset but does not identify the dates the costs were incurred for each asset. The total direct construction cost of the Project was reported as \$Amount 7. In addition, there were

\$Amount 8 of reported indirect or soft costs consisting of internal labor cost, general conditions, architectural and design fees, permit fees, traffic-planning costs, and legal fees capitalized with the construction bringing the total cost of the Project to \$Amount 6.

For all items of property in the Project assigned a recovery period of 20 years or less placed in service after January 1, 2008 in the C Building, Taxpayer claimed the 50 percent additional first year depreciation deduction under I.R.C. §168(k). During review of the cost segregation study, the Service questioned the eligibility of these properties for the 50 percent additional first year depreciation deduction under I.R.C. §168(k).

G. Taxpayer Position

Taxpayer submitted a position paper (“Taxpayer’s position paper”) and in it, argues its entitlement to the 50 percent first year depreciation deduction related to the underlying shorter-lived properties constructed in the Project. Taxpayer’s position is that the Project was provided under a turnkey contract and final acceptance of the Project by Taxpayer did not occur until Contractor completed all work required for final acceptance. Taxpayer concludes that because final completion and acceptance of the Work occurred in Year 6, it did not incur costs until such time and thus the Project meets the acquisition date requirement of I.R.C. §168(k) under the 10 percent safe harbor rule of Treas. Reg. §1.168(k)-1(b)(4)(iii)(B)(2).

Taxpayer states that its position on when costs related to the Project was incurred is based on the all events test and economic performance tests of I.R.C. §461(h)(1). Taxpayer’s position paper argues that economic performance occurs as the property is provided and, per Treas. Reg. §1.461-4(d)(6)(iii), a taxpayer is permitted to treat property as provided when the property is delivered, accepted, or when title to the property passes. Taxpayer relies on PLR201210004 and states that the IRS addressed the provision of property in PLR201210004, stating in part that “(g)enerally speaking, a turnkey project is one in which the contractor is responsible for turning over to its customer the subject matter of the contract in ready-to-use condition.”

Taxpayer represents that the Project at issue constitutes a “turnkey project” and as such, under PLR 201210004, final acceptance did not occur until Contractor completed all of the work for the Project. Based on this assumption, Taxpayer argues it did not incur costs for the construction projects and underlying properties until Year 6, when final acceptance of the Project occurred. We disagree; underlying properties do not become qualified properties simply because the overall project meets the definitions for “qualified property” under §168(k)(2)(A). The “D” project discussed in PLR201210004 relate to an engineering, procurement and construction management contract (EPCM contract) for construction and installation of pollution control equipment consisting of a baghouse, a scrubber, a selective catalytic reduction system, and an activated carbon injection system and an engineering, procurement and construction contract (EPC contract) for construction of a pulse jet fabric filter and a spray dryer absorber at their coal-fired generating stations. That project and its related contracts are significantly

different from the contracts for the design and construction of the building at issue in this case. Based on the facts of this case, we believe the project at issue does not constitute a true “turnkey project” and thus it cannot be assumed that final acceptance occurred only when Contractor completed the work in Year 6. Instead, each property is to be analyzed under the rules of §168(k) to determine its eligibility for bonus depreciation.

II. Discussion:

A. Turnkey Project

The traditional and most common form of construction project delivery method for a building construction project is the design-bid-build method (DBB method). The DBB method differs from a turnkey project. It is our opinion that the C Project is not a turnkey project, but rather, is a DBB project. We first discuss the characteristics of a DBB method of delivery and contrast them with the characteristics of a turnkey project.

1. DBB method:

There are three main phases in the typical building construction project completed using the DBB method:

- Design Phase – The owner engages the architect for the design and for the preparation of construction documents (drawings and specifications) for the project
- Bid Phase – When the construction documents are complete, or near 100% completion, they are used for construction bidding (or some other method such as negotiation) to select a contractor to perform the construction
- Build or Construction Phase – The owner contracts with the general contractor to build the project

A. The Parties in DBB Method:

There are three primary parties involved in this project delivery method: the owner, the architect, and the general contractor. Each of these parties has specific functions and responsibilities. Under the DBB method, the owner holds separate contracts with the architect and contractor. There are communications between the architect and contractor, but there is no direct contractual relationship between them. In this case, Taxpayer holds separate contracts with Architect and Contractor and while there are communications between Architect and Contractor, there is no direct contractual relationship between them.

1. Owner

Under the DBB method, the owner is involved throughout the entire project including the pre-design, design, bid or negotiation, construction, and post-construction phases. The architect's main responsibilities occur during the design, bid or negotiation, and construction phases. The contractor's main responsibilities begin in the bid or negotiation phase and continue through the construction and post-construction phases, although in some cases the contractor is brought on board earlier to provide value engineering services during the design phase.

The main responsibilities of the owner in a DBB construction project typically include:

- Determining the requirements and goals of the project;
- Acquiring a usable site for the building;
- Financing the construction project;
- Directing both the architect and contractor;
- Resolving issues between the architect and contractor.

2. Architect

The main responsibilities of the architect in a DBB construction project typically include:

- Assisting the owner to determine the requirements and goals of the project;
- Developing the design of the project;
- Coordinating the designs of other consultants with the architectural design;
- Ensuring regulatory and code compliance;
- Preparing the construction documents (drawings and specifications);
- Estimating the probable construction cost for budgetary purposes;
- Assisting with construction bidding or negotiation;
- Reviewing and approving shop drawings;
- Administering the contract for construction.

3. Contractor

In a traditional DBB construction project, there is only one contractor who has a contract with the owner. The contractor is responsible for completing the entire project according to both the construction documents (plans and specifications) and the terms and conditions of the construction contract. The contractor typically subcontracts much of the work, especially the more specialized construction items or systems such as elevators or HVAC, fire protection, and electrical systems, to specialized subcontractors. These subcontractors have no contractual relationship with the owner and the contractor is fully responsible to the owner for the performance of the subcontractor's work.

The main responsibilities of the contractor in a DBB method project typically include:

- Committing to the cost of construction;

- Obtaining building permits and other entitlements related to the construction;
- Preparing shop drawings and other submittals needed to accomplish the work;
- Developing the means and methods of construction;
- Contracting and coordinating the work of subcontractors;
- Establishing and meeting the construction schedule;
- Maintaining job-site safety;
- Meeting the requirements of the construction documents;
- Guaranteeing the quality of construction;
- Correcting deficiencies covered by warranties and guarantees.

B. The Turnkey Project Delivery Method:

PLR201210004 states that “generally speaking, a “turnkey” project is one in which a contractor is responsible for turning over to its customer, the subject matter of the contract in a ready-to-use condition.” The PLR falls short of identifying more specific characteristics of a turnkey project. The turnkey project has been described as follows: “In a turnkey relationship, the design-builder not only designs and constructs the factory, processing plant or similar facility, it also ensures that the plant is functioning and ready to operate for the owner. The term “turnkey” derives from the concept that the owner may figuratively insert a key into a slot and turn it to begin successful operation of the plant.” See “A Primer on Industrial Design-Build Construction Contracts” by Mark Friedlander of Schiff Hardin LLP. The American Institute of Architects California Council (1996) also offers a succinct summary of the turnkey project in its Handbook on Project Delivery (1996):

The design-build by developer option incorporates the functions of design and construction, but in addition the design-build entity takes on some responsibilities of real estate development. Also known as turnkey construction... this method is characterized by the legal transfer of title to real property. It is distinct from speculative development because an owner initiates the process and contracts for services with the DB-developer. There are two prime players: the owner who initiates the project and will purchase it upon completion, and the design-builder.

Based on the references above, the turnkey contractor acts as developer, designer, and contractor in one and agrees to design and construct a completed project for the owner.

The turnkey method is in contrast to the contractor’s role under the traditional DBB delivery method as well as Contractor’s role under the facts of the instant case, where the design and construction is performed by different and unrelated entities. In addition, under the turnkey delivery method, legal title to the construction and project is not transferred to the intended owner until the project is completed and typically not until the contractor has maintained and operated the subject of the project long enough to ensure that all systems are functioning properly.

C. The Project is Not a Turnkey Project

Based on industry practice and the authorities above, the Project does not qualify as a turnkey project. In fact, a thorough review of the relevant agreements including the Architectural Agreement, the Contractor Agreement, and the General Conditions support the conclusion that the contracts between Taxpayer and Contractor are not turnkey contracts but are traditional DBB construction contracts. In this case, the “prime players” were not limited to the owner and design- builder; rather, the prime players were Taxpayer, Architect (designer) and Contractor (builder). Per the Architectural Agreement, Architect is not responsible for the performance of any part of the actual construction of the Project, just as Contractor had nothing to do with the preliminary development and actual design work. The service providers (Architect and Contractor) maintained independent contractual relationships with Taxpayer for each aspect of the Project. There is no contractual relationship between Architect and Contractor.

Unlike a typical Turnkey Project where the contractor maintains multiple roles and is heavily involved throughout the Project, here, Contractor’s role was limited to only construction. Under the terms of the relevant agreements, Taxpayer is the party significantly involved throughout the construction of the Project. Taxpayer, through Taxpayer’s Representative, is responsible for administering the construction contract, reviewing work, approving pay applications, making decisions that affect the construction, and approving or rejecting subcontractors.

The facts of this case demonstrate there is a clear demarcation of each party’s responsibilities. Initial development work on the project was performed by Taxpayer, who held separate contracts for design and construction and remained involved throughout the project during both the design and construction phases of the Project. The design work was performed and completed by Architect who had no construction responsibilities. The construction activities on the project were undertaken and completed by Contractor, who had no responsibilities related to design of the Project. Contractor and Architect had only an informational relationship, no contractual relationship.

In addition, under a turnkey delivery method, legal title to a property is not transferred to the intended owner until completion of said project. Here, in marked contrast, partial legal title passes to Taxpayer prior to completion of the Project and Taxpayer was able to take possession of the released properties.

Based on the analysis of the relevant agreements as well as the field authorities defining a turnkey project, we conclude that the Project was not a turnkey project in the construction industry and thus Taxpayer cannot assume that final acceptance of the properties in question did not occur until final completion of the project.

II. Applicable Law Related to Bonus Depreciation for Self-Constructed Property

A. Qualified Property

Section 168(k)(1)(A) provides a 50-percent additional first year depreciation deduction for the taxable year in which qualified property is placed in service by a taxpayer.² “Qualified property” is defined under § 168(k)(2)(A) as property (1) with a recovery period of 20 years or less and to which § 168 applies, (2) the original use of which commenced with the taxpayer after December 31, 2007, (3) which was acquired by the taxpayer after December 31, 2007, and before January 1, 2014, but only if no written binding contract for the acquisition was in effect before January 1, 2008, or that is acquired by the taxpayer pursuant to a written binding contract which was entered into after December 31, 2007, and before January 1, 2014, and (iv) that is placed in service by the taxpayer before January 1, 2014, or in the case of property described in section 168(k)(2)(B) or (C), before January 1, 2015.

Based on the layout of the regulations, the first step to determine whether a property is eligible for the bonus depreciation is to determine whether it is “qualified property”. As discussed above, §168(k)(2)(A) defines qualified property for purposes of bonus depreciation. Significantly, the plain language of §168(k)(2)(A) makes clear that eligibility for bonus depreciation is determined with reference to factors related to each property at issue rather than with reference to the project at issue. This means a taxpayer cannot argue that a property qualifies for bonus depreciation simply because the “project” to which said property relates qualifies (based on contract date, acquisition date and placed in service date of the “project”). Rather, taxpayer is required to separately identify the properties associated with a project to determine which assets constitute “qualified property.” Taxpayers may do this by performing a cost segregation study which properly identifies separate section 1245 property constructed in conjunction with section 1250 property. Only after the properties are segregated can the individual properties be considered for bonus depreciation eligibility.

With reference to the Project, Taxpayer acquired a number of properties based on the terms of the contract and accounted for its entitlement to bonus depreciation based on a cost segregation study. The cost segregation study identified a number of separately identifiable properties including sidewalks, paving, and landscaping. These properties, if new, have a MACRS recovery period of less than 20 years so they would be qualified property and eligible for bonus depreciation as long as they meet the other requirements. In addition to the properties already mentioned, the C Building also has other properties which were reviewed by Exam. An example is “decorative lighting” which includes the fixtures, lamps, and electrical wiring to the lighting as well as the direct cost of the installation of the lighting and the indirect cost of the design. All these costs together would be included in “decorative lighting” which would be qualified properties (as long as the lighting is new) because the recovery period would be 5 or 7 years depending on the Asset Class of Rev. Proc. 87-56 applicable to Taxpayer’s

² All section references are to the Internal Revenue Code, unless otherwise noted.

business activity in which the decorative lighting is primarily used.

B. Self-Constructed Property

Two separate standards are used to determine when qualified property is acquired. Section 1.168(k)-1(b)(4)(i) provides the rules relating to § 168(k)(2)(A)(iii) (the acquisition requirement) . Section 1.168(k)-1(b)(4)(iii) provides the rules relating to §168(k)(2)(E)(i) self-constructed property.

Self-constructed property is property the taxpayer manufactures, constructs, or produces for its own use or property that is manufactured, constructed, or produced for the taxpayer's use by another person under a written binding contract that is entered into before the manufacture, construction, or production of the property begins.

With respect to self-constructed property, Treas. Reg. §1.168(k)-1(b)(4)(iii)(A) provides that a taxpayer must begin manufacturing, constructing, or producing the property after December 31, 2007 and before January 1, 2014 in order to satisfy the acquisition rules and be considered qualified property for the 50% bonus depreciation deduction.

Section 1.168(k)-1(b)(4)(iii)(A) provides that if a taxpayer manufactures, constructs, or produces property for use by the taxpayer in its trade or business (or for its production of income), the acquisition rules in section 1.168(k)-1(b)(4)(i) are treated as met for qualified property if the taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2014. This regulation further provides that property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract (as defined in section 1.168(k)-1(b)(4)(ii)) that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business (or for its production of income) is considered to be manufactured, constructed, or produced by the taxpayer. There are no disputes that the properties at issue were constructed for Taxpayer by Contractor/Architect under written binding contracts.

Section 1.168(k)-1(b)(4)(iii)(B)(1) provides that for purposes of section 1.168(k)-1(b)(4)(iii), manufacture, construction, or production of property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances.

Section 1.168(k)-1(b)(4)(iii)(B)(2) provides that for purposes of section 1.168(k)-1(b)(4)(iii)(B)(1), a taxpayer may choose to determine when physical work of a significant nature begins in accordance with the safe harbor rule provided in section 1.168(k)-1(b)(4)(iii)(B)(2). Under this safe harbor rule, physical work of a significant nature does not begin before 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) is incurred by an accrual basis taxpayer or paid by a cash basis taxpayer. Until such time as physical work of a significant nature begins, assets will not be deemed to be acquired for bonus depreciation purposes. When property is manufactured, constructed, or produced for the taxpayer by another person, as in the present case, this safe harbor rule must be satisfied by the taxpayer. A taxpayer chooses to apply section 1.168(k)-1(b)(4)(iii)(B)(2) 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 consistent with section 1.168(k)-1(b)(4)(iii)(B)(2). Taxpayer chose to apply the safe harbor on its return as filed.

The terms “paid or incurred” are interpreted based on the taxpayer’s overall method of accounting, cash or accrual. PLR201210004 concluded that the taxpayer must determine when costs relating to the projects have been incurred by applying the economic performance requirements and the all events test of IRC §461(h).

In this case, Taxpayer undertook the Project by hiring Contractor and Architect, the purpose of which is the use of the C Building in its trade or business and/or for the production of income. There is no dispute that the properties at issue in this case are self-constructed assets under § 1.168(k)-1(b)(4)(iii)(A) and that Taxpayer chose to apply the safe harbor rule under §1.168(k)-1(b)(4)(iii)(B)(2). As such, the safe harbor rule must be satisfied by Taxpayer. We next turn to the application of the all events test and economic performance requirements under §461 to determine whether Taxpayer meets the 10% safe harbor rule under § 1.168(k)-1(b)(4)(iii)(B)(2) to qualify for bonus depreciation for each property.

C. The Application of All Events Test and Economic Performance under § 461.

1. § 461(h) and regulations thereunder

Section 461(a) provides, in part, that a deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 461(h) and § 1.461-1(a)(2) provides, in part, that under an accrual method of accounting, a liability is incurred in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. The first two requirements are commonly referred to as the all events test and the third requirement is called the economic performance requirement. See also § 1.446-1(c)(1)(ii)(A).

Section 461(h) and 1.461-4(a) provide, in part, that in determining whether an amount has been incurred with respect to any item during the taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item has occurred.

Section 461(h)(2)(A)(i) and (ii), and § 1.461-4(d)(2)(i) provide that if the liability of the taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as services or property is provided.

Section 1.461-4(d)(6) provides the rules relating to the provision of services or property to the taxpayer for purposes of § 1.461-4(d). § 1.461-4(d)(6)(iii) provides that a taxpayer is permitted to treat property as provided to the taxpayer when the property is delivered or accepted, or when title to the property passes. The method used by the taxpayer to determine when property is provided is a method of accounting that must comply with the rules of section 1.446-1(e). Thus, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner of Internal Revenue.

2. Discussion:

An item is incurred when it meets the requirements of the all-events test and economic performance requirement. To satisfy the all events test, it must be shown (1) that all events have occurred which determines the fact of a liability and (2) that the amount of the liability can be determined with reasonable accuracy. Sec. 461(h)(4); see Restore, Inc. v. Commissioner, T.C. Memo.1997–571, affd. 174 F.3d 203 (11th Cir.1999); Spitzer Columbus, Inc. v. Commissioner, T.C. Memo.1995–397. For an item to be deductible, the fact of liability must be “firmly established”, “fixed and certain”, and “fixed and absolute”. Colonial Wholesale Beverage Corp. v. Commissioner, T.C. Memo.1988–405 (and cases cited therein), affd. 878 F.2d 23 (1st Cir.1989).

In the instant case, the all events test as well as the economic performance requirement is met to the extent work is accepted with each periodic pay application. Pursuant to the terms of the parties' agreements, Contractor submits a pay application at relevant times. Pay applications are the formal certification from Contractor which shows the total contract amount, the amount of the construction completed and a completion figure. As each request for a progress payment is made by Contractor, Taxpayer reviews the amount, ascertains that the work has been completed and meets the standards set forth in the contracts, accepts the work, and soon afterwards, releases the progress payment as provided under the contract. At the point when Taxpayer accepts the work, the all events test and the economic performance test is met. With each acceptance, Taxpayer incurred costs for properties. However, neither the pay applications nor the cost segregation study provided by Taxpayer clearly indicate when the costs of any separately identifiable properties were incurred. Specifically, as the pay applications are not broken down to the individual properties, it may not be possible to determine when the total costs of separate properties that could be qualified properties such as depreciable landscaping, business signage, or decorative items were incurred. The burden is on Taxpayer to prove which separately identifiable property, if

any, was acquired under the safe harbor rules after December 31, 2007³. Taxpayer has not met its burden and as a result is not entitled to bonus depreciation on any of the properties.

In the alternative, the all events test and the economic performance test is met on or about the date the progress payment is made by Taxpayer. As Contractor is paid, Contractor provides partial lien waivers to Taxpayer representing that Contractor no longer has a financial interest in that particular portion of the property. In addition, Contractor warrants that "title to all work" will pass to Taxpayer no later than the time of payment. The title received by Taxpayer is free and clear of any encumbrances from any of the contractors who performed the work. Further, under the terms of the Agreements, Taxpayer may occupy or use any completed or partially completed portion of the work at any stage provided such occupancy or use is not contrary to law or the requirements of Taxpayer's insurers. With those caveats, Taxpayer is thus free to use the released property as it wishes. Based on the above facts, every element of the all events test and economic performance requirement (whether Taxpayer's method of treating property as provided is acceptance, delivery, or title passage) is met no later than the date the progress payment is made by Taxpayer. Taxpayer has failed to demonstrate which, if any, properties had met the all events test and economic performance requirements only after December 31, 2007. As a result, Taxpayer is not entitled to bonus depreciation on any of the properties.

This writing is based upon the facts and representations submitted by Exam. This advice has been coordinated with CC:ITA. If you have any further questions or comments, please contact _____ at _____.

Associate Area Counsel
(Retailers, Food, Transportation & Health Care)

By: _____

Senior Attorney (_____)
(Large Business & International)

³ Taxpayer must prove when it incurred the total cost (both direct and indirect costs) of each separately identifiable property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching). Architectural fees are indirect costs allocable to the basis of each property designed and constructed. The costs relating to the services provided by the Architect under the Architectural Agreement are incurred as the services are provided to Taxpayer. However, the architectural activities in the design phase are design activities and thus, are preliminary activities. Accordingly, the design phase architectural fees are not included in the safe harbor determination. The construction phase architectural fees are costs to be included in the safe harbor determination.

