Capital Recovery – Depreciation and Cost Segregation

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Construction Life Cycle

- Pre-decisional development
- Research & development
- Construction
- Commissioning
- Commercial operation
Pre-decisional Development Costs

• Deduct costs associated with pre-decisional activities
• Wells Fargo & Co. (8th Cir. 2000)
• Reg. Sec. 1.263(a)-4
• Identify separate assets that are created
  – Favorable treatment for internal costs related to the creation of intangible assets
R&D Costs

- Deduct costs associated with activities to discover information that eliminates uncertainty concerning the development or improvement of a product – Section 174
- Automatic method change
- Elections – Sections 174(b) and 59(e)
Original Capitalization

• Section 263 and Section 263A
  – Direct costs
  – Indirect costs
  – Interest capitalization (Section 263A(f))
Interest Capitalization

• Interest costs paid or incurred during the production period (from beginning of production to date placed in-service) and

• Allocable to property having
  – Long useful life
    • Real property or
    • Class life of 20 years or more
  – Estimated production period exceeding 2 years or
  – Estimated production period exceeding 1 year and cost exceeding $1 million
Interest Capitalization

• Real property includes land, unsevered natural products of land, buildings, and inherently permanent structures (Reg. Sec. 1.263A-8(c)(1))
  – Real property includes structural components of both buildings and inherently permanent structures
  – Inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time
    ▪ Examples – roads, paved parking areas, fences, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos

• CCA 200827034 – unit of property
Original Capitalization
Basis Reduction

- Energy Credits (Section 48)
  - 30%
    - Qualified fuel cell property
    - Solar property for periods ending before January 1, 2009
  - 10% for other energy property (geothermal, etc.)
  - Energy property excludes public utility property
  - 50% basis reduction for energy credits under Section 48 (Section 50(c)(3))
  - Adjustment in basis of interest in partnership or stock in S corporation for adjustments made in the basis of property held by partnership or S corporation (Section 50(c)(5))
- Basis reduced by subsidized financing and by tax exempt private activity bonds (Section 48(a)(4))
Original Capitalization
Commissioning

- Treatment of costs incurred between mechanical completion and commercial operation
- Sections 162, 263 and 263A
- Use of “final performance” test as cut-off of construction period
Start-Up Costs

• Section 195
  – 60-month amortization; 180-month amortization for amounts incurred after October 22, 2004
  – Election
    ▪ Requirement to itemize costs
    ▪ Prohibition against blanket/protective elections
    ▪ Protection against elections made in a tax year prior to when the trade or business began
    ▪ New regulations (issued July 8, 2008) – no election statement required for costs paid or incurred after September 8, 2008
  – Business expansion costs
  – Acquisition of subsidiaries
Placed-in-service

• Ready and available standard
  – Reg. Sec. 1.167(a) – 11(e)(1)(i)
    • “…when first placed in a condition or state of readiness and availability for a specifically assigned function…”
  – Reg. Sec. 1.46-3(d)(1)(ii)
    • “…placed in a condition or state of readiness and availability for a specifically assigned function…”
Placed-in-service Case Law

- *Consumers Power Co. v. Commissioner* (T.C. 1987)
- *Oglethorpe Power Corp.* (TC Memo 1990)
- *Northern States Power Co.* (8th Cir. 1998)
- *Sealy Power, Ltd.* (5th Cir. 1995)
Placed-in-service Generation Facilities

• Administrative authorities
  – Rev. Ruls. 76-428 and 79-98

• The five-factor test
  – Necessary permits and licenses have been obtained
  – All critical tests necessary for proper operation have been performed
  – The unit has been placed in the control of the taxpayer by the construction contractor
  – The unit has been synchronized with the transmission grid
  – Daily operation of the unit has begun
Placed-in-service
Generation Facilities

• No single factor is determinative
• See TAM 200334031 regarding wind turbine generators
• See also Notice 2006-88 regarding open-loop biomass facility
Bonus Depreciation

• Section 168(k)
• 30 percent
  – 9/11/01 to 5/5/2003
• 50 percent
  – 1/1/2008 to 12/31/2008
Bonus Depreciation
Four Basic Requirements

• Qualifying property
• Original use
• Acquired by the taxpayer
• Placed-in-service requirement
Bonus Depreciation
Qualifying Property

- Recovery period of 20 years or less
- Software depreciable under Section 167(f)(1)
- Water utility property
- Qualified leasehold improvement property
Bonus Depreciation
Original Use Requirement

- Original use commences with the taxpayer after December 31, 2007
- ITC “original use” factors are relevant guidance – Treas. Reg. §1.48-2
- Sale-leaseback exception
- Rebuilt property
- The first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer
- Example – acquire used machine and make capital expenditures to recondition it
Bonus Depreciation
Reconditioned or Rebuilt Property

• Additional capital expenditures incurred to recondition or rebuild acquired (or owned) property qualify

• Cost of reconditioned or rebuilt property acquired by the taxpayer does not qualify
  – Question of fact
  – Safe harbor
    • Property containing used parts not treated as reconditioned or rebuilt if the cost of the used parts is not more than 20 percent of the total cost
    • Rev. Rul. 68-111
Bonus Depreciation
Acquisition of Property Requirement

- After December 31, 2007, and before January 1, 2009
  - No written binding contract before January 1, 2008
- Pursuant to a written binding contract entered into after December 31, 2007, and before January 1, 2009
- For self-constructed property, begin manufacturing, constructing or producing the property after December 31, 2007, and before January 1, 2009
Materials and Supplies on Hand on January 1, 2008

- Acquired components of self-constructed property
- Methodology employed for 2001-2004 bonus depreciation
- IRS examination issue
Bonus Depreciation
Placed-in-service Date Requirement

• Before January 1, 2009, or January 1, 2010, for Long Production Property
• Long Production Property – to the extent of the adjusted basis attributable to manufacture, construction or production before January 1, 2009
  – Recovery period of at least 10 years or transportation property,
  – Subject to Section 263A, and
  – Estimated production period exceeding one year and cost exceeding $1 million
• Sales-leasebacks
Bonus Depreciation
Binding Contract Defined

• Enforceable under state law
• Damages not limited to a specified amount (e.g., liquidated damage provision)
  – Limits of 5 percent or more of total contract price not considered limiting damages to a specified amount
Bonus Depreciation
What is a Binding Contract?

- Binding
  - Contract subject to a condition not within control of either party
  - Insubstantial subsequent changes
  - Significant obligation despite insubstantial contract terms yet to be negotiated
  - Supply agreements or purchase orders specifying amount and design specifications
Bonus Depreciation
What is a Binding Construct?

• Not binding
  – Option to buy/sell
  – Supply agreements or purchase orders not specifying amount and design specifications
  – Binding contract for components is not a binding contract for larger property
  – Full refund of purchase price in lieu of any damages allowable by law in the event of breach or cancellation
Bonus Depreciation
Self Constructed Property

- Manufacture, construction or production of property for taxpayer’s own use
  - Including property constructed by another person for taxpayer
- When construction by an agent may be attributed to the taxpayer
  - ITC guidance – right of control
    - Lykes Bros. v. United States, 513 F.2d 1342 (Ct. Cl. 1975)
- Turbine acquisition vs construction
  - Installation and operational tests performed by agent
Bonus Depreciation
Construction Start

• When physical work of a significant nature begins
  – Facts and circumstances analysis
  – Safe harbor “election” – construction begins when 10 percent of total costs (excluding land and preliminary activities) is paid or incurred

• Physical work does not include preliminary activities such as planning or designing, securing financing, exploring or researching

• Physical work may commence at an off-site location
Components of Self Constructed Property

- Two types of components:
  - Acquired
  - Self-constructed
- Separate analysis required for components and the larger self-constructed property
- Possible for component to be ineligible, yet the larger property to be eligible
- Under the front-end rules, component is not eligible if the larger property is not eligible
- Under the back-end rules, component may be eligible even if the larger property is ineligible
When Construction Begins  
Safe Harbor – Example #1

<table>
<thead>
<tr>
<th>Activity</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preliminary activities</td>
<td>$60,000</td>
</tr>
<tr>
<td>Physical work</td>
<td></td>
</tr>
<tr>
<td>Pre-1/1/08</td>
<td>49,000</td>
</tr>
<tr>
<td>1/1/08 – 12/31/08</td>
<td>451,000</td>
</tr>
<tr>
<td>Total cost</td>
<td>$560,000</td>
</tr>
</tbody>
</table>

$49,000 < 10% - QUALIFIES  
$560,000 - $60,000

$451,000 qualifies for bonus depreciation
When Construction Begins
Safe Harbor – Example #2

<table>
<thead>
<tr>
<th>Activity</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preliminary activities</td>
<td>$100,000</td>
</tr>
<tr>
<td>Physical work</td>
<td></td>
</tr>
<tr>
<td>1/1/08 – 12/31/08</td>
<td>101,000</td>
</tr>
<tr>
<td>1/1/09 – 12/31/09</td>
<td>899,000</td>
</tr>
<tr>
<td><strong>Total cost</strong></td>
<td><strong>$1,110,000</strong></td>
</tr>
</tbody>
</table>

\[
\frac{101,000}{1,100,000 - 100,000} > 10\% \text{- QUALIFIES}
\]

$201,000 qualifies for bonus depreciation
PROPERTY QUALIFIES FOR BONUS DEPRECIATION
Example – Construction Stop/Start

Begin power plant construction  
Suspend construction  
Resume construction  
Complete construction

1/1/08 1/1/09 1/1/10

$3MM incurred

1/1/08 1/1/09 1/1/10

$3.0MM incurred

DOES NOT QUALIFY

Begin power plant construction  
Suspend construction  
Resume construction  
Complete construction

$1.6MM incurred

$3.0MM Qualifies for Bonus Depreciation
Acquired Component of Self-constructed Plant Front-End Examples

1/1/08
Enter contract to ACQUIRE new turbine

1/1/09
Begin power plant construction

1/1/10
Complete construction

TURBINE DOES NOT QUALIFY
REMAINING PLANT BASIS QUALIFIES FOR BONUS DEPRECIATION

1/1/08
Begin power plant construction

1/1/09
Enter contract to ACQUIRE new turbine

1/1/10
Complete construction

NEITHER QUALIFIES FOR BONUS DEPRECIATION
Acquisition of CWIP
Example

ABC began construction for self-use

XYZ purchased CWIP from ABC for $6MM

XYZ places plant in service

1/1/08

XYZ spends $1.2MM

1/1/09

1/1/10

$7.2MM QUALIFIES FOR BONUS DEPRECIATION
Acquired Component of Self-Constructed Plant Back-End Examples

Enter contract to ACQUIRE new turbine
1/1/08

Begin power plant construction
1/1/09

Received completed turbine

Placed in service
1/1/10

TURBINE QUALIFIES FOR BONUS DEPRECIATION

REMAINING PLANT IS INELIGIBLE FOR BONUS DEPRECIATION
Bonus Depreciation Election Out

- Taxpayer by taxpayer
  - Affiliates, not entire consolidated group
  - Partnership, not partners
- Class by class
  - Pursuant to statute, not Rev. Proc. 87-56
  - Vintage by vintage
  - Results in assets being subject to AMT adjustment
Bonus Depreciate Mechanics

• Bonus depreciation not limited by short tax years
  – Remaining basis subject to short year rules
• Not limited by mid-quarter convention
  – Subject to capitalization under Sections 263(a) and 263A
  – Subject to recapture provisions
  – Form 4562-FY
Bonus Depreciation
2008 Implementation

• Methodology for January 1st cut-offs
• Overall approach for tax placed-in-service dates
  – Recordkeeping lag
  – Ready-and-available standard
• Aggregation of projects
• Managing December 31st placed-in-service dates
  – Finishing projects
  – Extending projects
Asset Classification

- Classes prescribed by the Code (Section 168(e))
- Rev. Proc. 87-56 – recovery period based on asset classes and activity (industry) classes
Cost Segregation Approach

• Investigation and allocation of capital expenditures into cost recovery periods:
  – Capitalized Costs
    • Depreciable Costs
    • Non-depreciable Costs
    • Amortizable Costs
  – Expensed Items
Wind Energy Assets

- Wind Energy Property – 5-year property
  - Section 168(e)(3)(B)(vi)(I)
  - Examples: wind turbine generators (WTGs), WTG foundations, collection systems, met towers
  - Typically 90-95% of cost

- Land Improvements – 15-year property
  - Asset Class 00.3 of Rev. Proc. 87-56

- Electric Utility Transmission and Distribution Plant
  - Asset Class 49.14 – 20-year property
  - Section 1308 of 2005 Energy Tax Incentives Act
    - 69 kV or greater – 15-year property
    - Original use after April 11, 2005
Wind Energy Assets (cont.)

• Buildings: eligible for depreciation over 39 years
  – Example: O & M Building
• Land: non-depreciable real property
• Amortizable:
  – Land leases that can be amortized over the life of the land lease
  – Transmission easement costs - 84 years (safe harbor)
    • Rev. Rul. 72-403
  – Contributions in aid of construction (CIAC) - 20 years
    • Notice 2001-82
    • Example: utility system upgrades
Ethanol Assets

- Corn Ethanol Production Plant
  - Industry argument: Asset Class 28.0 - Manufacture of Chemicals and Allied Products – 5-year property
  - IRS position: Asset Class 49.5 – Waste Reduction and Resource Recovery Plant – 7-year property
- CCA 200814025 and CCA 200835032

Approximately 85-90% of costs including land improvements
Ethanol Assets (*cont.*)

- **Section 168 (l) - Cellulosic Biomass Ethanol Plant**
  - 50% depreciation allowance for cellulosic biomass ethanol plant property - Section 209 of the Tax Relief and Health Care Act of 2006 (P.L. 109-432)
  - Plants placed in service before 2013

- **Section 179C - Election to Expense Certain Refineries**
  - Taxpayer may elect to treat 50% of the cost of any qualified refinery property as an expense for year placed in service
  - Property must be placed in service after August 8, 2005 and before January 1, 2012
Solar Energy Assets

• Solar Energy Property – 5-year property
  – Section 168(e)(3)(B)(vi)(I)
  – Includes photovoltaic cells, solar thermal systems integral to the solar heating/cooling of the building, concentrating solar power plants

• Building-integrated solar property
  – Integrated wall/roof panels
  – Dual functionality issue
  – Structural aspect may require recovery over 39 years
Other Assets

• Geothermal and certain biomass
  – Section 168(e)(3)(B)(vi)
  – 5 years
• Personal property with no class life
  – Rev. Proc. 87-56, Class A
  – 7 years
Asset Classification
Rev. Rul. 2003-81

• Addresses asset classification under Revenue Procedure 87-56 for general business assets of a regulated electric utility
  – Work bench
  – Bookcase
  – Parking lot by generation plant
  – Parking lot by headquarters building