

Office of Chief Counsel
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Memorandum

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to: Associate Area Counsel
(Large & Mid-Size Business)

from: Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel (Passthroughs and Special Industries)

subject: Request for guidance under section 168(k) - bonus depreciation

This Chief Counsel Advice responds to your request for assistance dated January 6, 2006. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Property =
Quantity1 =
Date1 =
Date2 =
Date3 =
Date4 =
A =
B =
C =
D =
E =
F =

<u>G</u>	=
<u>H</u>	=
<u>I</u>	=
<u>J</u>	=
<u>K</u>	=
<u>L</u>	=
<u>M</u>	=
<u>N</u>	=
<u>O</u>	=
<u>P</u>	=
<u>Q</u>	=
<u>R</u>	=

ISSUES

1. For acquired property, when are liquidated damages calculated to determine whether there is a written binding contract in effect before September 11, 2001, for purposes of section 168(k) of the Internal Revenue Code?
2. For purposes of the self-manufactured property rules under section 168(k) with respect to property manufactured for a taxpayer by another person, when are liquidated damages calculated to determine whether a written binding contract was entered into before the manufacture of the property?
3. If a written contract with a manufacturer covers the acquisition of multiple items of property, are the self-manufactured status and the liquidated damages amount tested for the contract as a whole or separately for each item of property covered by the contract for purposes of determining if the taxpayer entered into a written binding contract with the manufacturer of the property prior to the manufacture of the property?
4. Does the disqualified transaction rule of section 168(k)(2)(E)(iv) apply to Taxpayer to disallow the additional first year depreciation deduction under section 168(k) for property acquired pursuant to the contract?

CONCLUSIONS

1. Liquidated damages are calculated on September 10, 2001, to determine whether there is a written binding contract in effect before September 11, 2001, for purposes of section 168(k).
2. For purposes of the self-manufactured property rules under section 168(k) with respect to property manufactured for a taxpayer by another person, liquidated damages are calculated on the day immediately prior to the manufacture of the property to determine whether a written binding contract was entered into before the manufacture of the property.

3. If a written contract with a manufacturer covers the acquisition of multiple items of property, the self-manufactured status and the liquidated damages amount are tested separately for each item of property covered by the contract for purposes of determining if the taxpayer entered into a written binding contract with the manufacturer of the property prior to the manufacture of the property.

4. The disqualified transaction rule of section 168(k)(2)(E)(iv) does not apply to Taxpayer to disallow the additional first year depreciation deduction under section 168(k) for property acquired pursuant to the contract.

FACTS

On Date1, Taxpayer entered into a contract to purchase Quantity1 Property to be delivered serially. The contract also gave Taxpayer an option to purchase Quantity1 additional Property. The contract provided the delivery date for each Property. The contract contained a liquidated damages formula in the event Taxpayer defaults under the agreement. A, also dated Date1, amended the contract by providing for a liquidated damage amount that varies depending how far in advance Taxpayer cancels delivery of the Property in question. If Taxpayer is in material breach of the contract, the liquidated damages equal the greater of \$B or the sum of \$C for each Property more than D months from scheduled delivery, \$E for each Property between F and D months from scheduled delivery, \$G for each Property between H and I months from scheduled delivery, and \$J for each Property less than H months from scheduled delivery. Using this formula, one gets different liquidated damages amounts under the contract depending on the dates tested.

Taxpayer amended the contract several times before September 11, 2001. Some amendments changed the number of Property being purchased and the delivery dates, thus changing the liquidated damages calculation. If Taxpayer had defaulted on the original contract date, Date1, the liquidated damages would have been less than five percent of the total contract price. K, dated Date2, changed the delivery dates for L Property. If Taxpayer had defaulted immediately after executing K, the liquidated damages would have been greater than five percent of the total contract price. In M, dated Date3, Taxpayer exercised its option to purchase N additional Property. O, also dated Date3, canceled the remaining option Property and added P firm Property. O fixed a new price for the N and P Property. In Q, dated Date4, the parties rescheduled delivery dates. Had Taxpayer defaulted on September 10, 2001, immediately before the effective date of section 168(k), the liquidated damages would have been less than five percent of the total contract price.

Taxpayer claimed the additional first year depreciation deduction for several of the Property purchased under the contract.

LAW AND ANALYSIS

Issue 1. For acquired property, when are liquidated damages calculated to determine whether there is a written binding contract in effect before September 11, 2001, for purposes of section 168(k)?

Section 168(k)(1) allows a 30-percent additional first year depreciation deduction for qualified property acquired after September 10, 2001, and, in most cases, placed in service before January 1, 2005.

Section 168(k)(2)(A)(iii)(I) provides that qualified property is property acquired by the taxpayer after September 10, 2001, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001.

Section 1.168(k)-1T(b)(4)(ii) of the temporary Income Tax Regulations provides that a contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). For this purpose, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount.

Section 168(k) was added to the Internal Revenue Code by section 101 of the Job Creation and Worker Assistance Act of 2002, Public Law 107-147 (116 Stat. 21) and modified by section 201 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law 108-27 (117 Stat. 752). Congress enacted this provision to promote capital investment and purchasing of equipment, and to help spur an economic recovery for our nation following the events of September 11, 2001. H.R. Rep. No. 107-251, 2002-3 C.B. 44, 63 (2001). See also Joint Committee on Taxation Staff, General Explanation of Tax Legislation Enacted in the 107th Congress, January 24, 2003, page 218. Therefore, the purpose of the statute is to promote economic activity after September 11, 2001.

In this case, the parties to the contract at issue made several amendments to the initial contract made on Date1 that modified the number of firm Property to be purchased, and the delivery dates and prices of some of the Property. These amendments affect the calculation of the liquidated damages under the contract. Taxpayer argues that one tests whether a contract is a binding contract only on the date the contract is made. The examination team argues that “before September 11, 2001” means “at any time before September 11, 2001.”

The legislative intent to promote capital investment and equipment purchase following the events of September 11, 2001, is met if there is not a binding contract on September 10, 2001. Accordingly, we believe that it is reasonable to test the liquidated damages amount on September 10, 2001, to determine if a written contract is a binding contract for purposes of sections 168(k)(2)(A)(iii)(I) and 1.168(k)-1T(b)(4)(ii).

Furthermore, Congress did not intend “before” in section 168(k)(2)(A)(iii)(I) to mean “at any time before.” Where Congress intended to mean “at any time before” in section 168(k), Congress clearly stated so as they did in section 168(k)(2)(E)(iv). Thus, the liquidated damages amount is tested immediately before September 11, 2001, and not at any time before September 11, 2001, to determine whether there is a written binding contract in effect before September 11, 2001, for purposes of section 168(k).

Issue 2. For purposes of the self-manufactured property rules under section 168(k) with respect to property manufactured for a taxpayer by another person, when are liquidated damages calculated to determine whether a written binding contract was entered into before the manufacture of the property?

Section 168(k)(2)(E)(i) provides that in the case of a taxpayer manufacturing, constructing, or producing property for the taxpayer’s own use, the requirements of section 168(k)(2)(A)(iii) shall be treated as met if the taxpayer begins manufacturing, constructing, or producing the property after September 10, 2001, and before January 1, 2005.

Section 1.168(k)-1T(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)-1T(b)(4)(i) are treated as met for qualified property if the taxpayer begins manufacturing, constructing, or producing the property after September 10, 2001, and before January 1, 2005. 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)-1T(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.

In this case, Taxpayer contracted to purchase a total of R Property from the manufacturer of the Property. The determination of whether the Property is self-manufactured property for purposes of sections 168(k)(2)(E)(i) and 1.168(k)-1T(b)(4)(iii)(A) depends on whether Taxpayer entered into a written binding contract with the manufacturer of the Property prior to the manufacture of the Property. To make this determination and applying the same analysis as used for Issue 1 above, the liquidated damages amount is tested on the day immediately prior to the manufacture of the Property.

Issue 3. If a written contract with a manufacturer covers the acquisition of multiple items of property, are the self-manufactured status and the liquidated damages amount tested for the contract as a whole or separately for each item of property covered by the contract for purposes of determining if the taxpayer entered into a written binding contract with the manufacturer of the property prior to the manufacture of the property?

The determination of whether the R Property are self-manufactured property for purposes of section 168(k)(2)(E)(i) is made for each Property. Therefore, to determine if Taxpayer entered into a written binding contract with the manufacturer of the Property prior to the manufacture of each Property, the liquidated damage amount for each Property with respect to its contract price is tested.

Issue 4. Does the disqualified transaction rule of section 168(k)(2)(E)(iv) apply to Taxpayer to disallow the additional first year depreciation deduction under section 168(k) for property acquired pursuant to the contract?

Section 168(k)(2)(E)(iv) provides that the term 'qualified property' shall not include any property if (I) the user of such property (as of the date on which such property is originally placed in service) or a person which is related . . . to such user or the taxpayer had a written binding contract in effect for the acquisition of such property at any time on or before September 10, 2001, or (II) in the case of property manufactured, constructed, or produced for such user's or person's own use, the manufacture, construction, or production of such property began at any time on or before September 10, 2001.

Congress enacted section 168(k)(2)(E)(iv) to disallow the additional first year depreciation deduction for property when the user of such property (or a related party) would not have been eligible for the additional first year depreciation deduction if the user (or a related party) were treated as the owner. For example, if a taxpayer sells to a related party property that was under construction prior to September 11, 2001, the property does not qualify for the additional first year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to September 11, 2001, the property does not qualify for the additional first year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first year depreciation deduction. Joint Committee on Taxation Staff, General Explanation of Tax Legislation Enacted in the 107th Congress, January 24, 2003, page 219.¹

In this case, Taxpayer, the user, is the actual owner of the Property as opposed to being treated as the owner of the Property. Furthermore, Taxpayer is the first and only user of the Property while the above-mentioned examples illustrating the application of section 168(k)(2)(E)(iv) involve multiple owners or users of the property. Consequently, the legislative intent appears not to describe Taxpayer's situation and, accordingly, section 168(k)(2)(E)(iv) does not apply to Taxpayer's purchase of the Property.

¹ Footnote 213 of this legislative blue book states that a technical correction may be needed so that the statute reflects this intent. Congress made this technical correction by enacting section 168(k)(2)(E)(iv) by section 403(a)(2)(A) of the Working Families Tax Relief Act of 2004, Public Law 108-311 (118 Stat. 1166).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call _____ if you have any further questions.