Office of Chief Counsel
Internal Revenue Service

Memorandum

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(Small Business/Self-Employed)

from: Branch Chief, Branch 7
Office of Associate Chief Counsel (Income Tax and Accounting)

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subject: Tenant Improvements

This Chief Counsel Advice responds to your request for technical assistance dated January 30, 2014. This advice may not be used or cited as precedent.

<u>LEGEND</u>

Taxpayer =
Quantity1 =
Quantity2 =
Quantity3 =
Quantity4 =
Quantity5 =
Date1 =
Date2 =
Date3 =
Date4 =
Date5 =
Date6 =
Date7 =
Date8 =
Date9 =
Date10 =
Date11 =

Date12 =
Date13 =
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ISSUES

1. Are payments for the cost of certain tenant improvements rental income to Taxpayer in Date1, Date2, and Date4 under § 61(a)(5) of the Internal Revenue Code?

2. Are certain assets tax-exempt use property within the meaning of § 168(h), requiring Taxpayer to use the alternative depreciation system of § 168(g) ("ADS")? If so, may the Internal Revenue Service treat the disallowed depreciation resulting from the use of ADS as an adjustment required by a change in method of accounting under §§ 446(e) and 481(a)?

CONCLUSIONS

1. We conclude that the terms of the lease, as supplemented, and the surrounding circumstances do not indicate that the parties intended the lump sum reimbursements to be rent. [redacted]

2. We conclude that the qualified leasehold improvement property placed in service in Date1 relating to the original premises is not tax-exempt use property under § 168(h) because this property is nonresidential real property for purposes of § 168(h) and the lease is not a disqualified lease. [redacted]

We also conclude that the 5-year property, 7-year property, and 15-year property that is not qualified leasehold improvement property, placed in service in Date3 relating to the expansion premises are tax-exempt use property under § 168(h) because these assets are tangible property that is not nonresidential real property and the assets are part of a lease to a tax-exempt entity. Thus, Taxpayer is required to depreciate these assets under the ADS and is not allowed to deduct any additional first year depreciation for these assets. Since Taxpayer has depreciated these assets under the general depreciation system of § 168(a) ("GDS") and has deducted the additional first year depreciation for these assets on its Date3 and Date4 tax returns, Taxpayer has established an impermissible method of accounting for these assets. [redacted]

FACTS

Taxpayer owns an office building that Taxpayer leases to A, an agency of the United States Government. Taxpayer paid for renovations and a building expansion requested by A in Date1 and Date3, respectively, for which A reimbursed Taxpayer in lump sums paid in Date1, Date2, and Date4. The issues in this Chief Counsel Advice relate to these reimbursements and tenant improvements.

Lease and Supplemental Lease Agreements.

In Date15, the A made a Solicitation for Offers ("SFO") to lease an office building for use by a federal agency. The SFO included a Tenant Improvements Allowance of $xx.xx per office area square foot. Section 1.10 of the SFO, entitled "Tenant Improvements Included in Offer (Date5)," stated:

> The Tenant Improvements Allowance shall be used for the buildout of the Government-demised area in accordance with the Government-approved design intent drawings. All Tenant Improvements required by the Government for occupancy shall be performed by the successful Offeror as part of the rental consideration, and all improvements shall meet the quality standards and requirements of the solicitation and its attachments….

Section 1.11 of the SFO, entitled "Tenant Improvements Rental Adjustment (Date5)," stated:

> The Government, at its sole discretion, shall make all decisions as to the usage of the Tenant Improvements Allowance. The Government may use

> all or part of the Tenant Improvements Allowance. The Government may return to the Lessor any unused portion of the Tenant Improvements Allowance in exchange for a decrease in rent according to the amortization rate over the firm term….
>
> The Government reserves the right to make cash payments for any or all work performed by the Lessor. Prior to occupancy, the Government, at its sole discretion, may choose to pay lump sum for any or all of the Tenant Improvements Allowance. If, prior to occupancy, the Government elects to make a lump sum payment for any portion of the Tenant Improvements Allowance, the payment of the Tenant Improvements Allowance by the Government will result in a decrease in the rent.
>
> If it is anticipated that the Government will spend more than the allowance identified above, the Government reserves the right to 1) reduce the Tenant Improvements requirements, 2) pay lump sum for the overage upon completion and acceptance of the Improvements, or 3) increase the rent according to the negotiated amortization rate over the firm term of the lease.

In Date1, Taxpayer entered into a lease with A to lease real property to A for Quantity1 years, beginning Date6. The original leased premises include Quantity2 rentable square feet, plus Quantity3 surface parking spaces for government use (the original premises). In Date3, Taxpayer contracted with A to expand the premises. The expansion included an additional Quantity4 rentable square feet, plus Quantity5 parking spaces (the expansion premises).

Paragraph 5 of the Lease provides that stated rent includes a fixed amount for Tenant Improvements (TI). Paragraph 6 states: "The Lessor shall furnish to the Government for the stated rental consideration specified in Paragraph 5 . . . the following: . . . (b) All requirements including . . . buildout (except for lump sum reimbursable amounts) . . . ." Paragraph 19 reads as follows:

> 19. TENANT IMPROVEMENT ALLOWANCE: Referencing Paragraphs 1.10 & 1.11 of the SFO, Lessor has included in the rental rate a Tenant Improvement (TI) Allowance in the amount of $B calculated at $C per BOMA Office Area Square Foot, amortized over D years at the rate of E%. The Government may return to the Lessor any unused portion of the TI Allowance in exchange for a decrease in rent according to the amortization rate and the Lessor and the Government shall confirm said rental adjustment, if any, in writing by execution of a Supplemental Lease Agreement.

Supplemental Lease Agreement (SLA) #2, dated Date7, includes the following provisions regarding tenant improvements:

> Referencing Paragraph 19 of the Lease, the Lessor has provided, at the Government's request, Tenant Improvements in the total amount of $F. The original TI allowance of $B shall be amortized over D years at the rate of E% as stated in the lease. The Government shall reimburse the Lessor for amounts over and above the stated TI allowance as follows:
>
> SLA No. 1, Paragraphs I and II reference additional work authorized by a Notice to Proceed issued Date8 in the amount of $G over and above the specified Tenant Improvement Allowance being amortized in the lease. Upon completion of the work and written acceptance by the Contracting Officer's Rep., the government shall pay the Lessor $G in full consideration of this work. Request for payment shall be made by submission of an invoice after completion and acceptance. . . .
>
> Upon completion and acceptance by A of all Tenant Improvements performed as part of this lease, Supplemental Lease #3 shall be issued for the remainder to be paid via lump sum payment, and pertinent instructions for billing will be provided therein.

SLA #3, effective Date9, provides that in addition to the original TI allowance being amortized over the first D years of the lease, and in addition to the lump sum payment for additional tenant improvements accounted for in SLA # 2, "pursuant to other changes and directives for the Lessor to accomplish the buildout, the sum of $H is hereby added and authorized to be paid to the Lessor as final payment of additional Tenant Improvements . . . ." Payment for these improvements is payable in full upon completion of the work and written acceptance by the Contracting Officer's Representative. The Lessor requests payment by invoice after completion.

SLA #4, effective Date10, provides that Taxpayer agrees to build the expansion premises, including tenant improvements, for Government occupancy by Date11. The expansion premises include tenant improvements requested by A in the amount of $I. The cost of these improvements is amortized and included in the stated rent over J years. The leased premises and all common areas and appurtenances will be used "for General Governmental Purposes as determined by the Government."

SLA #5, effective Date12, provides that Taxpayer agrees to make additional tenant improvements in the amount of $K, and A agrees to pay Taxpayer that amount in a lump sum upon completion of the improvements.

Taxpayer's representative said in a letter dated Date13, that the amount Taxpayer received as lump sum reimbursements in Date4 that the revenue agent proposes to treat as rental income was in payment of invoices dated in Date14 pursuant to SLA # 5 and in compliance with change order # 1.

Proposed Adjustments.

In Date1, Date2, and Date4, Taxpayer received lump sum reimbursements for the cost of tenant improvements payable by lump sum under the lease, as supplemented. These amounts were not included in the stated rent. Taxpayer did not include the amount of the lump sum reimbursements in income in the year received and did reduce the basis of the tenant improvements by these amounts for purposes of depreciation. The revenue agent's position is that these lump sum reimbursements are rental income in the year received and that the cost of the tenant improvements are to be increased by the amount of these reimbursements. Taxpayer's position is that the lump sum reimbursements are not a substitute for rent. Rather, the payments are reimbursements of costs that the Lessor incurred on behalf of the Lessee.

The revenue agent also proposes certain adjustments to depreciation claimed by Taxpayer based on the characterization of certain assets as tax-exempt use property.

During Date1, Taxpayer placed in service tenant improvements related to the renovations of the original premises. Taxpayer classified such improvements under § 168(e) as qualified leasehold improvement property, claimed the additional first year depreciation provided by § 168(k) for this property, and depreciated its remaining cost under the GDS using a recovery period of 15 years. The revenue agent's position is that these tenant improvements are tax-exempt use property under § 168(h) and, therefore, must be depreciated under the ADS and are not eligible for any additional first year depreciation.

During Date3, Taxpayer placed in service tenant improvements related to the expansion premises. Taxpayer allocated the cost of such improvements as 5-year property, 7-year property, 15-year property that is not qualified leasehold improvement property, and nonresidential real property. Taxpayer claimed the additional first year depreciation provided by § 168(k) for the tenant improvements that are 5-year property, 7-year property, and 15-year property, and depreciated their remaining cost under the GDS. Taxpayer also depreciated the tenant improvements that are nonresidential real property under the GDS. The revenue agent's position is that the tenant improvements that are 5-year property, 7-year property, and 15-year property are tax-exempt use property under § 168(h) and, therefore, must be depreciated under the ADS and are not eligible for any additional first year depreciation.

The revenue agent states that the facts do not indicate that the lease is a disqualified lease for purposes of § 168(h).

The Service is examining Taxpayer's tax returns for Date3 and Date4. The period of limitation on assessment under § 6501(a) for the Date1 and Date2 taxable years has expired. The revenue agent proposes to make the adjustments related to Date1 and Date2 by imposing a change in method of accounting.

LAW AND ANALYSIS

<u>ISSUE 1. Are payments for the cost of certain tenant improvements rental income to Taxpayer in Date1, Date2, and Date4 under § 61(a)(5)?</u>

Section 61(a)(5) provides that gross income includes all income from whatever source derived, including rents. *See also* § 1.61-8(a) of the Income Tax Regulations.

Section 1.61-8(c) provides, in pertinent part, that

> As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor. If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor. Whether or not improvements made by a lessee result in rental income to the lessor in a particular case depends upon the intention of the parties, which may be indicated either by the terms of the lease or by the surrounding circumstances.

Even when improvements are required by the terms of a lease, the intent of the parties to treat improvements on real estate as a substitute for rent must be plainly disclosed. *M.E. Blatt Co. v. United States*, 305 U.S. 267, 277 (1938). In deciding the intent of the parties, first consider the express terms of the lease and then consider the surrounding circumstances. *Hopkins Partners v. Commissioner*, T.C. Memo 2009-107.

In addition to the leases, we considered information on leasing available on <u>A</u>'s website. <u>A</u> leases space when leasing is the best solution for meeting federal space needs. <u>A</u> then enters into an occupancy agreement with the tenant agency. The terms of the Occupancy Agreement (OA) relate to the terms of the lease between <u>A</u> and the lessor.

The pricing desk guide of <u>A</u>'s Public Building Service (PBS), Fourth Edition (April 5, 2010), available at <u>L</u>, is helpful in providing context for interpreting the lease agreement's provisions on tenant improvements. Chapter 2 relates to pricing in leased space, and section 2.5 is entitled, "Pricing Standards – Tenant Improvements."

Section 2.5.1 defines tenant improvements (TI) as the finishes and fixtures that typically take space from the shell condition to a finished, usable condition. The resulting space is complete, meets applicable building codes, and meets the tenant agency's functional needs. Section 2.5.2 lists some typical tenant improvements.

Section 2.5.3 states that the TI allowance is the funding source that enables the space to be built out for occupancy to meet a tenant agency's specific requirements. To accommodate the varying space needs of tenant agencies, the TI allowance has two components–general and customization, as defined in sections 2.5.4 and 2.5.5.

The TI allowance:

- Provides tenant agencies with flexibility, choice, and savings incentives . . .
- Allows both PBS and lessors to budget more reliably, since respective obligations are defined at the outset
- Enables separate treatment of TI costs in the Rent, allowing clear tracking of amortizations
- Helps PBS and tenant agencies comply with appropriations law and with the Office of Management and Budget (OMB) requirement that PBS set limits on amounts that can be amortized in Rent.

Section 2.4.2 of the desk guide provides that the rent charged to the tenant agency is a passthrough of the rent charged in the underlying lease contract between PBS and the lessor plus the amortized cost of other items, including A-installed improvements.

The following information relates to the application of the TI allowance to different space assignments:

- Initial occupancies (including expansions) – these assignments are new to a specific tenant agency in new space that is in shell/first generation condition. For initial occupancies, PBS is obligated to provide the full TI allowance (both the general and customization components).

- Backfill occupancies – these assignments occur when PBS has existing, built-out space (relet/second-generation space) that is vacant and available for a new tenant agency. The full TI allowance or functional space estimate may be provided subject to the availability of PBS funds.

- Mid-occupancy/post-initial occupancy request for TI – PBS is not obligated to provide a tenant agency a TI allowance at any time during the occupancy term after initial space alterations are complete. Tenant agency-initiated space changes, replacements, or enhancements after initial occupancy during the same OA term are typically funded by the tenant agency. Subject to funds availability, PBS may fully or partially fund and amortize a tenant agency request for TIs. If funded by the lessor, the TIs are typically amortized in the lease, and if funded by PBS, the TIs are amortized and billed as A-installed improvements.

Section 2.5.4 states that the general component is a dollar amount per usable square foot (USF) set to cover the cost of typical office space finish components such as doors, partitions, carpeting, electrical and telecommunication outlets, or other standard "work letter" items. The general component takes the space from shell to "vanilla" office space. This allowance is set nationally and indexed to local construction costs. The general TI allowance is provided to all prospective tenant agencies in initial occupancies.

Section 2.5.5 states that the customization component is a dollar amount per USF that is intended to cover special items, preparations, or finishes that are not typical to all office space, but are necessary to customize the space for a particular tenant agency. The customization component takes the space from vanilla office space to space specifically designed to function for a particular tenant agency. Examples of customization items include custom cabinetry or millwork, laboratory countertops and fume hoods, private restrooms, raised access flooring, upgraded ventilation for high occupancy uses, slab-to-slab walls, broadcast quality lighting, and sound attenuation.

Section 2.5.8 states that for tenant agency occupancies in leased space, PBS negotiates with the lessor to amortize the TI allowance expended in rent. The resulting amortization cost is passed through to the tenant agency in the occupancy agreement (OA).

Section 2.5.9 states that since the tenant agency elects how its space is to be finished, the tenant agency controls the costs of the buildout. If an amount less than the allowance limit is used, the resulting rent payment is lower. If the full allowance is not used for initial buildout, it is no longer available for future buildout needs. The TI allowance (general and customization components) may be used only to pay for items that are real property, or which become real property when attached or affixed to the building.

Section 2.5.10 states that in limited circumstances, tenant agencies may make lump-sum payments that effectively lower or replace the TI allowance. This option is available only at the beginning of the assignment. PBS does not allow tenant agencies in mid-occupancy to make lump-sum payments for TIs already being amortized. At the beginning of an assignment, PBS may use the lump sum to pay the lessor; however, PBS usually cannot buy down improvements with the lessor once occupancy begins.

At the beginning of an assignment, PBS allows the tenant agency to use lump-sum payments to cover TI costs above the TI allowance. Tenant improvements above the TI allowance are payable by a reimbursable work authorization (RWA). At any time during the Occupancy Agreement (OA) that the tenant agency wants reimbursable space changes, PBS requires tenant agencies to fund, in full and in advance, the cost of space changes through a RWA. The appendix of the desk guide defines a reimbursable work authorization, in part, as the funding document used by tenant agencies to pay A Public Building Service (PBS) for "above-allowance tenant improvements." Other information on A's website, M, states that reimbursable work authorizations (RWA) are established to bill tenant agencies the cost of altering, renovating, repairing, or providing services in space managed by A "over and above the basic operations financed through Rent."

Section 2.5.8 of the pricing desk guide provides that for tenant agency occupancies in leased space, PBS negotiates with the lessor to amortize the TI allowance in the stated rent. Consistent with the desk guide, paragraphs 5 and 19 of the Lease include a Tenant Improvement Allowance in the stated rent.

Section 2.5.10 of the desk guide provides that at any time during the Occupancy Agreement (OA) that the tenant agency wants reimbursable space changes, PBS requires the tenant agency to fund, in full and in advance, the cost of space changes through a reimbursable work authorization. Consistent with the desk guide, the relevant Supplemental Lease Agreements provide that the cost of certain tenant improvements in excess of the tenant allowance stated in the lease is payable as a lump sum reimbursement after A accepts the improvements and the lessor submits an invoice. These lump sum reimbursable amounts are not part of the stated rent.

The revenue agent relies on language in the Solicitation for Offers (SFO) in concluding that the lump sum reimbursements are rental income. The revenue agent quotes the following language: "All Tenant Improvements required by the Government for occupancy shall be performed by the successful Offeror as part of the rental consideration." The quoted language pertains to tenant improvements before occupancy, not to tenant improvements mid-occupancy. Paragraph 5 of the lease includes a specific amount of Tenant Improvement Allowance in the stated rent. Paragraph 6 of the lease expressly excludes buildout payable by lump sum reimbursement from the consideration for the stated rent. For the expansion space, Supplemental Agreement 4 provides for an additional amount of tenant improvements to be amortized in the stated rent. This provision is consistent with section 2.5.3 of the desk guide, which provides that A must pay a TI allowance for expansion space. By contrast, the Supplemental Lease Agreements do not provide that lump sum reimbursable amounts are rent.

The SFO also provides that if it is anticipated that the Government will spend more than the specified tenant allowance, the Government reserves the right to pay the overage in a lump sum upon completion and acceptance of the improvements or increase the rent according to the negotiated amortization rate over the firm term of the lease. We think that the Government will pay in a lump sum upon completion and acceptance of the improvements when a tenant agency must pay A in full and in advance for tenant improvements through a reimbursable work authorization. We think that the Government will negotiate an increase in the rent for expansion space. Note also that section 2.5.3 of the desk guide refers to limits on the cost of tenant improvements that can be amortized as rent, which are set by appropriations law and the Office of Management and Budget (OMB). As provided in section 2.4.2 of the desk guide, the rent charged to the tenant agency is a passthrough of the rent charged in the underlying lease contract between A and the lessor plus the amortized cost of other items, including A-installed improvements.

The request for assistance from the field and the revenue agent cite the following cases in support of the position that the lump sum reimbursements are rental income: *Sleiman v. Commissioner*, T.C. Memo 1997-530, *aff'd*, 187 F.3d 1352 (11th Cir. 1999); *Satterfield v. Commissioner*, T.C. Memo 1975-203; and *Martin v. Commissioner*, 11 B.T.A. 850 (1928). We think that the cited cases are distinguishable from this case. In each of the cited cases, the court found that the intent of the parties was to treat the amount at issue as rent. In *Sleiman*, lessee received a rent credit to recover the cost of carpeting purchased by the lessee. In *Satterfield*, the court found that the lessee agreed to reimburse the lessors for the cost of improvements through increased rental payments and to pay a higher rent during the first year of the lease to accommodate the repayment of the lessors' loan. In *Martin*, the lease contained specific language providing that the lessee would pay the lessor a percentage of the cost of remodeling as additional rental income. We think that this case is more like *McGrath v. Commissioner*, T.C. Memo 2002-231, *aff'd* in an unpublished opinion (5th Cir. 2003), in which the court found that some of the tenant improvements were a substitute for rent and some of the tenant improvements were capital expenditures by the lessee. In this case, we conclude that only amounts for tenant improvements included in the stated rent are rental income. The revenue agent attempts to distinguish *McGrath* from the present case by arguing that *McGrath* involved improvements by a lessee, rather than improvements by a lessor. We think that under the facts and circumstances of the present case, the lessee incurs the cost of the improvements payable by a lump sum reimbursable amount through a billing arrangement with the lessor.

We conclude that the terms of the lease, as supplemented, and the surrounding circumstances do not indicate that the parties intended the lump sum reimbursements to be rent. [redacted]

<u>ISSUE 2. Are certain assets tax-exempt use property within the meaning of § 168(h), requiring Taxpayer to use the ADS? If so, may the Service treat the disallowed depreciation resulting from the use of ADS as an adjustment required by a change in method of accounting under §§ 446 and 481(a)?</u>

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business, or property held for the production of income.

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the GDS and the other method is the ADS. Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

Section 168(g)(1)(B) provides that in the case of any tax-exempt use property, the depreciation deduction allowed under § 167(a) shall be determined using the ADS.

Section 168(g)(2) provides that for purposes of § 168(g)(1), the ADS is depreciation determined by using the straight line method (without regard to salvage value), the applicable convention determined under § 168(d), and a recovery period determined under the table prescribed under § 168(g)(2)(C). Pursuant to this table, nonresidential real and residential rental property have a 40-year recovery period.

Section 168(g)(3)(A) provides that in the case of any tax-exempt use property subject to a lease, the recovery period used for purposes of § 168(g)(2) shall in no event be less than 125 percent of the lease term.

Section 168(g)(3)(B) prescribes a table that provides the class life of property described in certain subparagraphs of § 168(e)(3) for purposes of § 168(g)(2). Pursuant to this table, the class life of property described in § 168(e)(3)(E)(iv) [qualified leasehold improvement property] is 39 years for purposes of § 168(g)(2).
Section 168(h)(1)(A) provides that except as otherwise provided in § 168(h), the term "tax-exempt use property" for purposes of § 168 means that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity.
Section 168(h)(1)(B) provides that, in the case of nonresidential real property, the term "tax-exempt use property" means that portion of the property leased to a tax exempt entity in a disqualified lease.

Section 168(h)(1)(B)(ii) defines "disqualified lease" as any lease of the property to a tax-exempt entity, but only if one of the conditions specified therein applies, including the following: (I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103(a) and such entity (or a related entity) participated in the financing, (II) under such lease there is a fixed or determinable price purchase or sale option which involves such entity (or a related entity) or there is the equivalent of such option, (III) such lease has a lease term in excess of 20 years, or (IV) such lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or a related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease.

For purposes of § 168, § 168(e)(2)(B) defines the term "nonresidential real property" as meaning § 1250 property that is not residential rental property or is not property with a class life of less than 27.5 years.

Section 168(h)(1)(E) defines the term "nonresidential real property" for purposes of § 168(h)(1) as including residential rental property.

Section 168(h)(2)(A) defines the term "tax-exempt" entity to include the United States or any agency or instrumentality thereof.

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.

Section 168(k)(2)(A) (as amended by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296

(December 17, 2010)) defines the term “qualified property” as meaning property (i) among other things, to which § 168 applies with a recovery period of 20 years or less, (ii) the original use of which commences with the taxpayer after December 31, 2007, (iii) that is acquired by the taxpayer after December 31, 2007, and before January 1, 2013, 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, 2013, and (iv) that is placed in service by the taxpayer before January 1, 2013, or in the case of property described in §§ 168(k)(2)(B) or (C), before January 1, 2014.

Section 168(k)(5) provides that in the case of qualified property acquired by the taxpayer (under rules similar to the rules of § 168(k)(2)(A)(ii) and (iii)) after September 8, 2010, and before January 1, 2012, and which is placed in service by the taxpayer before January 1, 2012 (January 1, 2013, in the case of property described in § 168(k)(2)(B) or (C)), a 100-percent additional first year depreciation deduction for the taxable year in which such qualified property is placed in service by the taxpayer is allowable.

Section 168(k)(2)(D)(i) provides that the term “qualified property” shall not include any property to which the alternative depreciation system under § 168(g) applies, determined (I) without regard to § 168(g)(7) (relating to election to have system apply) and (II) after application of § 280F(b) (relating to listed property with limited business use).

In the present case, the revenue agent is proposing adjustments to depreciation claimed by Taxpayer on certain tenant improvements placed in service in Date1 and Date3 based on § 168(g)(1)(B), which provides that ADS must be used in the case of any property that is tax-exempt use property. Specifically, the revenue agent proposes to depreciate the tenant improvements placed in service in Date1 that relate to the original premises under the ADS. The revenue agent has determined that this property is qualified leasehold improvement property under § 168(e)(3)(E)(iv). The class life of qualified leasehold improvement property is 39 years pursuant to the table prescribed under § 168(g)(3)(B). Consequently, qualified leasehold improvement property meets the definition of nonresidential real property under § 168(e)(2)(B) and, thus, is nonresidential real property for purposes of § 168(h)(1). Pursuant to § 168(h)(1)(B), the portion of nonresidential real property that is leased to a tax-exempt entity in a disqualified lease is tax-exempt use property. In the present case, the revenue agent states that the facts do not indicate that the lease is a disqualified lease. As the property at issue is nonresidential real property for purposes of § 168(h) and the lease is not a disqualified lease, then the property is not tax-exempt use property under § 168(h). [redacted]

The revenue agent also proposes to treat certain assets placed in service in Date3 relating to the expansion premises as tax-exempt use property subject to ADS. These assets include 5-year property, 7-year property, and 15-year property that is not qualified leasehold improvement property. As these assets are tangible property that is not nonresidential real property and the assets are part of a lease to a tax-exempt entity, they are tax-exempt use property under § 168(h). Accordingly, these 5-year, 7-year, and 15-year property must be depreciated under the ADS over the greater of the recovery periods determined under the table in § 168(g)(2)(C), or a recovery period based on 125 percent of the lease term. Also, the depreciation for these assets is determined by using the straight line method (without regard to salvage value) and the applicable convention determined under § 168(d). Also, pursuant to § 168(k)(D)(i), these assets do not qualify for any additional first year depreciation deduction.

May the Service treat the disallowed depreciation resulting from the use of ADS as an adjustment required by a change in method of accounting.

Section 446(a) provides that taxable income is to be computed under the method of accounting on the basis of which the taxpayer regularly computes his income keeping his books. See also § 1.446-1(a)(1).

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. See also § 1.446-1(b)(1).

The Commissioner of Internal Revenue has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-3 (1979); RCA Corp. v. United States, 664 F.2d 881, 886 (2nd Cir. 1981), cert. denied 457 U.S. 1133 (1982).

Except as otherwise expressly provide in Chapter 1 of Subtitle A of the Code, § 446(e) provides that a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books shall, before computing its taxable income under the new method, secure the consent of the Secretary.

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the taxable year in which taxable income is reported. See Rev. Proc. 97-27, § 2.01(1); Rev. Proc. 2002-9, § 2.01(1); Rev. Proc. 91-31, 1991-1 C.B. 566; Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v.

United States, 743 F.2d 781, 798 (11th Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

Although a method of accounting may exist under the definition in § 1.446-1(e)(2)(ii)(a) without the necessity of a pattern of consistent treatment, in most instances a method of accounting is not established for an item without such consistent treatment. See § 1.446-1(e)(2)(ii)(a). The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer has adopted a method of accounting for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57.

Section 1.446-1(e)(2)(ii)(d) provides what changes in depreciation for property subject to, among others, § 168 are a change in method of accounting and are not a change in method of accounting. For purposes of a change in depreciation to which § 1.446-1(e)(2)(ii)(d) applies, § 1.446-1(e)(2)(ii)(d)(4) provides that the item being changed generally is the depreciation treatment of each individual depreciable asset. Pursuant to § 1.446-1(e)(4)(ii), § 1.446-1(e)(2)(ii)(d) applies to a depreciable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003.

Section 1.446-1(e)(2)(ii)(d)(2)(i) provides that a change in method of accounting includes a change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

Section 1.446-1(e)(2)(ii)(d)(2)(iv) provides that a change in method of accounting includes a change from claiming to not claiming the additional first year depreciation deduction for an asset that does not qualify for the additional first year depreciation deduction.

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year (year of change), if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer. See also § 1.448-1(a).

A change in method of accounting to which § 481(a) applies includes a change in treatment of a single material item. See § 1.481-1(a)(1); Graf Chevrolet v. Campbell, 343 F.2d 568, 570-571 (5th Cir. 1965); Knight-Ridder v. United States, 743 F.2d at 798;

Peoples Bank & Trust v. Commissioner, 415 F.2d at 1344; Ryan v. Commissioner, 42 T.C. 386, 392 (1964).

An adjustment under § 481(a) can include amounts attributable to taxable years that are closed by the statute of limitations. Graff Chevrolet Co. v. Campbell, 343 F.2d at 571-572; Rankin v. Commissioner, 138 F.3d 1286, 1288 (9th Cir. 1998); Superior Coach of Florida v. Commissioner, 80 T.C. 895, 912 (1983); Weiss v. Commissioner, 395 F.2d 500 (10th Cir. 1968); Spang Industries, Inc. v. United States, 6 Cl. Ct. 38, 46 (1984), rev'd on other grounds 791 F.2d 906 (Fed. Cir. 1986).

In this case, Taxpayer, on its Date3 and Date4 tax returns, has depreciated certain 5-year property, 7-year property, and 15-year property which is tax-exempt use property and which was placed in service in Date3 under the GDS and has deducted the additional first year depreciation for these assets. However, these assets must be depreciated under the ADS over the greater of the recovery periods determined under the table in § 168(g)(2)(C) or a recovery period based on 125 percent of the lease term, using the straight line method (without regard to salvage value) and the applicable convention determined under § 168(d). Also, pursuant to § 168(k)(D)(i), these assets do not qualify for any additional first year depreciation. Thus, Taxpayer has established an impermissible method of accounting for depreciation for these assets. Since a change in the depreciation method or period of recovery of a depreciable asset, and a change from claiming to not claiming the additional first year depreciation deduction for an asset that does not qualify for the additional first year depreciation, are changes in method of accounting pursuant to § 1.446-1(e)(2)(ii)(d)(2), [redacted]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 317-7005 if you have any further questions.