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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index (UIL) No.: 167.01-00, 167.04-00, 167.13-00
CASE MIS No.: TAM-109035-99

SEP 10 1999

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Location =
City =
State =
A =
B =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Bank 1 =
Bank 2 =
X =

ISSUES:

1. Whether the infrastructure items such as street, sewage, and utility systems constitute tangible or intangible property to Taxpayer.

2. Whether the infrastructure items such as street, sewage, and utility systems have determinable lives such that they constitute depreciable property.

3. What is the effect on Taxpayer's method of accounting as a result of the conclusions reached on the previous two issues as to whether Taxpayer can depreciate amounts expended to build infrastructure including street, sewage, and utility systems, in order to develop two commercial projects.

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CONCLUSIONS:

1. The infrastructure items such as street, sewage, and utility systems constitute intangible property to Taxpayer.

2. The infrastructure items such as street, sewage, and utility systems do not have determinable lives such that they do not constitute depreciable property.

3. The effect on Taxpayer's method of accounting, as a result of the conclusion that Taxpayer cannot depreciate amounts expended to build infrastructure including street, sewage, and utility systems in order to develop two commercial projects, is that it constitutes a change in method of accounting.

FACTS:

Taxpayer is a corporation that sought to develop property it owns in Location, which is located in City. Its two development projects are titled A and B. In Date 1, City approved a map partitioning the two projects and dedicating certain streets. Development plans were finalized and approved by the planning commission and adopted by City in Date 2. City's final approval was contingent upon Taxpayer building certain improvements.

In Date 3, Taxpayer and City entered into an Acquisition/Financing Agreement under which public improvements built by Taxpayer for A and B were to be dedicated to City. City, in turn, would transfer the proceeds from a sale of bonds to Taxpayer. Such an agreement is required under State law where public improvements have not been completed but a final map has been approved by the local government. Title to the improvements passed to City on or before Date 4. City is responsible for the maintenance, repair, and reconstruction of the improvements.

The improvements include streets, sewer system, water system, and storm drainage infrastructure. Street improvements for A include the widening of four roads. Street improvements for B include the widening two roads, adding left turn lanes, traffic signals, and pedestrian barriers. Fire hydrants, and sidewalks were also added.

Taxpayer began depreciating the costs it incurred in building the improvements on Date 5. The basis was Taxpayer's actual cost, in the amount of $X. Taxpayer is depreciating this amount over 15 years using the declining balance method.

Taxpayer did not participate in the submission of the Request for Technical Advice. Taxpayer's arguments, however, are evidenced by two letters that were submitted with the Request for Technical Advice. Additionally, Taxpayer declined a conference of right with regard to the issuance of this technical advice memorandum.

LAW AND ANALYSIS:

Tangible vs. Intangible Property

The threshold issue is whether the infrastructure items such as street, sewage, and utility systems constitute tangible or intangible property to Taxpayer.

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

Section 1.167(a)-2 of the regulations provides that the depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to land apart from the improvements of physical development added to it.

Section 1.167(a)-3 of the regulations provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period...such an intangible asset may be the subject of a depreciation allowance. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life.

Rev. Rul. 68-607, 1968-2 C.B. 115, involves a developer who incurred costs for improvements made on a state-owned highway right-of-way to provide ingress and egress to a shopping center developed on leased land. After construction of the improvements, the developer formally transferred ownership of them to the state. The improvements will be maintained and replaced, when necessary, by the state. The ruling held that the taxpayer acquired no tangible property interest in the improvements to the state-owned highway right-of-way, rather it acquired a long-term direct business advantage, an intangible asset. The ruling further held that the period of economic usefulness to the taxpayer is limited in duration to the lease term of 99 years. The ruling provided that if the taxpayer had owned the land on which the shopping center was constructed, the useful life of the business advantage would not be limited since not only the maintenance of the improvements, but also their replacement, when necessary, will be provided by the state. Thus, the improvements would indefinitely benefit such land.

Gladding Dry Goods Co. v. C.I.R., 2 B.T.A. 336 (1925) supports the assertion in Rev. Rul. 68-607 that the taxpayer must have a capital investment in the property in order to be entitled to depreciation deductions. The court in Gladding states,"'Depreciation' is an allowance for the recovery of a capital investment. [Citing

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cases] It is not predicated upon ownership of the property, but rather upon an investment in property which is thereafter used. The important question is not, in whom vests the fee or when it vested, but who made the investment of the capital which is to be recovered over the period of the exhaustion of the property. The one who made the investment is entitled to its return." The taxpayer's capital expenditure results in a direct business advantage. The useful life of such benefits is not limited and therefore the cost of such benefits would not be recoverable by means of periodic depreciation deductions allowed under § 167 of the Code.

In order to have a depreciable interest in a tangible asset, several factors are considered including whether the taxpayer has a proprietary interest in the asset, whether the taxpayer uses the asset directly in his business, and whether the taxpayer will maintain and replace the asset as necessary. The third factor is the critical one. According to the facts underlying Rev. Rul. 68-607, the taxpayer had no proprietary interest in the assets and the state assumed liability for both the maintenance and replacement of the assets. The taxpayer therefore gave up all connection with the tangible elements of the improvements. All the taxpayer retained was the benefit of improved access to its shopping center. This benefit has no relationship to the life of any tangible asset and should not be treated as a tangible asset of the taxpayer.

In F.M. Hubbell Son & Co., Inc. v. Burnet, 51 F.2d 644 (8th Cir. 1931), the taxpayer was required by special assessments to make expenditures on account of paving, curbing, and sidewalk improvements abutting the taxpayer's property. The court noted that the taxpayer needs to have some sort of proprietary interest in the property which has depreciated to incur a loss due to the depreciation. The increase in value which the taxpayer has received from the improvements does not diminish by reason of its exhaustion, wear and tear, but by reason of the exhaustion, wear and tear of property in which the taxpayer has no special pecuniary interest and on account of whose exhaustion, wear and tear the taxpayer is entitled to no deduction. The court found that the improvements benefit the taxpayer's business, but they are not "in" the business and are not a part of it, even if the owner may have constructed them. Although the improvements incidentally benefit the taxpayer, they primarily are used in the business and for the service of the public.

In Algernon Blair, Inc. v. C.I.R., 29 T.C. 1205 (1958), the taxpayer constructed sidewalks, curbs, paved streets, sewers, and water mains concurrently with the construction of housing units. Upon completion of the improvements, the local government took over all the functions of maintenance of these facilities and they became part of the street systems for public use and convenience. The court noted that since the improvements were public property, the taxpayer does not have a pecuniary interest in the property. The fact that the taxpayer owned all of the adjoining properties is without controlling significance in view of the fact that the improvements are used primarily in the public business. See also Wilshire-La Cienega Gardens Co. v. Riddell, 148 F.Supp. 938 (S.D. Calif., 1956).

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In Cooper v. C.I.R., 31 T.C. 1155 (1959), the taxpayer developed subdivisions on property owned by the taxpayer and constructed improvements such as roads, curbs, gutters, waterlines, and storm sewers. The court asserted that the improvements were not used in the trade or business of the taxpayer, rather they were held for disposal either as part of each lot sold, or by dedication to public use. It ruled that the costs of the improvements were capital expenditures allocable to the basis of the unsold lots, to be realized upon the ultimate sale of the property. The court explicitly stated that it did not consider the argument that the improvements have been dedicated to public use, and thus the taxpayer has lost whatever depreciable interest he might have had therein.

In the present case, Taxpayer is required by City to construct certain transportation and utility improvements. Taxpayer then dedicated the streets to City and granted City easements with the rights of ingress and egress for the construction and maintenance of sewer and drainage facilities and slope rights. Therefore, Taxpayer relinquishes its proprietary interest in the improvements. Since the streets were dedicated to City, City is responsible for both the maintenance and replacement of the streets. Taxpayer ends up with a capital expenditure resulting in a benefit consisting of improved access to its developments. This benefit has no relationship to the life of any tangible asset and constitutes an intangible asset.

Determinable vs. Indeterminable Life

The second issue is whether the intangible assets obtained by Taxpayer through its construction of the improvements constitutes depreciable property.

Under § 1.167(a)-3, an intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. Similar to the ruling in Rev. Rul. 68-607, Taxpayer owns the land on which the developments are being constructed and the useful life of the business advantage due to the improvements is not limited since not only the maintenance of the improvements, but also their replacement, when necessary, will be provided by the state. Thus, the improvements have an unlimited useful life and are therefore not depreciable.

Taxpayer cites Rev. Rul. 73-188, 1973-1 C.B. 62, in support of its position. In that revenue ruling, a city made assessments against business property owners for their share of the expense of converting a downtown city street into an enclosed pedestrian mall. Title to the mall remained with the city, but the assessed landowners maintained the mall and paid the costs of heating and air conditioning it. The mall was expected to provide the affected landowners with a business advantage for a period of ten years. It was held that the assessments incurred by the property owners were capital expenditures that may be depreciated over the ten-year period in which the mall is expected to provide a business advantage.

According to Rev. Rul. 73-188, the assessment constitutes a capital expenditure in acquisition of an intangible asset in the form of an economic benefit that may be recovered through depreciation ratably over the period the economic benefit is expected to exist. If the payment of a tax assessed against local benefits produces or improves an asset that is used in the trade or business or for the production of income and that has a determinable useful life, such asset is subject to depreciation under Code § 167. The differences between Rev. Rul. 73-188 and the present case are who is responsible for maintenance and whether the intangible asset has a determinable useful life. In Rev. Rul. 73-188, the economic benefit of the pedestrian mall had a useful life of ten years whereas in the present case, the economic benefit of the streets and other improvements have an unlimited useful life and are therefore not depreciable under § 167. See §1.167(a)-3.

Taxpayer also cites D. Loveman & Son Export Corp. v. C.I.R., 34 T.C. 776 (1960) in support of its position. In this case, the taxpayer built a warehouse adjacent to a dead end dirt road. The taxpayer then paved the road because otherwise the warehouse would have been inaccessible by truck. Initially, the taxpayer asked the city to do the paving, but it refused. The road had not needed any repairs, but the taxpayer maintained the road. The court ruled that the taxpayer was allowed to depreciate its paving expenditures. It found that the city refused to pave the road and that although the road was open to public use, it was not used primarily in the public business, but was a dead end street used primarily in the taxpayer's business.

However, the court in Loveman made a distinction between that case and the case in Algernon Blair. The court stated that Algernon Blair was not in point because in that case, the improvements had been turned over by the taxpayer to the city, the city maintained the improvements, the streets and roads involved had been incorporated into the city road system, and the improvements were used primarily in the public business rather than in taxpayer's business. The facts in the present case are more closely aligned to those of Algernon Blair than Loveman. Thus, Loveman is not in point.

Taxpayer cites Noble v. C.I.R., 70 T.C. 916 (1978), in which a city ordinance required the taxpayer to connect properties to the city's sewer system, as a condition to continued use of the properties. The taxpayer was also required to pay an initial "tap fee" to the city which gave the taxpayer the indefinite right to use the sewer system (subject also to a monthly charge). The purpose of the tap fee was to pay the cost of expanding the sewage treatment plant. The court ruled that the sewer tap fee is a capital expenditure and stated that the benefits (use of the new plant) obtained by payment of the sewer tap fee have a life coextensive with the life of the system. Thus, the court decided that the taxpayer obtained an intangible right that has the same life as the tangible asset to which the right pertains, in this case, the court found that the sewage treatment plant had a life of 50 years. Again, in Noble the intangible right received by the taxpayer was depreciable because it had a determinable life whereas in the present case, Taxpayer's intangible right has an indeterminable life so that an opposite result is reached.

If City will assess Taxpayer for the costs of reconstruction of the improvements, the case of Noble would be more applicable to the present case. If Taxpayer would have to pay the costs of reconstruction of the improvements, then the current improvements would be deemed to have a determinable life (the useful life of the improvements). Consequently, Taxpayer would have obtained an intangible right that has the same life as the tangible asset to which the right pertains, in this case, the improvements (street, sewage, and utility systems). Since City currently has an obligation to replace the improvements when necessary and since there is no indication City will assess Taxpayer or a subsequent landowner for replacement costs, Taxpayer has an intangible right with an indeterminable life such that the costs are not depreciable under § 167. See §1.167(a)-3.

Change in Method of Accounting

The third issue is what is the effect on Taxpayer's method of accounting as a result of the conclusion that Taxpayer cannot depreciate amounts expended to build infrastructure including street, sewage, and utility systems, in order to develop two commercial projects.

Section 446(e) of the Code provides that a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes income in keeping books shall, before computing taxable income under the new method, secure the consent of the Secretary. Section 1.446-1(e)(2)(ii) of the regulations provides that a change in the 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 change from depreciating amounts expended to build infrastructure to not depreciating them constitutes a change in method of accounting.

Section 481(a) of the Code provides that in computing the taxpayer's taxable income for any taxable year, 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.

Section 481(b) of the Code provides that if the method of accounting from which the change is made was used by the taxpayer for the two taxable years preceding the year of the change, and the increase in taxable income for the year of the change which results solely by reason of the adjustments required by § 481(a) exceeds $3,000, then the tax attributable to such increase in taxable income shall not be greater than the aggregate increase in the taxes which would result if one-third of such increase in taxable income were included in taxable income for the year of the change and one-third of such increase were included for each of the two preceding taxable years.

In Diebold, Inc. v. U.S., 16 Cl.Ct. 193 (1989), aff'd 891 F.2d 1579 (Fed.Cir. 1989), cert. denied, 498 U.S. 823 (1990), the taxpayer had treated replacement modules for automated bank teller machines as inventory on its original returns for the years in issue. The taxpayer subsequently filed amended returns treating the modules as capital assets and claiming depreciation deductions. The Federal Circuit held that the reclassification from inventory property to depreciable property is a change in method of accounting. The court explained:

> [T]here is no question that a change from treating the replacement modules as nondepreciable inventory, where there is no deduction until the modules are removed from service, to treating them as capital assets, where there is a depreciation deduction in each year of useful life, raises the question of the taxable year in which income is reduced by the cost or a portion of the cost of manufacturing the replacement modules, that is, a question of timing. 891 F.2d at 1583.

In the present case, the change results from treating the cost of the property as depreciable to treating it as nondepreciable property. Taxpayer's treatment of the cost of this property as depreciable property on its original returns affects when, not whether, Taxpayer's cost of that property will be deducted. By treating the property as depreciable property, Taxpayer was deducting the cost of the property through depreciation over a certain recovery period. If Taxpayer had treated the property as nondepreciable, Taxpayer would have deducted its cost at the time of disposition. Under either treatment, Taxpayer is entitled to the same amount of deductions. Consequently, Taxpayer's incorrect treatment of the cost of the property as depreciable property on its original returns affects the timing of deductions. Thus, the change in the timing of the deduction for the cost of the property resulting from treating the cost as depreciable property to treating the cost as nondepreciable property is a change in method of accounting.

Thus, for the first taxable year under review, an adjustment should be made not only for the depreciation taken for the infrastructure in that taxable year, but also for all previous taxable years in which depreciation was taken for the infrastructure since Taxpayer's depreciation method is being changed. For each subsequent taxable year under review, an adjustment should be made only for the depreciation taken for the infrastructure in that taxable year.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.