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KBKG Tax Insight: IRS Takes Controversial Position on Building Placed in Service Dates

Internal Revenue Service in Action on Action on Decision 2017-02 announced that it will continue to litigate the issue surrounding placed in service dates for certain buildings that have received their certificate of occupancy but aren't ready and available for their "specifically assigned function." In the case of a retail building, the IRS appears to be signaling an "open for business" standard for determining when a building is placed in service.

Since the determination of the placed in service date could have a substantial impact on the amount of depreciation and availability of special incentives such as bonus depreciation, or qualified property with a 15-year tax life, tax professionals should advise clients about the potential for IRS controversy. As bonus depreciation phases out through 2019, placed in service dates will be especially important for determining the appropriate bonus rate (i.e. 50 percent, 40 percent or 30 percent). Buildings that are placed in service near the end of these next few years may be subject to scrutiny during an audit because of the potential impact of bonus depreciation.

The IRS announcement concerns the decision reached by the U.S. District Court for the Western District of Louisiana in *Stine, LLC v. United States*, which concluded that in the case of a building housing a retail store, the store doesn't need to be open for business for the building be considered placed in service (*Stine, LLC v. United States: 2015 BL 20439, W.D. La., No. 2:13-03224, 1/27/15*).

Per Treasury Department regulations, property is considered placed in service when it is in a condition or state of readiness and available for a specifically assigned function. The ambiguous nature of how it is defined has led to many disputes between taxpayers and the IRS.

Through AOD 2017-2, the IRS formally rejects the *Stine* case and contends a building is ready and available for use by considering the applicable factors set forth in Revenue Ruling 76-256 and Rev. Rul. 76-428 including:

- approval of all required licenses and permits;
- passage of control of the facility to the taxpayer;
- completion of critical tests; and
- commencement of daily or regular operations.

Background: *Stine, LLC v. United States*

In *Stine, LLC v. United States*, the district court considered whether two buildings that were substantially complete but not yet open for business could be considered placed in service for the purposes of beginning depreciation. The buildings in question were in a Gulf Opportunity Zone, an area designated for special tax treatment due to impact by hurricanes Katrina and Rita under Internal Revenue Code Section 1400N(d)(1)(A).

The buildings would qualify for 50 percent bonus depreciation, but only if the buildings were deemed to be placed in service prior to Dec. 31, 2008. Though substantially complete with certificates of occupancy, allowing them to receive furnishings, equipment, shelving, racks and merchandise, the store buildings weren't yet open to the public.

The court ruled in favor of the taxpayer, stating the IRS failed to cite any authority to show that "placed in service" equates to "open for business."

KBKG Insight: A point of significance is the perspective of the *Stine* case. *Stine* owned both the buildings and the businesses operating within them. The placed in service evaluation for the IRS may change when the building is owned by a landlord who leases to an unrelated party. From a landlord perspective, if a shell building is complete and space is available for tenant build-out, the IRS's placed in service requirements may have been met regardless of whether any tenants have moved in — especially if building operations (e.g., management and security) have commenced.

PATH Act and Bonus Depreciation

The Protecting Americans from Tax Hikes (PATH) Act of 2015 extended bonus depreciation through 2019 and introduced a new category of property eligible for the bonus. One criterion for bonus depreciation eligibility is the placed in service date as this determines the bonus depreciation rate. The rate has been mostly stable at 50 percent since 2008, increasing to 100 percent for a just over a year in the fourth quarter of 2010 through all of 2011. With the PATH Act, the bonus rate will decrease to 40 percent in 2018, then to 30 percent in 2019 and then expire.

Another impacted provision of the PATH Act involves qualified improvement property (QIP). QIP is defined as any improvement to an interior portion of a building that is nonresidential real property if that improvement is placed in service after the building was first placed in service (Section 168(k)(3)). Property eligible for QIP treatment receives bonus depreciation even though it has a 39-year recovery period!

Thanks to the PATH Act, many taxpayers can identify more bonus-eligible property improvements than ever before and this further increases the amount of bonus depreciation at stake related to the placed in service date.

KBKG Insight: For newly constructed buildings, both shell and interior improvements are commonly placed in service on the same date. However, depending on the facts and circumstances, a taxpayer may consider placing in service certain interior improvements after the building shell is placed in service to qualify as QIP.

Conclusion

By formally rejecting the *Stine* case, the IRS appears to be signaling an "open for business" standard for determining when a building is placed in service. Taxpayers who are relying on the reasoning in *Stine* should expect the IRS to challenge their position. Since the determination of the placed in service date could have a substantial impact on the amount and eventually the availability of bonus depreciation, taxpayers should consult with their tax advisers as they evaluate their facts and circumstances.

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