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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR District Counsel

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Investment Credit Transition Rule

This Field Service Advice responds to your memorandum dated February 22, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =
Division =

Vendor =

State =

System =

Nature of System =

Date 1 in 1985 =
Date 2 in 1985 =
Date 3 in 1985 =
Date 4 in 1985 =
Date 5 in 1985 =
Date 6 in 1985 =
Date 7 in 1985 =
Date 8 in 1985 =
Date 1 in 1986 =
Date 2 in 1986 =
Date 3 in 1986 =

Date 1 in 1987 =

Alternative A =
Alternative B =

Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =

Name 1 =
Name 2 =
Name 3 =

Newspaper =

ISSUE

Whether Taxpayer entered into a contract for the construction or acquisition of System that was both written and binding on December 31, 1985, so that System qualified for the investment tax credit pursuant to the binding contract transitional rule in section 203(b)(1)(A) of the Tax Reform Act of 1986.

CONCLUSION

The binding contract investment tax credit transitional rule is inapplicable in this situation because Taxpayer has not established that a contract was entered into by December 31, 1985. Moreover, the alleged contract was neither written nor binding on that date.

FACTS

Division, which is a division of Taxpayer, solicited proposals for the installation of a new System to service its operations in State. Proposals could be submitted for a totally workable (turn-key) system or for only part of System. The proposals were due by Date 2 in 1985.

A lengthy described the proposals sought and the detailed specifications of System in terms of its capabilities. Sections of the state that Taxpayer has the right to accept or reject, in whole or part, any proposal made in response to the . Section provides, “The accepted proposal will provide the basis for negotiating the terms and conditions of a mutually acceptable contract between [Taxpayer] and the selected supplier.”

Section of the provides for Taxpayer's project manager and Vendor's project manager to prepare certain plans for the system installation "[w]ithin two (2) weeks after contract award." Similarly, section requires Vendor to present Taxpayer with various plans "[w]ithin sixty (60) days of contract award." In addition to installing the system, the supplier was required by the to provide user training programs, on site maintenance personnel during the warranty period, and hourly rates for service not covered by the warranty.

Taxpayer received a number of proposals, including one from Vendor on Date 1 in 1985. Subsequently, Vendor submitted amendments to that proposal on eleven other dates. Taxpayer cannot locate any of the proposals, including the one submitted by Vendor. Taxpayer did produce a copy of a document entitled " " dated Date 3 in 1985, which appears to have been prepared by Vendor. This document quotes two prices for System, Alternative A for Amount 1 and Alternative B for Amount 2. It also discusses leasing options for System. Attachments to the document list property that would be installed under each option.

On or about Date 4 in 1985, Division requested a capital appropriation of Amount 3 from Taxpayer. Taxpayer's Board of Directors approved that request on Date 5 in 1985. Neither the request nor the minutes of the Board of Director's meeting identify a particular vendor who would install System.

The file contains a letter of Date 3 in 1986 from the President of Division to the President of Vendor stating that a telephone conversation between them took place on Date 6 in 1985. It states the call was placed by the President of Taxpayer "with the intent of finalizing the pending contract," that various terms were agreed to, including "finalizing the price of [Amount 3]" and at the conclusion of the conversation the President of taxpayer "felt we were in agreement to the terms of the contract" and asked the President of Vendor to proceed immediately. The President of Vendor signed this letter, concurring in what it stated, on Date 1 in 1987.

On Date 6 in 1985, the President of Division wrote a note on a buckslip to the Director of Advertising of Division stating:

> You have a deal with [Vendor].
> 1. Technician (digital) for two years free.
> 2. Guarantee 1 warrantee for 19 months.
> 3. President/CEO of [Vendor] will personally take charge of program and guarantee switch-over by end of 1986.

Good luck to you, Name 1, and Name 2.

[President of Division's Initials]

On Date 7 in 1985, Division sent a message to Vendor stating:

> This is to advise and congratulate you on your selection for the [Nature of System] project. Please express our thanks to all team members for their considerable effort. You will be contacted shortly by our technical people to finalize specifications and contract wording.
>
> Division, Name, Subcontract Specialist

On Date 8 in 1985, Vendor sent a proposed news release concerning the project to the Director of Advertising of Division. The proposed news release "announced a contract to install" System. Moreover, it stated: "The first phase of implementation -- incorporating planning, design and engineering -- is now under way and consists of a major rewiring and cabling effort."

Allegedly, Newspaper published an article about the project on Date 1 in 1986, but the article has never been furnished to the Service. Similarly, Taxpayer has alleged that Vendor began work on the project prior to January 1, 1986, but has never substantiated that allegation beyond the vague reference in the proposed news release.

On Date 2 in 1986, Taxpayer and Vendor entered into a formal, written contract for installation of System. The contract with attachments is long and quite detailed. It sets out the technical details, specifications, and performance requirements of the system to be built in considerable detail. The contract price is Amount 4.

Article of the formal contract is entitled . It provides for the contract to be interpreted under the laws of State. It states that the agreement constitutes a "binding obligation" and that it constitutes the entire agreement between the parties superceding "all previous communications, representations or agreements."

Article of the formal contract gives Taxpayer the absolute right to terminate the contract, in whole or in part, at any time. Upon such a termination, the contract gives the parties 180 days to negotiate the amount of fair compensation to Vendor for the termination. If the parties cannot agree on fair compensation, Taxpayer will pay Vendor (1) the unpaid costs of the work incurred by Vendor not previously paid for that are allocable to the terminated portion of the contract, (2) the costs of discharging liabilities allocable to the terminated portion of the contract, (3) the costs of Vendor in settling purchase money orders and subcontracts and in protecting and disposing of property in which Taxpayer has or may acquire an interest, (4) the amount of any discounts given by vendor, which as a result of the termination, have not been earned by Taxpayer, and (5) a sum as general and administrative, not to exceed twenty percent of the amount determined under (1), (2), and (3). The total sum to be paid to Vendor under (1) through (5) "shall not exceed the total of the Contract price as reduced by the amount of payments otherwise made and as further reduced by the Contract price of Work which has not been terminated."

Taxpayer claimed investment tax credits for System in 1986 and 1988. It asserts that the system was placed into service pursuant to a written contract binding on December 31, 1985, so that the credit is allowable under the general binding contract rule set forth in section 203(b)(1)(A) of the Tax Reform Act of 1986.

THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 repealed the investment tax credit, but provided transition rules to account for situations where taxpayers committed to certain expenses, or began to build qualifying property, with the expectation of getting the investment credit.

Section 38(a) of the Internal Revenue Code provides for a general business credit. Section 38(b)(1) provides that the current year business credit includes the investment credit determined under section 46(a). Section 46(a) provides that for purposes of section 38, the amount of the investment credit for any taxable year shall be an amount equal to the sum of certain specified percentages.
Section 48(a) identifies the categories of property eligible for the credit.

Section 49(a) of the Code provides that the 10 percent regular investment credit does not apply to property placed in service after December 31, 1985. Section 49(b)(1) provides that the repeal does not apply to "transition property" as defined in section 49(e), subject to the general limitations in sections 49(c) and (d).

Section 49(e)(1) of the Code defines the term "transition property," for purposes of the investment credit, as any property placed in service after December 31, 1985, and to which the amendments made by section 201 of the Act do not apply, except that in making such determination -- (A) section 203(a)(1)(A) of the Act shall be applied by substituting "1985" for "1986," (B) sections 203(b)(1) and 204(a)(3) of the Act shall be applied by substituting "December 31, 1985" for "March 1, 1986," (C) in the case of transition property with a class life of less than 7 years -- (i) section 203(b)(2) of the Act shall apply, and (ii) in the case of property with a class life -- (I) of less than 5 years, the applicable date shall be July 1, 1986, and (II) at least 5 years, but less than 7 years, the applicable date shall be January 1, 1987, and (D) section 203(b)(3) shall be applied by substituting "1986" for "1987."

In general, the definition of "transition property" under section 49(e)(1) of the Code relies on the transitional rules provided under the revised Accelerated Cost Recovery System (ACRS) provisions in sections 203 and 204 of the Act, but substitutes earlier effective dates than those used for ACRS. In order to satisfy the transitional rules of ACRS under sections 203 and 204 of the Act, property must satisfy both a specific effective date requirement and must be placed in service by a specified date depending on the property's class life.

Under the general ACRS transitional rule of section 203(b)(1) of the Act, as modified by section 49(e)(1)(B) of the Code, property may qualify as transition property if it satisfies any one of the following requirements:

(A) Any property that is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract that was binding on December 31, 1985. This is the transition rule Taxpayer asserts is applicable in this case.

(B) Property that is constructed or reconstructed by the taxpayer if (I) the lesser of $1 million or 5 percent of the cost of the property had been incurred or committed by December 31, 1985, and (II) the construction or reconstruction of the property began by the December 31st date.

(C) An equipped building or plant facility if construction had commenced as of December 31, 1985, pursuant to a written specific plan and more than one-half of the cost of the equipped building or facility had been incurred or committed by the December 31st date.[1]

The foregoing transition relief is not available unless an additional placement in service requirement under section 203(b)(2) of the Act, as modified by section 49(e)(1)(C) of the Code, is satisfied. To meet this requirement, property qualifying under one of the three previously–mentioned exceptions must be placed in service by a certain date depending upon the property's class life. For property whose class life is less than 5 years, the property must have been placed in service by June 30, 1986. For property whose class life exceeds 5 years but is less than 7 years, the property must have been placed in service by December 31, 1986. For property with a class life of at least 7 years but less than 20 years, the property must be placed in service by December 31, 1988. For property whose class life exceeds 20 years, the property must be placed in service by December 31, 1990.

[1](A), (B), and (C) are commonly referred to, respectively, as the "binding contract," "self-constructed property," and "equipped building" rules.

Section 203(b)(2)(C)(ii) of the Act further modified property described in section 204(a) by allowing a special exception. This provided for property with a class life of at least 7 years but less than 20 years to be treated as having a class life of 20 years. This provision therefore provides for a December 31, 1990 placement in service date for property having a 7 year or longer class life and which is related to a binding written contract.

The Conference Report, explaining the general binding contract transition rule set forth in section 203(b)(1)(A) of the Act, provides that the rule applies to the investment credit for property that is constructed, reconstructed, or acquired by the taxpayer pursuant to a written contract that was binding on December 31, 1985. Moreover, it applies only to contracts in which the construction, reconstruction, erection, or acquisition of property for which the credit is claimed is itself the subject matter of the contract. The report states:

> A contract is binding only if it is enforceable under State law against the taxpayer, and does not limit damages to a specific amount (e.g., by use of liquidated damages provisions). A contractual provision that limits damages to at least five percent of the total contract price is not treated as limiting damages.
>
> For purposes of the general binding contract rule, a contract under which the taxpayer is granted an option to acquire property is not treated as a binding contract to acquire the underlying property. In contrast, a contract under which the taxpayer grants an irrevocable put (i.e., an option to sell) to another taxpayer is treated as a binding contract, as the grantor of such an option does not have the ability to unilaterally rescind the commitment. In general, a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor (except in the limited circumstances described below). A contract that was binding as of March 1, 1986 (or December 31, 1985 in the case of the investment tax credit) will not be considered binding at all times thereafter if it is substantially modified after that date.
>
> * * * *
>
> Design changes to a binding contract to construct a project that are made for reasons of technical or economic efficiencies of operation and that cause an insignificant increase in the original price will not constitute substantial modifications of the contract so as to affect the status of the project under the binding contract rule.
>
> * * * *

> The conferees also wish to clarify that the general binding contract rule does not apply to supply agreements with manufacturers, where such contracts fail to specify the amount or design specifications of property to be purchased; such contracts are not to be treated as binding contracts until purchase orders are actually placed. A purchase order for a specific number of properties, based on the pricing provisions of a supply agreement, will be treated as a binding contract.

DISCUSSION

Whether a binding written contract existed on December 31, 1985, is a factual issue. The issue turns on the various documents and whether they establish the existence of a binding written contract on the last day of 1985. Although there are some facts that indicate the existence of such a contract by that date, we believe that the information available at this time demonstrates that a written, binding contract for purposes of the transition rule did not exist prior to 1986.

We concur in your conclusion that Taxpayer is not allowed the investment tax credit for System. System was not placed into service until after the credit was repealed and Taxpayer has not established entitlement to the credit under the general binding contract transition rule.

The essential reason that we conclude the contract was not in existence on December 31, 1985, is that Taxpayer has failed to establish its existence. In other words, we think this case turns not on the technicalities of contracts law, but on the failure of the available evidence to show that any agreement was reached and, if reached, was not put in the form of a binding, written contract. Indeed, the available facts indicate that any agreement reached was not reduced to a written contract until Date 2 in 1986.

We recognize that in 1985 Taxpayer could have solicited proposals, Vendor could have made a specific, written proposal in the nature of an offer containing all the essential terms of a contract, and Taxpayer could have accepted that proposal in writing, thereby creating a binding written contract. The evidence, however, fails to show that those events occurred and, in fact, shows that no contract of a binding and written nature was entered into prior to Date 2 in 1986.

Most of what Taxpayer must establish to qualify for transition relief under the binding contract rule is present in this case. Clearly, a written proposal was made and selected. What is not clear is whether the selection of that proposal formed a binding, written contract or merely evidenced the intent to work toward the formation of such a contract along the lines put forth in the proposal. The answer turns on the intent of the parties. A binding contract was formed if and when the parties intended a binding contract to be formed. If they intended to be bound by Vendor's proposal upon Taxpayer's selection of it, but also agreed to clarify and work out some minor aspects of the deal before reducing it to a formal contract, then a binding contract was formed at the time of the original agreement. On the other hand, if Taxpayer and Vendor merely intended to work toward creating a binding contract based on the proposal, then the agreement was not binding until the formal contract was signed on Date 2 in 1986.[2]

Some of the available information creates the impression that a binding written contract was entered into on Date 6 in 1985. Prior to that time, Vendor submitted a detailed written proposal to build System and that proposal was modified eleven times. Then, on that date Taxpayer notified Vendor in writing that its proposal had been selected. The proposed news release of Date 7 in 1985 provides some support for Taxpayer's assertion that a binding contract had already been created. That proposed news release stated that both parties were announcing a "contract" to install System, thereby evidencing an intent to be bound, and stated that Vendor had already begun work on the project.[3] Similarly, the note written by the President of Division on Date 5 in 1985 refers to an existing "deal" with Vendor, thereby indicating the formation of a binding contract.

On the other hand, other more controlling facts support the conclusion that a binding contract was not created until Date 2 in 1986. The creation of that formal contract on that date is strong evidence that a binding contract did not exist before that date. The statement in the that the accepted proposal will provide the basis for negotiating the terms of a contract strongly indicates that acceptance of

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[2] Arthur L. Corbin, Corbin on Contracts, Vol. 1, § 2.9, at pp. 145-146 (1993), provides:

> The parties have power to contract as they please. They can bind themselves orally or by informal letters or telegrams if they like. On the other hand, they can maintain complete immunity from all obligation, even though they have expressed agreement orally or informally upon every detail of a complete transaction. The matter is merely one of expressed intention. If their expressions convince the court that they intended to be bound without a formal document, their contract is consummated, and the expected formal document will be nothing more than a memorial of that contract.

[3] "The subsequent conduct and interpretation of the parties themselves may be decisive of the question as to whether a contract has been made, even though a document was contemplated...." Corbin, supra,, at p. 154.

the proposal did not create a binding contract, but merely provided the framework for negotiating such a contract at a later date. Also, the language of the message that is alleged to constitute acceptance of the terms proposed is ambiguous. By advising Vendor of its “selection” for the project, rather than stating that Vendor’s proposal was accepted, the Mailgram creates an ambiguous relationship rather than a binding contract. That relationship should not be interpreted as a binding contractual relationship, particularly because Taxpayer had the opportunity to use the language for creating a contract and failed to do so. Not only would we argue that the resulting ambiguity should be resolved against its maker, but also we would argue that the ambiguity existed because of the intended absence of a binding written contract.

Apart from the conflicting facts as to whether a contract was formed in 1985, Taxpayer’s case has a major problem. The key piece of evidence is missing. Taxpayer has failed to produce Vendor’s proposal that is alleged to contain the terms of the contract.

We are asked and a court would be asked to conclude that a multi-million dollar contract was created in 1985, but that the document setting out all the terms of that contract is unavailable. Just the fact that a copy of the proposal was not retained is some evidence its legal significance was less than that of a contract. Moreover, as the burden of proof is on Taxpayer to establish its entitlement to transition relief, it will be difficult for it to meet that burden in the absence of Vendor’s proposal. Without producing the terms of the alleged contract, Taxpayer cannot prove that it was a binding contract. Indeed, the proposal may well have contained clauses clarifying its legal significance. For example, the proposal may have contained a clause echoing the statement in section of the that the proposal was intended only to provide the basis for negotiating a contract. It may even have gone a step farther and stated that acceptance of the proposal did not constitute a binding contract. We simply do not know and, without knowing the terms of a relationship, there is no basis for concluding that relationship amounted to a binding contractual relationship. Therefore, in the absence of the proposal, Taxpayer will have difficulty meeting its burden of proof. This burden will be especially difficult in light of the general practice of strictly construing transitional rules allowing tax credits. Helvering v. Northwest Steel Mills, 311 U.S. 46, 49 (1940). That practice has been applied to the transitional rules applicable to the 1986 repeal of investment tax credit. United States v. Kjellstrom, 916 F. Supp. 902 (W.D. Wis. 1996), aff’d, 100 F. 3d 482 (7^{th} Cir. 1996).

As for whether the message of Date 5 in 1985 sufficiently identifies the property that was the subject of the alleged contract, it does not do so standing alone. That communication, however, must be read in conjunction with the Vendor’s detailed proposal to build System. Had Vendor made only one proposal, we think the reference to “the [Nature of System] project” could be interpreted as a reference to that proposal and the property identified in that proposal. If a binding contract was created upon the selection of that proposal, then the specifications in the proposal would become part of the contract itself.

Vendor, however, did not make a single proposal; it made alternative proposals. One of those proposals called for a price of Amount 1 and the other proposal called for a price of Amount 2. We do not know which of those proposals was selected, so we do not know what property was specified in the alleged contract. In fact, we have every reason to believe that neither proposal was selected because the contract price was Amount 4, which is significantly different from the price of either of the proposed alternatives.

In that regard, the Amount 4 contract price indicates the lack of a written contract. That price is significantly different from either the Amount 1 price of Alternative A or the Amount 2 price of Alternative B. As a result, it is not clear to us what was agreed upon in writing prior to the signing of the formal written contract on Date 2 in 1986. Indeed, the letter of Date 3 in 1986 recalling the Date 5 in 1985 conversation between the President of Division and the President of Vendor, states that in that conversation they finalized the price, set the warranty period, and agreed that Vendor would provide a switchman at Taxpayer's location during normal business hours for two years. Therefore, any agreement that was reached in that conversation as to the terms of a contract was oral. Even if a contract was created in 1985, that contract was oral and not reduced to writing until Date 2 in 1986.

We recommend that you make another argument that has not been suggested previously. We recommend that you argue the contract was not binding in light of the right to terminate it given Taxpayer in Article of the formal contract of Date 2 in 1986. That article gives Taxpayer the unconditional right to terminate the contract in whole or part at any time. Clearly, a contract that can be terminated at any time is not binding on the party with the right to terminate it. Taxpayer can avoid its future contract obligations as a result of its right to terminate the contract in this case, so the contract is not binding with respect to Taxpayer. Such a contract is the equivalent of a contract that grants Taxpayer an option to acquire the system.

Not only was the contract not binding on Taxpayer, but it contained a liquidated damages provision in the event Taxpayer terminated the contract, Taxpayer would have to compensate Vendor by paying an amount determined by adding together various actual costs incurred by Vendor, plus a sum not to exceed 20 percent of those costs for general and administrative costs, plus discounts given by Vendor but not earned by Taxpayer.

The Conference Report states that a contract must be both enforceable "and" without a liquidated damages provision to be considered as binding. This contract met neither of these requirements. The Conference Report, however, also states that a contract limiting damages to an amount equal to "at least five percent of the total contract price" is not to be treated as limiting damages. Article limits Taxpayer to compensating Vendor for its actual costs including its general and administrative expenses, but not to an amount that **must** be at least five percent of the contract price. Therefore, we believe that Article contains the kind of liquidated damages provision that Congress envisioned as disqualifying a contract from being "binding" under the transition rule.[4]

The provisions of Article are not entirely clear to us, and you may ask Taxpayer for further clarification of the provisions in light of this issue. We again assert that the Conference Report clearly states that unenforceable contracts are not binding and there can be little doubt that a contract terminable at will is unenforceable against the party with the right to terminate the contract. Therefore, we believe the argument that this was not a binding contract is a strong argument.[5]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Your submission also addresses the issue of whether the agreement in issue was one concerning services or goods. You state that a cogent argument can be made that the agreement was for installation services, so that the Uniform Commercial Code, which has been adopted in State, is inapplicable in determining whether a binding contract was formed. [redacted]

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[4] The relevant point in time here is December 31, 1985. We conclude that the termination clause meant taxpayer was not committed to purchasing System on that date. Although the damages provided for on termination were not tied to the contract price, they probably were less than five percent of the contract price at that early stage of the contract. It is likely that Vendor performed little of the contract, placed few orders, and incurred few liabilities at that early date before the formal contract was signed. As a result, any damages under the termination clause would be minimal. In any event, the burden would be on Taxpayer to establish that it was required to pay an amount in excess of five percent of the contract price as damages to meet the exception in the legislative history.

[5] Of course, Taxpayer might argue that the contract in issue is not the formal contract signed on Date 2 in 1986, but the contract finalized in the telephone call of Date 5 of 1985 and accepted in writing in the Mailgram of Date 6 in 1985. However, such an argument would be inconsistent with Taxpayer's basic contention that there was only one contract and that it was made in 1985 but was memorialized in 1986.

[redacted]

Likewise, we have another question for your consideration. [redacted] If so, the credit is not allowable for any such property that was placed into service after December 31, 1986.

Section 203(b)(2)(C)(i) of the Act specifically treats [redacted] referred to in section 168(e)(3)(B)(iii) of the Code as having a six-year class life for purposes of the placed in service requirements.[6] That means such equipment must be placed in service before January 1, 1987, to qualify for transition relief.

This is the first case to directly confront the issue of what constitutes a binding written contract for purposes of the investment tax credit transition rules. The issue, however, is fact intensive and has application only to certain property placed in service prior to 1991. Therefore, any resulting court opinion is likely to have limited precedential value. [redacted]

If you have any further questions, please call.

By: ___________________________
HARVE LEWIS
Chief, Passthroughs and Special
Industries Branch
Field Service Division

[6]Section 168(e)(3)(B)(iii) uses the term "computer-based telephone central office switching equipment," but does not define or further describe such property.