No. 12-12169-BB

IN THE

United States Court of Appeals

FOR THE ELEVENTH CIRCUIT

PECO FOODS, INC. & SUBSIDIARIES

Petitioner – Appellant,

—— v. ——

COMMISSIONER OF INTERNAL REVENUE

Respondent – Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

BRIEF FOR PETITIONER - APPELLANT

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Peco Foods, Inc. & Subsidiaries v. Commissioner of Internal Revenue
No. 12-12169-BB

CERTIFICATE OF INTERESTED PERSONS AND CORPORATE DISCLOSURE STATEMENT

Counsel for Appellant, Peco Foods, Inc. & Subsidiaries, hereby certifies, in accordance with Fed. R. App. P. 26.1 and 11th Cir. R.26.1-1, that the following persons may have an interest in the outcome of this case:

1) The name of the trial judge, all attorneys, persons, associations of persons, firms, partnerships, or corporations that have an interest in the outcome of this appeal:

Hickman, Denny

Hickman, Mark

Jerome Hickman Family Partnership

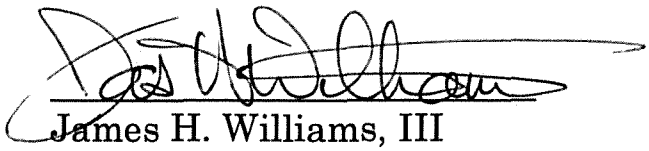
Laro, David (United States Tax Court Judge)

Perkins Williams Rice, PLLC

Rice, John Steven, Esq.

Williams, James H. III, Esq.

2) Appellant herein, has no parent company, and no publicly-held company owns a 10% or greater ownership interest in Appellant.



James H. Williams, III

STATEMENT REGARDING ORAL ARGUMENT

Appellant desires the opportunity for oral argument and asserts that such argument is needed to more thoroughly explore the jurisprudence underlying the rule in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), in light of the recent decision of this honorable court in *United States v. Fort*, 638 F.3d 1334 (11th Cir. 2011), and in particular whether the assignment of depreciable life to an asset is appropriately governed by a word or words rather than the classification guidance of IRC §168(e) and the well established body of law which must be used for that purpose.

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JURISDICTIONAL STATEMENT

This action was brought by the taxpayer by the timely filing of a petition with the United States Tax Court for redetermination of a deficiency under 26 U.S.C. § 6213. The United States Tax Court had jurisdiction under 26 U.S.C. § 7442.

This Court has jurisdiction under 26 U.S.C. § 7482. This is an appeal of the final decision of the United States Tax Court sustaining respondent's determination of deficiency.

The United States Tax Court entered its memorandum opinion on January 17, 2012 and a supplemental order on January 19, 2012 denying petitioner's motion in limine to shift the burden of proof to respondent. Petitioner timely filed a notice of appeal on April 11, 2012 which was docketed by the United States Tax Court on April 17, 2012.

A seven calendar day extension of time to file Appellant's initial brief and record excerpts was requested pursuant to 11th Cir. R. 31-2(a) on June 1, 2012 and an extension of time until June 11, 2012 to file Appellant's initial brief and record excerpts was granted.

ISSUES

I. **Ultimate Facts: Whether the evidence before the United States Tax Court and its subsidiary fact findings were sufficient to justify the inferences – the ultimate findings – that the taxpayer is precluded, by including the abbreviation "Bld" to describe an asset in one asset purchase agreement and by using the term "Real Property Improvements" in a different asset purchase agreement, from properly classifying those assets under 26 U.S.C. §168(e).**

STATEMENT OF THE CASE

A. Nature of the Case

Peco Foods, Inc. (hereinafter "Peco", or "taxpayer"), is the common parent of an affiliated group of corporations. The other members of the affiliated group are Peco Farms, Inc. (Peco Farms), Peco Foods of Mississippi, Inc. (PFMI), and Peco Foods of Brooksville, Inc. At all relevant time, Peco and the members of its affiliated group were engaged in the business of poultry processing.

During the mid-to-late 1990s, Peco expanded its production capacity by purchasing two poultry processing plants. In late 1995, it entered into an agreement with Green Acre Farms, Inc., a Mississippi corporation, to purchase a poultry processing plant in Sebastopol, Mississippi. The Asset Purchase Agreement (Doc. 18, Exh. 7-J) called

for an appraisal to be performed in order to allocate the purchase price among the real property and equipment and such an appraisal was performed. Doc. 63, Pg. 219 Exh. 12-P. The effective date of the appraisal was January 16, 1996, and based upon the appraisal's conclusions of value the parties to the agreement executed several amendments to the asset purchase agreement and agreed upon a closing date of February 18, 1996 and an allocation of value to the assets purchased.

Peco has a fiscal year end of March 31, and filed its U.S. Corporation Income Tax Returns for its 1995 tax year (i.e., fye 3/31/1996), 1996 tax year (i.e., fye 3/31/1997), and 1997 tax year (i.e., fye 3/31/1998) treating for depreciation purposes the amount of $3,802,550 allocated to an asset described in the allocation agreement as "Processing Plant Bld" as nonresidential real property.

On May 12, 1998, Peco acquired certain assets relating to a poultry processing facility in Canton, Mississippi pursuant to an asset purchase agreement, in which the purchase price of $10,500,000 was allocated to three assets: Real Property - Land in the amount of

$350,000; Real Property - Improvements in the amount of $5,100,000; and Machinery, Equipment, Furniture and Fixtures in the amount of $5,050,000. Doc. 18, Exh. 8-J. The allocation of value was made in accordance with an appraisal performed with an effective date of February 4, 1998.

Peco commissioned Moore Stephens Frost, PLC in 1999 to perform a segregated cost analysis of the two plants which it had purchased and that study classified the Sebastapol assets designated as "Processing Plant Bld" (which had been acquired in February of 1996) in accordance with the classification rules of 26 U.S.C. §168(e), based on the methodology allowed by *Hospital Corporation of America v. Commissioner*, 109 T.C. 21 (1997). The same approach was applied with respect to the Canton assets designated as "Real Property – Improvements" (which had been acquired in May of 1998). Included with its U.S. Corporation Income Tax Return for the fiscal year ended March 31, 1999, Peco included Form 3115 to change the useful lives and depreciation methods of that portion of the Sebastapol asset which had been described as "Processing Plant Bld", and claimed depreciation

benefits with respect to the Canton assets which had been described as "Real Property – Improvements" based upon the cost segregation study which it had commissioned.

The Commissioner of Internal Revenue subsequently disallowed the benefits claimed through the cost segregation study on the bases that, because the value allocated to those assets in the purchase agreement were 'per se' §1250 property and that the language of IRC §1060(a) did not permit Peco to deviate from its characterization of the Sebastapol asset described as "Processing Plant Bld" and that Peco was similarly precluded from deviating from the characterization of the Canton asset described as "Real Property – Improvements". As a second reason for disallowing the benefits claimed through the cost segregation study, the Commissioner stated that the rule in the case of *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967) precluded the taxpayer from challenging the tax consequences of a written agreement as construed by the Commissioner "only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of

mistake, undue influence, fraud, duress, etc." The Court of Appeals for the Eleventh Circuit has expressly adopted the *Danielson* rule. See *Plante v. Commissioner*, 168 F.3d 1279 (11th Cir., 1999), affg. T.C. Memo. 1997-386; *Bradley v. U.S.*, 730 F.2d 718 (11th Cir. 1984).

B. Prior Proceedings

Peco timely filed a Petition in the United States Tax Court contending that neither section 1060 nor the rule in *Danielson* prohibited it from classifying the properties acquired in the Sebastopol and Canton acquisitions in accordance with the classification rules of IRC §168(e) and the methodologies employed in the *Hospital Corporation of America* case. Doc. 1.

The case was initially assigned to Judge Thornton, respondent filed motions to limit the testimony of the expert identified by taxpayer as well as to exclude the appraisals which had been performed and the cost segregation study which had been obtained on the basis that the author of each report was no longer living. Docs. 9, 10, 12 & 13. The case was continued. Doc. 11 (Ord 3/19/2009) Respondent's Motions in Limine were dismissed as moot.

Respondent thereafter filed a motion for summary judgment, petitioner was then ordered to respond to the respondent's motion, the case was assigned to Judge Nims, who denied respondent's initial motion for summary judgment, and then the case was no longer assigned and was restored to the general docket.

The case was subsequently assigned to Judge Laro, and respondent filed a second round of Motions in Limine to exclude the cost segregation study and the two appraisals as expert reports. Those motions were granted at the trial of the matter. However, petitioner had moved at the beginning of trial to shift the burden of proof to respondent and because respondent's expert had relied/reviewed those the appraisals and cost segregation study for purposes of preparing his reports, the reports were admitted as business record exceptions to the hearsay rule. Doc. 63, Pgs. 219 and 220.

A briefing schedule was ordered, petitioner and respondent appropriately complied with the briefing schedule, and on January 17, 2012, Laro, J. issued T.C. Memo. 2012-18 entering decision for respondent.

C. Statement of Facts

Taxpayer is a corporation incorporated in the State of Alabama on April 4, 1969 and consists of the parent company, Peco Foods, Inc. and three wholly owned subsidiaries: Peco Farms, Inc., Peco Foods of Mississippi, Inc. and Peco Foods of Brooksville, Inc. Taxpayer has a mailing address of 1020 Lurleen Wallace Blvd. North, Tuscaloosa, AL 35401. Taxpayer's federal identification number is 63-0574021. Doc 4, Admission 1.

On December 29, 1995 Taxpayer entered into an agreement to purchase assets from Green Acre Farms, Inc. Included in the assets to be acquired was the purchase of a poultry processing plant, poultry holding sheds and a waste water treatment plant that was located in Sebastopol, Mississippi, as well as other assets and assets acquired which are not involved in this controversy. Doc. 18, Statement 7 & Exhibit 7-J.

The agreement between taxpayer and the seller of the Sebastopol assets included provisions referenced as Paragraph 2(c)(ii)(A), which specified that an appraisal would be performed to determine the

amount allocated to the Real Property and Equipment. Doc. 18, Exhibit 7-J, Pg 6.

The agreement between taxpayer and the seller of the Sebastopol assets also included provisions referenced as Paragraph 2(f) entitled "Allocation" which stated, "The Parties agree to allocate the Purchase Price (and all other capitalizable costs) among the Acquired Assets for all purposes (including financial accounting and tax purposes) in accordance with the allocation schedule *** ." Doc. 18, Exhibit 7-J, Pg 7.

To facilitate the allocation of the Purchase Price to be paid with respect to the agreement entered into on December 29, 1995 between Taxpayer and Green Acre Farms, Inc., William A. Payne, MAI, of Paynesmall Investment Property Appraisals prepared a Summary Appraisal Report, Complete Appraisal, Green Acre Farms, Sebastapol, MS with an effective date of January 16, 1996. Doc. 63, Pg. 219. Exh. 12-P.

Pursuant to the allocation agreement entered into by the parties upon the closing of the transaction on February 18, 1996, taxpayer

allocated amounts of the purchase price to assets here pertinent described as follows: (1) Processing Plant Building with an assigned a value of $3,802,550.00; (2) Holding Shed #1 with an assigned a value of $64,800.00; (3) Holding Shed #2 with an assigned a value of $75,395.00; (4) Waste Water Treatment Plant Lagoon with an assigned a value of $112,000.00; (5) Fencing with an assigned a value of $27,700.00; (6) Utility Extension with an assigned a value of $50,000.00; (7) Concrete and Paving with an assigned a value of $50,000.00; (8) Site Work with an assigned a value of $100,000.00; and (9) Waste Water Treatment Plant with an assigned a value of $1,879,545.00. Doc. 18, Stmt 30; "allocation schedule" included as part of Exhibit 7-J of Doc. 18.

Taxpayer's allocation of the consideration paid among the assets acquired with respect to the Sebastopol, Mississippi acquired assets, was entirely to Class III under the residual method prescribed by 26 U.S.C. § 1060 and the applicable regulations issued under 26 U.S.C. § 338 (to an acquisition occurring on February 18, 1996). Reg. § 1.1060-1T(d)(2)(ii) as it applied to applicable asset acquisitions completed before February 14, 1997 (i.e., before it was amended by TD 8711,

1/9/1997) stating that Class III was comprised of assets not included in Class I, II or IV (Class I assets were cash and similar items; Class II assets were certificates of deposits and similar items; Class IV assets were comprised of intangible assets in the nature of goodwill and going concern value).

Taxpayer's federal income tax return for the 1995 tax year, 1996 tax year, 1997 tax year reported depreciation expense of the assets described as "Processing Plant Bld"; "Holding Shed#1"; "Holding Shed#2"; "Site Work"; and "Waste Water TP" without appropriately identifying the specific components and the portions of the processing facilities which qualify as I.R.C. § 1245 property and segregating the cost of that property from I.R.C. § 1250 property as is permitted by the case law. Doc. 18, Statement 31 of the Stipulation of Facts with respect to the "Processing Plant Bld"; Statement 48 of the Stipulation of Facts with respect to "Holding Shed #1"; Statement 49 of the Stipulation of Facts with respect to "Holding Shed #2"; Exhibit 1-J of the Stipulation of Facts as well as the I.R.C. § 481(a) adjustment included on the Form 3115 that was part of Exhibit 1-J.

The amount of depreciation expense reported by Taxpayer was less than the depreciation expense Taxpayer would have reported if Taxpayer had appropriately classified the purchased asset under IRC §168(e) by identifying the specific components and the portions of the processing facilities that qualify as I.R.C. §1245 property and segregated that property from the I.R.C. § 1250 property. Doc. 18, Exhibit 1-J of the Stipulation of Facts; 26 U.S.C. § 481(a) adjustment included on the Form 3115 as was part of Doc. 18, Exhibit 1-J, as well as taxpayer's 1995, 1996 and 1997 income tax returns.

On May 12, 1998 Taxpayer purchased assets in Canton, Mississippi from Marshall Durbin Food Corporation and Marshall Durbin Farms, Inc. In this acquisition the Taxpayer acquired a poultry processing plant that was located in Canton, Mississippi. Doc. 18, Statement 8, and Exhibit 8-J.

Based on a Complete Appraisal Self Contained Report of the Marshall Durbin Processing Plant with an effective date of February 4, 1998 prepared by Terry L. Payne, MAI, of PayneSmall Investment Property Appraisals, Doc. 63, Pg. 220, Exh. 13-P, the allocation

schedule referenced as Exhibit "E" in the Canton Asset Purchase Agreement allocated the purchase price of $10,500,000.00 between three items listed as follows: (1) Real Property: Land was allocated a value of $350,000.00; (2) Real Property: Improvements was allocated a value of $5,100,000.00; and (3) Machinery, Equipment, Furniture and Fixtures was allocated a value of $5,050,000.00. Doc. 18, Exhibit 8-J, paragraph 2(f) and the "allocation schedule" included as part of Exhibit 8-J.

Taxpayer's allocation of consideration paid for the assets acquired with respect to the Canton, Mississippi acquired assets was entirely to Class III of the residual method prescribed by I.R.C. § 1060 and the applicable regulations issued under I.R.C. § 338 (to an acquisition occurring on May 12, 1998). Reg. § 1.1060-1T(d) as it applied to applicable asset acquisitions completed on May 12, 1998 (i.e., before it was removed by TD 8940, 2/12/2001) stating that Class III was comprised of assets not included in Class I, II, IV or V (Class I assets were cash and similar items; Class II assets were certificates of deposits and similar items; Class IV assets were comprised of all 26 U.S.C. §197

intangibles except those in the nature of goodwill and going concern value; and Class V were Code Sec. 197 intangibles in the nature of goodwill and going concern value).

Taxpayer retained the accounting firm of Moore Stephens Frost to perform a cost segregation analysis on the assets Taxpayer acquired on February 16, 1996 from Green Acre Farms and on May 12, 1998 from Marshall Durbin Food Corporation to allow Taxpayer to appropriately classify the specific components and the portions of the processing facilities that qualify as I.R.C. § 1245 property in order to properly depreciate such properties under the appropriate methodologies. Doc. 18, paragraph 10, and Doc. 63, Pg. 220, Exhibit 14-P, the Cost Segregation Study.

Taxpayer filed its 1998 federal income tax return (year ended April 3, 1999) pursuant to the holding by the U.S. Tax Court's opinion in *Hospital Corporation of America*, 109 T.C. 21, (1997), and based upon information contained in the cost segregation study performed on the assets acquired from Green Acre Farms, Taxpayer determined that it had been calculating the depreciation expense for certain assets in a

manner not consistent with the classification methods of IRC §168(e). Doc. 18, Statements 31 through 62.

Taxpayer included with its federal income tax return for the 1998 tax year (f/y/e 3/31/99), a Form 3115, Application for Change in Accounting Method, filed under the automatic consent provisions of Revenue Procedure 98-60. Doc. 4, admission in paragraph 5a of the Answer.

The Form 3115 stated that Taxpayer was changing the depreciation method and the recovery period for certain assets. Doc. 18, Form 3115 that is a part of Exhibit 1-J.

The Form 3115 filed with that return also reported an I.R.C. §481(a) adjustment which reflected the difference in the depreciation expense allowable to Taxpayer as if Taxpayer had utilized the appropriate depreciation method and recovery period from the acquisition date through the end of Taxpayer's 1997 federal income tax return. Doc. 18, paragraph 31.

Taxpayer's use of the cost segregation study to allocate specific components which qualified as I.R.C. §1245 property and portions of the processing facility which supported I.R.C. § 1245 property did not result in a reallocation of any of the consideration paid that was originally allocated to Class III to another asset class of the residual method prescribed by regulations under I.R.C. § 338 as required by I.R.C. §1060, and the consideration that was allocated pursuant to I.R.C. § 1060 to Class III remained allocated to Class III at all times.

On August 30, 1999 the IRS acquiesced to the validity of the method the United States Tax Court approved in *Hospital Corporation of America v. Commissioner*, 109 TC 21 (1997). See IRS Action on Decision #cc-1999-008 and the IRS Chief Counsel's guidance in CCA 19992145.

Taxpayer's federal income tax returns were examined by the IRS. Doc. 18, Exhibit 6-J, the statutory notice of deficiency.

On November 17, 2003 the IRS issued Form 5701, Notice of Proposed Adjustment. The adjustments proposed by the IRS disallowed the increased depreciation deduction for the assets in Sebastopol,

Mississippi acquired from Green Acres Farms, Inc. described as "Processing Plant Bld"; "Holding Shed#1"; "Holding Shed#2"; "Site Work"; "Waste Water TP"; and also disallowed depreciation deductions for assets in Canton, Mississippi acquired from the Marshall Durbin companies described as "Real Property: Improvements" -- stating that the reasons for the proposed adjustment as follows: "The increased depreciation deduction is not allowable based on the I.R.C. § 1060(a)(2) and case law. Agreements between taxpayer's are binding unless the Secretary determines that the allocation is inappropriate. The two purchase agreements the taxpayer signed includes a paragraph 2(f) Allocation, that states both parties agree to the allocation for tax purposes." Form 5701, Notice of Proposed Adjustment.

On January 15, 2004 the IRS Large and Mid-Size Business Division issued an Engineering and Valuation Report which did not address the methodology or merits of the cost segregation study; it simply provided the engineer's legal analysis that I.R.C. 1060(a)(2) and case law prohibited any changes in Taxpayer's depreciation deductions.

Around March 2, 2004 Taxpayer appealed the examination findings to the Appeals Office of the IRS and requested that an appeals officer review the adjustments from the examination. On September 11, 2006 the IRS appeals officer cited I.R.C. section 1060(a) in addition to the case *Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967) as the reasoning as to why a buyer and seller are bound by written allocations. The appeals officer stated, "[t]he term building is per se section 1250 property."

On March 7, 2008 the IRS issued a Notice of Deficiency to the Taxpayer. The methodology and the merits of the cost segregation study were not addressed by the Internal Revenue Service at the administrative level. Doc. 18, paragraph 6 in the Stipulation of Facts and the history of the IRS's examination of the cost segregation study.

Exhibit 12-P, Complete Self Contained Appraisal, is a business record which is used as an authoritative source in the Cost Segregation Study report. Doc. 62, Pgs. 43, 77. Doc. 63, Pgs. 113, 134 & 220, Exhibit 14-P.

Exhibit 13-P, Complete Self Contained Appraisal, is a business record which is used as an authoritative source in the Cost Segregation Study report. Doc. 62, pg. 69, 77. Doc. 63, Pgs. 113 & 220, Exhibit 14-P.

Exhibit 14-P, Cost Segregation Study, is a business record which sets forth the methodology used in segregating the I.R.C. § 1245 property from the I.R.C. § 1250 property with respect to the assets at issue in this case. Doc. 63, Pg. 220, Exhibit 14-P.

D. Standard of Review

In *Estate of Wallace v. Commissioner*, 965 F.2d 1038 (11th Cir. 1992), the Eleventh Circuit Court of Appeals held that a trial court's findings of ultimate facts would be reviewed under a clearly erroneous standard. See *Pullman-Standard v. Swint*, 456 U.S. 273 (1982). However, the court further stated: "the Tax Court's rulings on the interpretation and application of the statute are conclusions of law subject to *de novo* review," *Young v. Commissioner*, 926 F.2d 1083 (11th Cir. 1991), and the tax court's "findings of ultimate fact which result from the application of legal princdiples to subsidiary facts are subject to *de novo* review." *Walter v. Commissioner*, 753 F. 2d 35 (6th Cir.

1985). This standard was reiterated in *Sleiman v. Commissioner*, 187 F.3d 1352 (11th Cir. 1999) as follows: "The Tax Court's rulings on the interpretation and application of the statute are conclusions of law subject to *de novo* review . . . and the tax court's findings of ultimate fact which result from the application of legal principles to subsidiary facts are subject to *de novo* review. (internal quotations, citations, and punctuation omitted). We review the tax court's other findings of fact for clear error. *See id.*"

SUMMARY OF THE ARGUMENT

Petitioner contends that the ultimate findings by the court, that the words used to describe assets in the purchase agreements involved preclude it from properly classifying the assets so purchased in accordance with the guidance of IRC §168(e) and the well developed body of case law which must be applied to make that classification, are clearly wrong and must be set aside. In addition, if neither IRC §1060 nor the rule in *Danielson* preclude taxpayer from appropriately classifying the assets acquired under the two asset purchase

agreements involved, the court should look behind respondent's notice of deficiency and shift the burden of proof to respondent.

ARGUMENT

I. The evidence before the United States Tax Court did not justify the inferences – the ultimate findings by the court – that the taxpayer is precluded, by including the abbreviation "Bld" to describe an asset in one asset purchase agreement and by using the term "Real Property Improvements" in a different asset purchase agreement, from properly classifying those assets under Internal Revenue Code §168(e).

A. Words used in an asset purchase agreement to describe a purchased asset bear no relevance in determining the proper classification of that property for depreciation purposes under §168(e) of the Internal Revenue Code.

The Tax Court took judicial notice of the Treasury Department's *Report to the Congress on Depreciation Recovery Periods and Methods* (July 28, 2000) at Doc 61 – pg 12. The report concludes that the legal distinction between section 1245 and section 1250 property is fact-specific and often ambiguous, requiring the character of a particular item of property to be decided by reference to nearly 40 years of regulations, rulings, and court decisions to decipher the correct meaning of terms such as "personal property," "real property," "buildings," and "structural components." See Exh. 11P, Pg 84. The

report notes that a complicating factor is that most legal decisions in this area were made in the context of determining eligibility for the (long-ago-repealed) investment tax credit, and not directly for deciding depreciation classification or recapture issues.

The assets here involved were placed into service by the taxpayer in 1996 and 1998 (Doc. 18: Exh. 7-J, Second Amendment; Exh. 8-J, Pg. 1). Accordingly, the Code requires the use of the Modified Accelerated Cost Recovery System (MACRS) to calculate the depreciation deductions for those assets. See Tax Reform Act of 1986, Pub. L. No. 99-514, secs. 201, 203.

The first step in using MACRS is classifying the assets to determine the proper recovery period and MACRS provides lists of the appropriate classifications for some specific assets. However, if an asset doesn't fit into one of the listed categories, the asset must be classified by class life. See IRC §168(e)(1). Once an asset is classified, MACRS informs the applicable depreciation method and recovery period. See 26 U.S.C. §168(b) and (c).

While residential real property is specifically described in §168(e)(2)(A) to mean any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units; under 26 U.S.C. §168(b)(3)(B), residential rental property must be depreciated using the straight line method and a recovery period of 27.5 years. §168(e), however, does not clearly define what constitutes a building.

§168(e)(2)(B) defines "nonresidential real property" to mean §1250 property which is neither residential rental property nor property with a class life of less than 27.5 years; however, §1250(c) defines §1250 property to mean any real property (other than §1245 property, as defined in §1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in 26 U.S.C. §167.

The guidance in §1245(a)(3) states that the term "section 1245 property" means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either: personal property (see §1245(a)(3)(A)); other property (not including a building or its structural components) but only if such

other property is tangible and has an adjusted basis in which there are reflected adjustments for depreciation taken for a period in which such property: was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services; constituted a research facility used in connection with any of the activities referred to in the previous clause; or constituted a facility used in connection with any of the activities referred to in the first clause for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state) (see §1245(a)(3)(B); a single purpose agricultural or horticultural structure (as defined in 26 U.S.C. §168(i)(13) -- see §1245(a)(3)(D)); as well as the items described in §§1245(a)(3)(C), (E) and (F)[1].

Thus, real property may have components which are "tangible personal property", and since §168(e) instructs that property is classified on the basis of its class life; 26 U.S.C. §168(i)(1) then directs the inquiry to 26 U.S.C. § 167(m), as in effect before its repeal, to determine what that is.

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[1] It does not appear that any of the items described in §§1245(a)(3)(C), (E) or (F) pertain to the facts of the instant case.

Former § 167(m) gave the Secretary authority to provide guidance on the class lives for each class of property so taxpayers can compute their depreciation expenses and periodically the Secretary amends the asset classes and periods that determine class lives and publishes the new ones in a revenue procedure. See sec. 1.167(a)-11(b)(4)(ii), Income Tax. Regs.

The revenue procedure in effect for the years at issue is Rev. Proc. 87-56, 1987-2 C.B. 674, which has as its stated purpose: "to set forth the class lives of property that are necessary to compute the depreciation allowances available under [26 U.S.C.] § 168 of the Internal Revenue Code." See Rev. Proc. 87-56, sec. 1, 1987-2 C.B. at 674. To accomplish this purpose, Rev. Proc. 87-56, sec. 5, 1987-2 C.B. at 675, describes certain classes of property and their recovery periods and lists other asset classes along with their class lives and appropriate recovery periods in a twelve-page table. If an item doesn't fall within that § or the table (or is not otherwise provided for by statute), then the property is treated as having no class life. *Id.* sec. 2.04, 1987-2 C.B. at 675.

§§1245 and 1250, with their accompanying regulations, confirm that §1.48-1, Income Tax Regs., must be referenced. Under §1245(a)(3)(A), depreciable personal property is §1245 property. §1245 in turn looks to §1.48-1(c), Income Tax Regs., see sec. 1.1245-3(b)(1), Income Tax Regs., to define tangible personal property: "Tangible personal property includes all property (*other than structural components*) which is contained in or attached to a building", sec. 1.48-1(c), Income Tax Regs. (emphasis added). Thus, structural components are § 1250 property. See sec. 1.1250-1(e)(3)(i), Income Tax Regs.; sec. 1.1245-3(c), Income Tax Regs., and §1.48-1(e), Income Tax Regs., provides the relevant definition of structural components.

However, upon finally arriving at §1.48-1, Income Tax Regs., which is entitled "Definition of § 38 property," referring to *former* 26 U.S.C. § 38, which dealt with the investment tax credit (ITC), the entire body of caselaw interpreting the ITC to determine whether §1.48-1(e), Income Tax Regs., becomes implicated in order to determine whether to classify the taxpayer's assets as structural components for purposes of

depreciation. *Hospital Corporation of America v. Commissioner,* 109 , T.C. 21, 54-55 (1997).

While § 1.48-1(e), Income Tax Regs., defines "building" and "structural components," § 1.48-1(e)(2), Income Tax Regs., provides:

> The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components *relating to the operation or maintenance of a building*. [Emphasis added.]

Thus, the ultimate inquiry which guides a taxpayer's determination of whether real property is either §1245 property or §1250 property is to determine whether an item — whether inside or outside the building — relates to the *operation or maintenance of a building.* See *Scott Paper Co. v. Commissioner*, 74 T.C. 137, 183 n.12

(1980). Words used to describe an asset are of no utility in connection with its categorization as a structural component.

The catchall language in the final phrase of § 1.48-1(e)(2), Income Tax Regs., modifies the specifically listed items so that even they, in "unusual circumstances," are tangible personal property when not relating to the overall operation or maintenance of a building. *Id.* at 183.

By elevating the importance of linguistics, i.e., words used to describe the assets here involved[2], to control the depreciable lives of those assets, the Tax Court failed to properly apply the body of law which has been consistently used by the courts, and must be used, to determine the proper MACRS classification of those assets. See *Hospital Corporation of America*, 109 T.C. at 69 (describing certain five-year property); *Morrison, Inc. v. Commissioner*, T.C. Memo. 1986-129, aff'd, 891 F.2d 857 (11th Cir. 1990). *Metro Nat'l Corp. v. Commissioner*,

[2] It should be noted that the precise words used in the Allocation Schedule with respect to the Asset Purchase Agreement through which the taxpayer acquired the assets in Sebastopol, MS on February 18, 1996 were "Processing Plant Bld", rather than the words "Processing plant building" as set forth in the allocation schedule at page 4 of the court's Memorandum Findings of Fact and Opinion. Doc. 70, Pg. 4, and also at Pgs. 10, 17, 19, 20, & 21.

T.C. Memo. 1987-38; *Duaine v. Commissioner*, T.C. Memo. 1985-39; *Samis v. Commissioner*, 76 T.C. 609, 618 (1981); *Whiteco Indus., Inc. v. Commissioner*, 65 T.C. 664 (1975); *Consol. Freightways, Inc. v. Commissioner* 708 F.2d 1385, 1390 (9th Cir. 1983) (citing *Whiteco*, 65 T.C. at 672-73), aff'g in part, rev'g in part 74 T.C. 768 (1980); *Mallinckrodt, Inc. v. Commissioner* T.C. Memo. 1984-532, aff'd, 778 F.2d 402 (8th Cir. 1985).

At the trial proceedings of this matter, see Doc. 61, Pg. 21, the Court engaged in the following colloquy with counsel for respondent:

THE COURT: But 1060 goes to basis. Right?

MR. McCLENDON: Yes, Your Honor.

THE COURT: It doesn't go to recovery period, does it?

MR. McCLENDON: No, Your Honor. It goes to basis.

With that background, it cannot be gainsaid that the words used to describe an asset control the classification of property for purposes of depreciation under §168(e). The court's conclusion to the contrary is clearly erroneous.

B. The distinctions made by the taxpayer between section 1245 and section 1250 property in making the proper classification under IRC §168(e) did not constitute a challenge to the form of the transaction.

As noted above, the *Report to the Congress on Depreciation Recovery Periods and Methods* (July 28, 2000) (See Exh. 11P, Pg 84.) concludes that the legal distinction between section 1245 and section 1250 property is fact-specific and often ambiguous, requiring the character of a particular item of property to be decided by reference to nearly 40 years of regulations, rulings, and court decisions to decipher the correct meaning of terms such as "personal property," "real property," "buildings," and "structural components."

In *United States v. Fort*, 638 F.3d 1334 (11th Cir. 2011) the United States Court of Appeals for the Eleventh Circuit clarified its application of the rule in *Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967), cert. denied 389 U.S. 858 (1967) to make that rule applicable only when a taxpayer challenges the ***form*** of a transaction. In that regard, the Court stated as follows: "Agreeing to a certain form of transaction is significant, because different transaction forms can yield different tax liability consequences. Yet, agreeing to ***form*** (*e.g.,* agreeing to sell A for

B on October 18, 1985) is different from agreeing that the result of the transaction will yield no tax liability in 1985."

With respect to the contention by the United States that the agreed upon form of the transaction had particular tax consequence, this Honorable Court held that such an argument was outside the scope of the *Danielson* rule, citing from *United States v. Fletcher*, 562 F.3d 839, 842-3 (7th Cir.2009), wherein the Seventh Circuit rejected reliance on the *Danielson* rule -- writing that "because the [plaintiff] does not try to recharacterize the transaction, doctrines that limit or foreclose taxpayers' ability to take such a step are beside the point."

In further clarification of its newly enunciated position, the Court cited *United States v. Nackel*, 686 F.Supp.2d 1008, 1019 (C.D. Cal. 2009) for the proposition: "The government impermissibly conflates case law concerning a party's effort to look through and re-characterize the form of a transaction with that which addresses what the parties intended would be the tax consequences of a transaction. The former is subject to the heightened scrutiny sought now by the government, the latter is not."

The Tax Court below incorrectly and impermissibly applied the rule in *Danielson*, *supra*, to govern the tax consequences of transactions in which Petitioner has made no attempt to characterize the asset acquisitions here involved in any way different than the form in which those asset acquisitions were structured. The taxpayer did not seek to deduct a covenant not to compete which was not agreed upon between the parties to the agreements, nor did the taxpayer seek to recharacterize either asset acquisition as a merger or lease or anything other than what they were -- asset acquisitions. Since the taxpayer has not sought and does not seek to recharacterize the transaction by looking through the form chosen in order to improve its tax treatment with the benefit of hindsight, the Tax Court below erred in applying the rule in *Danielson*, *supra*, to the facts of this case.

IRS Chief Counsel Advice Memorandum dated May 28, 1999 (CCA 199921045) advises that the determination of whether an asset is a structural component (i.e., I.R.C. § 1250 property) or tangible personal property (i.e., I.R.C. § 1245 property) is a facts and circumstances assessment and no bright-line test exists. At the time the

Commissioner issued Form 5701, Notice of Proposed Adjustment, to the taxpayer, the Fifth Circuit in *Brookshire Brothers Holding, Inc. & Subsidiaries v. Commissioner*, 320 F. 3d 507 (5th Cir. 2003), aff'g T.C. Memo. 2001-150, *reh'g en banc denied*, 65 Fed. Appx. 511 (5th Cir. 2003), the Fifth Circuit had held that a change in classification under MACRS is the functional equivalent of a change in useful life and, therefore, such a change fell under the useful life exception in Treas. Reg. §1.446-1(e)(2)(ii)(b). Also by that time, the Eighth Circuit in *O'Shaughnessy v. Commissioner*, 332 F.3d 1125 (8th Cir. 2003), *rev'g in part* 2002-1 U.S.T.C. (CCH) ¶50,235 (D. Minn. 2001), had adopted the analysis in *Brookshire* and held that a change in classification under MACRS fell within the useful life exception and did not constitute a change in method of accounting.

The Tax Court extended its reasoning in *Brookshire*, in *Green Forest Manufacturing Inc. v. Commissioner*, T.C. Memo. 2003-75. Citing from its own opinion in *Brookshire*, the court held that a change in computing depreciation from the general depreciation system in section 168(a) to the alternative depreciation system in section 168(g) is

a change in classification that falls within the useful life exception and, accordingly, is not a change in method of accounting.

While the Service and Treasury issued Treas. Reg. §1.446-1T(e)(2)(ii)(d) (TD 9105, 69 FR 5, January 2, 2004) providing the changes in computing depreciation or amortization under section 167, 168, 197, 26 U.S.C. 1400I, 26 U.S.C. 1400L(b), or 26 U.S.C. 1400L(c), or ACRS that are, and are not, a change in method of accounting under section 446(e), the applicability of those regulations was specified to apply to such a change in method of accounting made for taxable years ending on or after December 30, 2003. With respect to a change in depreciation or amortization that is not a change in method of accounting, the regulations were specified to apply to such a change made for taxable years ending on or after December 30, 2003.

In Chief Counsel Notice CC-2004-007, the IRS announced a change in litigating position for depreciable or amortizable property placed in service by the taxpayer in taxable years ending before the effective date of Treas. Reg. § 1.446-1T(e)(2)(ii)(d). In that notice, the Service stated that it would not assert that a change in computing

depreciation under section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or ACRS for depreciable or amortizable property that is treated as a capital asset under the taxpayer's present and proposed methods of accounting is a change in method of accounting under 26 U.S.C. §446(e). That Chief Counsel Notice contains the following example:

> Consequently, if, for example, a taxpayer completes a cost segregation study in 2004 for its MACRS property placed in service in 2001 and, as a result, reclassifies that property from nonresidential real property to 15-year property under section 168(e), the Service will not assert that the change in computing depreciation resulting from this reclassification is a change in method of accounting under section 446(e) and, accordingly, the taxpayer may file amended federal tax returns for 2001 and any affected subsequent taxable year to effect this change in computing depreciation. Alternatively, the taxpayer may treat this change in computing depreciation as a change in method of accounting and, thus, file a Form 3115 under new section 2.01 of the Appendix of Rev. Proc. 2002-9 for the current taxable year (provided the filing requirements of Rev. Proc. 2002-9 are met, and the taxpayer and the property are within the scope of Rev. Proc. 2002-9 and new section 2.01 of the Appendix of Rev. Proc. 2002-9).

In view of the Tax Court's holding in *Brookshire*, supra, its affirmance by the 5th Circuit, its ratification by the 8th Circuit in *O'Shaughnessy*, supra, and the Tax Court's extension of *Brookshire* in *Green Forest Manufacturing*, supra, the Tax Court's ruling in this case

that the taxpayer, by changing the MACRS classification of the assets purchased, has challenged the form of the transaction, is nearly impossible to reconcile.

The kind of change implemented by the taxpayer for the years here involved were the functional equivalent of a change in useful life, no more and no less. The useful life exception which existed under Treas. Reg. 1.446-1 at the time the taxpayer here involved changed the classification of the assets here involved, and was held by the Tax Court, the 5th Circuit and the 8th Circuit to exempt the taxpayers in the cases there involved from the need to have obtained the consent of the Commissioner under IRC §446(e), should similarly exempt Peco from dissimilar treatment by the Commissioner. The Tax Court erred in viewing Peco's change in the classification of the assets here involved as a challenge by the taxpayer to the form of the transaction.

The Tax Court erred in applying the rule in *Danielson*, supra, to govern the tax consequences of the asset acquisitions here involved, where the taxpayer has not made any attempt to characterize those acquisitions in any way different than the form in which those asset

acquisitions were structured. Peco has not sought to deduct a covenant not to compete which was not agreed upon between the parties to the agreements, nor has Petitioner sought to recharacterize either asset acquisition as a merger or lease or anything other than what they were -- asset acquisitions. Since Peco has not sought and does not seek to recharacterize the transaction by looking through the form chosen in order to improve its tax treatment with the benefit of hindsight, the rule in *Danielson*, supra, should not be applied to the facts of this case. The Eleventh Circuit's new explanation of the rule in *Danielson* as explained by the court in *Fort*, supra, should be applied.

C. The burden of proof should be shifted to respondent if neither the language of IRC §1060 nor the rule of *Danielson* preclude taxpayer from properly classifying the assets under the classification rule of IRC §168(e) and the applicable body of case law which must be used for that purpose.

Since no bright-line test exists, Petitioner asserts that the mere use of the term "Processing Plant Bld" or "Improvements" does not by itself permit Respondent to base its Notice of Deficiency upon a conclusion that such property is I.R.C. § 1250 property subject to a 39-year recovery period under the straight-line method of depreciation. In

similar fashion, insofar as the Eleventh Circuit has now ruled that the rule in *Danielson*, *infra,* is simply inapplicable to a case in which a taxpayer is not 'looking through' the form of a transaction to recharacterize that transaction, Respondent, by arbitrarily and erroneously refusing to examine the cost segregation study performed for Petitioner as to its merits on the false premise that I.R.C. § 1060 and the *Danielson* rule precluded such to be done, has rendered a naked assessment upon Petitioner which undermines the principle that tax cases are to be thoroughly investigated before, rather than after, the notice of deficiency is issued.

In consequence thereof, not only does respondent's IRC §1060(a) argument fail, but the second and final leg of respondent's position must also fall and respondent's endeavors to apply the rule in *Danielson*, supra, cannot survive the Eleventh Circuit's new explanation of that rule.

Insofar as I.R.C. §1060 does not require an interpretation of the allocation language contained in the respective asset purchase agreements as an allocation of purchase price solely among I.R.C. §1250

property and as highlighted by the court in *Westreco, Inc. v. Commissioner* (1990) T.C. Memo. 1990-501, an inadequate audit produces a docketed case that is ill-defined and unmanageable, thus requiring much more time by the Court and the attorneys to prepare the case for trial and to actually try the case. And while it is true that the Tax Court considers the Commissioner's determination to be presumptively correct, thereby placing on the taxpayer the burden of going forward and the burden of persuasion, if the taxpayer establishes that the Commissioner's determination is arbitrary, courts generally shift the burden onto the Commissioner, putting the Commissioner in the same position as a civil plaintif. See *Clapp v. Commissioner* (1989) 875 F.2d 1396.

Insofar as Respondent's construction of I.R.C. §1060 is unsupported by the flush language of that section, its legislative history, and no published ruling or regulation promulgated supports that construction, and in view of the erroneous application by Respondent of the Danielson rule to the facts herein, Respondent's

Notice of Deficiency is arbitrary and the proper remedy is to shift the burden to the Commissioner.

CONCLUSION

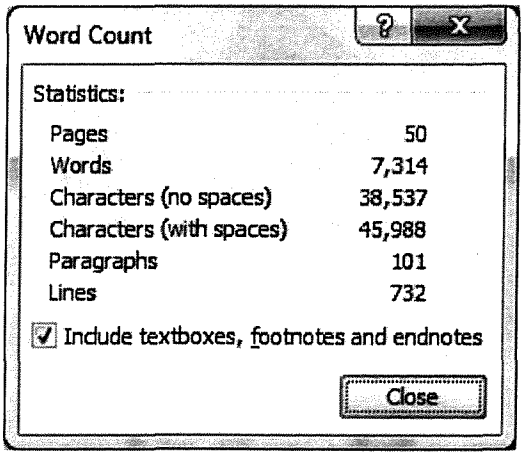
The Tax Court's decision for respondent should be overturned and the case remanded for further proceeding consistent with such a ruling.

CERTIFICATE OF COMPLIANCE

Taxpayer's brief is in compliance with the type-volume limitation of F.R. App. P. 32(a)(7)(B)(i) because this brief contains 7,314 words, excluding the parts of the brief exempted by Fed.R.App.P.32(a)(7)(B)(iii).

This brief complies with the typeface requirements of Fed.R.App.P.32(a)(5) and the type style requirements of Fed.R.App.P.32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2010 in 14 font Century style.

James H. Williams, III



CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing has been furnished by federal express this 11th day of June, 2012, to:

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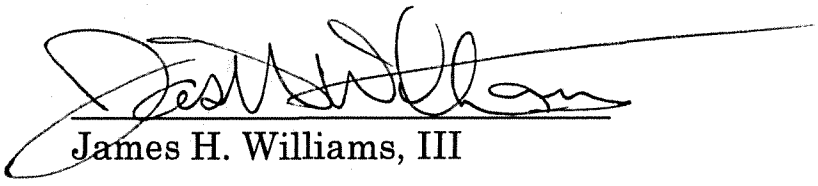

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