Cost Segregation Audit Techniques Guide - Chapter 2 - Legal Framework

Note: Each chapter in this Audit Techniques Guide (ATG) can be printed individually. Please follow the links at the beginning or end of this chapter to return to either the previous chapter or the Table of Contents or to proceed to the next chapter.

Chapter 1 | Table of Contents | Chapter 3

CHAPTER 2 - LEGAL FRAMEWORK

- Overview
- Bulletin F
- Component Depreciation
- Asset Depreciation Range (ADR)
- Accelerated Cost Recovery System (ACRS)
- Modified Accelerated Cost Recovery System (MACRS)
- Expensing Provisions And Bonus Depreciation - IRC §§ 168, 179, And 1400L
- What Is Tangible Personal Property?
- Investment Tax Credit - IRC § 48
- Tangible Personal Property
- Buildings And Structural Components
- Section 1245 And Section 1250 Property
- Functional Use Test
- Inherent Permanency Test And The Whiteco Factors
- Repeal Of ITC And Component Depreciation
- Hospital Corporation Of America (HCA) v. Commissioner
- Action On Decision
- Chief Counsel Guidance
- Lack Of Bright-Line Tests For Distinguishing § 1245 And § 1250 Property
- Summary And Conclusions

OVERVIEW

In order to better understand the tax controversy surrounding the use of cost segregation studies, it is important to review the relevant legal history and the motivations of taxpayers to allocate costs to personal property. The legislative and judicial history of depreciation, depreciation recapture, and Investment Tax Credit (ITC) are closely related. Accordingly, much of the discussion will focus on the rules and decisions impacting several interrelated Code sections (including ITC that was generally terminated in 1986). By establishing a legal framework for § 1245 and § 1250 property, examiners will have a better understanding of this issue and have a basis for determining property classifications and cost allocations.

The Internal Revenue Code (IRC) has historically authorized depreciation as an allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or for the production of income (IRC § 167 and the regulations thereunder). Several different methods are described for calculating depreciation under IRC §§ 167 and 168, including straight line, declining balance, sum-of-the-years digits, and income forecast. The deduction has generally been calculated with respect to the adjusted basis and useful life of (or recovery period for) the property and by utilizing an appropriate depreciation method. At one time, salvage value was also a factor in the computation. The shorter the useful life (or recovery period), the larger the current tax deduction, thus providing an incentive for tax purposes. Buildings and structural components have substantially longer depreciable lives than personal property. Therefore, it is desirable for taxpayers to maximize personal property costs in order to accelerate depreciation deductions and, hence, reduce tax liability. The remainder of this chapter provides a brief historical perspective of the statutes, rulings and major court cases that relate to depreciation and cost segregation studies.

back to the top

BULLETIN F

Many attempts have been made to provide bright-line tests for classifying property by its useful life (or recovery period) due to the frequent controversies that have arisen with the determination of economic life. For example, IRS Publication Number 173 (also known as "Bulletin F") was published in 1942 and provided a useful life guide for various types of property based on the nature of a taxpayer's business or industry. Bulletin F identified over 5,000 assets used in 57 different industries and activities and described two procedures for computing depreciation for buildings:

1. **Composite Method:** A depreciation chart provided a composite rate for buildings, including all installed building equipment. The recommended rates ranged from 1.5% per year for good quality warehouses and grain elevators to 3.5% per year for inexpensive theaters.
2. **Component Method:** Taxpayers could elect to depreciate the building equipment separately from the structure itself. A list provided lives for various types of structures, ranging from 50 years for apartments, hotels, and theaters, to 75 years for grain elevators and warehouses. A separate list provided lives for over 100 items of installed building equipment, ranging from 5 to 25 years, or the life of the building.

Regulation § 1.167(a)-7(a) allows taxpayers to either depreciate individual items on a separate basis or to combine assets into group accounts and depreciate the group account as a single asset. Historically, some taxpayers have interpreted this to mean that assets can be segregated into components and depreciated separately.

back to the top

COMPONENT DEPRECIATION

In 1959, the Tax Court recognized the right of taxpayers to calculate depreciation using a component method for newly constructed property **Shainberg vs. Commissioner**, 33 T.C. 241 (1959)]. While the building shell was given a useful life of 40 years, the plumbing, wiring, and elevators were assigned a life of 15 years, and the paving, roof, and heating and air conditioning systems were given a useful life of 10 years.

Revenue Procedure 62-21, 1962-2 C.B. 418, superceded Bulletin F and provided safe harbor useful lives based on industry-specific asset classes for taxpayers that met the reserve ratio test (a complex provision). As long as the taxpayer could demonstrate that its retirement policies were consistent with the selected class life, the Service would not challenge the useful life. The asset class for buildings included "…the structural shell of the building and all integral parts thereof…", as well as equipment which services normal heating, plumbing, air conditioning, fire prevention and power requirements, and equipment such as elevators and escalators. Except to the extent the class lives were incorporated into the Class Life Asset Depreciation Range System (ADR), this revenue procedure was revoked for all years after 1970.

Revenue Ruling 66-111, 1966-1 C.B. 46 (subsequently modified by Revenue Ruling 73-410, 1973-2 C.B. 53), addressed the use of component depreciation for used real property, in light of the decision in Shainberg. The ruling concluded that "When a used building is acquired for a lump sum consideration, separate components are not bought; a unified structure is purchased… Accordingly, an overall useful life for the building must be determined on the basis of the building as a whole."

Revenue Ruling 68-4, 1968-1 C.B. 77, concluded that the asset guideline classes outlined in Revenue Procedure 62-21 "…may only be used where all the assets of the guideline class (building shell and its components) are included in the same guideline class for which one overall composite life is used for computing depreciation."

back to the top

ASSET DEPRECIATION RANGE (ADR)

The elective ADR system was developed for tangible assets placed in service after 1970, with the intent of minimizing controversies about useful life, salvage value, and repairs. It also abolished the controversial reserve ratio test. Under the ADR system as enacted by former IRC § 167(m) and implemented by Revenue Procedure 72-10, 1972-1 C. B. 721, all tangible assets were placed in one of the more than 100 asset guideline classes (which generally corresponded to those set out in Rev. Proc. 62-21). The classes of assets were based on the business and industry of the taxpayer. In addition, each class of assets other than land improvements and buildings was given a range of years (called "asset depreciation range") that was about 20 percent above and below the class life. As long as taxpayers did not deviate from this range in useful lives, the Service would not challenge the useful life. An optional repair allowance method was also permitted at the election of the taxpayer.

If the taxpayer did not elect the ADR system, Revenue Ruling 73-410, 1973-2 C.B. 53, clarified that a taxpayer may utilize the component method of depreciating used property if a qualified appraiser "…properly allocates the costs between non-depreciable land and depreciable building components as of the date of purchase."

back to the top

ACCELERATED COST RECOVERY SYSTEM (ACRS)

Issues involving salvage value and useful life continued to arise, as well as controversy regarding the repair allowance, so Congress enacted IRC § 168 in 1981 (generally effective for property placed in service after December 31, 1980). The Accelerated Cost Recovery System (ACRS) was intended to provide a less complicated method for computing depreciation (known as "cost recovery") by eliminating salvage value and specifying recovery periods for various classes of assets. Depreciation deductions were calculated based on the applicable depreciation methods, recovery periods and placed-in-service conventions outlined in § 168. In contrast to the elective ADR system, ACRS was mandatory and provided only five (later six) recovery periods. ACRS also allowed for a faster write-off of assets than had been allowed under previous rules (e.g., the 40-year life for real property was reduced to either a 15, 18, or 19-year recovery period, as reflected by the 1985 amendments to ACRS).

back to the top

MODIFIED ACCELERATED COST RECOVERY SYSTEM (MACRS)

Significant modifications, generally less favorable to taxpayers, were made to ACRS by the Tax Reform Act of 1986 (effective for property placed in service after December 31, 1986). Under the Modified Accelerated Cost Recovery System (MACRS), the recovery period for buildings and structural components increased dramatically. For example, the 15, 18, or 19-year recovery periods for real property are now 39 years for nonresidential real property (or 31.5 years for nonresidential real property placed in service by the taxpayer before May 13, 1993) and to 27.5 years for residential rental property, under the general depreciation system of § 168(a). Equipment and machinery generally fall into the 3, 5, or 7-year recovery periods. Land improvements generally have a 15-year recovery period under the general depreciation system of § 168(a). The wide gap in MACRS recovery periods provides a strong incentive for taxpayers to allocate or reallocate costs of long- lived property to short-lived property, wherever possible.

Revenue Procedure 87-56, 1987-2 C. B. 674, provides the class lives and recovery periods for most MACRS assets. These determinations are based on the specific industry of a taxpayer and the specific activity for which the assets are used. But see discussion of Duke Energy Natural Gas Corporation v. Commissioner, 109 T.C. 416 (1997), rev'd, 172 F.3d 1255 (10th Cir. 1999), nonacq., 1999-2 C.B. xvi; Saginaw Bay Pipeline Co., et al v. United States, 124 F. Supp. 2d 465 (E.D. Mich. 2001), rev'd and rem'd, 2003 FED App. 0259P (6th Cir.) (No.01-2599); and Clajon Gas Co. LP, et al v. Commissioner, 119 T.C. 197 (2002), rev'd, 2004 U.S. App. LEXIS 284 (8th Cir. Mo. Jan. 12, 2004), and Revenue Ruling 2003-81, 2003-2 C.B. 126, on page 6.3-10. Appendix Chapter 6.3 provides an overview of recovery period determinations.

back to the top

EXPENSING PROVISIONS AND BONUS DEPRECIATION - IRC §§ 168, 179, AND 1400L

Another incentive for allocating costs to shorter-lived property is the expensing provision of IRC § 179. The ceiling limitation for expensing capital amounts invested in qualifying section 179 property (qualifying tangible personal property acquired by purchase for use in the active conduct of a trade or business) has steadily increased over time, from $10,000 to over $25,000 per year ($100,000 per year, adjusted annually for inflation, for certain qualifying property placed in service for taxable years beginning after December 31, 2002, and before January 1, 2008). By maximizing the costs allocable to tangible personal property, the taxpayer can not only get an immediate write-off under § 179, but also qualifies for a shorter recovery period under § 168 for any remaining basis in the property. Also, the 30-percent additional first year bonus depreciation allowance pursuant to § 168(k), enacted by the Job Creation and Worker Assistance Act of 2002 (Public Law 107-147), provides even further incentive for taxpayers to segregate property into shorter recovery periods. The Jobs and Growth Reconciliation Tax Act of 2003 recently increased the bonus depreciation under § 168(k) to 50 percent for certain qualifying property acquired after May 5, 2003, and placed in service before January 1, 2005 (January 1, 2006, for certain property with a longer production period). Code section 1400L provides special rules for qualifying property used by a business in the New York Liberty Zone. Also, Code section 1400N, as inacted by the Gulf Opportunity Zone Act of 2005, extends some of the rules to property acquisitions after August 28, 2005, and before December 31, 2007, (December 31, 2008, for residential rental and nonresidential real property), for use in areas impacted by Hurricanes Katrina, Rita, and Wilma.

back to the top

WHAT IS TANGIBLE PERSONAL PROPERTY?

While § 167 provides an allowance for depreciation for both tangible and intangible property, § 168 (as written) only applies to tangible property. Since neither § 167 nor § 168 provides a definition of tangible property, one must look to §

48 and the regulations thereunder (prior to the passage of Public Law 101-508) for definitions and examples of tangible property (as well as for buildings and structural components). This area will be discussed further in the following sections.

back to the top

INVESTMENT TAX CREDIT - IRC § 48

In order to stimulate the economy, Congress enacted Code § 48 in 1962. The ITC was designed to encourage the modernization and expansion of productive facilities through the purchase of certain new or used assets for use in a trade or business. Section 48 generally allowed a tax credit for investment in tangible depreciable property placed in service during the taxable year. The amount of the credit was the "applicable percentage" of the investment in qualifying property placed in service during the taxable year, depending on the useful life of the property and whether it was new or used when acquired. The percentage was initially 7 percent but was later increased to 10 percent (Revenue Act of 1978). The amount of the qualifying investment was limited and the ITC was subject to recapture if the property was not held for its entire useful life. Over the years, many other changes were made to the rules, including reductions in the depreciable basis of property for which ITC was claimed, temporary suspensions, termination, reinstatement, and, ultimately, the general repeal of ITC in 1986. Most of these revisions were related to the perceived economic needs of the country at the time they were enacted.

back to the top

TANGIBLE PERSONAL PROPERTY

Eligible ITC property is defined in former IRC § 48(a)(1) with reference to IRC § 38 (in fact, eligible property is often referred to as "section 38 property"). It included tangible personal property (other than heating or air conditioning units) and other tangible property (primarily machinery and equipment) that was closely integrated into the taxpayer's trade or business. Land, buildings, structural components contained in or attached to buildings, and other inherently permanent structures, generally were not eligible for ITC. Local law was not controlling with regard to property qualifying as tangible personal property for purposes of ITC.

Treas. Reg. § 1.48-1(c) provides examples of qualifying property, and states that

> …'tangible personal property' means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures).

This same subsection states that "tangible personal property" includes

> …all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Furthermore, all property that is in the nature of machinery (other than structural components of the building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

In addition, the regulations provide examples of non-qualifying property. For example, "…buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property."

The Senate Report accompanying the enactment of the Revenue Act of 1978 provided additional insight into Congressional intent by providing further examples of qualifying and non-qualifying property.

> …[T]he committee wishes to clarify present law by stating that tangible personal property already eligible for the investment tax credit includes special lighting (including lighting to illuminate the exterior of a building or store, but not lighting to illuminate parking areas), false balconies and other exterior ornamentation that have no more than an incidental relationship to the operation or maintenance of a building, and identity symbols that identify or relate to a particular retail establishment or restaurant such as special materials attached to the exterior or interior of a building or store and signs (other than billboards). Similarly, floor coverings which are not an integral part of the floor itself such as floor tile generally installed in a manner to be readily removed (that is it is not cemented, mudded, or otherwise permanently affixed to the building floor but, instead, has adhesives applied which are designed to ease its removal), carpeting, wall panel inserts such as those designed to contain condiments or to serve as a framing for picture of the products of a retail establishment, beverage bars, ornamental fixtures (such as coats-of-arms), artifacts (if depreciable), booths for seating, movable and removable partitions, and large and small pictures of scenery, persons, and the like which are attached to walls or suspended from the ceiling, are considered tangible personal property and not structural components. Consequently, under existing law, this property is already eligible for the ITC.

[S. Rep. No. 1263, 95th Cong., 2d Sess. 117 (1978), reprinted in 1978-2 C.B. Vol. 1 315,415.]

back to the top

BUILDINGS AND STRUCTURAL COMPONENTS

Treas. Reg. § 1.48-1(e)(1) provides a detailed explanation of buildings and their structural components for ITC purposes and has been the primary source for guidance, both with respect to component depreciation and cost segregation studies. The term "building" is described as

> …any structure or edifice enclosing a space within its walls and usually covered by a roof whereby the structure improves the land, and provides shelter or housing for work, office, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease.

Specifically excluded from the definition of the term "building" are the following:

> i. a structure which is essentially an item of machinery or equipment, or
>
> ii. a structure which houses property used as an integral part of an activity specified in section 1.48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure is closely related to the use of the property it houses include the fact that the structure is specifically designated to provide for the stress and other demands of such property and the

> fact that the structure could not be economically used for other purposes.

The term "structural components" is defined in § 1.48-1(e)(2) of the Regulations as

> …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 condition 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.
>
> However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components".

back to the top

SECTION 1245 AND SECTION 1250 PROPERTY

The benefits of the ITC were somewhat offset by the provisions of IRC §§ 1245 and 1250, also enacted in 1962. These Code sections result in the conversion of capital gain to ordinary income on the disposition of a property, to the extent its basis has been reduced by an accelerated depreciation method. The definitions of property for purposes of §§ 1245 and 1250 are very similar to that for ITC and make reference to the regulations under § 48 and the definitions under § 38 property. These interrelated Code sections and the regulations (38, 48, 1245 and 1250) provide the pertinent authority for determining eligibility for ITC. They also determine eligibility for the immediate write-offs under section 179, the appropriate recovery periods for depreciation (§§ 167 and 168) and for depreciation recapture upon a disposition.

The primary issue in cost segregation studies is the proper classification of assets as either § 1245 or § 1250 property. Accordingly, the ITC rules are critical in determining whether a taxpayer has classified property into the appropriate asset class.

Section 1245(a)(3) provides that "section 1245 property" is any property which is or has been subject to depreciation under § 167 and which is either personal property or other tangible property used as an integral part of certain activities. Such activities include manufacturing, production or extraction; furnishing transportation, communication, electrical energy, gas, water, or sewage disposal services. Certain other "special use" property also qualifies as § 1245 property, but is not of a primary concern for purposes of this discussion. It is important to note that § 1245(a)(3) specifically excludes a building or its structural components from the definition of § 1245 property.

Treas. Reg. § 1.1245-3 defines "personal property," "other tangible property," "building," and "structural component" by reference to Treas. Reg. § 1.48-1. As previously discussed, those regulations (§ 1.48-1) provide definitions of tangible personal property that qualifies as § 38 property for ITC.

Section 1250(c) defines "section 1250 property" as any real property, other than section 1245 property, which is or has been subject to an allowance for depreciation. In other words, § 1250 property encompasses all depreciable property that is not § 1245 property.

Land improvements (i.e., depreciable improvements made directly to or added to land), as defined in Asset Class 00.3 of Rev. Proc. 87-56, may be either § 1245 or § 1250 property and are depreciated over a 15-year recovery period. Buildings and structural components are specifically excluded from 15-year property. Examples of land improvements include sidewalks, roads, canals, waterways, drainage facilities, sewers, wharves and docks, bridges, fences, landscaping, shrubbery, and radio and television towers. Note that some activity asset classes also include land improvements such as asset class 57.1 of Rev. Proc. 87-56.

From a statutory standpoint, the primary test for determining whether an asset is § 1245 property eligible for ITC is to determine whether or not it is a structural component of a building. In other words, if an asset is not a structural component of a building, then it can be considered to be § 1245 property. The structural component determination hinges on what constitutes an inherently permanent structure and how permanently the asset is attached to such a structure. Clearly, this is a factually intensive determination and explains the lack of bright-line tests for segregating property into § 1245 and § 1250 classifications.

back to the top

FUNCTIONAL USE TEST

The early administrative rulings on ITC focused on a "functional use test" to determine whether an asset constituted § 1245 property. Rather than examining the inherent permanency characteristics of the asset, the test evaluated the purpose for which the asset was used. For example, if the asset served a function normally attributable to a structural component or permanent structure, it was not treated as tangible personal property even if it could be moved. However, following several conflicting court decisions which addressed the inherent permanency of particular assets, the Service shifted its focus from the functional use test to an evaluation of factors indicating inherent permanency.

back to the top

INHERENT PERMANENCY TEST AND THE "WHITECO FACTORS"

Revenue Ruling 75-178, 1975-1 C.B. 9 outlined several criteria to determine § 1245 property classification. These criteria included (1) whether the asset is movable or removable; (2) how the asset is attached to real property; (3) the design of the asset; and (4) whether the asset bears a load.

The classic pronouncement addressing inherent permanency was Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664, 672-673 (1975). The Tax Court, based on an analysis of judicial precedent, developed six questions designed to ascertain whether a particular asset qualifies as tangible personal property. These questions, referred to as the "Whiteco Factors," are:

1. Can the property be moved and has it been moved?
2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances that show that the property may or will have to be moved?
4. Is the property readily movable?
5. How much damage will the property sustain when it is removed?
6. How is the property affixed to land?

It should also be noted, however, that moveability is not the only determinative factor in measuring inherent permanency. In L.L. Bean, Inc. v. Comm., T.C. Memo. 1997-175, aff'd, 145 F.3d 53 (1st Cir. 1998), it was determined that, even though the structure could be moved, it was designed to remain permanently in place. Thus, it was determined to be an inherently permanent structure.

Examiners should also consider the following points when addressing the Whiteco factors:

- The manner in which an item is attached to a building or to the land,
- The weight and size of the item,
- The time and costs required to move the components,
- The number of personnel required in planning and executing a move,
- The type and quantity of equipment required for a move,
  The history of the item or similar items being moved,
- The time, cost, manpower and equipment required to reconfigure the existing space if the item is removed,
- Any intentions regarding the removal,
- Whether the item is designed to be moved, and
- Whether the item is readily usable in another location.

back to the top

REPEAL OF ITC AND COMPONENT DEPRECIATION

Due to the significant tax benefits derived from ITC-eligible property, the use of component depreciation proliferated during the 1970's and created problems not unlike those faced today by taxpayers, practitioners, and the Service regarding cost segregation studies. The problem became so pronounced during the late 1970's that Congress disallowed component depreciation as a method of computing depreciation for buildings, simultaneously with the enactment of ACRS in the Economic Recovery Tax Act of 1981 (ERTA) [see IRC § 168(f)(1)]. In addition to the controversies surrounding the determination of qualifying § 1245 property, the driving force behind this action was the disadvantage suffered by smaller taxpayers that could not afford to have expensive ITC studies performed.

In 1986, MACRS reiterated that the use of component depreciation was not allowable. Section 168(i)(6) provides that depreciation for any addition or improvement to property shall be computed in the same manner as the depreciation for the underlying property, as if the underlying property had been placed into service at the same time. [Prior to 1981, an asset composed of separately replaceable components could have been fragmented for depreciation purposes even though the interdependent components were parts of an integrated whole.].

back to the top

HOSPITAL CORPORATION OF AMERICA v. COMMISSIONER ("HCA") (1997)

A recent landmark decision, Hospital Corporation of America v. Commissioner, 109 T.C. 21 (1997)("HCA"), provided the legal support to use cost segregation studies for computing depreciation. In effect, this decision has reinstated a form of component depreciation.

In HCA, the Service took the position that certain property items were structural components of a building and that § 168(f)(1) prohibited the use of a component depreciation method for computing depreciation on buildings (including structural components). The Service also argued that § 168(f)(1) effectively changed the definition of tangible personal property for ACRS purposes (i.e., after the enactment of ACRS in 1981) by excluding any item attached to the building from being § 1245 property. Accordingly, the prohibition against component depreciation precluded an item from being treated as § 1245 property if it was attached to a building and had utility beyond its relationship to the particular piece of property.

However, Judge Wells ruled that the property at issue was § 1245 property and rejected the Service's argument that findings based on Treas. Reg. § 1.48-1(e) were inapplicable following the enactment of ACRS in 1981. Based on his review of the statutory and regulatory language, as well as case law, Judge Wells concluded that the enactment of ACRS did not redefine § 1250 property to include property that had been § 1245 property for purposes of ITC. Accordingly, the court determined that §168(f)(1), prohibiting component depreciation, applied only to §1250 property.

The HCA ruling effectively reinstated a form of component depreciation for certain building support systems, such as the electrical and plumbing systems that directly serve tangible personal property. Therefore, cost segregation methodologies previously used to allocate the cost of a building between structural components and ITC property can now be used for § 1245 and § 1250 property.

back to the top

ACTION ON DECISION

The Service did not appeal HCA since it could not state that the court's reasoning and decision were clearly erroneous. In an Action on Decision (AOD CC-1999-008), the Service acquiesced to the validity of the method approved by the court (i.e., pre-1981 ITC tests remained applicable for determining tangible personal property under both ACRS and MACRS). However, the Service non-acquiesced to the court's findings as to which specific assets qualified as tangible personal property. Two cases, LaPetite Academy and Boddie-Noell, were specifically referenced in the AOD with respect to the determination of structural components and tangible personal property. In Boddie-Noell Enterprises, Inc. v. United States, 36 Fed. Cl. 722 (1996), aff'd without op., 132 F.2d 54 (Fed Cir. 1997), the court held that acoustical tile ceilings, a portion of an electrical system and a plumbing system were structural components under the regulations. In LaPetite Academy, Inc. v. United States, 95-1 U.S.T.C. (CCH) 50,193 (W.D. Mo. 1995) aff'd without op., 72 F.2d 133 (8th Cir. 1995), wall panels, kitchen plumbing, bathroom accessories and a portion of the electrical system were held to be structural components under the regulations.

back to the top

CHIEF COUNSEL GUIDANCE

Chief Counsel issued further guidance to the field in the form of an advice memorandum dated May 28, 1999. It made the following observations and recommendations for field agents examining cost segregation studies:

- The determination of whether an asset is a structural component or tangible personal property is a facts-and-circumstances assessment.
- The use of cost segregation studies must be specifically applied by the taxpayer.
- Allocations must be based on a "logical and objective measure" of the portion of the equipment that constitutes § 1245 property.
- An accurate cost segregation study may not be based on non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records.
- Cost segregation studies should be closely scrutinized by the field.
- A change in depreciation method is a change in method of accounting, requiring the consent of the Secretary or his delegate.

[Note, however, that the recent 5th Circuit opinion in **Brookshire Brothers Holding, Inc. & Subsidiaries v. Commissioner**, 320 F.3d 507 (5th Cir. 2003), aff'g T.C. Memo. 2001-150, reh'g denied (March 31, 2003), which was adverse to the Service, may impact cases in that circuit. The court affirmed the Tax Court decision that the regulations allow taxpayers to make temporal changes in their depreciation schedules, as well as changes in the classification of property, without the consent of the IRS. However, the 10th Circuit opinion in **Kurzet v. Commissioner**, 222 F.3d 830 (10th Cir. 2000), was favorable to the government on this issue. Clearly, the issue is unsettled. However, Treas. Reg. § 1.446-1T(e)(2)(ii)(d)(2)(i), effective for taxable years ending on or after December 30, 2003, provides that a change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset is a change in method of accounting. See Example 9 of Treas. Reg. § 1.446-1T(e)(2)(iii), which specifically relates to changes based on a cost segregation study. On January 28, 2004, Chief Counsel Notice CC-2004-007 was issued, setting forth Chief Counsel's Change in Litigating Position on the application of § 446(e) to changes in computing depreciation. Examiners may contact the Change in Accounting Method Technical Advisors, for the most current information.

Reference may also be made to Appendix Chapter 6.2 for additional information and details regarding Notice CC-2004-007 (January 28, 2004).]

back to the top

LACK OF BRIGHT-LINE TESTS FOR DISTINGUISHING § 1245 AND § 1250 PROPERTY

A myriad of court cases has addressed the classification of property for ITC purposes. All of the cases are factually-intensive and quite often the opinions of the courts conflict. In addition, though the Service has issued numerous revenue rulings to address specific fact patterns, no bright-line tests have evolved. Because of this problem, significant controversy still exists regarding property classification for depreciation purposes.

It is beyond the scope of this chapter to review all the applicable cases. However, Appendix Chapter 6.4 provides a summary of the major court decisions and pronouncements in this area. This chapter is organized by case name and by construction division per the Construction Specification Institute (CSI) Master Format Division. In addition, specific guidance for the casino, restaurant, ahd retail industries is provided in Appendix Chapter 7.1, Appendix Chapter 7.2, Appendix Chapter 7.3, and Appendix Chapter 7.4, respectively.

back to the top

SUMMARY AND CONCLUSIONS

This chapter has provided a legal framework for distinguishing § 1245 property from § 1250 property and for determining appropriate recovery periods. It cannot be overemphasized that the classification of assets is a factually intensive determination. Based on HCA, the recent AOD, and the 1999 Chief Counsel Advice Memorandum, the use of cost segregation studies is expected to increase. Thus, examiners need to examine and evaluate a cost segregation study in light of the applicable statutes and judicial precedent established for a similar fact pattern.

In the next chapter, we will take a closer look at the methodologies used to prepare cost segregation studies.

Chapter 1 **|** Table of Contents **|** Chapter 3