

Summary Regulatory History of Cost Segregation

BACKGROUND

In order to calculate depreciation for Federal income tax purposes, taxpayers must use the correct method and proper recovery period for each asset or property owned. Property often consists of numerous asset types with different recovery periods, which must be separated into individual components or asset groups having the same recovery periods and placed-in-service dates.

When the actual cost of each individual component is available, this is a rather simple procedure. However, when only lump-sum costs are available, cost estimating techniques may be required to “segregate” or “allocate” costs to individual components of property (e.g., land, land improvements, buildings, equipment, furniture and fixtures, etc.). This type of analysis is generally called a “cost segregation study,” “cost segregation analysis,” or “cost allocation study.”

Significant tax benefits may be derived from utilizing shorter recovery periods. The issues for Internal Revenue Service Examiners (Service Examiners) are 1) the rationale used to segregate property into its various components, and 2) the methods used to allocate the total project costs among these components.

The most common situation is the allocation or reallocation of building costs to tangible personal property. A building, termed "section (§) 1250 property", is generally 39-year property eligible for straight-line depreciation. Equipment, furniture and fixtures, termed "section (§) 1245 property", are tangible personal property. Tangible personal property has a short recovery period, thus, a faster depreciation write-off (and tax benefit).

Property allocations and reallocations are typically based on criteria established under the Investment Tax Credit (ITC).

In a recent landmark decision, the Tax Court ruled that, to the extent tangible personal property is included in an acquisition or in overall costs, it should be treated as such for depreciation purposes. The court also decided that the rules for determining whether property qualifies as tangible personal property for purposes of ITC (under pre-1981 tax law) are also applicable to determining depreciation under current law. [See Hospital Corporation of America, 109 T.C. 21 (1997)] The Service acquiesced to the use of ITC rules for distinguishing § 1245 property from § 1250 property.

OVERVIEW

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.

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 Sec. 167 and the regulations thereunder.)

BULLETIN F

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:

Composite Method: A depreciation chart provided a composite rate for buildings, including all installed building equipment.

Component Method: Taxpayers could elect to depreciate the building equipment separately from the structure itself.

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)].

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).

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."

ASSET DEPRECIATION RANGE (ADR)

The elective ADR system, implemented by Revenue Procedure 72-10, 1972-1 C. B. 721, was developed for tangible assets placed in service after 1970. 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.

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."

ACCELERATED COST RECOVERY SYSTEM (ACRS)

Congress enacted IRC Sec. 168 I 1981. The ACRS was intended to provide a less complicated method for computing depreciation (known as "cost recovery" by eliminating salvage value and specifying recovery periods of various classes of assets. 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.

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, the recovery period for buildings and structural components increased dramatically.

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.

EXPENSING PROVISIONS AND BONUS DEPRECIATION

Another incentive for allocating costs to shorter-lived property is the expensing provision of IRC Sec. 179. 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. 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, 2006. Section 1400L provides special rules for qualifying property used by a business in the New York Liberty Zone.

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. 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.

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 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.

SECTION 1245 AND SECTION 1250 PROPERTY

The benefits of the ITC were somewhat offset by the provisions of IRC Sec. 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 Sec. 1245 and 1250 are very similar to that for ITC and make reference to the regulations under Sec. 48 and the definitions under Sec. 38 property. These interrelated Code sections and the regulations (38, 48, 1245 and 1250) provide the pertinent authority for determining eligibility for ITC.

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.

INHERENT PERMANENCY TEST AND THE “WHITECO FACTORS”

Revenue Ruling 75-178, 1975-1 C.B.9 outlined several criteria to determine Sec. 1245 property classification. 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. The questions were referred to as the “Whiteco Factors.”

It should also be noted, however, that movability 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.

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 1986, MACRS reiterated that the use of component depreciation was not allowable.

HOSPITAL CORPORATION OF AMERICA v. COMMISSIONER (“HCA”) (1997)

A 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). However, Judge Wells ruled that the property at issue was § 1245 property and rejected the Service's argument. 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.

CHIEF COUNSEL GUIDANCE (on method of accounting)

Chief Counsel issued further guidance to the field in the form of an advice memorandum dated May 28, 1999. One observation was -- 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.

In general, it is the position of the Service that a change in depreciation method, recovery period, or convention for depreciable property resulting from the reclassification of property is a change in accounting method. Such a change requires the consent of the Commissioner (i.e., the taxpayer must generally file Form 3115, Application for Change in Accounting Method) and the adjustment to income is made pursuant to IRC § 481(a). Accordingly, claims for adjustment based on a cost segregation study performed after the original return was filed should not be allowed (i.e., unless a Form 3115 has been filed).

The issue of whether or not changes in depreciation methods, conventions, or recovery periods constitute accounting method changes is unsettled due to conflicting court opinions. However, Treas. Reg. § 1.446-1T(e)(2)(ii)(d)(2)(i) and Example 9 of Treas. Reg. § 1.446-1T(e)(2)(iii), effective for taxable years ending on or after December 30, 2003, provide that they do constitute changes in method of accounting.

Taxpayers may conduct a cost segregation study on used property and then recompute its depreciation deductions for prior years.

Service Position on Method of Accounting

In general, it is the position of the Service that in the year an asset is placed in service, an accounting method is adopted relative to the depreciation method, recovery period, or convention for the depreciable property. In any subsequent year from the placed-in-service year, a change in depreciation method, recovery period, or convention resulting from a reclassification of such property, results in a change in method of accounting. Such a change requires the consent of the Commissioner (i.e., the taxpayer must generally file Form 3115, Application for Change in Accounting Method), and the adjustment to income is made pursuant to IRC § 481(a). If a taxpayer has adopted a method of accounting, the taxpayer may not change the method by amending its prior income tax returns. See Rev. Rul. 90-38, 1990-1 C.B. 57. Accordingly, amended returns or claims for adjustment, based on a cost segregation study performed after the original return was filed (for the placed-in-service year), should generally be disallowed on the basis that the taxpayer is attempting to make a retroactive method change.

LOOK-BACK STUDIES

The correct procedure for a taxpayer to change its accounting method is the timely filing of Form 3115, Request for Change in Accounting Method. Pursuant to Revenue Procedure 2002-9, 2002-3 I.R.B. 327, a taxpayer may request automatic consent for the change.

It is the position of the Service that a change in recovery period is a change in accounting method. Accordingly, a taxpayer is required to obtain the consent of the Commissioner by filing a timely Form 3115.

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.

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SUMMARY AND CONCLUSIONS

The foregoing commentary has described key portions of the legal framework for distinguishing Sec. 1245 property from Sec. 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.

Cost Segregation

Historical Background Recap

In order to compute depreciation using proper class lives and recovery periods, assets must be assigned to the proper asset classes. Cost segregation studies generally produce listings or groups of assets, based on asset classes under ACRS (Accelerated Cost Recovery System) or MACRS (Modified Accelerated Cost Recovery System).

Pre-ACRS/ MACRS Depreciation Methods - Prior to 1981

Prior to the enactment of ACRS in 1981, depreciation deductions were generally calculated by applying the appropriate depreciation method to the basis, useful life, and salvage value of the asset. Taxpayers were permitted to use component depreciation, whereby assets were segregated into separate components with different useful lives, which were depreciated separately. Alternatively, taxpayers could elect to use the Asset Depreciation Range (ADR) system for computing depreciation deductions. Property was generally classified as either § 1245 or § 1250 property, based on the rules governing Investment Tax Credit (ITC), pursuant to Code § 48 and the regulations thereunder.

ACRS /MACRS Depreciation Methods - Post-1980

Following the enactment of the ACRS depreciation system in 1981, component depreciation was specifically prohibited. The Service position has been that this prohibition continued under the MACRS depreciation system, enacted in 1986. Generally, ACRS is effective for property placed in use between 1981 and 1986, and MACRS is effective for property placed in use after 1986.

Hospital Corporation of America, Inc. v. Commissioner, 109 T.C. 21 (1997) ("HCA")

In HCA, the Tax Court concluded that the taxpayer was permitted to apply ITC principles to classify property as either § 1245 property or § 1250 property for purposes of determining asset classes and recovery periods under ACRS and MACRS. In effect, the HCA decision has reinstated a form of component depreciation.

Action on Decision (AOD) Number CC-1999-008

In Action on Decision (AOD) Number CC-1999-008, the Service acquiesced to the application of ITC principles in the HCA case. However, the Service did not acquiesce to the particular results in this case (i.e., the Service did not agree with the classification of specific assets as qualifying § 1245 property).

Use of Cost Segregation Studies to Compute Depreciation Deductions

Based on these developments, the use of cost segregation studies by taxpayers to accelerate depreciation deductions is expected to increase. The assignment of assets to the appropriate asset class is critical in determining the proper recovery period and, accordingly, the amount of depreciation.