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CAREFUL ALLOCATION BETWEEN PERSONAL PROPERTY (SECTION 1245) AND REAL PROPERTY (SECTION 1250) CAN BOOST FIRST-YEAR DEPRECIATION WRITEOFFS

Businesses interested in maximizing their first-year writeoffs have a powerful incentive to place new assets in service this year. Under current tax laws (Code Sec. 168(k)), they can write off 100% of the cost of qualifying assets in the placed-in-service year. Most building costs are long-lived Code Sec. 1250 property and generally are ineligible for the 100% first-year writeoff, unless they are qualified leasehold improvement property. However, as this *Tax Alert* explains, enterprises or investors that build, renovate or expand commercial properties this year still can wind up with big first-year writeoffs. That's because many of the assets installed in a commercial building may in fact be Code Sec. 1245 personal property (as opposed to Code Sec. 1250 realty) and, as such, may be eligible for 100% bonus first-year depreciation.

BEST TERMS EVER FOR BONUS DEPRECIATION

In general, an asset qualifies for the 100% bonus depreciation allowance if:

- It is property to which the modified accelerated cost recovery system (MACRS) rules apply with a recovery period of 20 years or less; computer software other than computer software covered by Code Sec. 197; qualified leasehold improvement property; or certain water utility property;
- It is acquired and placed in service after Sept. 8, 2010 and before Jan. 1, 2012 (placed in service before Jan. 1, 2013 for certain long production property and aircraft); and
- Its original use commences with the taxpayer. (Code Sec. 168(k)(5))

Please note: The 100% first-year writeoff rules are not likely to be extended. So, for most qualifying property, taxpayers that want to front-load their depreciation deductions are well advised to make their moves early enough so that the assets are placed in service by the end of this year.

SEC. 1250 VS. SEC. 1245 PROPERTY

Code Sec. 1250 property that is a non-residential building (as well as its structural components) generally is depreciated over a 39-year recovery period using the straight-line method. Because of that long recovery period, it is not eligible for bonus depreciation (except for assets that are “qualified leasehold improvement property.” It also can't be expensed under first-year writeoff of Code Sec. 179. Some types of land improvements are, however, recoverable over a 15-year MACRS period, even though they are Code Sec. 1250 property, and may be eligible for the 100% bonus first-year depreciation deduction. Additionally, most types of Code Sec. 1245 property (by and large, tangible personal property) are eligible for bonus first-year depreciation (and may be expensed under Code Sec. 179).

In the depreciation context, there is no stand-alone definition of “personal property.” Instead, the tax regulations say the term is defined the same way as “tangible personal property” is defined under Reg. § 1.48-1(c), which deals with property eligible for the repealed investment tax credit (ITC).

COST SEGREGATION STUDIES

Commercial building owners often conduct detailed cost segregation studies or analyses to distinguish items of Section 1245 property from items of Section 1250 property, and to find shorter-lived (15-year) Section 1250 property. Following a number of pro-taxpayer court decisions, these studies have been aggressive in designating property as Section 1245 property. Such studies will be valuable assets for businesses or investors that build, renovate, or expand commercial properties this year.

Please note: The leading case on the shorter tax lives issue is *Hospital Corp of America & Subsidiaries*, in which the Tax Court held that realty-related property is rapidly depreciable tangible personal property (rather than slowly recoverable section 1250 commercial realty) if it would have been classified by the courts as tangible property for ITC purposes. The Tax Court OK'd quick writeoffs for a wide variety of assets, including part of the cost of the primary and secondary electrical distribution systems (as well as a portion of other electrical components), carpeting, vinyl wall coverings, and accordion-style room partitions. IRS acquiesced in the *Hospital Corp* holding that the tests developed under the ITC are applicable in determining whether an asset is a structural component for purposes of ACRS and MACRS depreciation.

VALUABLE GUIDANCE IN IRS FIELD DIRECTIVES

IRS has published a series of Field Directives on the planning and examination of cost segregation issues in various industries (restaurant, casino, retail, pharmaceutical, auto dealership) that categorize a wide array of assets as either Section 1250 property that must be written off over 39 years (or over 15 years, if it is a qualifying land improvement) or Section 1245 property that is depreciable over 5 or 7 years depending on the type of asset.

The Field Directives say that if a return position for enumerated assets is consistent with the Directives' recommendations, examiners should not make adjustments to the categorization of assets or their recovery period.

Please note: The Field Directives all declare that they are not an official pronouncement of the law or IRS's position and cannot be used, cited or relied upon as such. Nevertheless, their classification of assets provides valuable guidance to a broad range of commercial property owners whose buildings are likely to contain many of the types of assets classified as Section 1245 property (or 15-year real property) in the Field Directives. And, as a practical matter, it seems unlikely that an auditor will challenge the classification of broad asset types treated as Section 1245 property (or 15-year real property) in the Field Directives (e.g., signs and decorative light fixtures), even if the taxpayer is not in one of the industries covered by the Directives.

ASSETS ELIGIBLE FOR QUICK WRITEOFF

Following are some of the more widely applicable types of assets classified as having shorter recovery periods by the Field Directives, and therefore eligible for a 100% first-year writeoff if they otherwise qualify under Code Sec. 168(k) (see discussion above). The assets generally are recoverable over a 5- or 7-year MACRS period, depending on the type of industry, unless otherwise indicated.

- ***Canopies and awnings.*** Readily removable equipment or apparatus used for providing shade or cover. Includes canopies that are largely decorative, but not canopies that are an integral part of a building's structural shell.
- ***Decorative millwork.*** This is decorative finished carpentry, examples of which include detailed crown moldings, lattice work placed over finished walls or ceilings, and cabinets. Decorative millwork serves to enhance the overall décor of the business (e.g., restaurant, casino) and is not related to the operation of the building. (Cabinets and counters in a restroom are excluded from this category.)
- ***Doors.*** Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area (e.g., "Eliason" type door). For example, flexible doors, clear curtains, or strip curtains used between stock areas and selling areas.
- ***Electrical outlets.*** Only those outlets specifically associated with particular items of machinery and equipment (as opposed to operation of the building as a whole).
- ***Electrical connections.*** Special electrical connections which are necessary to and used

directly with a specific item of machinery or equipment or connections between specific items of individual machinery or equipment, such as dedicated electrical outlets, wiring, conduit, and circuit breakers by which machinery and equipment is connected to the electrical distribution system.

- **Facades in interior of building.** Facades, such as a false storefronts, made primarily of synthetic materials (foam, fiberglass, cast stone, or glass reinforced concrete) that are not permanently attached and not intended to be permanent. This category would include false balconies, as well as finishes on interior columns that are not permanently attached and not intended to be permanent.
- **Fire protection equipment.** This includes special fire detection or suppression systems directly associated with a piece of equipment. For example, a fire extinguisher designed and used for protection against a particular hazard created by the business activity (e.g., a restaurant).
- **Floor coverings.** Only if not permanently attached and not intended to be permanent, such as vinyl composition tile installed with strippable adhesive, sheet vinyl, and carpeting.
- **Foundations or footings, concrete.** Foundations or footings for signs, light poles, canopies and other land improvements have a 15-year MACRS recovery period.
- **Heating, ventilation, and air conditioning (HVAC).** The HVAC unit must meet the sole justification test (i.e., machinery the sole justification for the installation of which is that it is required to meet temperature or humidity requirements that are essential for the operation of other machinery (such as lifts in a car dealership) or the processing of materials or foodstuffs (in a kitchen setting)). A HVAC unit may meet this test 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.
- **Kiosks.** These are small, often prefabricated, retail outlets that aren't permanent.
- **Landscaping & shrubbery.** This is landscaping (including irrigation systems) that will be replaced contemporaneously with a related depreciable asset or that will be destroyed when the related depreciable asset is replaced. Examples: depreciable landscaping, shrubbery, trees, plant foliage, or sod

placed around a parking lot. Such assets have a 15-year MACRS recovery period.

- **Light fixtures, interior.** These are light fixtures that are decorative in nature and not necessary for the operation of the building. In other words, if all the decorative lighting were turned off, the other sources of lighting would provide sufficient light for the building. These fixtures are 5- or 7-year MACRS property depending on the type of industry.
- **Lighting, exterior.** Lighting that highlights only the landscaping or building exterior (but not parking areas or walkways), as well as plant grow lights, and that does not relate to the operation or maintenance of the building.
- **Lighting, exterior, pole mounted.** Outdoor lighting systems that are pole mounted or freestanding and serve to illuminate sidewalks, parking or recreation areas have a 15-year MACRS recovery period.
- **Music and public address (PA) system.** Equipment and apparatus used to provide amplified music or sound; also includes wiring. Does not include a PA system that is an integral part of a fire protection system.
- **Parking lots.** Grade level surface parking areas built of asphalt, brick, concrete, stone or similar material have a 15-year MACRS recovery period. This category includes bumper blocks, curb cuts, curb work, striping, landscape islands, perimeter fences, and sidewalks.

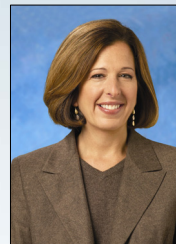
Please note: By contrast, in a Coordinated Issue Paper, IRS has said that open-air parking structures providing multi-level parking accessed by a ramp system are structures for Code Sec. 168 purposes and therefore are depreciable over 39 years. IRS's stance on stand-alone open-air parking structures is to be contrasted with its more favorable view of parking towers consisting of an auto carousel mechanism and supporting tower structure. PLR 9751010 says that such towers are tangible personal property for purposes of the Code Sec. 168 depreciation rules.

- **Poles and pylons.** Light poles for parking areas and poles used in concrete footings or bolt-mounted for signage have a 15-year MACRS recovery period.
- **Plumbing and similar hookups.** Water, gas, or refrigerant hook-ups, if directly connected to appliances or equipment needed for a particular type of business (e.g., restaurant or hair salon).

- **Security equipment.** Includes electronic article surveillance systems including surveillance cameras, recorders, monitors and related equipment, that have as a primary purpose the minimization of theft in retail areas.
- **Signs.** Interior and exterior signs used for display or theme identity, and any signage not pertinent to the operation of the building. Does not include exit signs.
- **Site grading.** All of the following assets have a 15-year MACRS recovery period:
 - Clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements.
 - Site work, including site drainage, sewers, roads, sidewalks, paving, curbing, general site improvements, site fencing and enclosures, and other site improvements not directly related to the building.
 - Patio stonework embedded in the ground and applied to exterior half walls that are not an integral part of the building's structural shell.
- **Walls, if movable.** These are interior (partition) walls built so that they can be (1) readily removed and remain in substantially the same condition after removal as before, or (2) moved and reused, stored or sold in their entirety.

- **Wall coverings.** Includes strippable wall paper and vinyl that causes no damage to the underlying wall or wall surface.
- **Window accessories.** Window accessories such as drapes, curtains, louvers, post-construction tinting that is readily removable, and interior decorative theme decor.

If you would like more details about any aspect of this tax law, our cost segregation services or other tax services, please do not hesitate to call your Brown Smith Wallace tax advisor at 314.983.1200 or contact:



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