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MEMORANDUM FOR JOSEPH M. ABELE
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FROM: HARVE M. LEWIS
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SUBJECT: DEPRECIATION/HCA–SPR-122705-98

You have asked for our response as to the position that examiners should take in light of the Tax Court's decision in Health Corp. of America, Inc. v. Commissioner, 109 T.C. 21 (1997) ("HCA"). In the following discussion we review the factors relevant to a determination of whether an item is a structural component of a building or tangible personal property, as well as what facts and circumstances may be of special concern to examiners. The determination is still a highly factual one, with no bright line tests.

In HCA petitioners argued that several disputed items associated with facilities built in the 1980's constituted Internal Revenue Code § 1245 property and therefore were appropriately depreciated using a 5-year recovery period (pursuant to petitioner's business asset guideline class under ACRS and MACRS). The Commissioner countered that allowing these items to be depreciated over a different recovery period than the buildings to which they related resulted in component depreciation, which is no longer allowed under ACRS and MACRS. Further, the Commissioner argued that investment tax credit ("ITC") cases involving years prior to 1981, when the cost recovery system was adopted and component depreciation was disallowed, are of limited application in determining what constitutes a structural component. Finally, the Commissioner took the position that these items were structural components and thus section 1250 property and should be depreciated over the same recovery period as the building to which they relate.

The Tax Court rejected the Commissioner's primary argument stating that in prohibiting component depreciation, Congress did not intend to redefine section 1250 property to include property which prior to the enactment of ACRS had been section 1245 property for the purposes of the ITC. The court looked at the statutory and regulatory language of ACRS and MACRS, as well as its legislative history and determined that to the extent disputed property would qualify as tangible personal property for ITC purposes under pre-1981 law, it will also qualify as tangible personal property for ACRS and MACRS.

The court then turned to the Commissioner's contention that the disputed items were structural components under an ITC analysis. The court examined each category of disputed items to determine whether the assets should be characterized as section 1250 property, a structural component of the facility, or section 1245 property, tangible personal property under Treas. Reg. § 1.48-1(c). In making this determination the court employed the factors set forth in Whiteco Indus., Inc. v. Commissioner, 65 T.C. 664, 672-673 (1975) to ascertain whether the items were inherently permanent and thus not tangible personal property within the meaning of Treas. Reg. § 1.48-1(c). These factors include: 1) Is the property capable of being moved, and has it in fact been moved?; 2) Is the property designed or constructed to remain permanently in place?; 3) Are there circumstances which tend to show the expected or intended length of affixation, i.e., are there circumstances which show that the property may or will have to be moved?; 4) How substantial a job is removal of the property and how time-consuming is it? Is it "readily removable?"; 5) How much damage will the property sustain upon its removal?; and 6) What is the manner of affixation of the property to the land? HCA, 109 T.C. at 57 (citing Whiteco, 65 T.C. at 672. The presence of one factor is not the sole determinant of what is tangible personal property. Id.

HCA went on to define structural components by way of example as set forth in §1.48-1(e)(2):

"building envelope"

> 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. . . . 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.

The court summarized the regulation saying, "an item constitutes a structural component of a building if the item relates to the operation and maintenance of the building. . . ." HCA, 109 T.C. at 58. Be aware, however, that the list may be misleading. The HCA court followed Scott Paper Co. v. Commissioner, 74 T.C. 137, 182-3 (1980) in determining that even though wiring is an example under Treas. Reg. § 1.48-1(e)(2), it is not a structural component unless it relates to the operation or maintenance of a building. HCA, 109 T.C. at 66. The focus, the court found, should be on ultimate use. Id. at 68. In addition, the Service has stated that it will not challenge the Scott Paper approach. Illinois Cereal Mills, Inc. v. Commissioner, T.C. Memo. 1983-469, *action on decision*, 1991-019 (Oct. 22, 1991).

Again, the determination of whether an asset is a structural component or tangible personal property is a facts and circumstances assessment. As noted above, pre-1981 case law and factors set forth therein are still relevant to the assessment. In view of the factual nature of the inquiry, no bright line test exists.

As a practical matter, it should be noted that the use of cost segregation studies must be specifically applied by the taxpayer. The HCA court sustained the Service's position that certain "allocated" equipment must be depreciated over the same period as the buildings to which they relate because the record did not provide any "logical and objective measure" of the portion of the equipment that would constitute § 1245 property. HCA, 109 T.C. at 92. 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. See Boddie-Noell Enterprises, Inc. v. United States, 36 Fed. Cl. 722, 746 (1996), aff'd without op. 132 F.2d 54 (Fed. Cir. 1997). Thus, cost segregation studies should be closely scrutinized by the field.

Treas. Reg. § 1.167(e)-1(a) provides that any change in the method of computing the depreciation allowances with respect to a particular account is a change in method of accounting. Further, the legislative history underlying the statutory language of section 446(e) and former section 167(e) clearly indicates that a change in depreciation method is a change in method of accounting. The legislative history of section 446(e) provides that a change in method of accounting includes "a change in the treatment of a material item such as . . . a change in the method of depreciating any property." S. Rep. No. 1622, 83d Cong., 2d Sess. (1954). The legislative history of former section 167(e) provides that "[a]ll changes in depreciation method are changes in accounting method under section 446(e) and, therefore, will require the consent of the Secretary or his delegate." S. Rep. No. 1622, 83d Cong., 2d Sess. (1954). Also, in Standard Oil Co. v. Commissioner,

77 T.C. 349 (1981), which concerned a taxpayer that reclassified certain assets from section 1250 property to section 1245 property and then sought to use different depreciation methods, the Tax Court stated that it "is unquestioned that a change in the method of computing depreciation is a change in the method of accounting." 77 T.C. at 410. Thus, a change in depreciation method is a change in method of accounting.

With respect to a change in recovery period or convention, Treas. Reg. § 1.446-1(e)(2)(ii)(a) indicates that such a change is a change in method of accounting. This section provides that a change in method of accounting includes a change in the treatment of any material item, and that a material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. The recovery period determines the period of time over which the basis of depreciable property is recovered. The convention determines the portion of the taxable year for which depreciation is allowable and determines how much of the applicable recovery period remains as of the beginning of the taxable year following the placed-in-service year. A change in recovery period or convention affects when, not whether, the cost of depreciable property will be recovered. Consequently, a change in recovery period or convention affects the timing of deductions and is a change in method of accounting.

Treas. Reg. § 1.446-1(e)(2)(i) provides that a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income using a new method for tax purposes, secure the consent of the Commissioner, whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

Sincerely,

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