Recent decisions allow for faster depreciation: Certified Public Accountant
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RECENT DECISIONS ALLOW FOR FASTER DEPRECIATION

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Recent developments will allow many businesses to accelerate their depreciation write-offs. In two separate matters, the IRS concluded that personal property used in hospitals and rental real estate businesses should be depreciated over five years (not seven years). The IRS's findings, however, may apply to a wide spectrum of businesses.

In one of the matters, the Tax Court further decided that certain property associated with realty constituted personal property and, therefore, could be depreciated over significantly shorter periods than the 27.5- or 39-year periods typically used for realty.

Hospital Corporation of America

Hospital Corporation of America (HCA) was one of the largest owner/operators of private hospitals and health care facilities in the United States. It is now part of the Columbia/HCA Healthcare Corporation system. From 1985 through 1988, HCA constructed a number of hospital facilities that were used in its trade or business. On tax returns for these years, HCA classified as tangible personal property (IRC section 1245 property) certain items related to the newly constructed hospital facilities and claimed depreciation deductions using a five-year recovery period. The IRS, however, determined that a number of those items were structural components of the related buildings (IRC section 1250 property) and should be depreciated over the same recovery period as the associated buildings.

Prior to the Tax Court opinion [*Hospital Corporation of America and Subsidiaries*, 109 T.C. 21 (1997)], HCA and the IRS agreed that if the disputed property constituted section 1245 class property, the property should be included in Class 57.0 of the asset guideline class tables. These tables provide the depreciable lives used in the class life asset depreciation range (ADR) system for property placed in service prior to 1981. The modified accelerated cost recovery system (MACRS) uses these tables to determine the appropriate recovery period. Class 57.0, Distributive Trades and Services, includes assets used in wholesale and retail trade and personal and professional services (Rev. Proc. 87-56). Assets included in Class 57.0 have a five-year recovery period for regular tax purposes under the general depreciation system (GDS) and a nine-year recovery period under the alternative depreciation system (ADS). However, if the property is placed in service after 1998, the same recovery period applies for both the regular tax and the alternative minimum tax (AMT).

The Tax Court, holding in favor of HCA, concluded that tests developed under pre-1981 law for purposes of the investment tax credit (ITC) are applicable in deciding whether assets constitute tangible personal property. Under the old ITC law, an asset was not ITC eligible if it was a building or other inherently permanent structure or a structural component of either. As synthesized by the Tax Court in *Whiteco Industries Inc.* [65 T.C. 664 (1975)], the following essential factors were examined to determine whether property was inherently permanent:

- Is the property capable of being moved, and has it in fact been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that tend to show the expected or intended length of affixation, i.e., are there circumstances that show that the property may or will have to be moved?
- How substantial and time-consuming a job is removal of the property? Is it "readily removable"?
- How much damage will the property sustain upon its removal?
- What is the manner of affixation of the property to the land?

The Tax Court further held, in *HCA*, that the prohibition contained in IRC section 168 against the use of the component method of depreciation does not preclude the use of analysis based on the "sole justification test" set forth in Treasury Regulations section 1.48-1(e), *Scott Paper Co. v. Comm'r* [74 T.C. 137 (1980)], and subsequent related decisions. Accordingly, such authorities are applied to assign appropriate recovery classes or recovery periods to the assets at issue.

Federal tax law does not look to local law for purposes of determining whether an item is personal property or a component of realty. Instead, Federal law looks to the relationship of the item to the building in determining its character [Treasury Regulations section 1.48-1(e)]. Therefore, items that may qualify as components of realty for sales tax or property tax purposes may nonetheless be considered personal property for Federal income tax purposes. An item constitutes a structural component of a building if the item relates to the operations and maintenance of the building. An item is not considered a structural component if its sole justification is to meet the temperature and humidity requirements of other machinery [Treasury Regulations section 1.48-1(e)(2)].

Taxpayers have expanded the sole justification test to include machinery that is used other than in the operation of the building. In *Scott Paper*, the taxpayer argued, and the Tax Court agreed, that the portion of the taxpayer's primary electrical distribution systems that did not relate to the overall operations or maintenance of buildings constituted tangible personal property and therefore was eligible for ITC.

On the basis of the above analysis, the Tax Court concluded that the following assets placed in service by HCA constituted section 1245 personal property: that portion of the primary and secondary electrical distribution systems associated with the hospital equipment, television wiring, telephone equipment, carpeting, vinyl wall and floor coverings, kitchen plumbing connections and exhaust hoods, patient corridor handrails, and accordion-style room dividers.

In Action on Decision 1999-008 (which can be found at ftp.fedworld.gov/pub/irs-aod/hcaaod.pdf), the IRS acquiesced to HCA regarding the concept that the ITC analysis has continued viability under ACRS and MACRS. However, the IRS disagrees, albeit with a degree of uncertainty, with the specific findings pertaining to the various disputed properties.

The IRS has indicated that it will closely scrutinize tax returns and related cost segregation studies that rely on *HCA*. An accurate cost segregation study "may not

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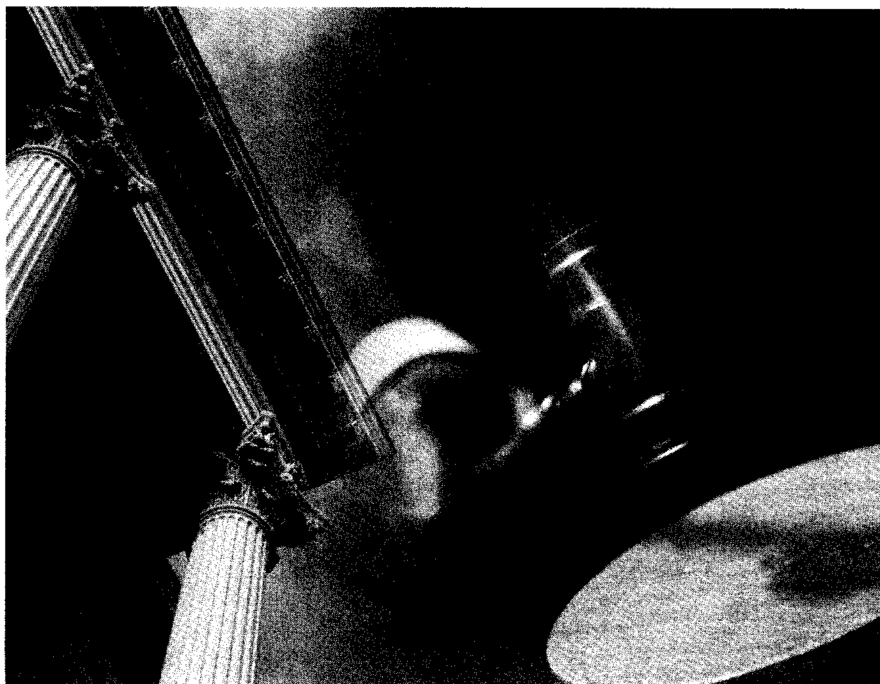

be based on noncontemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records." With respect to amended returns, which provide for changes in depreciation pursuant to *HCA*, prior approval of the change in depreciation period is required from the IRS commissioner, since a change in an asset's depreciation period is treated as a change in method of accounting (IRS Notice 1999-21045).

Announcement 99-82

The 1998 instructions for Form 4562, Depreciation and Amortization, and Publication 527, Residential Rental Property, erroneously classified certain personal property used in a rental real estate activity (appliances, carpeting, furniture) as seven-year property. The IRS has since announced that the correct classification is five-year property, because it is included in Asset Guideline Class 57.0, Distributive Trades and Services.

Announcement 99-82 outlines alternative courses of action taxpayers can take, depending upon when the property was placed in service and whether or not a return has been filed for such year, as shown in the following examples:

- For property placed in service during any tax year for which a return has not yet been filed, taxpayers must use a five-year recovery period under GDS (nine years under ADS), and a nine-year recovery period for property placed in service before 1999 for the AMT.
- For property placed in service during the most recent tax year for which a tax return has been filed, the taxpayer can either: 1) continue to depreciate the property using a seven-year recovery period under GDS (12 years under ADS) and a 12-year recovery period for property placed in service before 1999 for the AMT or 2) file an amended return for that year to change the recovery period from seven years to five years under GDS (12 years to nine years under ADS) and to change from a 12-year to a nine-year recovery period for property placed in service before 1999 for the AMT.
- For property placed in service during any tax year prior to the most recent tax year for which a tax return has been filed, the taxpayer can either: 1) continue to depreciate the property using a seven-year recovery period under GDS (12 years under ADS) and a 12-year recovery period for property placed in service before 1999 for the AMT or 2) file Form 3115, Application for Change in Accounting Method, to change to a five-year recovery period under GDS (nine years under ADS) and to change to a nine-year recovery period for property placed in service before 1999 for the AMT. The change is automatic and no user fee is required, but Form 3115 must be filed. See Rev. Proc. 98-60 for details on how to make the change and file Form 3115.

Office Furniture Used by the Professional

In general, equipment used by a professional service business is classified as Class 57.0 five-year property. However, office furniture, fixtures, and equipment are included in Class 00.11, which provides for a seven-year recovery period under GDS. Class 00.11 applies to all business industries. In the case of professional firms, including accounting firms, furniture is often modified to meet the unique requirements of the profession. For example, a drafting table used by an architect is designed differently than a standard desk. Likewise, tables used by accountants to collate financial statements and tax returns may not be considered standard office furniture. In cases where the furniture is designed or used to meet specific needs of a professional business, a strong argument can be made for Class 57.0 (five-year) treatment.

Advantage: Taxpayer

The following favorable actions are now available as a result of *HCA* and Announcement 99-82:

- Assets other than realty and office furniture placed in service by any wholesale, retail, or professional business should be reviewed for classification as Class 57.0 five-year property.
- Any significant realty acquired or constructed by the taxpayer should be examined by a qualified expert to see if tangible personal property can be carved out for specific depreciation treatment.
- The building systems associated with operations of machinery and equipment, computers, telephone, and video equipment should be depreciated over much shorter lives: In many cases, the correct recovery period is five years.
- Furniture designed or used to meet the unique needs of businesses in the wholesale and retail trades or providing professional services should be identified and treated as five-year property.

Both the Tax Court decision and the IRS announcement highlight the importance of the asset guideline class tables. In many cases, the recovery periods associated with industry-based categories are shorter than the typical 7-, 27.5-, and 39-year periods used by most taxpayers. ❑

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