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IRS

Cost Segregation Audit Technique Guide

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Table of Contents

Chapter 1 – Introduction 1

A. Preface 1

B. Purpose of the Cost Segregation Audit Techniques Guide 1

C. Background 1

D. Summary and Conclusions 3

Chapter 2 – Legal Framework 4

A. Overview 4

B. Early History of Depreciation 4

C. Bulletin F 5

D. Codification of Depreciation Changes 6

E. Guideline Life System 6

F. Asset Depreciation Range (ADR) System 7

G. Accelerated Cost Recovery System 7

H. Modified Accelerated Cost Recovery System 8

I. Section 1245 and 1250 Property 9

J. Investment Tax Credit - § 48 10

K. Tests for Distinguishing § 1245 and § 1250 Property 12

L. Inherently Permanent Test 12

M. Hospital Corporation of America Case 14

N. Electrical Distribution Systems 14

O. Incentives for Cost Segregation and Cost Recovery 15

P. Audit Guidance 16

Q. Summary 16

Chapter 3 – Cost Segration Approaches 17

A. Introduction 17

B. What are the Most Common Approaches Utilized for Cost Segregation Studies? 18

C. What are the Attributes of the Various Cost Segregation Approaches?.... 18

D. What Approach is Required by the IRS? 22

E. Summary and Conclusions 22

Chapter 4 – Principal Elements of a Quality Cost Segregation Study and Report 24

A. Introduction 24

B. What is a "Quality" Cost Segregation Study? 24

C. Principal Elements of a Quality Cost Segregation Study 24

D. Principal Elements of a Quality Cost Segregation Report 31

E. Summary and Conclusions 32

Chapter 5 – Review and Examination of a Cost Segregation Study 34

A. Introduction 34

B. Steps for Examining a Cost Segregation Study and Report 34

1. Initial Risk Analysis 34

2. Examination..... 38

3. Other Considerations 44

C.Summary and Conclusions..... 56

Chapter 6 Special Topics 57

A. Uniform Capitalization..... 57

1. Introduction 57

2. Application of the Capitalization Rules Under § 263A..... 57

3. Capitalization of Costs Under § 263A 57
4. Capitalization of Interest Under § 263A(f) 59
B. Change in Accounting Method 61
1. Introduction 61
2. Historical Service Position 61
3. Change in Litigating Position 63
4. Peco Foods Case 63
5. Tangible Regulations – Treas. Reg. §§§ 1.263(a)-1, -2, -3 64
6. Revenue Procedures Involving Method Changes 64
7. Summary 65
C. Depreciation Overview 66
1. Introduction 66
2. MACRS 66
3. Depreciation Periods and Conventions 67
4. Recovery Periods 68
5. Class Lives 70
6. Revenue Procedure 87-56 71
7. Examples 72
8. Additional References 73
D. Relevant Court Cases 74
1. Introduction 74
2. Arrangement of Information 74
3. Table 1: Case Law by Case Name (Reverse Chronological Order) 75
4. Table 2: Case Law by CSI MasterFormat Divisions (2004 and 1995) 84

5. Table 3: Listing of CSI MasterFormat Divisions (2004 and 1995)..... 94

6 MASTERFORMAT 1995 EDITION 95

E. Inherently Permanent Standard 96

1. Introduction 96

2. Inherently Permanent Standard Under § 168 96

3. Inherently Permanent Standard Under § 263A 99

4. Comparison of Inherently Permanent Standard Under §§ 168 and 263A.. 99

5. Inherently Permanent Standard Under § 199 102

6. Comparison of Inherently Permanent Standard Under §§ 168 and 199 .. 103

7. Conclusion 105

F. Construction Process 105

1. Introduction 105

2. Stages in the Construction Process 105

3. Other Project Delivery Methods 119

G. Information Document Requests 119

1. Introduction 119

2. IDR G.1 Purpose – To Identify the Participants and their Respective Roles in the Preparation of a Cost Segregation Study/Analysis 120

3. IDR G.2 Purpose – not Identify the Specific Properties Subject to Cost Segregation Study/Analysis 120

4. IDR G.3 Purpose – To Locate the Source of Property Blueprints and Drawings 120

5. IDR G.4 Purpose – To Obtain a Copy of the Cost Segregation Study..... 120

6. IDR G.5 Purpose – To Obtain a Copy of the Study Computations and Formula 120

7. IDR G.6 Purpose – To Ask Specific Questions about Segregated Properties 121

8. IDR G.7 Purpose – Request for Specific Items and Amounts 122

H. IRC §§ 179, 179D, and Bonus Depreciation 123

1. Recent Law 123

2. IRC § 179 Deduction 123

3. IRC § 179D Deduction… 124

4. Bonus Depreciation – In General 125

5. Acquisition Requirements and Placed in Service Dates 129

6. Bonus Depreciation Rates After 9/27/2017 131

7. Acquisition Requirement – In General 132

8. Chief Counsel Guidance on the Application of Bonus Depreciation Regulations to a Cost Segregation Study – FAA 20140202F 135

9. Method of Accounting Issues Related to Bonus Depreciation 137

10. Election Out of Bonus Depreciation 139

Chapter 7 Industry Specific Guidance 140

A. Casinos 141

B. Restaurants 153

C. Retail Industries 164

D. Pharmaceutical and Biotechnology 175

E. Auto Dealership Industry 190

F. Auto Manufacturing Industry 205

Chapter 8 Issue Specific Guidace 240

A. Electrical Distribution System 240

1. Introduction 240

2. Definitions and Building Electrical System Illustration 240
3. Legal Background 242
4. Functional Allocation – Illustration 244
5. Summary 251
B. Stand-Alone Open-Air Parking Structures 252
1. Introduction 252
2. Description of Stand-Alone Open-Air Parking Structures 252
3. Applicable Tax Law 253
4. Parties Positions 254
5. Analysis 255
6. Penalty 257
7. Summary 261

Chapter 1 – Introduction

Preface

The 2022 update of the Cost Segregation Audit Technique Guide was accomplished through collaboration led by the Deductible & Capital Expenditures Practice Network (DCE PN), the Methods of Accounting and Timing (MAT) Practice Network, and the Inventory & 263A Practice Network. Updates were necessitated due to changes in the tax law from the passage of the Protecting Americans from Tax Hikes (PATH) Act - P.L. 114-113, the Tax Cuts and Jobs Act (TCJA) – P.L. 115-97, the Coronavirus Aid, Relief, and Economic Security (CARES) Act – P.L. 116-136, and the Taxpayer Certainty and Disaster Tax Relief Act of 2020, enacted as Division EE of the Consolidated Appropriations Act, 2021 - P.L. 116-260. Topics updated include § 263A, Change of Accounting Method, Depreciation, Bonus Depreciation, § 179 deduction, § 179D deduction, and Qualified Improvement Property (QIP).

Purpose of the Cost Segregation Audit Techniques Guide

This Audit Techniques Guide (ATG) has been developed to assist Internal Revenue Service (Service) examiners in the review and examination of cost segregation studies. The primary goals are to provide examiners with an understanding of:

- **Why** cost segregation studies are performed for Federal income tax purposes;
- **How** cost segregation studies are prepared;
- **What** to look for in the review and examination of these studies; and,
- **When** certain issues identified in the cost segregation study need further examination.

The ATG was originally developed by a cross-functional team of Service Engineers and Revenue Agents. It was updated by members of the DCE PN and is not intended as an official IRS pronouncement. Accordingly, it may not be cited as authority.

Background

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, whether acquired or constructed, often consists of numerous asset types with different recovery periods. Property is typically separated into individual components or asset groups having the same recovery periods and placed-in-service dates to properly compute depreciation. When the actual cost of each individual component is available, this procedure is simple. When only lump-sum costs are available, however, 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."

An increasing number of taxpayers have submitted either original tax returns or claims for refund with depreciation deductions based on cost segregation studies. The underlying incentive for preparing these studies for Federal income tax purposes is the significant tax benefits derived from using shorter recovery periods and accelerated depreciation methods (including bonus depreciation and Internal Revenue Code (IRC) § 179 deduction) for computing depreciation deductions. Examiners need to understand both the rationale used to segregate property into its various components, and the methods used to allocate the total project costs among these components.

Cost segregation studies are most commonly prepared for the allocation or reallocation of building costs to tangible personal property. A building, termed "§ 1250 property", is generally non-residential real property (39-year) or residential rental property (27.5-year) property eligible for straight-line depreciation. Equipment, furniture, and fixtures, termed "§ 1245 property", are tangible personal property. Tangible personal property has a shorter recovery period (e.g., 5 or 7 years) and is also eligible for accelerated depreciation (e.g., double declining balance, bonus depreciation and § 179 deduction). Therefore, a faster depreciation write-off (and tax benefit) can be obtained by allocating property costs to § 1245 property.

The following example illustrates the tax benefits of a cost segregation study. In general, a turnkey construction project includes elements of tangible personal property (e.g., phone system, computer system, process piping, storage tanks, etc.). It is relatively easy to identify these items as § 1245 property and allocate a portion of the total project costs to them. A taxpayer's cost segregation study might also report certain building occupancy items (e.g., carpeting, wall coverings, partitions, millwork, lighting fixtures) as § 1245 property that likely would have been classified or grouped under § 1250 property without the completion of a cost segregation study. These items may or may not constitute as qualifying § 1245 property depending on the particular facts and circumstances for which the project was designed.

This next example illustrates the complexity of cost segregation issues. In addition to identifying specific project components that qualify as § 1245 property, cost segregation studies may treat portions of building components as § 1245 property. For example, some items of the building's electrical system support both § 1245 property and § 1250 property. The Study will typically identify the costs of the branch circuits feeding the § 1245 property and classify according to the recovery period of the § 1245 property (i.e., 5 or 7-year recovery). It may also identify that, for example, 15 percent of a building's electrical distribution system (EDS) directly supports § 1245 property, such as specialized kitchen equipment. Based on that conclusion, the study will then treat 15 percent of the EDS cost as § 1245 property along with the identified § 1245 branch circuits. See Chapter 8.A - Functional Allocation of a Buildings Electrical Distribution System for further details. The allocation of building components to § 1245 property is often a contentious issue.

Property allocations and reallocations are typically based on criteria established under the Investment Tax Credit (ITC) laws under § 48. Complex and often conflicting guidance relating to property qualifying for ITC, resulting from numerous legislative acts, court decisions and Service rulings, and a lack of bright-line tests, have impacted the ease of

distinguishing § 1245 property from § 1250 property. Related issues, such as the capitalization of interest and production costs under IRC § 263A and changes in accounting method, add to the complexity of this issue. For additional guidance on court rulings refer to Chapter 6.D - Relevant Court Cases included in this ATG.

In a 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.

This ATG provides technical information, audit techniques and examples of proper cost segregation studies to focus the efforts of examiners. The use of cost segregation studies will likely continue to increase, and there are currently no standards regarding the preparation of these studies. These studies vary widely in terms of the methodology, documentation, depth, format, and expertise of the study's preparer. This lack of consistency, coupled with the complexity of the law in this area, often results in an examination that can be controversial and burdensome for all parties.

Examiners reviewing cost segregation studies must determine the proper classification and correct costs of property. In some cases (e.g., small projects) examiners may be able to evaluate a study without assistance. However, other studies may require specialists with expertise, industry experience, and specialized training (e.g., Engineers, Computer Audit Specialists and/or DCE PN Senior Engineers and Revenue Agents). Examiners should perform a risk analysis as early as possible to determine the depth of an examination and the need for additional assistance.

Technical and/or procedural cost segregation questions may be submitted to the DCE PN.

Summary and Conclusions

Depreciation issues involving cost segregation studies cross all Large Business and International (LB&I) industry lines and impact Small Business and Self Employed (SB/SE) taxpayers as well. The lack of consistency in cost segregation studies and the absence of bright-line tests for distinguishing property contribute to the difficulties of this issue. The purpose of this ATG is to provide the foundation to a better understanding of cost segregation studies and to provide the examination steps that will facilitate the audit process and minimize burden on taxpayers, practitioners, and Service examiners alike.

Chapter 2 – Legal Framework

A. Overview

To better understand 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 asset classification, depreciation, 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 revoked in 1986).

The Internal Revenue Code (IRC) has historically authorized depreciation deductions 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 (§ 167 and the regulations thereunder). The deduction has generally been calculated with respect to the adjusted basis and useful life (or recovery period) of the property by utilizing an appropriate depreciation method. At one time, salvage value was also a factor in the computation. Buildings and structural components have substantially longer depreciable lives than tangible personal property. The shorter the useful life (or recovery period) of any given property will result in a larger annual tax deduction to the taxpayer. Therefore, it is desirable for taxpayers to maximize costs allocable to tangible personal property to accelerate depreciation deductions and reduce tax liability. This chapter provides a brief historical perspective of the statutes, regulations and major court cases that relate to cost segregation studies.

B. Early History of Depreciation

For about 20 years after the introduction of our present income tax system in 1913, taxpayers were generally given freedom to determine depreciation allowances. Both individuals and corporations could claim a reasonable allowance for depreciation of property arising out of its use or employment in the business or trade. The deductions claimed were not challenged unless it could be shown by clear and convincing evidence that they were unreasonable. Prior to 1934, a taxpayer had wide leeway as to the amount which could be written off each year against current income as an allowance for the cost of machinery, equipment, and buildings. As long as the taxpayer's policy was consistent and in accordance with sound accounting practice, the tax authorities raised little question, realizing that the cost could be written off only once. See Announcement 71-76, 1971-2 C.B. 503.

In 1934, the Treasury Regulations (Treas. Reg.) were amended to provide that the burden of proof would rest upon the taxpayer to sustain the depreciation deduction claimed. Taxpayers became responsible to furnish full and complete information with respect to the cost or other basis of the assets related to the claimed depreciation. The required information for each asset included the age, condition and remaining useful life, the portion of their cost or other basis, which had been recovered through depreciation allowances for prior taxable years, and any other information as the Commissioner may require in substantiation of the deduction claimed. Whatever plan or method of depreciation a

taxpayer would choose to adopt, it “must be reasonable and must have due regard to operating conditions during the taxable period.” T.D. 4422, 1934-1 C.B. 58.

C. Bulletin F

The earliest edition of Bulletin “F” was a pamphlet issued in 1920, which contained no schedule of suggested average lives, but defined depreciation as follows: “Depreciation means the gradual reduction in the value of property due to physical deterioration, exhaustion, wear, and tear through use in trade or business.” Obsolescence was treated as a separate and supplemental factor in computing the depreciation allowance where the facts supported an additional amount. Bulletin “F” was first revised in 1931, at which time the first schedule of suggested lives was published as a separate pamphlet. The schedule provided useful lives for individual assets used by industry groups. In Bulletin “F”, the Internal Revenue Service (Service) explicitly frowned on the use of a composite rate of depreciation; rather, the Service advocated depreciation by items or by groups of items having practically identical physical characteristics and length of life. In conjunction with the burden shifting from the Service to the taxpayer regarding depreciation deductions, useful life became largely determined by reference to standardized lives prescribed in Bulletin “F” and a taxpayer had a heavy burden of proof to sustain any shorter life for an individual asset.

Bulletin “F" underwent a second revision 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 14 different types of 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 lesser quality theaters. These composite depreciation rates correspond to useful lives ranging from 28.5 years to 66.7 years.
2. **Component Method:** Taxpayers could elect to depreciate building equipment separately from the structure. A list provided lives for various types of structures, ranging from 50 years for apartments, hotels, and theaters, to 75 years for warehouses and grain elevators. A separate list provided lives for over 100 items of installed building equipment, ranging from 5 to 25 years, with certain installed building equipment listed as having the same life as the life of the building in which it was installed.

Bulletin “F” also allowed taxpayers to either depreciate individual items on a separate basis or to combine assets into composite, classified, or 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.

D. Codification of Depreciation Changes

In 1954, major changes were made to depreciation laws. Aside from the authorization of new methods of depreciation, § 167(d) was added which authorized written agreements between the Service and taxpayers specifically dealing with the useful life and rate of depreciation of any property.

In 1956, the ability to depreciate on an account basis (first allowed in Bulletin “F”) was codified in Treas. Reg. § 1.167(a)-7(a). The regulations moved away from the concept of physical life, focusing instead on the period of time the property was used in the trade or business of the taxpayer. See Treas. Reg. § 1.167(a)-1(a). Also, as part of a policy designed to reduce administrative controversies, the Service codified a policy that it would only re-determine estimated useful life when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. See Treas. Reg. § 1.167(a)-1(b).

In *Shainberg vs. Commissioner*, 33 T.C. 241 (1959), the Service challenged the taxpayer’s method of depreciation of segregating buildings and the various items of equipment in the buildings into separate component groups. The Tax Court held that the taxpayer could calculate depreciation using a component grouping method as was their right under the regulations. In general, the courts have sustained the estimated useful lives assigned by taxpayers such as a 40-year life for the building structure, a 15-year life for the roofs, plumbing, wiring and elevators, and a 10-year life for the paving, ceilings, and heating and air conditioning systems.

E. Guideline Life System

Revenue Procedure (Rev. Proc.) 62-21, 1962-2 C.B. 418, superseded Bulletin “F”. Instead of thousands of asset classifications, assets were grouped into approximately 75 broad industrial classifications and by certain broad general asset classifications, with a “Guideline Life” established for each of these classes. The guideline lives were about 30-40 percent shorter than Bulletin “F” lives and about 15 percent shorter than the lives in actual use by taxpayers. Use of the guideline lives required taxpayers to meet a reserve ratio test (complex provision). The Rev. Proc. represented a fundamental change by treating assets as a class rather than as individual assets; even though assets within a class were heterogeneous with respect to ages, useful lives, and physical characteristics. 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.” The Rev. Proc. listed 13 different types of buildings, with guideline lives ranging from 40 years for apartments, hotels, and theaters, to 60 years for warehouses and grain elevators. The Guideline Life system did not address repair and maintenance expenditures.

Revenue Ruling (Rev. Rul.) 66-111, 1966-1 C.B. 46, addressed the use of component depreciation for used real property and distinguished its facts from those in *Shainberg,* Rev. Rul. 66-111 decided that "when a used building is acquired for a lump sum consideration, separate components are not bought; a unified structure is purchased” such that the value

of components (e.g., ceilings, floors, electrical systems, etc.) of a used building cannot be separated from the value of the building as a whole. Thus, the cost basis of used real property cannot be allocated into separate component accounts for determining a composite life in computing depreciation; rather, an overall useful life for the building must be determined based upon the building as a whole. The ruling was later modified by Rev. Rul. 73-410, 1973-2 C.B. 53, which held that the component method of computing depreciation may be utilized for used real property if: 1) the cost of acquisition is properly allocated to the various components based on their value; and 2) useful lives are assigned to the component accounts based on the condition of such components at the time of acquisition. See also *Lesser v. Commissioner*, 352 F.2d 789 (9th Cir. 1965).

Rev. Rul. 68-4, 1968-1 C.B. 77, concluded that "it is not proper to use the component method of computing depreciation by assigning the guideline class life from Rev. Proc. 62-21 to the structural shell of a building and assign different useful lives to the other integral parts or components of the building. Rev. Proc. 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."

F. Asset Depreciation Range (ADR) System

Rev. Proc. 72-10, 1972-1 C. B. 721, superseded Rev. Proc. 62-21 and set forth the Class Life Asset Depreciation Range (ADR) system for tangible assets placed in service after 1970. The purpose of the ADR system was to minimize controversies about useful life, salvage value, and repair and maintenance expenditures. It also abolished the controversial reserve ratio test. Under the elective ADR system, all tangible assets were grouped into more than 100 asset guideline classes (generally corresponding to those set out in Rev. Proc. 62-21) based on the business and industry of the taxpayer. Each class of assets (other than land improvements and buildings) was given a class life as well as a range of years (called "asset depreciation range") that was approximately 20 percent above and below the class life. A taxpayer could select a depreciation period from this range and it would not be challenged by the Service. Thus, the ADR system disassociated an asset's depreciation period from its useful life but treated it as the useful life for all income tax purposes, even though the depreciation period could be significantly shorter than the actual useful life. However, buildings were generally excluded from the ADR system (except for a 3-year transitional period). The ADR system served as a comprehensive scheme for dealing with property, including repair and maintenance expenditures (via an optional repair allowance) and salvage value. The asset guideline set forth in Rev. Proc. 72-10, was superseded by Rev. Proc. 77-10, 1977-1 C.B. 548, and served as an update to the asset guideline classes and class lives.

G. Accelerated Cost Recovery System

In 1981, Congress enacted the Accelerated Cost Recovery System (ACRS) to simplify the depreciation rules and to stimulate the economy by allowing greater deductions over shorter periods. ACRS eliminated salvage value, minimized exceptions and elections, and moved away from the useful life concept. ACRS allowed depreciation deductions (this term is used for convenience; since ACRS is not based on estimated useful lives, cost recovery

under it may not technically qualify as depreciation) for recovery property over a predetermined recovery period by applying a statutory percentage to its basis (cost). These statutory percentages were set forth in a series of tables. In contrast to the elective ADR system, ACRS was mandatory and provided only five (later six) recovery periods. ACRS allowed for a faster cost recovery of assets than had been allowed under previous rules (e.g., the 40-year life for real property was reduced to a 15, 18, or 19-year recovery period, depending on the placed-in-service date of the property). ACRS was generally applicable for property placed in service from 1981 through 1986.

ACRS prohibited component depreciation as a method of computing depreciation for buildings. ACRS required the depreciation deduction for any component of a building to be computed in the same manner as the deduction allowable for the building, beginning on the later of the date the component is placed in service or the building is placed in service. See former § 168(f)(1); Proposed Treas. Reg. §§ 1.168-2(e) and 1.168-6. The driving force behind this action was to eliminate controversies surrounding the determination of qualifying § 1245 property (as explained below).

H. Modified Accelerated Cost Recovery System

In 1986, Congress enacted the Modified Accelerated Cost Recovery System (MACRS). Cost recovery was now based on the applicable depreciation method, the applicable recovery period, and the applicable convention, as outlined in § 168. MACRS provided two depreciation systems: the general depreciation system and the alternative depreciation system (applicable for property used outside the United States, tax-exempt use property, property for which an alternative depreciation system election has been made, and a couple of other finite categories not germane to this discussion). MACRS also required appropriate basis adjustments to compute subsequent year deductions and modified other ACRS provisions including property classifications. The recovery period for buildings and structural components increased dramatically. For example, the 15, 18, or 19-year recovery periods for real property became 39 years for nonresidential real property (31.5 years for nonresidential real property placed in service before May 13, 1993) and 27.5 years for residential rental property, under the general depreciation system. Both types of buildings have a 40-year recovery period under the alternative depreciation system. In Rev. Proc. 87-57, 1987-2 C.B. 687, the Service furnished optional tables to provide applicable deduction percentages under MACRS.

The classification of property under MACRS is important because it affects the applicable depreciation method, recovery period, and convention. Each item of property depreciated under MACRS is assigned to a property class, which establishes the item's recovery period. The applicable recovery periods for MACRS are determined by statute or by reference to class lives. Class lives for MACRS are set forth in Rev. Proc. 87-56, 1987-2 C. B. 674. This Rev. Proc. establishes two broad categories of depreciable assets: 1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and 2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property can be described in both an asset category (asset classes 00.11 through 00.4) and an activity category (asset classes 01.1 through 80.0), in which case the item is classified in the asset category (unless it is

specifically included in the activity category). See *Norwest Corp. & Subs. v. Commissioner*, 111 T.C. 105 (1998) (item described in both an asset and an activity category should be placed in the asset category). Chapter 4 - Principal Elements of A Quality Cost Segregation Study and Report provides an overview of asset classifications and recovery period determinations.

MACRS continued the prohibition against the use of the component method of depreciation. Although MACRS repealed ACRS § 168(f)(1), which related specifically to components of § 1250 class property, it enacted § 168(i)(6), which provides that improvements made to real property are depreciated using the same recovery period applicable to the underlying property as if the underlying property were placed in service at the same time the improvements were made. Regarding improvements, the statute refers to § 1245 property and § 1250 property. § 168(i)(12) provides that the terms "§ 1245 property" and "§ 1250 property" have the meanings given such terms by § 1245(a)(3) and § 1250(c), respectively.

I. Section 1245 and 1250 Property

In 1962, Congress enacted the provisions of §§ 1245 and 1250. 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 essential for determining eligibility for a number of other Code provisions (including §§ 167, 168, 179, and former § 48). One of the primary issues in cost segregation studies is the proper classification of assets as either § 1245 or § 1250 property. The main difference between §§ 1245 and 1250 is whether the provisions apply to the entire amount or an applicable percentage of the gain.

Section 1245(a)(3) provides that "§ 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 (not including a building or its structural components) that was 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 relevant to this discussion. It is important to note that a building or its structural components is specifically excluded 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. This regulation relates to former § 48 which was enacted in 1962 along with §§ 1245 and 1250. § 48 allowed an Investment Tax Credit (ITC) based on the "applicable percentage" of the investment in tangible depreciable property placed in service during the taxable year. The ITC (§ 48) was later repealed in 1986.

Section 1250(c) defines "§ 1250 property" as any real property, other than § 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.

J. Investment Tax Credit - § 48

Eligible ITC property is defined in former § 48(a)(1) with reference to § 38 (in fact, eligible property is often referred to as "§ 38 property"). Eligible property 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 classifying property as tangible personal property for purposes of ITC.

Treas. Reg. § 1.48-1(c) defines “tangible personal property” as 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). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. 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 § 38. Further, 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. For example, a gasoline pump, hydraulic car lift or automatic vending machine, although annexed to the ground, shall be considered 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.]

Treas. Reg. § 1.48-1(e)(1) defines a "building" as any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, 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. It also 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: (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 [former] § 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 includes 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. Thus, the term “building” does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns and coal tipples.

Treas. Reg. § 1.48-1(e)(2) provides that "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.

However, the term "structural components" does not include machinery as 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 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."

K. Tests for Distinguishing § 1245 and § 1250 Property

There is no general bright-line test for segregating property into § 1245 property and § 1250 property classifications. Each situation is factually intensive and is dependent on the particular facts and circumstances involved.

From a regulatory standpoint, the primary test for determining whether an asset is § 1245 property eligible for ITC is to ascertain that it is not a building or other inherently permanent structure, including items which are structural components of such buildings or structures. In other words, if an asset is not a building or a structural component of a building, then it can be deemed to be § 1245 property. The determination of structural component hinges on what constitutes an inherently permanent structure, how permanently the asset is attached to such a structure and whether it relates to the operation or maintenance of the structure. See Treas. Reg. §§ 1.48-1(c)-(e).

Early administrative rulings by the Service on ITC focused on the use of a "functional" or "equivalency" test. This test is based on the determination that if the primary use of property is to provide for the functions normally served by inherently permanent structures or structural components thereof, then the property should be so classified. Several courts, however, rejected this approach.

In Rev. Rul. 75-178, 1975-1 C.B. 9, the Service reconsidered its position based on the contrary case law. It states, "The use of a functional or equivalency test (1) to classify property as inherently permanent where it is not itself physically attached to the land, or (2) to classify property as a structural component where it is not an integral part of (and therefore a permanent part of) a building, is no longer the criteria to be used to classify property. Rather, the problem of classification of property as 'personal' or 'inherently permanent' should be made on the basis of the manner of attachment to the land or the structure and how permanently the property is designed to remain in place." Thus, the test to be used to determine whether an asset is tangible personal property is the inherently permanent test.

L. Inherently Permanent Test

The seminal case involving the determination of whether an asset is inherently permanent is *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975). The Tax Court noted that "tangible personal property" is not intended to be defined narrowly, nor to follow the rules of State law where fixation to the land is a basis for distinguishing personal property from other property. It further stated that assets accessory to the operation of a business, such as machinery, printing presses, office equipment, individual air-conditioning units, display racks and shelves, etc., generally constitute tangible personal property for purposes of § 48, even though such assets may be termed fixtures under local law. Based on an analysis of prior case law, the Tax Court put forth six questions designed to ascertain whether a particular asset qualifies as tangible personal property. These questions, also referred to as the "*Whiteco* factors," are:

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 lengths of affixation, i.e., are there circumstances, which show that the property may or will have to be moved?
4. How substantial of a job is the removal of a property and how time-consuming is it? Is it "readily removable"?
5. How much damage will the property sustain upon its removal?
6. What is the manner of affixation of the property to the land?

It should be noted that movability is not determinative in measuring permanence. The court in *Whiteco* held that affixation to land does not per se exclude the property from the category of tangible personal property. Additionally, in *L.L. Bean, Inc. v. Commissioner*, T.C. Memo. 1997-175, aff'd, 145 F.3d 53 (1st Cir. 1998), the court held that the mere fact that a structure is theoretically capable of being moved does not conclusively establish that it is not inherently permanent.

Examiners should also consider the following additional factors when addressing permanency (some of which may overlap with the *Whiteco* factors):

- History of the item or similar items being moved;
- Manner in which an item is attached to a building or to the land;
- Weight and size of the item;
- Function and design of the item;
- Intent of the taxpayer in installing the item;
- Time, cost, manpower, and equipment required to move the components;
- Time, cost, manpower, and equipment required to reconfigure the existing space if the item is removed;
- Effect of the item's removal on the building; and
- Extent the item can be reused after removal.

See *Amerisouth XXXII, Ltd. V. Commissioner*, T.C. Memo. 2012-67; *Trentadue v. Commissioner*, 128 T.C. 91 (2007); *PDV America, Inc. and Subs. v. Commissioner*, T.C. Memo. 2004-118; *Hospital Corp. of America and Subs. v. Commissioner*, 109 T.C. 21 (1997).

Please note that land improvements may or may not be inherently permanent. Asset Class 00.3 of Rev. Proc. 87-56 describes land improvements as depreciable improvements made directly to or added to land, whether such improvements are § 1245 property or § 1250 property. Examples of land improvements include sidewalks, roads, canals, waterways, drainage facilities, sewers, wharves and docks, bridges, fences, landscaping, shrubbery, and radio and television transmitting towers. Buildings and structural components are specifically excluded from the category of land improvements. Land improvements may also be included in some activity asset classes such as asset class 57.1 of Rev. Proc. 87-56.

M. Hospital Corporation of America Case

In *Hospital Corporation of America v. Commissioner*, 109 T.C. 21 (1997) ("HCA"), the taxpayer classified as tangible personal property certain items relating to hospital facilities and claimed depreciation deductions using a 5–year recovery period. The Service took the position that a number of those items were structural components of the related buildings and that they must be depreciated over the same recovery period as the buildings to which they related. The Service also argued that using a different recovery period for the disputed property items than for the buildings to which they relate in effect results in component depreciation, which is a method that is no longer permitted under ACRS and MACRS (§ 168(f)(1) and § 168(i)(6), respectively). Thus, according to the Service, the tests developed under the ITC to differentiate between § 1245 property and § 1250 property were inapplicable to ACRS and MACRS.

The Tax Court held that at the time ACRS was enacted, Congress did not intend to redefine § 1250(c) to include property which was considered under long-standing precedent to constitute § 1245 property. Thus, the precedent that was developed to ascertain whether property constituted eligible § 38 property for purposes of ITC was equally applicable to ascertain whether property constituted § 1245 property for purposes of ACRS/MACRS. Conversely, to the extent that property did not qualify as eligible § 38 property for purposes of ITC, the property cannot constitute § 1245 property for purposes of ACRS/MACRS. The court further held that the prohibition contained in § 168 against the use of component depreciation applied only to § 1250 property.

In an Action on Decision (AOD-1999-008), the Service acquiesced to the decision in *HCA* to the extent that the term "tangible personal property" as defined under the ITC remained applicable under both ACRS and MACRS. The Service, however, did not agree with the court's determinations as to whether the various assets at issue constituted tangible personal property.

N. Electrical Distribution Systems

Pursuant to *HCA*, cost segregation methodologies previously used to allocate the cost of a building between ITC property and structural components likewise can be used for segregating § 1245 property from § 1250 property. However, this does not necessarily mean that an asset is exclusively either § 1245 property or § 1250 property; certain assets can contain characteristics of both code sections. Regarding primary and secondary electrical distribution systems, the court in *HCA* concluded that the portion of the cost of the primary and secondary electrical distribution systems corresponding to the percentage of the electrical load carried to the hospitals' equipment constituted as § 1245 property, whereas the portion corresponding to building operations constituted as § 1250 property. As a result of the ruling in HCA, the Tax Court followed its precedent in *Morrison, Inc. v. Commissioner*, T.C. Memo. 1986-129, and *Scott Paper Co. v. Commissioner*, 74 T.C. 137 (1980).

In *Scott Paper*, the court focused on the ultimate uses of power at the taxpayer's facility and distinguished the power used in the overall operation or maintenance such as lighting,

heating, ventilation and air-conditioning of the building from the power used to operate the taxpayer's machinery. It held that items which occur in an unusual circumstance and do not relate to the operation or maintenance of a building should not be structural components despite being listed in Treas. Reg. § 1.48–1(e)(2). To the extent that the primary electric carried electrical loads to be used for the taxpayer's production processes or other such qualifying uses, the investment credit was allowed for the primary electric improvements; to the extent that the primary electric related to the overall operation or maintenance of buildings, they were structural components of such buildings such that they did not qualify as tangible personal property for purposes of the ITC. This became known as the functional allocation approach. Hence, the court made an allocation of the facility's primary electric between § 1245 property and § 1250 property.

In *Morrison*, the court followed the functional allocation approach from *Scott Paper* and held that the electrical distribution systems were not structural components to the extent of the load percentages that were carried to equipment (§ 1245 property). On appeal, 891 F.2d 857 (11th Cir. 1990), the Circuit Court affirmed the decision in the Tax Court. It also made three broad announcements with regard to the electrical distribution system issue. First, taxpayers can claim ITC on a percentage basis. Second, it adopted the Tax Court's method of focusing on the ultimate use of electricity distributed with regard to the electrical system. Third, the Tax Court's method is consistent with the ITC's purpose to provide an incentive for businesses to make capital contributions. Subsequent to the Eleventh Circuit's opinion in *Morrison*, the Service issued AOD-1991-019 in which it stated that the Service would not challenge the functional allocation approach set forth in *Scott Paper* to determine the eligibility of electrical systems of a building to qualify as § 38 property. For a more detailed explanation of the functional allocation approach, please see Chapter 8.A - Electrical Distribution Systems.

Case law has extended the reasoning of *Scott Paper* to such items as electrical wiring, outlet receptacles, electrical connectors, telephone connection equipment, fire protection systems, water piping and lines, drain lines, gas lines, and plumbing and gas connectors. See *Amerisouth*, *supra*, *HCA*, *supra*; *Morrison*, *supra*; *Texas Instruments, Inc. v. Commissioner*, T.C. Memo 1992-306; *Duaine v. Commissioner*, T.C. Memo.1985–39. Please note, however, that the functional allocation approach is only applied to a building's primary and secondary electrical distribution systems.

O. Incentives for Cost Segregation and Cost Recovery

The tax code provides numerous incentives for taxpayers to perform cost segregation studies and allocate costs to § 1245 property. Aside from a shortened cost recovery period (since § 1245 property has shorter lives than § 1250 property), certain incentives generally apply to tangible personal property (§ 1245 property) and not real property (§ 1250 property). Some of these incentives include:

- § 168(k), Special Allowance for Certain Property (i.e., Bonus Depreciation)
- § 179, Election to Expense Certain Depreciable Business Assets Other incentives included in the tax code, however, may reduce the need for a taxpayer to perform a

cost segregation study because they give preferential treatment for certain qualifying § 1250 property. Some of these incentives include:

- § 168(e)(6), Qualified Improvement Property
- Former § 168(e)(6), Qualified Leasehold Improvement Property
- Former § 168(e)(7), Qualified Restaurant Property
- Former § 168(e)(8), Qualified Retail Improvement Property
- Former § 1400L, Tax Benefits for New York Liberty Zone
- Former § 1400N, Tax Benefits for Gulf Opportunity Zone

The requirements and restrictions for using the above incentives can be complex. In addition, the eligibility and the amount of the deduction allowed by the above incentives has changed over time such that one needs to pay special attention to the placed-in-service date of the property at issue. You may wish to contact the Practice Network that has jurisdiction over the incentive to ensure that the applicable provisions are properly followed.

P. Audit Guidance

The Service issued a series of Field Directives to effectively use resources in the classification and examination of a taxpayer who is recovering costs through depreciation of tangible property used in the operation of a business. The directives were issued for a variety of industries including casinos, restaurants, retail industries, biotech and pharmaceutical industries, and auto dealerships. The directives contained matrices and related definitions as tools to reduce unnecessary disputes and foster consistent audit treatment. The directives specified that if the taxpayer's tax return position was consistent with the recommendations in the matrix, then examiners should not make adjustments to categorization and lives. If the taxpayer reported assets differently, however, then adjustments should be considered. See Chapter 7 of this Guide for matrices applicable to various industries.

Q. Summary

This chapter has provided a legal framework for cost segregation by providing a brief history of depreciation, discussing various asset classification and cost recovery models, defining relevant terms, examining the former investment tax credit (ITC), explaining tests for distinguishing § 1245 property from § 1250 property, showing how cost segregation principles transferred from the ITC to current cost recovery systems, clarifying how cost segregation applies to building systems, enumerating incentives for cost segregation, and conversing about audit tools.

It cannot be overemphasized that the classification of assets is a factually intensive determination. There are no bright-line tests for segregating property into § 1245 property and § 1250 property classifications. Based on the final tangible regulations released in September 2013, it is expected that the use of cost segregation studies by taxpayers will increase. Thus, examiners need to examine and evaluate a cost segregation study in light of the applicable statutes, regulations, and judicial precedent.

Chapter 3 – Cost Segration Approaches

A. Introduction

Cost segregation studies are conducted for a variety of reasons (e.g., income tax, financial accounting, insurance purposes, and property tax). For income tax purposes, cost segregation studies involve the allocation (or reallocation) of the total cost (or value) of property into the appropriate property classes and recovery periods in order to properly compute depreciation deductions. The results of cost segregation studies are typically summarized in an accompanying cost segregation report. At this time, there is no standard format for either cost segregation or cost segregation reports.

The methodology or approach utilized in allocating total project costs to various assets is critical to achieving an accurate cost segregation study. The terms “methodology” and “approach” are often used interchangeably in discussions of cost segregation; however, to simplify, the term “approach” is used in this ATG. Also, in this ATG, the term “cost segregation” refers to the process of performing cost segregation and the term “cost segregation report” refers to the written report that conveys the results of the cost segregation. This chapter summarizes some of the more common approaches to cost segregation and their potential drawbacks. This discussion should assist the examiner in evaluating the accuracy of the cost segregation and in performing a risk analysis with respect to the depreciation deductions based on the cost segregation.

Cost segregation is generally performed for either newly constructed property or acquired property. Each of these situations requires a very different overall approach.

Newly constructed property, which includes remodels of existing properties and additions to existing properties, usually involves construction that was completed for the taxpayer that has occurred relatively recently. The cost segregation is normally performed either at the completion of the construction project or soon after. At this point, direct cost information (from contractors, vendors, suppliers, etc.) and indirect cost information (from architects, engineers, construction testing firms, local government building departments, etc.) is generally readily available from the taxpayer. Also, construction documents that were used for the construction project (construction drawings, specifications, contract documents, etc.) are generally readily available as well.

Acquired property involves existing properties that are purchased by the taxpayer. The acquired property could have been constructed fairly recently or far in the past. The available cost and construction information may range from as much as that available for a newly constructed property down to nothing more than the basis of the property.

When construction cost information for a property is not available, it must be reconstructed using the construction cost data, methods, and techniques normally employed for property appraisal. The reconstructed cost is then adjusted for the current physical condition of the property at the time of acquisition and finally adjusted to match the actual amount paid by the taxpayer for the property.

B. What are the Most Common Approaches Utilized for Cost Segregation Studies?

Various approaches may be utilized in completing cost segregation, including:

1. Detailed Engineering Approach from Actual Cost Records
2. Detailed Engineering Cost Estimate Approach
3. Survey or Letter Approach
4. Residual Estimation Approach
5. Sampling or Modeling Approach
6. "Rule of Thumb" Approach

Examiners should not necessarily expect to see the approach that was used for a cost segregation mentioned in a cost segregation report. Some cost segregation reports may describe the approach that was used for the cost segregation in great detail and some cost segregation reports may not mention the approach that was used at all. However, based on the information in this chapter, an examiner should be able to recognize the attributes of the cost segregation and identify the approach that was used (and also identify the potential drawbacks of the approach). It should be noted that other approaches not mentioned here may be used, although most are merely derivatives of the approaches discussed in this chapter.

C. What are the Attributes of the Various Cost Segregation Approaches?

The following discussion takes a closer look at the steps involved and the attributes of each of the approaches listed above. Keep in mind that these are the steps normally taken when completing cost segregation. The examiner's responsibility is to review the steps taken in the cost segregation and to evaluate the accuracy of the cost segregation and, additionally, to evaluate the quality of the accompanying cost segregation report. Chapter 5 - Review and Examination of Cost Segregation Study provides guidance in how to review cost segregation and cost segregation reports.

1. Detailed Engineering Approach from Actual Cost Records

The detailed engineering approach from actual cost records, also called the “detailed cost approach” or “direct cost method”, uses cost information from contemporaneous construction and accounting records. In general, it is the most methodical and accurate approach, relying on solid documentation of the construction costs and minimal cost estimating. Construction documentation, such as construction drawings, specifications, contracts, job reports, change orders, payment requests, and vendor and supplier invoices, are used to determine unit costs. The use of actual cost records in this approach contributes to the overall accuracy of cost allocations, although issues may still arise as to the proper classification of specific assets. Refer to Chapter 6.F - Construction Process, for a discussion of a typical construction project and an explanation of the construction cost information and documentation mentioned above.

The detailed engineering approach from actual cost records is generally applicable only to new construction, where detailed direct cost information (from contractors, vendors, suppliers, etc.) and indirect cost information (from consultants, testing firms, local government building departments, etc.) is readily available.

The detailed engineering approach from actual cost records typically includes the following activities:

- Identify the specific project and assets that will be analyzed in the cost segregation.
- Obtain information on all direct and indirect project costs. Substantiate the total project cost and reconcile the cost segregation to the total project cost.
- Conduct a site visit to inspect the facility. Determine the nature of the facility, its intended use, and identify the specific assets that are contained within the facility and on the facility site.
- Photograph specific assets for reference. Request any available photographs that document the condition of the property prior to the start of construction as well as progress photographs that document the progress of the construction during the construction project.
- Review record drawings, specifications, contracts, bid documents, contractor pay requests, change order detail, and any other construction cost information or documentation that is available.
- Assign the specific assets identified in the document review and site visit to property classes and recovery periods (e.g., land, land improvements, building, equipment, furniture and fixtures, and other items of tangible personal property).
- Prepare quantity take-offs for all assets and use contractor cost information to compute unit costs.
- Apply unit costs to each asset to determine its total cost basis. Reconcile the total costs basis obtained from quantity take-offs to the total actual contractor costs.
- Allocate indirect costs to the appropriate assets. This allocation is normally done on a pro rata basis for indirect costs applicable to the entire project and on a specific basis for indirect costs applicable only to specific assets.
- Group assets with similar class lives, recovery periods, and placed-in-service dates to simplify depreciation computations and the entry of the assets into the taxpayer's fixed assets system.

Even though the detailed engineering approach from actual cost records generally provides the most accurate cost allocations for the assets, the examiner should recognize that the proper cost basis and recovery periods of the Internal Revenue Code (IRC) § 1245 property analyzed in the cost segregation could still be an issue even when this approach is used.

2. Detailed Engineering Cost Estimate Approach

The detailed engineering cost estimate approach (or detailed estimate approach) is similar to the detailed cost approach. The difference is that the detailed estimate approach **estimates** costs, rather than using **actual** costs. This approach is used when cost records

are not available such as for an acquisition of used property. In the context of an acquisition, additional steps must be taken to determine the values of the acquired assets, such as addressing physical depreciation and functional obsolescence in the cost approach and addressing other approaches to value.

The detailed estimate approach is methodical, relying on solid documentation and utilizing construction-based documents such as blueprints, specifications, contracts, job reports, change orders, payment requests, invoices, appraisals, etc. When estimates are required, they are based on costing data, either from contractors or from reliable published sources (e.g., R. S. Means or Marshall Valuation Service). The sources of estimating data are clearly referenced, including identification of the specific volume, page, and item number. Further, the **same** estimating techniques and unit cost data sources are used for all of the items that comprise the actual cost.

In essence, the steps for this approach are the same as the detailed cost approach, except for Step 7 (in which costs come from contractor estimates or estimating guides). However, if detailed cost estimates are prepared methodically, and the estimates are reconciled to actual costs, then reasonably-accurate cost allocations are possible.

A field inspection is recommended for all quality studies, whether the studies are for new or used properties. When construction drawings and specifications are limited or are not available, which is often the case for used or acquired property, field inspection of the property is a critical step. This field inspection should document the physical details of the building, type of construction, materials used for construction, the assets contained in the building, the size and types of building systems (HVAC, plumbing, fire protection, electrical, data and communications, etc.), and any land improvements (such as parking lots, sidewalks, site lighting, etc.) that were included in the purchase of the property and the condition of that property at the time of purchase. It is important that this field inspection be completed thoroughly and accurately as it forms the starting point for reconstructing the construction costs of the property.

3. Survey or Letter Approach

The survey or letter approach is an alternative method for estimating costs for newly constructed property. In this approach, contractors and subcontractors are contacted via a survey or letter to provide information on the cost of specific assets that they installed on a particular project. These costs are then used in one of the engineering approaches or in the residual estimation approach (discussed in the following section). Cost allocation using the survey approach involves the following steps:

- Complete Steps A - F of the detailed engineering approach from the actual cost records to identify the specific property items that require cost estimates. Estimates should be reconciled to an actual cost if possible [either to an overall project cost or to an individual system cost (e.g., plumbing, electrical)].
- Divide property items by contractor and/or subcontractor.
- Ask contractors and/or subcontractors to provide the quantities and prices of specific property items.

- Use unit cost estimates obtained from the surveys to determine and allocate property costs.

In situations where the contractor provides actual cost data, the allocations may be reasonably reliable. However, when contractor data is obtained from other sites or projects, the data may not be comparable or reliable. The amount of detail provided by different contractors may also vary. The wide disparity in cost estimation methods dictates the use of caution to ensure that the total allocated costs do not exceed the actual total project cost.

4. Residual Estimation Approach

The residual estimation approach is an abbreviated method in which only short-lived asset costs (e.g., 5- or 7-year property) are determined. Short-lived asset costs are added together and then subtracted from the total project cost. The remaining or "residual" cost is then simply assigned to the building and/or other long-lived assets. Although this method is simpler and less time consuming than the engineering approaches, it can also be less accurate.

It should be recognized that this method generally does not reconcile project costs. In general, residual costs are not estimated or checked for reasonableness. A proper and "reasonable" residual cost should always be determined and then added back to the total of all short-lived asset costs to check if the total project cost is reconciled.

It should also be understood that different estimation techniques for short-lived assets can produce a skewed result in favor of § 1245 property (e.g., § 1245 property based on single-unit costs for high quality construction, while the building is based on gross square footage).

5. Sampling or Modeling Approach

The sampling or modeling approach uses a created model (or template) to analyze multiple facilities that are nearly identical in construction, appearance, and use (e.g., fast food chains and retail outlets). The use of sampling minimizes resources and costs compared to conducting studies on all properties.

Typical steps are:

- Stratify properties by facility type (e.g., free-standing facility, mall location, leased or owned property, etc.).
- Perform a cost segregation study by sampling properties within each stratum.
- Based on the results in Step B, develop a standard model for each type of facility.
- Apply the costs derived from the model(s) to the population on a percentage basis. For example, the model may indicate that 10% of the project costs are allocable to 5-year property. This same percentage is then applied to each facility within the same stratum.

A frequent issue is the accuracy of the sampling results. In some cases, the sampling method may not be statistically valid. In addition, a population less than 50 could limit the accuracy of a sampling technique, unless an appropriate sampling error is considered. Also, despite the fact that facilities within certain strata may appear to be very similar, variations in building codes, geographic location, and material and labor costs may make it difficult to determine an appropriate model. Statistical sampling is discussed in more detail in Chapter 5 - Review and Examination of a Cost Segregation Study.

6. "Rule of Thumb" Approach

Some cost segregation studies are merely based on a "rule of thumb" approach. In general, this approach uses little or no documentation and is based on a preparer's "experience" in a particular industry. For example, a preparer will estimate IRC § 1245 property as a fixed percentage of project cost by relying on previously determined "industry averages" (e.g., 40% for a manufacturing facility). An examiner should view this approach with caution, since it lacks sufficient documentation to support its allocation of project costs.

D. What Approach is Required by the IRS?

Neither the Internal Revenue Service (Service) nor any group or association of practitioners has established any requirements or standards for the preparation of cost segregation studies. The courts have addressed component depreciation but have not specifically addressed the methodologies of cost segregation studies.

The Service has addressed this issue but only briefly, i.e., Revenue Ruling 73-410, 1973-2 C.B. 53, Private Letter Ruling (PLR) 7941002 (June 25, 1979), Chief Counsel Advice Memorandum 199921045 (April 1, 1999). These documents all emphasize that the determination of § 1245 property is factually intensive and must be supported by corroborating evidence. In addition, an underlying assumption is that the study is performed by "qualified individuals" and "professional firms" that are competent in design, construction, auditing, and estimating procedures relating to building construction (See PLR 7941002).

Despite the lack of specific requirements for preparing cost segregation studies, taxpayers still must substantiate their depreciation deductions and classifications of property. Substantiation using actual costs is more accurate that using estimates. However, in situations where estimation is the only option, the methodology and the source of any cost data should be clearly documented. In addition, estimated costs should be reconciled back to actual costs or purchase price.

E. Summary and Conclusions

Cost segregation studies are prepared for a variety of reasons (e.g., income tax, financial accounting, insurance purposes, property tax), and many different methodologies and procedures are used. While neither the Service nor any group or association of practitioners prescribes a specific methodology, there are certain approaches (e.g., studies based on actual costs or on proper estimation techniques) that produce more accurate and

reliable allocations. Despite the use of one of these more reliable methods, issues may still arise with respect to the proper classification of IRC § 1245 property.

Approaches that yield accurate cost allocations expedite the Service's review, saving time and resources for taxpayers, practitioners, and Service examiners alike. A study that is both accurate and well documented is considered (in this ATG) a “quality” cost segregation study. The specific characteristics that comprise a quality study are described in Chapter 4 - Principal Elements of a Quality Cost Segregation Study and Report.

Chapter 4 – Principal Elements of a Quality Cost Segregation Study and Report

A. Introduction

As discussed in the last chapter, there is no standard format for cost segregation studies. Thus, examiners will encounter a wide variety of studies and reports, as well as supporting documentation. For example, some studies will be very brief and other studies may be quite voluminous and complex. Regardless of the length of a study or the methodology used, a cost segregation study and report should always:

- Classify assets into property classes (e.g., land, land improvements, building, equipment, furniture and fixtures);
- Explain the rationale (including legal citations) for classifying assets as either § 1245 or § 1250 property: and
- Substantiate the cost basis of each asset and reconcile total allocated costs to total actual costs.

B. What is a "Quality" Cost Segregation Study?

A "quality" cost segregation study is a study that is both accurate and well-documented with regard to the three points above. Quality studies greatly expedite the Service's review, thereby minimizing the audit burden on all parties. A quality study contains a number of characteristics, which are set forth below.

C. Principal Elements of a Quality Cost Segregation Study

The 13 principal elements of a quality study are:

1. Preparation by An Individual with Expertise and Experience
2. Detailed Description of The Methodology
3. Use of Appropriate Documentation
4. Interviews Conducted with Appropriate Parties
5. Use of A Common Nomenclature
6. Use of A Standard Numbering System
7. Explanation of The Legal Analysis
8. Determination of Unit Costs and Engineering "Take-Offs"
9. Organization of Assets into Lists or Groups
10. Reconciliation of Total Allocated Costs to Total Actual Costs
11. Explanation of The Treatment of Indirect Costs
12. Identification and Listing of § 1245 Property
13. Consideration of Related Aspects (e.g. I.R.C. § 263A, Change in Accounting Method and Sampling Techniques)

1. **Preparation by An Individual with Expertise and Experience**

The preparation of cost segregation studies requires knowledge of both the construction process and the tax law involving property classifications for depreciation purposes. Unfortunately, there are no prescribed qualifications for cost segregation preparers. However, a preparer's credentials and level of expertise may have a bearing on the overall accuracy and quality of a study.

In general, a study by a construction engineer is more reliable than one conducted by someone with no engineering or construction background. However, the possession of specific construction knowledge is not the only criterion. Experience in cost estimating and allocation, as well as knowledge of the applicable tax law are also important criteria.

A quality study identifies the preparer and always references their credentials, experience, and expertise in the cost segregation area.

2. **Detailed Description of The Methodology**

Chapter 3 – Cost Segregation Approaches discusses the most common approaches and methodologies used in preparing cost segregation studies. However, an actual study may be based upon a variant or combination of methods and, in fact, may not even identify by name the method used.

A quality study always describes the methodology that was used and details the steps that were taken to classify assets and determine costs.

3. **Use of Appropriate Documentation**

A quality study uses the best available documentation to classify assets and determine costs. Documentation supporting a quality study will vary, depending on whether a property is new or used or whether original construction documents are available. Contemporaneous documentation is the most reliable and trustworthy. The documentation in a quality study for both new and used properties is detailed below.

- **New Construction**
- **Allocation of Land and Land Development Costs**

A quality study explains the treatment of land and land development costs, (e.g., survey, subdivision costs, and temporary roads,). Generally, these costs are allocated to non-depreciable land accounts. Also included in this account are the costs of improvements or land that are transferred to a local municipality (to obtain approval for subdividing or for a change in use).

- **Site Visit**

A quality study includes a site visit to gain a better perspective and understanding of the design and purpose of the project, as well as the use of specific assets. Before-and-after

photographs are used to establish land and site preparation costs (i.e., surveying, clearing, grubbing, general grading and compaction).

- **Construction Documents, Blueprints, Construction Drawings, Specifications and Contractor Payments**
  - **A quality study reviews all pertinent construction documentation**. The taxpayer's capital expenditure request is reviewed to ascertain the intended functional use of a building and other assets included in the project. Site, architectural, and engineering plans, as well as "as-built" or record drawings, blueprints and bid documents, are all reviewed and referenced in a quality study. The specific assets deemed to be § 1245 property are clearly highlighted or otherwise identified on the "as-built" or record drawings. Project specifications are analyzed to determine conformity to the blueprints. Purchase and change orders are also reviewed to ascertain cost information, changes in costs, and details of the work performed.
  - **A quality study reviews the "General Contractor's Applications for Payment" (AIA Forms G-701, G-702, G-703, and G-704)** to ascertain what was actually paid for during construction. In addition, subcontractor payment applications, as well as invoices paid for items outside the scope of the general contractor's work, will be reviewed to provide greater insight and detail of the construction. Actual or estimated costs are cross-referenced to the supporting documentation.

- **Acquired or Used Properties**

Cost segregation studies on used real property should be performed by qualified appraisers and should properly allocate the purchase price between the non-depreciable land, building and personal property based on their value as of the date of purchase. See *AmeriSouth XXXII, Ltd. v. Commissioner*, T.C. Memo. 2012-67.

- **Purchase Price Allocations**

A quality study documents how the purchase price was allocated between land, land improvements, building and other assets. Land value is always determined first and is based on "highest and best use." In simple terms, highest and best use means the probable use of land that result in its highest value. The balance of the purchase price is then allocated to the building and to other assets based on their value as of the date of purchase.

- **Address Physical Deterioration and Functional Obsolescence**

The lack of cost records and the age of a property add to the uncertainty in determining its value or cost. In making this determination, a **quality study always accounts for the physical deterioration and functional obsolescence of assets**. It also provides the documents and the corroborating evidence used to determine values or costs.

- **Site Visit**

Similar to quality studies completed for new construction, **a quality study for acquired or used properties includes a site visit**, as well as photographic evidence, to assist in identifying the assets and in determining the allocations of values or costs.

- **Review of Purchase or Lease Agreements and Appraisals**

As discussed above under new construction, original construction documents, such as construction drawings, specifications, change orders and contractor pay applications, are used in a quality study to classify assets and determine costs. **When original construction documents are not available, as is often the case with acquired or used property, a quality study will support its allocations by using other corroborating evidence (e.g., purchase/lease agreements, appraisals)**. A quality study will review the purchase agreement as a first step. This is important to identify the assets acquired and to identify any contract allocations of the purchase price. If the property is leased, the lease agreement will be reviewed and documented. A quality study will also review any appraisals, if applicable. The availability of historical construction records will also be addressed in a quality study (i.e., if these are not available, the study will indicate what efforts were made to obtain these records).

4. Interviews Conducted with Appropriate Parties

Interviews with contractors and subcontractors, as well as with taxpayers and property managers, are quite valuable in ascertaining the specific use of a property and the construction process involved. **A quality study documents all interviews conducted with appropriate parties**, thus adding credibility to the depth and accuracy of its study. However, the examiner should recognize that subcontractor work details can be difficult to obtain since taxpayers generally have had no direct contact with them. In addition, general contractors may also be reluctant to share certain information because of confidentiality (e.g., profit margins).

5. Use of A Common Nomenclature

The use of creative or misleading nomenclature to describe property items, rather than common and clearly understood terms, detracts from the quality of a study. “Creative” descriptions may be used to disguise the true nature or character of an asset (e.g., a building sewage or water piping system referred to as "process piping"; an emergency exit sign termed "decorative placard").

A quality study always uses terminology consistent with the blueprints and other project documents (e.g., contract specifications, pay requests, etc.). The use of common and clearly understood terms facilitates the Service’s review and avoids the confusion caused by misleading terms.

6. Use of A Standard Numbering System

The use of a standard numbering system, such as the Construction Specification Institute (CSI) Master Format Division, is helpful. **A quality study numbers assets consistent**

with the contract bid documents and pay requests. This numbering system facilitates classifying property for computing depreciation and thus expedites the Service's exam.

The CSI format categorizes costs by specific building systems or components, such as concrete, carpentry, metals, woods and plastics, mechanical, electrical and lighting. Other typical groupings of assets may include land, land improvements, furniture and fixtures, electrical systems, plumbing systems, equipment, etc. Refer to Special Topics Chapter 6.F – Construction Process, which provides a more detailed discussion of standard numbering systems.

7. Explanation of The Legal Analysis

A quality study contains a thorough legal analysis, including relevant citations, to support its § 1245 property classifications. The treatment of some items may be fairly clear based on consistent judicial decisions. In other instances court decisions may appear to be inconsistent, or the Service has not acquiesced in the decision. These apparent incongruities reflect the intensely factual basis that underlies the proper classification of property. As might be expected, the proper classification of property is the source of much audit controversy.

The legal discussion in a quality study recognizes these conflicts and attempts to reconcile them to the specific facts and circumstances of the property at issue. An accurate analysis of the statutes and judicial precedent adds to the overall quality of a study and facilitates the Service's review.

8. Determination of Unit Costs and Engineering "Take-Offs"

Once property items or assets have been identified and assigned to property classes (e.g., building and personal property), their respective costs must be determined. In order to determine a cost for each unit or class of property in a project, total project costs must generally be broken down. This breakdown process is commonly known as engineering "take-offs".

In a quality study, engineering "take-offs" are carefully documented to show derived unit costs, and individual property units are clearly identified or highlighted on the "as-built" blueprints. For new construction, the cost of property items in an engineering take-off can generally be obtained from actual cost records. However, when actual costs are not available, costs must be estimated.

Cost estimates can vary widely depending on which estimating guide is used and whether costs are for "high" or "low" quality construction. In a quality study, cost estimates are always reconciled to an acquisition price or a total project cost to ensure the accuracy of an allocation. The proper use of an estimation technique is another frequent source of audit controversy. **A quality study minimizes this controversy by clearly explaining and documenting the methodology used to assign costs to each asset**.

9. Organization of Assets into Lists or Groups

Typically, a study lists assets by recovery period (e.g., land, land improvements, furniture and fixtures, electrical systems, plumbing systems, equipment). **To facilitate the Service's review, a quality study should list assets and generally tie to a taxpayer's fixed asset ledger**.

10. Reconciliation of Total Allocated Costs to Total Actual Costs

It is important that the **same** estimating technique be used on **all** of the items that reconcile to a purchase price, a project cost, or to a particular property cost. If different methods or cost guides are used on different property items (e.g., one method for tangible personal property and a different method for the building), cost distortions arise. **A quality study always reconciles total allocated costs to total actual costs to ensure the accuracy of its allocations**.

A quality study also considers and lists separately acquired § 1245 property to prevent possible duplication. For example, if the total project cost includes furniture, fixtures and equipment (FFE), then it is appropriate to allocate costs to those items. However, if FFE is acquired separately and not included in the total project cost, then it is not appropriate to assign costs to FFE.

11. Explanation of The Treatment of Indirect Costs

A quality study lists all the costs associated with a particular project, including both direct and indirect costs, and explains the treatment of any indirect costs. Direct costs are the labor and material costs for specific items or assets. Indirect costs, also referred to as "allocables," are intangible costs that are incident to the construction of a facility. Indirect costs must be allocated proportionately to the basis of the specific assets to which they relate.

Indirect costs may also include expenditures that should not be allocated to the entire project but rather assigned to the property class to which they relate. Costs to survey and subdivide land, and general grading are typically allocable only to land. On the other hand, costs for building permits, general conditions, and contractor overhead and profit are typically allocated to assets on a pro-rata basis.

Generally, indirect costs do not relate to the placement of business machinery, or furniture and fixtures since these assets are typically purchased and installed under separate contracts. However, indirect costs that specifically relate to components of personal property may be assigned to § 1245 property. For example, costs for special consultants (e.g., for computer wiring and process engineering) or costs to design the computer system may be assigned directly to that system. In addition, it may be reasonable to allocate certain indirect costs, such as liability insurance, bonds and overhead/profit, where it can be shown that the total amount of the indirect cost is based upon the pro rata cost of each class of property.

The treatment of indirect costs is another area of frequent controversy. **A quality study explains the purpose of each indirect cost and describes its allocation.**

12. Identification and Listing Of § 1245 Property

A quality study lists § 1245 property (including amounts) and shows any property originally classified as § 1250 property that is reclassified to § 1245 property.

13. Consideration of Related Issues (i.e., § 263A, Change in Accounting Method, and Sampling Techniques)

A quality study addresses related issues, such as § 263A, Change in Accounting Method, and Sampling Techniques.

The uniform capitalization (UNICAP) rules of § 263A(a) require the capitalization of all direct costs and certain indirect costs allocable to real property and tangible personal property produced by the taxpayer. Self-constructed assets and property built under contract are treated as property "produced" by the taxpayer. Furthermore, § 263A(f) requires the capitalization of certain interest expenses incurred in connection with the production of property. For tax years beginning after December 31, 2017, a small business taxpayer is not required to capitalize costs including interest under § 263A. A small business taxpayer is a taxpayer that (a) has average annual gross receipts of not more than $25 million for the 3 prior tax years (adjusted annually for inflation), and (b) is not a tax shelter as defined in § 448(d)(3).

Although the courts have not uniformly agreed, it is the position of the Service that a change in depreciation method, recovery period or convention for depreciable property constitutes a change in accounting method. Therefore, the use of a cost segregation study to reclassify property and/or reallocate costs generally requires the consent of the Commissioner. Please refer to Special Topics Chapter 6.B – Change in Accounting Method for more information.

Studies may utilize sampling techniques when taxpayers have a large number of substantially similar properties, such as in retail or food stores. Studies may use techniques such as statistical sampling, modeling, or judgmental sampling.

When conducted properly, statistical sampling can be a reliable technique. However, improper sampling techniques may result in a final answer that does not accurately reflect a valid estimate. Factors addressed in a quality study's sampling technique include the definition of the population being sampled, the size of the population, a description of stratification techniques, and the consideration of sampling error.

A modeling approach may also be used to segregate property costs. This approach uses created models to approximate the different types of units involved. If the models are properly analyzed, then this method may be reasonably accurate when applied to the entire population. However, as discussed in Chapter 3 – Cost Segregation Approaches, the delineation of strata may be difficult and is often an area of controversy. Furthermore, issues may arise as to whether the sampling method is statistically valid.

Some studies may rely solely on a judgmental sampling technique, which carries a higher level of risk due to the elements of subjectivity involved. A judgment sample is typically selected on the basis of perceived similarities and is not statistically valid. However, under certain, limited circumstances, the use of a judgment sample may be appropriate. In such a case, the underlying basis for the selection of particular units in a judgment sample must be rational and supported by adequate data.

A quality study addresses these related audit issues and comments on the treatment of these items for tax purposes, especially where the amounts are restated for prior tax years.

D. Principal Elements of a Quality Cost Segregation Report

A cost segregation report reflects a study's methodology and conclusions. The amount of detail included in a report varies considerably since there is no standard or prescribed format. The following elements are found in a quality report:

1. Summary Letter/Executive Summary

A quality report contains a summary to identify: the preparer, the date of the study, the taxpayer (or client), the subject property, and the property units classified as land, land improvements, building or personal property.

2. Narrative Report

A quality report discusses the theory, definitions, and the rationale behind the study in the narrative section. This section generally includes a more detailed description of the property/facility (i.e., a physical description and an explanation of the use for which it is intended, as well as a legal description of the property and its location). In addition, the narrative section provides a thorough discussion of the regulations, rulings and court cases that support classifying certain assets as § 1245 property. The narrative also discusses the types and sources of data used (e.g., cost records, contracts, purchase agreements, published estimates) as well as how they were used. A list of potential data sources is included in Special Topics Chapter 6.F – Construction Process.

3. Schedule of Assets

A quality report has a schedule of assets that are the focus of the study. Generally, this schedule ties directly to the taxpayer's depreciation records. When a taxpayer reallocates costs of assets already "on the books," a quality report clearly identifies the specific assets impacted (and includes depreciation records from both before and after the reallocation).

4. Schedule of Direct and Indirect Costs

A quality report lists all direct and indirect costs associated with a project. Indirect costs allocated to § 1245 property are clearly identified and explained. Separately-acquired

assets are listed and discussed in the report to avoid duplication errors. Costs subject to IRC § 263A are also addressed.

5. Schedule of Property Units and Costs

A quality report provides a detailed schedule of property units and costs (with property descriptions) **that are segregated into land, § 1245 property, and § 1250 property**. This schedule is the final product of the study and serves as the basis for computing depreciation.

6. Engineering Procedures

A quality report describes the engineering procedures and methodology for determining the cost of each property unit. It also identifies the specific taxpayer records that were reviewed and discusses whether actual cost records or estimating techniques were utilized to break costs into smaller property units. A record of inspections and/or interviews is included as well. The use of a common nomenclature or a standard numbering system is also referenced and/or explained. Note that the engineering procedures utilized to perform a quality study will differ based on whether the subject of the study is new construction or used properties as well as on the amount of the contemporaneous construction documentation available. The engineering procedures used for quality studies of new properties and used or acquired properties is discussed in step C.3 of this chapter.

7. Statement of Assumptions and Limiting Conditions

A quality report describes the general understanding and conditions applicable to the report. This information may also provide an indication of the overall quality of the study.

8. Certification

A quality report certifies that the person who signed the report actually developed the analysis, opinions and conclusions of the report. This section may also include the resume or state the credentials and/or level of experience of the preparer.

9. Exhibits

A quality report generally includes various exhibits, such as the "Client Cost Sources" and the "Cost Source Reconciliation." These exhibits show the "book" (accounting) records on which the preparer relied in deriving total costs and may include a reconciliation of the study to the fixed asset ledger. Photographs and/or videos may also be included as exhibits to assist in identifying and understanding the assets in the study.

E. Summary and Conclusions

This chapter described the principal elements of a "quality" cost segregation study and report. The degree to which a cost segregation study/report conforms to these elements will

likely dictate the scope and depth of an examination. A quality study and report will expedite the exam process, as indicated in Chapter 5 – Review and Examination of a Quality Cost Segregation Study and Report, and ultimately minimize audit burden on taxpayers, practitioners, and examiners alike.

Chapter 5 – Review and Examination of a Cost Segregation Study

A. Introduction

The preceding chapters described the legal framework for classifying assets (Chapter 2), common methodologies used to segregate costs (Chapter 3), and elements of a quality cost segregation study and report (Chapter 4). This chapter provides suggested audit steps for reviewing and examining a cost segregation study and report.

The appropriate audit steps depend on the nature and size of the cost segregation project as well as on the overall quality of the study. Cost segregation is a factually intensive determination that is based on complex tax law and engineering analysis. While examiners may be able to evaluate the adequacy of some cost segregation studies, other studies may require specialists with expertise, industry or construction experience and specialized training.

The Engineering Program in the Large Business and International (LB&I) business unit of the IRS is the principal source of technical expertise for examining cost segregation studies. The Computer Audit Specialist (CAS) Program in LB&I is also available to provide assistance when a study is based on statistical sampling. Formal advice, using the referral process, should be solicited through the LB&I website and the Specialist Referral System (SRS). Informal advice through consultation is also available by contacting your engineering or computer audit specialist group. The Senior Revenue Agents in the Deductible and Capital Expenditures Practice Network (DCE PN) are also available to assist examiners with this issue. Refer to the DCE PN website for up-to-date information and guidance on this issue or to submit an inquiry.

Cost segregation studies and fixed asset reviews typically utilize documents and cost information prepared for purposes of the construction process; Special Topics Chapter 6.F – Construction Process, provides a brief overview of the construction process. Cost segregation studies can be examined using a step-by-step approach. The suggested audit steps below may not apply to all cost segregation studies, however, each step should be carefully considered and determined to be applicable or not before moving on to the next one.

B. Steps for Examining a Cost Segregation Study and Report

1. Initial Risk Analysis

1. Risk analysis is the process that compares the potential benefits to be derived from examining a specific area on a tax return with the resources needed to complete the examination. **Review A Copy of The Cost Segregation Study Report for Initial Risk Analysis Purposes**

Every Cost Segregation Study should have a report that summarizes the results of the cost segregation study. The report should provide:

- Background regarding the subject property
- An explanation of the methodology used by the preparer
- Details regarding the assets classified in the study
- The applicable class lives and recovery periods of the assets
- The rationale and authority for the property classifications made in the Study.

Refer to Chapter 4 for a discussion of the principle elements of a quality cost segregation study and report.

In reviewing a Cost Segregation Study Report for risk analysis purposes, one must read the report to obtain a general understanding of the study methodology and the property classifications made therein. The following steps are suggested when reviewing a cost segregation report for risk analysis purposes:

- **Request a copy of the Cost Segregation Study Report**. Refer to the IDR Exhibits in Special Topics Chapter 6.G – Information Document Requests for suggested language.
- **Read the Entire Report with Emphasis on the Property Classifications.**
- **Review the Property Units and the Types of Assets.**
    - Assets are generally classified by cost segregation studies into various units or groups of assets and are often listed in both a "Summary" and a "Detail" format.
        - A "**Unit (or Asset) Group**" is a group of individual assets that together form a larger assembly that is considered to be and treated as a single asset.
        - The "**Property Unit Summary**" is a list summarizing the Unit Groups by asset class or recovery period (i.e., land, 3, 5, 7, 10, 15, 20, 27.5 and/or 39-year property.)
        - The "**Property Unit Detail**" is a listing of the individual assets that comprise each Unit Group. This list describes the individual assets and indicates the cost basis of the asset as determined in the study.
            - ✓ An example of a Unit Group is "Kitchen Equipment - Plumbing" (which is made up of a group of individual assets). For this Unit Group, the Property Unit Detail would list the individual assets (for example floor drain, grease trap, sanitary piping, sink, water supply piping, etc.) that make up the "Kitchen Equipment – Plumbing" Unit Group and provide the cost basis of each of the individual assets as determined in the cost segregation study.
    - Abbreviated methodologies may not classify assets into Unit Groups, Property Unit Summary or Property Unit Detail. Nevertheless, assets should be identified, supported, and documented in a cost segregation report.

2. Verify the Cost Basis and Reconcile Depreciation Records

Cost Segregation Studies are used to classify taxpayer assets into shorter recovery periods to accelerate the depreciation deductions for the assets. The study results should be easily reconcilable to the taxpayer's depreciation or fixed asset schedules.

Examiners should reconcile the cost basis of property in a study to the cost basis contained in the taxpayer's books and records.

- **Request Detailed (Asset-by-Asset) Depreciation Schedules** that tie to the tax return. Determine how the study assets are shown on the depreciation schedules.
- **Review Tax Depreciation Schedules** to verify that tax basis reconciles with the study and note any differences. Are fixtures, furnishings and equipment included in the study? Are they located on other depreciation or fixed asset schedules? Have these costs been duplicated?
- **Request Prior Year Tax Depreciation Schedules** that correspond to the study's assets. Do these schedules reconcile to depreciation for prior year returns? Property reclassified to a shorter recovery period must be depreciated using the proper method pursuant to IRC § 168(b). For example, if straight-line depreciation was used for other property placed in service for a given recovery period during the same year that the reclassified assets were placed in service, then § 168(b)(3) requires that the reclassified assets must also be depreciated using the straight-line method. The election to use straight-line depreciation is irrevocable pursuant to § 168(b)(5).

3. Conduct A Risk Analysis to Evaluate Audit Potential

Conduct a risk analysis to evaluate the audit potential and determine audit scope.

- **Review the descriptions in the Property Unit Detail schedule** to determine the type of property in each unit (or group).
- **Review the individual assets in each Property Unit Detail schedule.** Is each asset classified properly? (The asset matrices included in Chapter 7 can be of great assistance in this review.)
- **Compare the Study's Property Descriptions and Classifications to Revenue Procedure 87-56, 1987-2 C.B. 674.** Is the property included in the proper Asset Class? Are there any deviations that may indicate a potential audit issue? Identify specific assets that might need to be viewed during a tour of the facility.

Common situations suggesting audit potential include:

- Mixed asset types in the same unit (or group). (i.e., assets with different recovery periods).
- Building structural components or leasehold improvements classified with improper shorter-lived § 1245 recovery periods.
- Minimal or no dollar amounts assigned to land, non-depreciable land improvements, building, or other longer-lived assets.

- Use of “creative” nomenclature, inconsistent titles and/or descriptions to disguise the true character of an asset. All asset descriptions should be clear and understandable. Does the nomenclature used for assets in the study agree with the nomenclature used in the construction records and documents?

- **Request Additional Information (as needed)** to determine audit potential. In some cases, it may be more appropriate and efficient for the preparer of the study to respond to the document requests. Supporting documents may include computer files, hardcopy files, plans, etc. A CAS can assist in viewing computer files not ordinarily viewable on IRS computers.
  - Issue IDRs to determine the classification of items not readily understood or that are described in the report using an ambiguous description. Refer to Special Topics Chapter 6.G – Information Document Requests for suggested language.
  - Request contemporaneous records (permits, design studies, contractor payment records, AIA payment documents such as G702 and G703, contracts, purchase orders, invoices) to verify the costs and descriptions of property as well as to ascertain their functional use. This will facilitate the determination of the proper asset classification pursuant to Revenue Procedure 87-56. For example, machinery located in a chemical plant is 5-year property instead of 7-year property if it meets the requirements of Asset Class 28.0 (refer to Special Topics Chapter 6.C – Depreciation Overview for information on asset classes).
  - Request project information, such as the Capital Expenditure Request (CER) or Authorization for Expenditure (AFE), to verify project costs and identify related purchases. This information may also help determine the intended use of the property.
- **Summarize Your Preliminary Findings.** Determine the tax impact of potential audit issues, such as:
  - Assets with a cost basis that is questionable, disputed, or unsubstantiated.
  - Assets that have been misclassified and given an improper recovery period.
  - Double deductions for separately acquired assets.
  - The use of improper depreciation methods.
  - Incorrect placed-in-service dates.
  - Large look-back computations (i.e., the study reflects a change in method of accounting, with the return reflecting a deduction for depreciation not deducted in prior years).
- **Determine the Need for Specialists (e.g., Engineers and/or Computer Audit).** Specialists may be required to assist in the examination of complex projects. It is important that specialists be involved in the audit as early as possible. Informal assistance may also be requested when needed.
  - A study with significant tax impact generally requires the assistance of specialists. These studies will typically have a large number of assets, or complex assets.
  - A study that allocates **estimated** costs between § 1245 and § 1250 property (particularly electrical or plumbing component systems) typically requires the assistance of an engineer who is experienced in construction and construction estimating. Engineers can provide the expertise needed for the proper development and resolution of the issue.

- Studies involving numerous assets or allocations may require the assistance of a CAS to process the data and/or evaluate any statistical sampling methods.

- **Determine the Scope and Depth of Your Examination.** Risk analysis is a subjective process based on the experience, knowledge, and judgment of the examiner. Guidelines provided in the previous chapters will assist examiners in evaluating the overall accuracy and adequacy of a study as well as in determining audit potential and scope. Studies with little tax impact should be closed expeditiously. Studies with significant tax impact may require specialist assistance and should be considered for additional review and examination.

2. Examination

The examination of the cost segregation issue should proceed if the Risk Analysis identifies audit potential due to the asset classifications in the study, and required materiality thresholds of the specific examination are met.

4. Review the Cost Segregation Study Report for Examination Purposes

- **Request a copy of the Cost Segregation Study Report**, if not previously done for the Risk Analysis. Refer to the IDR Exhibits in Special Topics Chapter 6.G – Information Document Requests for suggested language.
- **Request a copy of the Letter of Engagement** to determine the scope of the study.
- **Determine the Nature of the Fee Arrangement.**
  - Many firms charge a fee based primarily on the size of the project. Out-of-pocket expenditures are generally added to this cost.
  - Some firms use contingency fees where cost is based primarily on the tax benefits received from a study. Contingency fee arrangements create the incentive to maximize § 1245 costs, usually through "aggressive" legal interpretations and/or by inappropriate cost or estimation techniques. Accordingly, examiners should closely scrutinize studies performed on contingency fees. Refer to Circular 230.
- **Evaluate the Study** with respect to its depth, accuracy and methodology and consider the following questions: What methodology was used (see Chapter 3 – Cost Segregation Approaches)? How does the study and report compare to the quality elements described in Chapter 4 – Principal Elements of a Quality Cost Segregation Study and Report?
- **Determine the Cost Allocation Process used in the Study and the Source of any Unit Costs.** The following questions may assist in determining the Cost Allocation Process: How were costs allocated? Were actual costs or estimates used? How were unit costs determined?
- **Request Contemporaneous Documentation to Substantiate and Verify the Cost Basis of Assets.**
- **Determine Whether Cost Basis was Properly Allocated** to land, non-depreciable land improvements (clearing, grubbing, general land grading) and/or other property types aside from those considered by the study.

- Consider if any project costs were allocated to land or land improvements. Many studies allocate almost all costs to building and personal property, instead of allocating appropriate amounts to land, land improvements or other long-lived assets. In the case of acquired property, it is often appropriate to assign a large portion of an acquisition price to land prior to allocating the remaining purchase price to other property. See "Allocating Purchase Price of Acquired Property" later in this chapter.

5. Interview the Cost Segregation Study Preparer

An interview with the preparer of the cost segregation study is an efficient way to obtain detail regarding the methodology used for the study as well as answers on the classification of questionable assets and the reasoning behind those classifications.

- **Schedule an Interview with the Preparer**. If possible, this should be completed before or contemporaneous with the on-site inspection. The interview should address the scope and assumptions of the study and any observations of the project or facilities. Possible interview questions include:
  - Were the properties inspected at the time of the study?
  - Were photographs and/or video media taken and/or relied upon in classifying property?
  - Were sampling techniques used?
  - What cost estimating guides were used? Where are the guides located (for purposes of verifying estimates)?
  - What documentation was used to establish the cost basis and particular use of a property item?
  - How was the cost of each property item identified, segregated, and classified?
  - Where are the supporting workpapers located?

6. Inspect the Property

In some instances, the only way to resolve a question regarding the proper classification of an asset is to actually inspect the asset as installed in the taxpayer's facility. An inspection can provide information to the examiner on the purpose and use of an asset as well as details of the installation and construction of the asset.

In general, the Service Engineer (if assigned) is responsible for arranging the on-site inspection, which provides the opportunity to view the assets in question. Inspections also help identify underground utilities, off-site improvements and general grading costs that may have been misclassified as § 1245 or § 1250 property. Overall, the inspection provides information to assist in determining classifications of § 1245 and § 1250 property.

- **Prior to Scheduling the Tour, Complete your Review of the Study** to identify specific assets and concerns that require inspection.
- **Prepare a List of Assets/Items that Warrant Inspection** and provide it to the taxpayer beforehand. Ask additional questions and/or view additional property components during the tour as needed.

- **Plan the Inspection to Minimize Time and Travel Costs.** For cases involving multiple properties of similar character, consider inspecting only a representative number of properties or facilities.
- **Take a Camera or Video Recorder (Camcorder)** to record the condition of the property. Confirm beforehand that photography will be permitted.
- **Request that the Property Manager/Maintenance Engineer be Available During the Tour**. It is important that someone familiar with the physical attributes and workings of the property be available to answer questions and provide access to non-public areas.
- **Request that the Preparer Attend the Tour**. The preparer should be able to identify the physical attributes of specific assets and explain how they were classified.
- **Request Access to Plans, Drawings and Contract Documents** that are located on-site.
- **Prepare an IDR in duplicate** so that any requested items received during the inspection can be noted and an acknowledgement copy of the IDR can be left with the taxpayer.
- **View the Project Site and Document Features** that impact the cost allocations and property classifications. Consider the following points:
  - Location - Record the address and locate it on a map for future reference. What is the character of the neighborhood and how does the location impact land value? Is there any other property for sale in the area? Note the real estate company name and the address of the property for future reference.
  - Topography - Observe the topography and determine whether the land was initially hilly or low-lying. Did the project include the general grading of the land? Were large amounts of fill required in order to build?
  - Site Conditions - Determine whether the project included the subdividing or rezoning of land. Did it require environmental or land use permits, or the construction of access roads? Were off-site improvements (e.g., streets, sidewalks, sewers, storm drains) constructed? Were any of these improvements dedicated to the local municipality?
  - Condition of Property - Is the property new or old, worn or renovated? Were the materials modern or old?
  - Project Records – Where are the original project records (e.g., drawing, plans, contracts, payment records) located? Ask for the names of the employees who may have particular knowledge of the construction. Request interviews with such individuals as needed.
  - Individual Assets - View each challenged asset to gain a thorough understanding of the facts and circumstances that affect its classification and cost. Ask the site manager how the facility is used and how individual assets operate.
    - Cost Data - Discuss the methodology that was used to determine the cost of assets. Were standard cost guides used to estimate costs? Ask on-site maintenance and facility operations personnel about local construction and repair costs to verify the estimated costs in the study.
- **Prepare Notes and Drawings** for future reference.
  - Obtain sufficient information to properly classify each challenged asset.
  - When possible, obtain local cost data to verify estimates and cost allocations.

7. Review and Verify the Asset Classes and Recovery Periods of Property

A major goal of a Cost Segregation Study examination is to verify the proper classifications and recovery periods of the assets included in the study.

Review the study again to determine whether the property classifications assigned to the assets in the study are correct. This review is done in greater detail than the initial review performed for risk analysis purposes. The goal is to verify the proper recovery period of all assets and to identify possible land or non-depreciable land improvements classified as depreciable property in the study. As in the initial risk analysis review, the property matrices in Chapter 7 can be of great assistance in this detailed review.

- **Are Assets Classified into Proper Groups according to Asset Class or Recovery Period?** Consider the following assets:
  - Land
  - Non-Depreciable Land Improvements (i.e., non-recurring land preparation costs such as general land shaping and grading)
  - Depreciable Land Improvements
  - Buildings, Structural Components and Other § 1250 Property
  - Office Furniture, Fixtures and Equipment
  - Information Systems
  - Building Systems (e.g., mechanical, electrical, plumbing)
  - Process Systems (e.g., process piping)
  - Non-Residential Real Property
  - Other Miscellaneous Property
- **Are Assets Assigned to the Proper Asset Class and Recovery Period?**
  - The classification of assets as either § 1245 or § 1250 property is a factually intensive determination with no bright line tests.
    - List Assets into the Proper Asset Class and Recovery Period.
    - Refer to Chapter 2 – Legal Framework, and to Special Topics Chapter 6.D – Relevant Court Cases for a summary of the pertinent law and judicial precedent with respect to the classification of property.
    - Recovery periods are either specifically assigned by statute (§ 168 and the Regulations thereunder) or are determined pursuant to Rev. Proc. 87-56, 1987-2 C.B. 674. Refer to Special Topics Chapter 6.C – Depreciation Overview, for further information on recovery periods.

  - Common Audit Issues

A common issue is the allocation of specific components or portions of a building system to § 1245 property. The issue often arises as a result of poor documentation and/or improper legal support.

    - Example 1

Some studies may include a specific component of a building's electrical system (e.g., plug outlet, switch, branch circuit) as being allocable to the piece of tangible personal property

that it supports (e.g., dishwasher, garbage disposal, etc.). Accordingly, the component item is treated as § 1245 property (*e.g.*, 7-year MACRS). However, if that same electrical component item can be used for other pieces of equipment, the Service examiner may consider it to be part of the building's general electrical system. Accordingly, it would then be classified as part of the building as § 1250 property (39-year MACRS).

- Example 2

Some studies allocate a portion of the primary electrical feeder circuit that carries electricity to one specific item of equipment or machinery as § 1245 property. The use of a "standard" percentage of electrical costs is a common approach. However, in the Service's view, these types of allocations should be based on usage or load studies designed to ascertain the percentage of electricity allocable to specific § 1245 property (as opposed to supporting the general function or maintenance of the building). Examiners can also check whether a company was reimbursed for the sales tax paid on electricity used in manufacturing; this information may provide insight as to the correct percentage. In summary, the examiner should conduct an in-depth analysis of the allocation and supporting documentation when a standard percentage is used. Refer to Chapter 8.A for a discussion of the proper methodology for the functional allocation of an electrical distribution system.

- Example 3

Some taxpayers have filed claims based on cost segregation studies of leased property. Typically, leases were assigned to 39-year recovery property on the originally filed tax returns. Subsequently, the taxpayer redetermines its allowable depreciation on the basis that the acquisition was for goodwill rather than for the lease. The benefit is a potential 15-year amortization of goodwill pursuant to § 197 (if the acquisition otherwise qualifies under § 197). Examiners should closely scrutinize allocations of this type.

8. Research the Law, The Regulations and Appropriate Rulings

Before reaching a final conclusion on the classification of a specific asset, the examiner should have conducted all the necessary research and reviewed all the relevant court cases, rulings and regulations that relate to asset classification and the challenged asset. While some assets may, at first glance, appear to be building-related, there may be revenue rulings or court cases that have concluded that these assets are instead tangible personal property (e.g., electrical wiring, HVAC, decorative millwork).

Special Topics Chapter 6.D – Relevant Court Cases contains a summary of pertinent court cases that relate to the classification of property for depreciation purposes. The examiner should read and study these cases for guidance. An examiner must also recognize that the determination of class life for a particular asset is factually intensive and that the determination may vary with a particular industry and/or with the specific use by the taxpayer.

Industry-specific guidance is included in Chapter 7.A (Casinos), Chapter 7.B (Restaurants), Chapter 7.C (Retail), Chapter 7.D (Biotechnology and Pharmaceutical), Chapter 7.E (Auto

Dealerships), and Chapter 7.F (Auto Manufacturing). It is anticipated that specific guidance for additional industries will be developed in the future, and will be added to Industry Specific Guidance Chapter 7 as it becomes available.

9. Cost Analysis

Once the proper classifications and recovery periods for the assets have been established, the next step, if required, is to perform a Cost Analysis. In a Cost Analysis, the examiner considers how the study allocated the project construction costs to the individual assets, evaluates whether the allocation was performed properly, and determines whether the cost basis of the assets as shown in the study is correct.

The methodology used for the Cost Analysis depends on whether the assets are part of a newly constructed facility or are part of an existing facility that was acquired by the taxpayer. The difference in Cost Analysis methodologies between these two situations is due to the different methods used to perform studies for these properties. Actual construction cost information is nearly always available for Newly Constructed properties; however, it is rarely available for acquired properties. Property appraisal approaches and construction cost estimating techniques are often used to determine the construction costs for acquired properties.

To properly perform a Cost Analysis, knowledge of construction and construction estimation is required and will most often involve the assistance of a Service Engineer. Because performing a Cost Analysis is also very time consuming, they should only be completed if there are significant questions regarding the proper basis amounts assigned to the assets on the study.

If a cost analysis is required, see Step 12 below.

10. Summarize the Findings and Discuss the Challenged Assets with The Taxpayer

If the preliminary conclusion is that the taxpayer has misclassified certain assets, the examiner should meet with the taxpayer as soon as practical to discuss his/her findings and the reasoning behind them. This discussion may clear up any misunderstandings and disagreements as to the facts and may provide an opportunity to resolve the issue.

11. Prepare the Final Report or The Notice of Proposed Adjustments (if necessary)

At the conclusion of the examination, the examiner (Revenue Agent and/or Specialist) should prepare and issue a final report. The regulations under §1.168(i)-7 allow a taxpayer to account for its MACRS property by treating each asset as being in a Single Asset Account (SAA) or by combining two or more asset in a Multiple Asset Account (MAA). Make the necessary adjustments to the basis of each asset affected by the cost segregation study, or to the basis of each multiple asset account (MAA) affected in which the taxpayer established an MAA, rather than making adjustments in a contra account. The record keeping rules under Treas. Reg. § 1.167(a)-7(c) require the adjustment on an asset-by-asset (or MAA-by-MAA) basis. This is especially important since the issuance of

the 2014 IRC § 168 disposition regulations. See the Capitalization of Tangible Property ATG for more information about accounting for, and dispositions of, MACRS property. Specialists should consider having the examiner calculate the depreciation or amortization adjustments to ensure that all pertinent factors are included in the computation. Adjustments to the construction period interest may also be applicable. Consider if proposed adjustments should be treated as a Service initiated change in accounting method and, if so, follow the guidance in Rev. Proc. 2002-18. The Methods of Accounting and Timing Practice Network is available to assist Examiners with the method changes.

3. Other Considerations

Depending on the methodology used for the cost segregation study, the type of indirect costs that were part of the construction, and whether the study is changing the classification of existing assets, the following steps should be considered as part of the examination.

12. Perform A Cost Analysis

A. Cost Analysis of Newly-Constructed Property

Actual cost records should be available for Newly-Constructed Properties. This information can most likely be obtained from the cost segregation study preparer, the taxpayer, the project architect, the project construction manager, or the general contractor. Cost records should be requested for **significant** property items only. Significant in this situation is defined based on the materiality amounts of the specific examination.

- **Gather Background Information.**
  - Secure total project costs by requesting information related to the construction project billings.
  - Review construction drawings and specifications.
    - Construction drawings and specifications identify property items, construction methods and locations of items within the structure.
    - Review the record drawings (often called “as-built” drawings) if they are available. Record drawings are prepared at the end of the construction project and incorporate all changes to the original building design made during construction, so they represent a record of what was actually constructed. These drawings are generally available from the taxpayer, the project architect, the project general contractor or the construction manager. Other possible sources include the local building department, local fire department or the taxpayer’s insurance carrier. Review the most “up-to-date” drawings as well. These drawings include the latest revisions made by the architect and engineers and are typically found in the taxpayer’s facilities engineering or maintenance departments or the property manager’s office depending on the type of facility.
  - Request copies of the building permit and certificate of occupancy (C of O), which can assist in establishing the construction start date and the placed in service date.

- Request photographs of the site showing the condition of the property before the project began. This will help determine whether significant site preparation or general grading costs were incurred.

- **Request Contemporaneous Records to Substantiate the Cost Basis of Assets in the Study.**
  - Contract documents specify how payments are made and typically require payment requests to be broken down into individual items of property. Refer to Special Topics Chapter 6.F on the Construction Process for a discussion of how payments to contractors and suppliers are made and documented in a typical building construction project.
  - For purchases made outside the construction contract (i.e., furniture or equipment) or for indirect costs (i.e. architectural/engineering fees, plan review fees, etc.), purchase orders and invoices are a good source of cost data.
- **Analyze the Total Project Costs.**
  - Review the General Contractor's and major Subcontractor Requests for Payment (i.e.. AIA G702 and G703). Particular attention should be made to the final pay applications, as these should be more indicative of the final total construction cost.
  - Review any construction costs that may not be shown on the pay applications, including change orders, indirect costs and out-of-pocket costs. Test for completeness by looking for any missing elements (e.g., land shaping costs may be in a separate contract).
  - Review invoices for any pre-purchased or owner-furnished equipment. On large construction projects, the taxpayer may separately pre-purchase items that have a long delivery time (e.g., large capacity electrical sub-stations or transformers) or may directly purchase large equipment items such as air handling units to avoid the contractor markup. The contractor may also install owner-furnished equipment. The examiner should verify if any pre-purchased owner-furnished equipment is included in the total project cost and that the cost of such equipment is treated appropriately.
- **Reconcile Total Project Costs in the Taxpayer's Records with the Total Project Costs in the Study.**
  - Request a copy of the taxpayer's general ledger data to support the fixed asset amounts on the depreciation schedule. How does it compare to the amounts shown in the study?
    - Typically, the property unit numbers or reference numbers found in a study do not track the taxpayer's accounting entries. Find out what sources the preparer used in preparing the study.
    - Verify that the total project cost in the study reconciles to the total cost basis of assets in the taxpayer's books and records. The examiner is in the best position to do this since he/she is the most familiar with the taxpayer's accounting methods. The examiner will also know where to look for other costs that should be in the building account, but may have been expensed or otherwise entered improperly into another account.
  - Compare all data with the contemporaneous cost records.
  - List any unsupported basis for potential disallowance.

- **Reconcile Detailed Cost Breakdowns** to individual property elements.
  - Actual cost records should be used whenever possible.
  - Review the taxpayer's internal "Job Cost Reports." Typically, a preparer relies on these documents to derive the unit costs (assuming that the cost and description of the assets in the Job Cost Reports are accurate).
    - The study methodology should be disclosed in the Assumptions and Limiting Conditions section of the report.
    - A careful analysis of the Job Cost Reports may yield significant audit adjustments. The following is an example illustrating how the taxpayer does not always properly classify items that are listed in this report.
    - Example: The Job Cost Report includes a code for Furniture and Fixtures. Within this code are multiple records of vendors from whom the taxpayer claimed to have purchased items, such as furniture and fixtures. The preparer included the total cost as § 1245 property and listed it in the study as "FF&E." However, upon requesting contracts for each of the vendors under this heading, the Service examiner discovered that some of these assets were actually § 1250 property and, therefore, concluded that these costs were erroneously included in "FF&E." Therefore, it is important that the examiner review the vendor contracts in the Job Cost Reports, especially those that detail the “Description of Work”, to verify asset costs.
- **Prepare a List of Items/Costs that are Not Properly Substantiated.**
- **Compute the Correct Costs (as necessary)** for individual items or groups of property.
- **Review the Cost Segregation Study Report Again.**
  - Review the study for its style and order of presentation. The narrative typically describes the order of the development of costs and the spreadsheets show the analysis and sequence.
  - Review the study’s conclusions, recommendations, assumptions and limiting conditions.
  - Verify that the assumptions and limiting conditions are consistent with the facts developed from the inspection and the review of the drawings and specifications.
- **Analyze How the Detailed Cost Breakdown was Prepared.**
  - Review Direct Costs.
    - Confirm that the direct costs are properly classified as either § 1250 or § 1245 property and identify any questionable items for further review.
  - Review Indirect Costs.
    - Ensure that indirect costs are properly allocated to their respective assets.
    - Indirect costs generally relate to the land, certain land improvements, and/or the building or other structures. Indirect costs generally do not relate to the placement of machinery or furniture and fixtures. However, there are exceptions, such as for the design of a manufacturing line. Refer to Chapter 4 – Principle Elements of a Qualified Cost Segregation Study and Report, for additional discussion of indirect costs.
    - Studies often use large spreadsheets and sophisticated formulas to compute the allocation of indirect costs (generally on a pro-rata basis). The

examiner should verify any formula by testing the allocations of indirect costs to ensure they do not exceed the total indirect costs.

- **Identify Potential Audit Issues.**
  - Site Preparation, General Grading and Land Shaping Costs
    - Building and facility projects often require general grading, site preparation and other costs to make the site suitable for a proposed use. These costs, along with costs for stripping existing forest and vegetation (called clearing and grubbing) in addition to grading and compaction to provide a level site, are generally non-depreciable costs allocable to the basis of the land. A study may exclude these costs as being outside the scope of its work. In other instances, a study may argue that none of these costs are allocable to non-depreciable land improvements. Whether these types of costs are included in the study or not, the examiner should determine all land preparation costs included in the project, analyze them and allocate them to non-depreciable land improvements, building, and/or depreciable land improvements. Before-and-after photographs may help with this determination. Also, the examiner should inspect the taxpayer's books and records to determine how these items were treated for both financial and tax purposes.
  - § 1245 Property – Did the Study Utilize Cost Estimates or Actual Cost Records?
    - Review the § 1245 and § 1250 property listings and identify the most significant items. The examiner should check the contractor payment records (e.g., AIA Form G-702) to see if actual costs of these items were used in the study or whether these item costs were based on some sort of allocation or estimate.
      - ✓ For example, if the Form G-702 shows $1.2 million for the "electrical" division work and the study shows or allocates $1.8 million to specialized § 1245 electrical equipment, then there may be a problem with the study's cost determination. In this case, the examiner should request additional information to determine the source of the $1.8 million allocation. Note that this is only a quick check since additional equipment or other property purchased by the taxpayer outside the construction contract may significantly affect this type of comparison.
  - Potential Problems with Residual Methods.
    - When a residual approach has been used, the examiner must be especially careful when reviewing § 1245 property costs. In essence, this method estimates the § 1245 property costs and then simply assigns the remaining portion of the total cost to § 1250 property. In general, the § 1250 residual cost is neither estimated nor checked for reasonableness. Often the result of this procedure is that the § 1245 property cost is too high and the § 1250 property cost is too low.
    - Cost estimates can also be manipulated to produce unreasonably high estimates for § 1245 property. This is because there are a wide variety of cost data publications that may be used, and some of these have relatively high estimates for costs.

- Most data sources have a higher cost for installing only one unit (e.g., a single electrical outlet) as opposed to installing 10 or 100 units. Economies of scale, "Quantity discounts" and competitive bidding may significantly reduce the actual unit cost. Accordingly, estimates for multiple units based on a single unit cost may be incorrect. The following is an example of this problem.
    - ✓ Assume that 500 of the 120-volt electrical outlets (duplex receptacle) in a particular building have been determined to qualify as § 1245 property. The R. S. Means Database, 2003 Edition, page 464, line 4015, lists a total price of $34.50 per 120-volt duplex receptacle. Based on this data, a study may estimate that the 500 outlets have a total installed cost of $17,250 (500 x $34.50). However, this estimate should be reviewed or compared with the contractor's actual price to determine its validity. When the taxpayer awarded the contract, the contractor submitted a schedule of cost for each item of work, such as for plumbing, electrical, heating, and site work (Forms G-702 and G-703). The examiner should review Forms G-702 and G-703 to determine the cost that the contractor assigned to the electrical work. If the Form G-703 indicates that $120,000 was assigned to electrical receptacles and there were 5530 receptacles to install, then the actual unit cost to install each receptacle is only $ 21.70 per outlet. The total actual cost for the 500 outlets is therefore only $10,850 (500 x $21.70). The total actual cost compared to the estimated cost ($17,250) may result in a significant difference. Note that cost estimates based on either the R. S. Means data or on the contractor's actual costs would need to be increased by any applicable indirect costs.

- Potential Problems with "Rule of Thumb" Methods
    A. While the documentation of costs drawn from the use of a "rule of thumb" method is typically sketchy and inadequate, the examiner should not categorically reject a study involving the use of "rule of thumb." The documentation needs to be examined and verified on its own merits to determine if cost recovery properties are accurately identified and placed into proper recovery periods.

B. **Cost Analysis of Existing or Acquired Property**

Allocating Purchase Price of Acquired Property

Cost segregation is applied both to determine the classification of property and to allocate the cost basis of property. This section focuses on cost segregation studies involved in allocating cost basis when acquiring a group of assets. Such allocations generally must rely on determining the fair market values of the acquired assets.

In this audit technique guide, new property and particularly new building construction projects receive much attention in the chapters addressing cost segregation studies and reports. However, cost segregation is not limited to Newly-Constructed property. Cost

segregation also applies to the acquisition of a group of assets often acquired for a lump sum, such as real estate or a trade or business. Approaches for segregating newly constructed property rely on contemporaneously billed and itemized costs, published costs of new property, or other estimated costs new. To determine the fair market values of the acquired assets, appraisal practices and procedures must be relied on to allocate/segregate a lump sum basis.

In the case of an acquisition including a combination of depreciable and non-depreciable property for a lump sum (e.g., buildings and land), the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time; Treas. Reg. § 1.167(a)–5, apportionment of basis. The relevant inquiry is the fair market values of the properties at the time of acquisition. Whether an opinion of value is provided in a report styled as a cost segregation study or an appraisal report, any opinion of value should be developed and reported by appropriate standards of the professional appraisal practice.

Examiners should consider seeking the expertise of IRS Engineers and Appraisers when examining value and allocation issues.

Real Estate Allocations

In allocating, a lump sum price paid for real estate, appropriate appraisal practices and procedures must be applied to determine the fair market values of the non-depreciable land and each of the depreciable assets (buildings, land improvements and personal property). The cost segregation study should explain the standard of value that is applied. When performing a risk analysis of a cost segregation study, examiners should also consider whether value opinions were provided by a competent and qualified appraiser.

The fair market value of land should be based on the highest and best use of the land as though vacant, even if the land has improvements. The land value may equal the value of the total real estate even if the real estate has substantial improvements, when such improvements do not contribute value to the property. Whereas land has value, improvements contribute value. The value of the total real estate, less the value of the land, results in the value of the improvements. Accordingly, it is inappropriate to estimate the value of the land by subtracting the estimated value of the improvements from the lump real estate price. Basis assigned to land in this residual fashion may result in understating the appropriate basis in the land and overstating the appropriate basis in the depreciable improvements. Examiners should also be wary if a cost segregation study relies solely on local assessed values rather than appropriately determining fair market values.

Section 1060 Allocations

Section 1060 prescribes special allocation rules for determining a transferee's (buyer's) basis and a transferor's (seller's) gain or loss in an applicable asset acquisition. An applicable asset acquisition is any transfer of assets (either directly or indirectly) that

constitutes a trade or business and with respect to which the purchaser's basis in such assets is determined wholly by reference to the consideration paid for them. See § 1060(c).

A group of assets constitutes a trade or business if i) the use of the assets would constitute an active trade or business under § 355 or, ii) its character is such that goodwill or going concern value could under any circumstances attach to such group of assets. See Treas. Reg. § 1.1060-1(b)(2).

The Omnibus Budget Reconciliation Act of 1990 amended § 1060(a) to provide that where the parties to an applicable asset acquisition agree in writing as to the allocation of any amount of consideration, or as to the fair market value of any of the assets transferred, that agreement is "binding" on the transferee and the transferor unless the Commissioner determines that the allocation (or fair market value) is not appropriate. See § 1060(a)(2). The House Report accompanying the amendment to § 1060(a) explained that:

> "… a written agreement regarding the allocation of consideration to, or the fair market value of, any of the assets in an applicable asset acquisition will be binding on both parties for tax purposes, unless the parties are able to refute the allocation or valuation under the standards set forth in the *Danielson* case. The parties are bound only with respect to the allocations or valuations actually provided in the agreement. * * *
>
> The committee does not intend to restrict in any way the ability of the Internal Revenue Service to challenge the taxpayers' allocation to any asset or to challenge the taxpayers' determination of the fair market value of any asset by any appropriate method, particularly where there is a lack of adverse tax interests between the parties. See H. Rept. 101-881, at 351 (1990)."

In *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), the Court of Appeals ruled that a taxpayer can challenge the tax consequences of a written agreement "as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." The Court of Appeals for the Eleventh Circuit has expressly adopted the *Danielson* rule. See *Peterson v. Commissioner,* 827 F.3d 968 (11th Cir. 2016); *Plante v. Commissioner*, 168 F.3d 1279, 1280-1281 (11th Cir. 1999); *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984); and *North American Rayon Corp. v. Commissioner*, 12 F.3d 583, 589 (6th Cir. 1993).

In *Peco Foods, Inc. v. Commissioner*, T.C. Memo. 2012-18, *aff'd* 522 Fed. Appx. 840 (11th Cir. 2013), the taxpayer purchased two poultry processing plants in applicable asset acquisitions under § 1060. As part of the acquisitions, Peco Foods entered into written agreements with the seller allocating the purchase price among the acquired assets. In addition, Peco Foods hired an outside consulting firm to perform a cost segregation study on the acquired plants, and subsequently filed a Form 3115 with its tax return to change its accounting method and reclassify certain property from nonresidential real property to tangible property. The IRS disputed these changes, arguing that the taxpayer could not modify the purchase price allocations and subdivide them into component assets in a manner at odds with the allocation schedules. The Tax Court held that Peco Foods was

bound by the clear and unambiguous terms of the original allocation schedules and could not deviate from its characterization of those assets. Thus, the taxpayer was not allowed to change its method of accounting for the acquired assets pursuant to its cost segregation study. It is unclear whether the holding in *Peco Foods* would apply to acquisitions other than applicable asset acquisitions under § 1060.

Where the parties to an applicable asset acquisition do not agree in writing to the allocation of consideration of the assets, § 338(b)(5) applies. In general, sellers and purchasers must allocate the consideration under the residual method as described in Treas. Reg. §§ 1.338-6 and 1.338-7 to determine the transferee's basis in, and the transferor's gain or loss from, each of the assets transferred. See Treas. Reg. § 1.1060-1(a).

In addition to the steps previously discussed for Newly-Constructed property, the following audit steps for existing properties should be considered.

- **Review the Acquisition Documents** to determine the assets purchased. Determine whether there was a written purchase price allocation agreed to by the buyer and seller (you may need to contact the seller). If there was an allocation between personal and real property, then the written purchase price allocation is binding on the taxpayer and cannot be changed by a taxpayer's subsequent cost segregation study. Only the Service can challenge a contract allocation. See § 1060(a); *Danielson*, *supra*. If there was not a written price allocation, then the examiner should address the study and go to the next step. See *Peco Foods*, *supra*.
- **Review the Escrow Documents and Payment Records** to substantiate the overall purchase price.
- **Ensure that the Land has been Properly Valued.**
  - Request a copy of the appraisal that provides the opinion of the fair market value of the property. The appraisal should indicate the value of the land and improvements separately. Land included in the purchase price is valued first. The value of land should be determined at its "highest and best use." Properties tend to appreciate based on the value of land.
  - Land value should not be reduced for any pre-existing environmental contamination because the prior owners are often held responsible for this and/or the property is generally insured for this situation.

1. **Ensure that Older Properties are Adjusted for Depreciation.**
   - Assets and asset groupings must be carefully reviewed and scrutinized to determine their physical and economic condition.
   - Relatively new items should be valued as new (e.g., windows, building exterior, emergency generator).
   - Older items may be physically deteriorated or functionally or economically obsolete, and should be assigned a value commensurate with their condition or use. For example, a building may have been pre-wired for telephones but, if it is a "non-digital" system, it may have a low value.

- **Ensure that Replacement Cost Values are Properly Adjusted** for the actual condition and remaining economic useful life of the assets.

- The value of used components must be reduced from the replacement cost new value in proportion to the observed economic obsolescence or physical depreciation as compared to similar new assets. This principle is discussed in regard to the "Helipot Building" in *Lesser v. Commissioner*, 42 T.C. 688 (1964), aff'd, 352 F.2d 789 (9th Cir. 1965), acq., 1966-2 C.B. 5, *cert. denied*, 384 U.S. 927 (1966).

- **Review the Contract Files** for information regarding the original construction and any subsequent repairs or modifications. This information should be used when viewing the existing condition of the building to verify, if possible, that the original contract work was performed.
  - **Review the Construction Drawings.** The existing structure should be compared to the record drawings (commonly called "as-built" drawings) to help identify subsequent repairs and modifications. In many instances for an acquired property, full construction drawings are not available or are minimal.
- **Consider Demolition Expenses.**
  - Assets scheduled to be demolished should have no basis or value assigned to them.
  - § 280B provides that the demolition cost of any structure is a capital cost chargeable to the land. Any abandonment losses incurred in connection with a demolition should also be considered for capitalization to the land. See TAM 9131005 (Apr. 25, 1991).

In summary, the examiner should ensure that:

- The study methodology for the proper allocation of the purchase price between the non-depreciable land and depreciable building and personal property must be based upon their values as of the date of purchase.
- The value of property items must take into account the physical wear and tear of each property item and any economic or functional obsolescence.

13. Review Sampling Techniques (If Necessary)

Taxpayers may utilize sampling techniques to minimize the time and costs associated with performing an analysis on all the properties (refer to the discussion in Chapter 4, Cost Segregation Methodologies). Sampling may also be utilized with cost documents. The use of sampling adds another level of difficulty when examining these studies. The examiner should take the following steps in reviewing a taxpayer's sampling technique.

- **Request the Assistance of Engineers and Computer Audit Specialists.**
  - If the taxpayer has utilized **any** form of sampling in a study, it is imperative that a CAS be consulted to review the sampling method. The CAS will use Rev. Proc. 2011-42 as guidance in evaluating the adequacy of the statistical sampling program. If needed, the CAS will request that a statistical sampling coordinator be assigned to specifically review the sampling procedures used by the taxpayer. An engineer can also assist in the review of strata and property groups, and the cost allocations of property.

- Sampling techniques may also be a useful tool for examiners when reviewing the adequacy and accuracy of a cost segregation study. Consultation and/or referral to a statistical sampling coordinator in the CAS Program is highly recommended to develop a reliable and supportable sample.

- **Understand the Sampling Technique.**
  - In situations involving large numbers of substantially identical properties, a study may utilize sampling or estimation techniques to select specific properties on which a "full" cost segregation study is performed. This approach, often referred to as "modeling", is typical for retail or food chain operations, where a "cookie-cutter" type of structure is involved.
  - The taxpayer may have a limited number of "prototype" structures, such as free-standing units, locations in strip/enclosed malls, full-service locations, carryout units, leased properties. The population is stratified by prototype to form groups of similar structures.
  - Sampling within each prototype group is then performed with the results projected to the entire population within that prototype. The projection of sampling results is limited to items and years included in the original population. The results **cannot** be extrapolated to years outside this population. The application of “extrapolation with a haircut” to items or years not included in the sampled population is not allowed for cost segregation studies.
  - Adjustments made by an examiner to the cost allocation performed on a sampled item are projected to the overall population to determine the overall adjustment. Based on which strata the adjusted sample resides in, the adjustment to the overall population may be significantly more than the adjustment made to the sampled item. This should be considered when performing a risk analysis on cost segregation studies that use statistical sampling.
- **Determine/Evaluate the degree of Similarity Between Properties Within a Group.**
  - The determination of the similarity between properties within a prototype group is difficult and creates a potential area of dispute. The examiner should be aware that while the appearance of a particular structure may be very similar to the prototype, differences could exist.
  - The rationale for stratifying properties is generally based on factors such as the style of the structure (e.g., location in strip/enclosed mall as opposed to a free-standing location), geographical location, and total square footage, leased, or owned. A stratification that is based on relatively unimportant factors or irrelevant similarities, such as the total number of windows in a structure or the total square footage of the site, is highly suspect and generally warrants further analysis.
  - Geographic variations due to physical site characteristics, climate, building codes and union versus nonunion labor, may create a wide disparity in structure costs. Therefore, stratification of otherwise similar properties across wide geographical areas may not be an accurate approach. Accordingly, the methodology should be carefully reviewed, as the "sampled" property may not be relevant to the other properties within the strata or group.
  - CAS and engineers should be involved to properly analyze and evaluate the strata and groupings, as well as the sampling methodology.

- **Review the Sampling Methodology.**
  - When conducted properly, statistical sampling is a reliable technique when the risk (sampling error) of not examining 100 percent of the properties can be accurately determined.
  - The use of a modeling technique is a reliable technique, provided the standard models or templates are properly analyzed and are similar to their respective groups (i.e., appropriate stratification into similar groups).
  - Judgment sampling is another technique, but this technique does not rely on statistical methodology and is highly subjective. Therefore, it warrants greater scrutiny by the examiner.
- **Potential Issues**
  - Improper sampling techniques (regardless of the methodology used) that do not reflect a valid estimate.
  - A relatively small number of units in the population (less than 100) can yield a small sample size. However, small sample size can be overcome by the application of a proper statistical sampling methodology and the utilization of the least advantageous limit computed at a 95% one-sided confidence level.
    - Simply stated, the least advantageous limit is computed as the point estimate plus or minus the sampling error, where the result provides the least benefit to the taxpayer.
    - Many taxpayers simply use the point estimate without regard to the sampling error, thereby ignoring the risk of error inherently associated with sampling techniques.
  - Missing records, substitution of missing items, missing documentation, and the use of estimated costs.
  - Properties that may not be appropriate for sampling (e.g., small number of dissimilar properties).
  - Inappropriate stratification of properties and faulty statistical sampling within each stratum.
  - Use of judgment sampling, which is highly subjective and thus may be of limited value.

14. Consider § 263A

The uniform capitalization (UNICAP) rules of § 263A require the capitalization of all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer. Self-constructed assets and property built under contract are treated as property “produced” by the taxpayer. Therefore, changes to the class life or basis of an asset may require a concurrent adjustment of UNICAP costs.

Furthermore, § 263A(f) requires the capitalization of certain interest expenses incurred in connection with the production of property. The interest capitalization rules under Treas. Reg. § 1.263A-8 contain precise definitions of designated property and include inherently permanent structures in the definition of real property. In summary, all real property and certain tangible personal property are subject to the interest capitalization rules. Therefore,

changes to real and tangible personal property costs may impact the amount of capitalized interest.

Taxpayers may attempt to exclude all § 1245 property from interest capitalization by arguing that § 1245 property is tangible personal property that does not meet the classification thresholds of Treas. Reg. § 1.263A-8(b)(1). However, § 1245 property that is an inherently permanent structure is subject to interest capitalization without any restrictions. In general, the standard for determining whether an item of property is inherently permanent for purposes of § 263A and § 199 is broader than the standard for cost recovery (depreciation). For more discussion and analysis used to determine whether an item is inherently permanent under various Code provisions, see Appendix Chapter 6.E, "Inherently Permanent" Standard Under Various Code Sections.

For tax years beginning after December 31, 2017, a small business taxpayer is not required to capitalize costs including interest under § 263A. A small business taxpayer is a taxpayer that (a) has average annual gross receipts of not more than $25 million for the 3 prior tax years (adjusted annually for inflation), and (b) is not a tax shelter as defined in § 448(d)(3).

Ideally, a taxpayer's books and records should consider and comment on the treatment of UNICAP when amounts are restated for prior tax years based on a cost segregation study. Refer to Special Topics Chapter 6.A – Uniform Capitalization for a summary of the major provisions of § 263A. Specific questions regarding § 263A can be referred to the Inventory & 263A Practice Network.

15. Consider Change in Accounting Method

In general, it is the position of the Service that a change in an adopted 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 a Form 3115, Application for Change in Accounting Method) and the adjustment to taxable income is made pursuant to § 481(a). Accordingly, claims for adjustment to a taxpayer's adopted depreciation method based on a cost segregation study performed after the original return was filed should not be allowed. Instead, the taxpayer should use the voluntary method change procedures provided in Rev. Proc. 2015-13 (or successor) to change its depreciation method on a prospective basis by filing a Form 3115. See IRM 4.11.6.

Some of the more common issues encountered in this area include:

- Use of incorrect revenue procedure for implementing change in accounting method (i.e., use of automatic change procedures instead of non-automatic change procedures);
- Terms of applicable revenue procedure(s) not properly applied;
- Change is not made to a permissible method;
- Form 3115 is not filed;
- Taxpayers want to add items to the original Form 3115, as filed;
- Lack of records to substantiate the § 481(a) adjustment;

- Informal claims filed in lieu of Form 3115;
- Informal claims filed prior to preparation of cost segregation study;
- Lack of detail to determine basis and recovery periods.

Prior to the issuance of final regulations under IRC 446(e), the issue of whether a change in depreciation method, convention, or recovery period constitutes a change in accounting method was unsettled due to conflicting court opinions. However, Treas. Reg. § 1.446-1(e)(2)(ii)(*d*)(*2*)(*i*) and Example 9 of Treas. Reg. § 1.446-1(e)(2)(iii), effective for taxable years ending on or after December 30, 2003, provide that each such change constitutes a change in accounting method. Please refer to Special Topics Chapter 6.B for a more detailed discussion on Change in Accounting Methods. You can refer specific questions regarding change in accounting methods to the Methods of Accounting and Timing Practice Network.

16. Penalty for Cost Seg Study Preparer:

Chief Counsel Advice CCA 201805001 determined that an engineer tax consultant was liable for the Section 6701 penalty for aiding and abetting understatements of tax. The CCA concluded that the engineer prepared and furnished to each client a cost segregation report that mischaracterized components of a 39-year recovery building to a shorter recovery period (5-year) personal property. The engineer knew that their taxpayer-client would rely upon the determinations of the report to file their income tax returns with excessive depreciation deductions. The IRS also concluded that the engineer knew the reports, if relied upon, would result in understatements of tax liability. Under Code Section 6701, the penalty is $1,000 for each individual return and $10,000 for each corporate return.

C. Summary and Conclusions

Using the steps outlined in this chapter, the Service examiner can evaluate the adequacy and accuracy of a cost segregation study and determine the proper classification and cost of property. The need for a specialist, such as a CAS or an Engineer, should also be evaluated and determined as soon as possible. The guidance in this ATG is designed to facilitate the audit process and minimize burden on taxpayers, practitioners, and examiners alike.

Chapter 6 Special Topics

A. Uniform Capitalization

1. Introduction

The allocation of project costs in cost segregation studies for self-constructed assets may be impacted by the Uniform Capitalization (UNICAP) rules of § 263A(a). In addition, the interest capitalization rules of § 263A(f) may also apply. A brief summary of these provisions is presented below.

2. Application of the Capitalization Rules Under § 263A

The UNICAP rules require the capitalization of all direct costs and certain indirect costs allocable to real property and tangible personal property produced by the taxpayer. For purposes of the uniform capitalization rules, to "produce" means to construct, build, install, manufacture, develop, improve, create, raise or grow [§ 263A(g)(1); Treas. Reg. § 1.263A-2(a)(1)(i)]. Self-constructed assets and property built under contract are treated as property "produced" by the taxpayer and the rules under § 263A(a) govern.

In addition, § 263A(f) requires the capitalization of interest expense when the taxpayer produces certain property. The interest capitalization rules under Treas. Reg. § 1.263A-8 contain precise definitions of designated property and include inherently permanent structures in the definition of real property. In summary, all real property and certain tangible personal property are subject to the interest capitalization rules. Therefore, any change in the allocation of costs between real and tangible personal property may have an impact on the amount of capitalized interest. Many taxpayers attempt to exclude all § 1245 property from interest capitalization arguing that the § 1245 property is tangible personal property that does not meet the classification thresholds of Treas. Reg. § 1.263A-8(b)(1). Most of the § 1245 property in these situations are inherently permanent structures (real property) subject to interest capitalization without any restrictions.

For tax years beginning after December 31, 2017, a small business taxpayer is not required to capitalize costs including interest under § 263A. A small business taxpayer is a taxpayer that (a) has average annual gross receipts of not more than $25 million for the 3 prior tax years (adjusted annually for inflation), and (b) is not a tax shelter as defined in § 448(d)(3).

The following text summarizes the capitalization rules of § 263A(a) and the interest capitalization rules of § 263A(f). Further detail and updates can be obtained from the Inventory and § 263A Practice Network (PN). Also, §263A adjustments generally involve a change in accounting method. Please refer to Special Topics Chapter 6.B – Change in Accounting Method for more information.

3. Capitalization of Costs Under § 263A

How does § 263A identify the costs subject to capitalization? Any cost which (but for § 263A and the regulations thereunder) may not be taken into account in computing taxable

income for any taxable year is not treated as a cost properly allocable to property produced or acquired for resale. Thus, for example, any cost (or portion of cost) that is not deductible is not properly allocable to property produced or acquired for resale.

In addition, any cost required to be capitalized under § 263A may not be included in inventory or charged to capital accounts or included in basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446-1(c)(1)(ii).

What costs are capitalized under § 263A? Except as otherwise provided, direct costs and all indirect costs that are properly allocable to property produced must be capitalized. Indirect costs are properly allocable to property produced when they directly benefit or are incurred by reason of the performance of production activities. For a producer, the direct costs generally include direct material and direct labor. The regulations include examples of indirect costs [see § 1.263A-1(e)(3)(ii)]. Examples of indirect costs required to be capitalized to the extent they are properly allocable to property produced are:

- bidding costs
- capitalizable service costs (including capitalizable mixed service costs)
- cost recovery allowances (however, remember depletion is only allocated to inventory produced and sold during the year)
- engineering and design
- employee benefit expenses
- handling costs
- indirect labor costs
- indirect material costs
- insurance
- interest (see special rules under § 263A(f))
- licensing and franchise costs
- officers' compensation
- pension and other related costs
- purchasing costs
- quality control
- rent
- repairs and maintenance
- spoilage
- storage costs
- taxes
- tools and equipment
- utilities

Producers must capitalize costs (other than interest) whether incurred before, during, or after the production period of property. Interest is only capitalized during the production period of property. Pre-production costs are subject to capitalization if the property is held for future production or if it is reasonably likely that the property will be produced at a future date. Thus, costs of storing raw materials and property taxes for real property held for

development are required to be capitalized. Some issues may arise in determining the taxpayer's intent and the taxpayer's change in intent. Production period costs are costs incurred beginning on the date on which production of the property begins and ending on the date on which the property is ready to be placed in service or is ready to be held for sale. Post-production costs are costs incurred after the actual production and may include storage and handling costs incurred while holding the property produced for sale after production.

Treas. Reg. § 1.263A-1(f) sets forth various detailed or specific cost allocation methods that a taxpayer may use to allocate direct and indirect costs to property produced. Under Treas. Reg. § 1.263A-1(f) a taxpayer may use a specific identification method, burden rate method, standard cost method, or any other reasonable method to allocate costs. In addition, in lieu of these methods, producers may use the simplified production methods provided in Treas. Reg. §§ 1.263A-2(b) and (c).

4. Capitalization of Interest Under § 263A(f)

Treas. Reg. §§ 1.263A-8 through 1.263A-15 provides guidance with respect to the capitalization of interest under § 263A(f). These regulations are effective for 1995 and after, or at taxpayer's election, 1994. For years prior to the final regulations, Notice 88-99, 1988-2 C.B. 422, and temporary regulations provide guidance with respect to the capitalization of interest.

For tax years beginning after December 31, 2017, a small business taxpayer is not required to capitalize costs including interest under § 263A. A small business taxpayer is a taxpayer that (a) has average annual gross receipts of not more than $25 million for the 3 prior tax years (adjusted annually for inflation), and (b) is not a tax shelter as defined in § 448(d)(3).

Interest is capitalized with respect to each unit of **designated property**. Interest is capitalized during each computation period; the amount of interest that is capitalized is a function of:

- the amount of accumulated production expenditures;
- the amount of outstanding debt(s) on each measurement date; and
- the interest rate of the outstanding debt(s).

In determining the amount of outstanding debt, traced debt is considered first. The excess expenditure amount is the amount (if any) by which the accumulated production expenditures exceed the amount of traced debt. Interest on non-traced debt, up to the excess expenditure amount, must be capitalized, based upon a weighted average interest rate. Pursuant to Treas. Reg. § 1.263A-9(d), taxpayers may elect not to trace debt. See Treas. Reg. § 1.263A-9.

Designated property is defined in § 263A(f)(1) and Treas. Reg. § 1.263A-8(b)(1). In general, § 263A(f) applies to designated property. Designated property is any property that is produced and that is:

1. Real property; or,

2. Tangible personal property (as defined in Treas. Reg. § 1.263A-2(a)(2)) that meets any of the following classification thresholds:

    - Property with a class life of 20 years or more that is not inventory in the hands of the taxpayer or a related person;
    - Property with an estimated production period (as defined in Treas. Reg. § 1.263A-12) exceeding 2 years; or
    - Property with an estimated production period exceeding 1 year and estimated cost of production exceeding $1,000,000.

Note: **All real property** is subject to the rules of § 263A(f); the classification thresholds **only apply to tangible personal property**.

The classification thresholds are applied individually to each unit of property.

Treas. Reg. § 1.263A-8(c)(1) defines real property. Real property includes land, unsevered natural products of land, **buildings, and inherently permanent structures**. Any interest in real property, including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property. Unsevered natural products of land include growing crops and plants (that have a pre-productive period more than 2 years), mines, wells, and other natural deposits. Real property includes the structural components of both buildings and inherently permanent structures.

Inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite time. Examples are swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. For purposes of this section, affixation to real property may be accomplished by weight alone. [Treas. Reg. § 1.263A-8(c)(3)]

Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former § 48(a)(1)(B) and Treas. Reg. § 1.48-1. Any property not otherwise described in Treas. Reg. § 1.263A-8(c)(3) that constitutes other tangible property under the principles of former § 48(a)(1)(B) and Treas. Reg. § 1.48-1(d) is treated for the purposes of Treas. Reg. § 1.263A-8 as an inherently permanent structure. [Treas. Reg. § 1.263A-8(c)(3)]

A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is not real property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property. A structure may be an inherently permanent structure, and not property in the

nature of machinery or essentially an item of machinery, even if the structure is necessary to operate or use, supports, or is otherwise associated with, machinery. [Treas. Reg. 1.263A-8(c)(4)]

B. Change in Accounting Method

1. Introduction

A taxpayer may conduct a cost segregation study on used property and then re-compute its depreciation deductions for prior years. The underlying incentive for preparing these studies for Federal income tax purposes is the significant tax benefits derived from utilizing shorter recovery periods and accelerated depreciation methods for computing depreciation deductions. Examiners need to be aware of the potential issues relating to these re-computations, including the need for taxpayers to notify the Service that it intends to make a change in accounting method for those items identified in the cost segregation study. This chapter provides a brief overview of the applicable law in this area.

2. Historical Service Position

It has been the long-standing position of the Service that a taxpayer adopts a permissible method of accounting in the tax year a depreciable asset is placed in service, relative to the depreciation method, recovery period (but not useful life), or convention for the depreciable property. A taxpayer adopts an impermissible method of accounting relative to depreciable property when it is treated in the same way on two or more consecutively filed returns. Once a method is adopted, a change in depreciation method, recovery period (but not useful life), 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 a Form 3115, Application for Change in Accounting Method), and the adjustment to taxable income is made pursuant to § 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 and the original return for the subsequent tax year, should generally be disallowed on the basis that the taxpayer is attempting to make a retroactive method change. See § 446(e) and IRM 4.11.6.7.5.

The Service's historical position is that a change in computing depreciation under §§ 167, 168, or 197, or former §§ 168 ("ACRS"), 1400I, 1400L(b), or 1400L(c) generally is a change in method of accounting under § 446(e) for which the consent of the Commissioner is required. However, this position was successfully challenged by several taxpayers in litigation with respect to depreciable property subject to § 168 (MACRS property). See *Brookshire Brothers Holding, Inc. & Subsidiaries v. Commissioner*, 320 F.3d 507 (5th Cir. 2003), *Green Forest Manufacturing Inc. v. Commissioner*, T.C. Memo. 2003-75, and *O'Shaughnessy v. Commissioner*, 332 F.3d 1125 (8th Cir. 2003); but contrast *Kurzet v. Commissioner*, 222 F.3d 830 (10th Cir. 2000). Because of these decisions, there was

inconsistent treatment of taxpayers with respect to whether a change in computing depreciation under § 168 was a change in method of accounting under § 446(e).

Final regulations under § 446(e), T.D. 9307, 71 F.R. 78066 (December 28, 2006), address the circumstances under which a change in calculating depreciation or amortization is a change in method of accounting under § 446(e). These regulations adopt, with modifications, temporary regulations published in the Federal Register on January 2, 2004. The final regulations provide that the following are changes in method of accounting under § 446(e):

- A change in the treatment of an asset from non-depreciable or non-amortizable to depreciable or amortizable, or vice versa, Treas. Reg. § 1.446-1(e)(2)(ii)(*d*)(*2*)
- A correction to require depreciation in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, Treas. Reg. § 1.446-1(e)(2)(ii)(*d*)(*2*)
- A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset, Treas. Reg. § 1.446-1(e)(2)(ii)(*d*)(*2*)(*i*) and
- A change to or from claiming the additional first year depreciation deduction provided by, for example, § 168(k), former § 1400L(b), or former § 1400N(d) under certain circumstances, Treas. Reg. § 1.446-1(e)(2)(ii)(*d*)(*2*)(*ii*).

Treas. Reg. § 1.446-1(e)(2)(iii), Example 9, provides an illustration of a change in accounting method due to changes in depreciation method, recovery period and convention, all resulting from a cost segregation study.

The final regulations clarify that a change in depreciation due to a posting or mathematical error, or a change in underlying facts, is not an accounting method change because the rules in Treas. Reg. § 1.446-1(e)(2)(ii)(a) and (b) also apply to a depreciation change.

In addition, Treas. Reg. § 1.446-1(e)(2)(ii)(d)(3)(i) provides that an accounting method change does not include an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under § 167 (other than under § 168, former § 1400I, former § 1400L(c), former § 168, or an additional first year depreciation deduction provision of the IRC). This rule does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Code, regulations, or other guidance published in the Internal Revenue Bulletin.

Treas. Reg. § 1.446-1(e)(2)(ii)(d)(3)(iii) provides that the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Code, regulations, or other guidance published in the Internal Revenue Bulletin.

Finally, Treas. Reg. § 1.446-1(e)(2)(ii)(d)(3)(v) provides that any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in accounting method.

The final regulations under § 446(e) only apply to a change in depreciation made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a tax year ending on or after December 30, 2003, regardless of whether the change in depreciation is a change in method of accounting.

3. Change in Litigating Position

On January 28, 2004, the Associate Chief Counsel (P&SI) issued a Change in Litigating Position Notice ("Notice") regarding the application of § 446(e) to changes in computing depreciation. See Notice CC-2004-007, as clarified by Notice CC-2004-024.

The Notice provides that the Service's position continues to be that a change in computing depreciation under §§ 167, 168, 197, former §§ 1400I, 1400L(b), or 1400L(c), or ACRS, is a change in method of accounting under § 446(e) for which the consent of the Commissioner is required. However, for depreciable or amortizable property that is treated as a capital asset and placed in service in taxable years ending before December 30, 2003, the Service will no longer litigate the issue of whether such a change in computing depreciation is a change in method of accounting under § 446(e).

It should be noted that the change in the Service's litigating position does not apply to a change in the treatment of property from a non-capital asset (for example, inventory, materials and supplies) to a capital, depreciable or amortizable asset (or vice versa), or to a change from expensing the cost of depreciable or amortizable property to capitalizing and depreciating or amortizing such cost (or vice versa). These changes are a change in method of accounting under § 446(e). Accordingly, examiners should consult with their local Chief Counsel attorneys should a taxpayer assert that these changes are not a change in method of accounting.

4. Peco Foods Case

In *Peco Foods, Inc. v. Commissioner*, T.C. Memo. 2012-018, *aff'd* 522 Fed. Appx. 840 (11th Cir. 2013), the taxpayer purchased two poultry processing plants in applicable asset acquisitions under § 1060. As part of the acquisitions, Peco Foods entered into written agreements with the seller allocating the purchase price among the acquired assets. Peco Foods then hired an outside consulting firm to perform a cost segregation study on the plants and filed a Form 3115 with its return to change its accounting method and reclassify certain property from nonresidential real property to tangible property. *Id.* at *3. The IRS disputed these changes, arguing that the taxpayer could not modify the purchase price allocations and subdivide them into component assets in a manner at odds with those schedules. The Tax Court held that Peco Foods was bound by the clear and unambiguous terms of the original allocation schedules and could not deviate from its characterization of those assets. *Id.* at *12. Thus, the taxpayer was not allowed to change its method of accounting for the acquired assets pursuant to its cost segregation study. It is unclear whether the holding in *Peco Foods* would apply to acquisitions other than applicable asset acquisitions under § 1060.

5. Tangible Regulations – Treas. Reg. §§§ 1.263(a)-1, -2, -3

The final tangible property regulations ("final regulations"), published on September 19, 2013, are generally effective for taxable years beginning on or after January 1, 2014.

Taxpayers have used cost segregation studies to determine what constitutes § 1245 (personal) or § 1250 (real) property for many years. Historically, these cost segregation studies have resulted in advantageous depreciation deductions for taxpayers. With the issuance of the final tangible property regulations, the demand for cost segregation studies is on the rise.

In many cases, taxpayers who previously decided not to conduct cost segregation studies for depreciation purposes are hiring specialists with engineering expertise to determine units of property for purposes of applying the improvement rules. Even taxpayers that conducted these studies in the past are once again hiring specialty firms or CPAs to take another look at their units of property and associated costs.

Cost segregation studies now serve additional purposes. For example, not only do these studies reclassify a building's components into assets with shorter class lives, but they also identify building systems for purposes of applying the improvement rules. These studies are also used to identify functionally interdependent plant property and to determine individual components or groups of components that perform a discrete and critical function. Such items may represent a change in accounting method in which the taxpayer must file a Form 3115 to request consent for the change.

The Examiner should request and review all cost segregation (or similar) studies, past and present and may need to engage the services of an IRS Engineer to determine whether the study was conducted properly.

The Examiner should also consider if the taxpayer's adjustments due to a cost segregation study represent a change in accounting method and if the changes were implemented properly following the appropriate revenue procedures. See Rev. Proc. 2015-13 (or successor) and Rev. Proc. 2022-14 (or successor) for current guidance. See the Capitalization of Tangible Property Audit Technique Guide for additional guidance on Treas. Reg. §§ 1.263(a)-1 to -3.

6. Revenue Procedures Involving Method Changes

To file a Form 3115 with the Service, a taxpayer needs to follow the procedures outlined in the applicable revenue procedure. Although taxpayers generally argue that they are simply reclassifying property placed in service in prior years to "correct" class lives, this reclassification results in a change in recovery period, depreciation method and/or convention.

Taxpayers who have adopted an impermissible method of accounting for depreciation (or amortization) and have either (1) claimed no depreciation, or (2) claimed less than or more than the allowable amount of depreciation and are making a change described in Treas.

Reg. § 1.446-1(e)(2)(ii)(d), are generally required to file a Form 3115 under either the automatic change or non-automatic change procedures (i.e., the voluntary method change procedures) to change the method of accounting. A taxpayer cannot change an adopted accounting method by filing an amended return unless specific guidance allows for an exemption.

The general voluntary method change procedures are found in Rev. Proc. 2015-13 (or successor) with the list of automatic changes found in Rev. Proc. 2022-14 (or successor). As provided in Rev. Proc. 2015-13, Section 6, for an automatic change, the original Form 3115 must be attached to the taxpayer's timely filed (including extension) original federal income tax return implementing the change in method of accounting for the year of change. Also, a duplicate copy of the Form 3115 must be filed with the IRS office in Ogden, UT no earlier than the first day of the year of change and no later than the date the taxpayer files the original Form 3115 with the federal income tax return for the year of change. If the automatic change procedures of Rev. Proc. 2015-13 (or successor) do not apply to a taxpayer's situation, the non-automatic change procedures should be followed.

The following is a list of the more common compliance issues involving accounting method changes:

a. Compliance issues for non-automatic method changes:

- Was the ruling letter granting consent to the change followed?
- Is the method the taxpayer implemented consistent with the facts presented and the representations made in the consent agreement?
- Is the § 481(a) adjustment correct?
- Exam may perfect the method change as an examination adjustment when deemed appropriate.
- A TAM is required to revoke or modify the ruling letter.

b. Compliance issues for automatic method changes:

- Did the taxpayer fully comply with the provisions in the voluntary method change procedure (Rev. Proc. 2015-13 or successor)?
- Is the method the taxpayer implemented consistent with the automatic method change provisions described in Rev. Proc. 2022-14 (or successor) for the designated change number?
- Is the § 481(a) adjustment correct?
- Exam may perfect the method change as an examination adjustment when deemed appropriate.
- A TAM is necessary if the taxpayer made the method change in compliance with the applicable procedures, but the examiner wants to revoke or modify the method change.

If after reviewing the taxpayer's cost segregation study and its implementation, the Examiner determines (1) the taxpayer is using an accounting method that does not clearly reflect income or is improper under § 446(b); or (2) the taxpayer changed its method of

accounting without obtaining the consent of the Commissioner under § 446(e), the Examiner should use the involuntary method change procedures in Rev. Proc. 2002-18 to resolve these accounting method issues. See IRM 4.11.6.7.

7. Summary

A change in the recovery period, depreciation method, and/or convention for depreciable property is a change in accounting method. Once a method of accounting is adopted, a taxpayer is required to obtain the consent of the Commissioner through the timely filing of a Form 3115 to change the accounting method. Pursuant to Rev. Proc. 2015-13, a taxpayer may request automatic or non-automatic consent for the change. Although a Form 3115 may be subject to National Office review, it is generally the responsibility of the examiner to verify the propriety of the revised method of accounting for depreciation and the accuracy of the § 481(a) adjustment at the time of the examination. The examiner should evaluate the need to review the cost segregation study that formed the basis for the depreciation re-computations and the resultant change in accounting method.

The issue regarding a change in accounting method with respect to the re-computation of depreciation (e.g., those based on cost segregation studies) can be quite complex. Examiners should consult Treas. Reg. § 1.446-1(e) for further guidance. Examiners should also contact the Methods of Accounting and Timing Practice Network for assistance regarding ongoing developments in this area, as well as determining the taxpayer's compliance with the proper procedures for changing the accounting method and computing the adjustment pursuant to § 481(a).

C. Depreciation Overview

1. Introduction

To compute depreciation for assets subject to a cost segregation study, one must use the proper property classification. The property classes control the applicable recovery period for assets, which are determined by statute or by reference to class lives. To determine the proper class lives, assets must be categorized into their appropriate asset classes. Cost segregation studies generally produce listings or groups of assets, based on asset classes under the Modified Accelerated Cost Recovery System (MACRS). This chapter provides a summary of the applicable authorities and available guidelines for classifying property into their appropriate classes as well as guidelines for computing depreciation deductions by using the proper depreciation method, recovery period, and convention.

2. MACRS

Internal Revenue Code § 167(a) provides a depreciation allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income. The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168, the Modified Accelerated Cost Recovery System. MACRS prescribes two methods for determining depreciation allowances: (1) the general depreciation system in § 168(a) ("GDS"); and (2) the alternative depreciation

system in § 168(g) ("ADS"). A taxpayer generally must use GDS unless the taxpayer is specifically required to use ADS or the taxpayer elects to use ADS. Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period and convention.

3. Depreciation Periods and Conventions

GDS contains ten property classes, based on the recovery period of an asset (3, 5, 7, 10, 15, 20, 25, 27.5, 39, or 50 years). Applicable depreciation methods include the 200% declining balance method, 150% declining balance method, and straight-line method. The depreciation methods under GDS are generally not elective, but a taxpayer may make an irrevocable election to use a less accelerated method under certain circumstances. However, 27.5-year property (residential rental property), 39-year property (nonresidential real property and qualified improvement property), 50-year property (railroad grading or tunnel bore), and certain 15-year property (*i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property placed in service before January 1, 2018) must be depreciated using straight-line depreciation. **Note – qualified improvement property placed in service before January 1, 2018, that also meets the definition of qualified leasehold improvement property, qualified restaurant property, or qualified retail improvement property is depreciable over 15-year straight line as well.**

ADS must be used for the following property: 1) listed property used 50 percent or less for business; 2) tangible property used predominantly outside the United States; 3) tax-exempt use property; 4) tax-exempt bond financed property; and 5) certain other finite categories of property that are not common. In addition, a taxpayer may make an irrevocable election to use ADS for any class of property eligible for depreciation under GDS and placed in service for a particular tax year. The recovery periods under ADS are generally longer than the recovery periods under GDS, and the straight-line method must be used.

For purposes of either GDS or ADS, there are three possible conventions: Half-year, mid-month, and mid-quarter conventions.

a. The half-year convention applies to property other than residential rental property, nonresidential real property, and railroad grading and tunnel bores. Under this convention, the recovery period begins or ends on the midpoint of the tax year that the property is placed in service or disposed of.
b. The mid-month convention applies to residential rental property, nonresidential real property, and railroad grading and tunnel bores. Under this convention, the recovery period begins on the midpoint of the month that the property is placed in service.
c. The mid-quarter convention applies to property (other than residential rental property, nonresidential real property, and railroad grading and tunnel bores) if more than 40% of the aggregate bases of such property is placed in service during the last three months of the tax year. Under this convention, the recovery periods for all property placed in service, or disposed of, during any quarter of a tax year begin on the midpoint of the quarter.

Note: Under all conventions, there is no depreciation deduction allowed for property placed in service and disposed of in the same tax year.

4. Recovery Periods

For purposes of either GDS or ADS, the applicable recovery period is determined by statute or by reference to class life.

The recovery period of residential rental property, nonresidential real property, and railroad grading and tunnel bore, are established by statute. See §§ 168(c) and 168(g)(2)(c).

- Residential rental property has a recovery period of 27.5 years for purposes of GDS and 40 years for purposes of ADS (30 years for purposes of ADS for residential rental property placed in service after December 31, 2017).
  - § 168(e)(2)(A) defines "residential rental property" as any building or structure if 80 percent or more of the gross rental income is rental income from dwelling units.
- Nonresidential real property has a recovery period of 39 years (or 31.5 years if the property was placed in service before May 13, 1993) for purposes of GDS and 40 years for purposes of ADS.
  - § 168(e)(2)(B) defines "nonresidential real property" as § 1250 property which is not residential rental property or property with a class life of less than 27.5 years.
- Railroad grading and tunnel bore have a recovery period of 50 years for purposes of both GDS and ADS. §§ 168(c) and 168(g)(2)(c).
- 15-Year Real Property: Under MACRS, while real property generally has a recovery period of 39 years (nonresidential real property or 27.5 years (residential rental property), the following designated real property is 15-year property:
  - Qualified leasehold improvement property (QLIP), defined in IRC former § 168(e)(6) circa 2005, placed in service between 10/22/2004 and 12/31/17.Qualified restaurant property (QRP), defined in IRC former § 168(e)(7) circa 2005, placed in service between 10/22/2004 and 12/31/17. Qualified retail improvement property (QRIP), defined in IRC former § 168(e)(8) circa 2009, placed in service between 12/31/2008 and 12/31/17.
  - These properties have a recovery period of 15 years and must be depreciated by the straight-line method and half-year convention (unless the mid-quarter convention applies). Under the alternative depreciation system (ADS) these properties have a recovery period of 39 years. See Chapter 6.H for the IRC § 179 and bonus depreciation treatment of QLIP, QRP, and QRIP.
- Qualified Improvement Property was created in 2015 to make certain § 1250 improvement property, placed in service after 1/1/16, eligible for bonus depreciation (§ 168(k)). It is defined as any improvement to an interior portion of a building if the improvement is placed in service after the date the building was first placed in service. However, QIP does not include any improvement attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. QIP was defined in § 168(k)(3) for property placed in service prior to 1/1/18. For property placed in service on or after that date it is

defined in § 168(e)(6). QIP typically has a recovery period of 39 years for (GDS) and 40 years for ADS. However, QIP placed in service after 12/31/2015 and before 1/1/2018 has a 15-year recovery period for GDS if it also meets the definition of QLIP, QRP, or QRIP. In 2020, the CARES Act (P.L. 116-136) retroactively changed the recovery period for QIP placed in service after 12/31/2017 from 39 years to 15 years (GDS) and from 40 years to 20 years (ADS) with the addition of IRC § 168(e)(3)(E)(vii). The definition of QIP in IRC § 168(e)(6)(A) was also clarified to include only those improvements "made by the taxpayer" to an interior of the building…"

Recovery Period for Qualified Real Property

Place In Service Range	Qualified Leasehold Improvement Property (QLIP)	Qualified Restaurant Property ** (QRP)	Qualified Retail Improvement Property (QRIP)	Qualified Improvement Property (QIP)
10/22/2004 - 12/31/2008	15SL (GDS) 39 (ADS)	15SL (GDS) 39 (ADS)	NA	NA
1/1/2009 – 12/31/2015	15SL (GDS) 39 (ADS)	15SL (GDS) 39 (ADS)	15SL (GDS) 39 (ADS)	NA
1/1/2016 – 12/31/17	15SL (GDS) 39 (ADS)	15SL (GDS) 39 (ADS)	15SL (GDS) 39 (ADS)	39 GDS – 40 ADS *
2018 and beyond	NA	NA	NA	15SL GDS – 20 ADS ***

*** If QIP also meets the definition of QLIP, QRP, or QRIP it is depreciable over 15 - Year SL (GDS) and 39-Yr SL (ADS).**
**** Initially, QLIP, QRP, and QRIP applied only to new improvements to the interior of the building. After 2008 QRP applies to the entire building for both new and purchased property and the 3-year rule was eliminated.**
***** For property placed in service after 12/31/17, QIP replaces QLIP, QRP, and QRIP. QIP was retroactively given a GDS 15-year recovery period and ADS 20-year recovery period pursuant to the CARES Act.**

Section § 168(i)(12) provides that the terms “§ 1245 property” and “§ 1250 property” have the meanings given such terms by § 1245(a)(3) and § 1250(c), respectively.

Section § 1245(a)(3) provides that "§ 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 (not including a building or its structural components) that was used as an integral part of certain activities

Section § 1250(c) defines "§ 1250 property" as any real property, other than § 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.

Section § 1245(a)(3) provides that "§ 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 (not including a building or its structural components) that was 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 relevant to this discussion. It is important to note that a building or its structural components is specifically excluded from the definition of § 1245 property.

Treasury Regulation (Treas. Reg.) § 1.1245-3 defines "tangible personal property," "other tangible property," "building," and "structural component" by reference to Treas. Reg. § 1.48-1. This regulation relates to former § 48, which was enacted in 1962 along with §§ 1245 and 1250. Section 48 allowed an investment tax credit (ITC) based on the "applicable percentage" of the investment in tangible depreciable property placed in service during the taxable year. The ITC (§ 48) was later repealed in 1986. See the previous chapter, Legal_Framework, for a description of the provisions set forth in Treas. Reg. § 1.48-1.

5. Class Lives

Section § 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former § 167(m) as if it were in effect and the taxpayer were an elector. Prior to its revocation, former § 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life, and the anticipated decline in value over time, of the property to the industry or other group.

Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b) sets out the method for asset classification under former § 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used, regardless of whether the activity is insubstantial in relation to all the taxpayer's activities. Thus, for depreciation purposes, a taxpayer may be engaged in more than one activity. If a taxpayer uses assets in more than one activity, the cost of the asset is not allocated between the two activities; rather, the total cost of the asset will be classified for depreciation purposes according to the activity in which the asset is primarily used. This determination may be made in any reasonable manner. Note that in Revenue Procedure (Rev. Proc.) 97-10, 1997-1 C.B. 628, either a gross receipts test or a square footage test was used to determine whether a building was primarily used as a retail motor fuels outlet.

For example, assume that a taxpayer owns and operates a hotel/casino complex. The taxpayer is engaged in two business activities: casino operations and hotel operations. Assets used by the taxpayer in its casino operations are includible in the activity category that includes casino operations (asset class 79.0 Recreation of Rev. Proc. 87-56). Assets used in hotel operations are includible in the activity category that includes hotel operations (asset class 57.0 Distributive Trades and Services of Rev. Proc. 87-56). If a particular asset is used in both activities, the total cost of the asset will be classified for depreciation

purposes according to the activity in which the asset is primarily used; the cost of the asset is not allocated between the two activities. The determination of primary use may be made in any reasonable manner. For additional information, see IRS FSA 200203009.

Asset classifications are based on how the asset is primarily used. In the case of a lessor of property, the asset class for such property is determined as if the property were owned by the lessee. See Treas. Reg. § 1.167(a)-11(e)(3)(iii) and the following court cases for additional information and consideration.

- *Clajon Gas Co. L.P. v. Commissioner*, 354 F.3d 786 (8th Cir. 2004), *rev'g* 119 T.C. 197 (2002): Pipelines leased to producers to transport natural gas fell under the asset class for producing natural gas regardless of ownership.
- *Saginaw Bay Pipeline Co. v. United States*, 338 F.3d 600 (6th Cir.2003), *rev'g* 124 F.Supp.2d 465 (E.D. Mich. 2001): Every natural gas carriage pipeline which functions as a gathering pipeline is in the methane gas production process irrespective of the primary business of the owner of that pipeline.
- *Duke Energy Natural Gas Corp. v. Commissioner*, 172 F.3d 1255 (10th Cir.1999), *rev'g* 109 T.C. 416 (1997): Based on the asset's primary use, the classification of natural gas gathering systems constituted as assets used in the production of natural gas.

As stated earlier, GDS contains ten property classes, based on the recovery period of an asset. For those classes of property not established by statute, the applicable recovery period is determined by reference to class life. See § 168(e)(1). It is also worth noting that qualified Indian reservation property, generally have shorter applicable recovery periods. See § 168(j)(1) and (2).

6. Revenue Procedure 87-56

Revenue Procedure 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under § 168 (MACRS). The revenue procedure establishes two broad categories of depreciable assets:

1. Asset classes 00.11 through 00.4 that consist of specific assets used in all business activities.
2. Asset classes 01.1 through 80.0 that consist of assets used in specific business activities.

The same item of depreciable property can be described in both an asset category (asset classes 00.11 through 00.4) and an activity category (asset classes 01.1 through 80.0). In this situation, the item is classified to the asset category unless it is specifically excluded from the asset category or specifically included in the activity category. For additional guidance see below:

- *Norwest Corporation & Subsidiaries v. Commissioner*, 111 T.C. 105 (1998) (item described in both an asset and an activity category (furniture and fixtures) should be placed in the asset category)

- Rev. Rul. 2003-81, 2003-2 C.B. 126 (an asset included in both an asset category and an activity category is placed in the asset category, unless it is specifically excluded from the asset category or specifically included in the activity category).

Revenue Procedure 87-56 contains tables of class lives and recovery periods. To properly utilize Rev. Proc. 87-56, the following steps are suggested:

1. Check Asset Classes 00.11 through 00.4 that consist of specific assets used in all business activities to see if it contains a description of the asset in question.
   - Refer below to Step 2 (if the asset is described in an asset category) or to Step 3 (if the asset is not listed in an asset category).
2. If the subject asset is described in one of the asset categories, then check asset classes 01.1 through 80.0 that consist of assets used in specific business activities to find the activity to which the property relates or in which it is primarily being used.
   - If the activity is described in one of the activity categories, read the text (if any) under the title to determine if the property is specifically included in the activity category.
   - If it is, then use the recovery period shown for the activity category following the description of that activity.
   - If the property is not specifically included in the activity category, or if the property is specifically excluded from the activity category, then use the recovery period shown in the appropriate asset category.
3. If the asset is not listed in an asset category, then find the activity to which the property relates or in which the property is primarily being used, and use the recovery period shown in the appropriate column following the activity category description.
   - If the property is not listed in an asset category and the activity to which it relates is not included in one of the activity categories, then the property should be categorized as "Certain Property for which Recovery Periods assigned (Personal Property/§ 1245 Real Property with No Class Life)." Property in this category generally has a recovery period of 7 years for GDS or 12 years for ADS. Please note that there are very few assets that fall under this default category.

7. Examples

The following examples illustrate the use of Rev. Proc. 87-56 for determining the proper asset recovery period. See also Appendix B of IRS Publication 946.

Example 1: Richard Green is a paper manufacturer. During the year, he made substantial improvements to the land on which his paper plant is located. Assume that these land improvements are depreciable property. He checks the asset categories and finds land improvements under Asset Class 00.3 Land Improvements. He then checks the activity categories and finds his activity, paper manufacturing, under Asset Class 26.1, Manufacture of Pulp and Paper.

If Richard had only looked at the asset categories, he would have erroneously selected Asset Class 00.3, Land Improvements, and would have incorrectly used a recovery period

of 15 years for GDS or 20 years for ADS. However, Richard uses the recovery period under Asset Class 26.1 Manufacture of Pulp and Paper, because it specifically includes land improvements. Thus, the land improvements have a 13-year class life and a 7-year recovery period for GDS. If he elects to use ADS, the recovery period is 13 years.

[Note: It is presumed in this example that the subject land improvements are directly associated with the factory site or production process, for example, effluent ponds or canals necessitated by the production process, or parking lots utilized by employees directly involved with the production process. However, those land improvements that are more closely associated with non-production activities, such as administrative or retail activities of the taxpayer, would be categorized in Asset Class 00.3 Land Improvements and have a 15-year recovery period under GDS. See Rev. Rul. 2003-81, 2003-2 C.B. 126.]

Example 2: Sam Plower produces rubber products. During the year, he made substantial improvements to the land on which his rubber plants are located. Assume that these land improvements are depreciable property. He checks the asset categories and finds land improvements under Asset Class 00.3. He then checks the activity categories and finds his activity, producing rubber products, under Asset Class 30.1, Manufacture of Rubber Products. Reading the headlines and descriptions under Asset Class 30.1, Sam finds that it does not specifically include land improvements. Therefore, Sam uses the recovery period for Asset Class 00.3 Land Improvements. Thus, the land improvements have a 20-year class life and a 15-year recovery period for GDS. If he elects to use ADS, the recovery period is 20 years.

Example 3: Pam Martin owns a retail-clothing store. During the year, she purchased a desk and a cash register for use in her business. She checks the asset categories and finds office furniture under Asset Class 00.11 Office Furniture, Fixtures, and Equipment. Cash registers are not specifically listed in any of the asset categories. She then checks the activity categories and finds her activity, retail store, under Asset Class 57.0 Distributive Trades and Services, which includes assets used in wholesale and retail trade. The description for this asset class does not specifically list office furniture or a cash register.

She looks back at the asset categories and uses Asset Class 00.11 for the desk, since it constitutes office furniture. Thus, the desk has a 10-year class life and a 7- year recovery period for GDS. If she elects to use ADS, the recovery period is 10 years. For the cash register, Pam uses Asset Class 57.0 Distributive Trades and Services, because cash registers are not specifically listed in one of the asset categories but are assets used in retail business. Accordingly, the cash register has a 9-year class life and a 5-year recovery period for GDS. If she elects to use the ADS method, the recovery period is 9 years.

8. Additional References for Determining the Proper Activity Category for Property

The Standard Industrial Classification Manual (SIC) published by the Office of Management and Budget can provide insight into the content of the asset classes described in Rev. Proc. 87-56. Care must be exercised because SIC does not make use of the same

classification techniques and depreciation concepts of Rev. Proc. 87-56. While SIC has precise categorization by primary business activity using language very similar to that found in Rev. Proc. 87-56, the revenue procedure departs dramatically from the categorization scheme of SIC by establishing two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. However, the asset class numbers for the specific business activities described in Rev. Proc. 87-56 are largely taken from SIC.

Additionally, it may be helpful to look at the North American Industry Classification System (NAICS). NAICS was introduced in 1997 to replace the SIC system and more closely reflects the many new industries that have propagated since the establishment of the SIC system in 1937, including many service industries currently under-represented in the SIC system. Although the manner of categorization is similar under both SIC and NAICS, the category codes are vastly different, which is why the Service generally does not look to NAICS for insight purposes. However, NAICS can be helpful (because of its expanded description of service industries) in determining in which one of two activity categories, a particular asset should be categorized.

D. Relevant Court Cases

1. Introduction

In addition to the legal framework presented earlier in Chapter 2, the court cases listed below provide further guidance as to whether a particular asset constitutes § 1245 property or § 1250 property. Although the issue in many of the cases below relates to whether property is eligible for the now-expired investment tax credit (ITC), the precedent that was developed to ascertain whether property constituted eligible property for purposes of ITC is equally applicable to ascertain whether property constitutes as § 1245 property for purposes of ACRS/MACRS.

Unfortunately, there are no bright-line tests for distinguishing § 1245 property from § 1250 property. Each of the cases below is factually intensive. Additionally, opinions by different courts sometimes conflict; therefore, an ultimate determination of the categorization of an asset generally cannot be based upon reading merely one case. In addition to reading all of the cases on point, one must also consider whether the Service has acquiesced to a particular position or case. Advice should be sought where the asset at issue is not specifically discussed in any of the below opinions, if one is not sure of how to categorize a specific asset, or if the opinions are vague or conflicting.

2. Arrangement of Information

This chapter contains two tables to assist examiners in locating pertinent cases that address specific assets:

Table 1: Case Law by Case Name (in reverse chronological order)

Table 2: Case Law listed by CSI MasterFormat Division (both 2004 (50 divisions) and 1995 (16 divisions))

NOTE: Cost Segregation studies are often organized following the Construction Specifications Institute (CSI) MasterFormat Division system. The CSI MasterFormat system is a master list of numbers and titles classified by construction trades (concrete, electrical, plumbing, mechanical, carpentry, masonry, steel, etc.) that was developed to simplify and facilitate communication within the construction industry. The inclusion of the CSI MasterFormat Divisions in these tables is for informational purposes only and is not an endorsement of either the Construction Specifications Institute or the MasterFormat system.

For reference purposes, this chapter also contains a third table listing all the CSI MasterFormat Divisions for both the 2004 and 1995 editions:

Table 3: Listing of CSI MasterFormat Divisions (both 2004 (50 divisions) and 1995 (16 divisions))

3. Table 1: Case Law by Case Name (Reverse Chronological Order)

Date	Case Name/Citation	Asset	Comments
3/12/2012	AmeriSouth XXXII, Ltd. v. Commissioner, T.C. Memo. 2012-67	Site prep and earthwork (nondep.) Water distribution system (§1250) Sanitary sewer system (§1250) Gas line (§1250) Site electric (§1250) Special HVAC – dryer vents (§1245) Special HVAC – kitchen vent hoods (§1250) Special plumbing – sinks and garbage disposals (§1250) Special plumbing – laundry drain and waste lines (§1250) Special plumbing – dryer gas lines (§1245) Special electric (§1245/§1250) Finish carpentry (§1250) Millwork (§1250) Interior windows & mirrors (§1250) Special painting (§1250)	Enumerates three categories of §1245 property: 1) accessory to a business; 2) non-permanence; and 3) is ornamental or decorative.

Date	Case Name/Citation	Asset	Comments
7/28/2010	PPL Corporation & Subs. v. Commissioner, 135 T.C. 176 (2010)	Street Lights	Street light assets did not fall with asset class 49.14 Utility Transmission and Distribution Plant, nor within asset class 00.3 Land Improvements. They fall within the residual asset class to which a 7-year recovery period.
4/3/2007	Trentadue v. Commissioner, 128 T.C. 91 (2007)	Well (§1250 land improvement) Underground irrigation system (§1250 land improvement) Trellises (§1245)	
5/28/1998	L.L. Bean, Inc. v. Commissioner, 145 F.3d 53 (1st Cir. 1998), aff'g T.C. Memo. 1997-175	Storage rack system (also supports roof and walls) (§1250) Concrete slab floor (§1250) Roof and wall panels (§1250) Electrical system (§1250) Heating/ventilation sys. (§1250) Fire protection system (§1250) Mezzanine system (§1250)	
12/10/1997	SuperValu Inc. v. United States, 993 F.Supp. 1243 (D.Minn. 1997)	Refrigeration system (§1245)	
7/24/1997	Hospital Corp. of America & Subs. v. Commissioner, 109 T.C. 21 (1997)	Primary and secondary electrical distribution sys. (§1245/§1250) Special electrical equip. and branch wiring (§1245) TV equipment and wiring (§1245) Telephone equip., wiring, jacks, and intercom equip. (§1245) Carpeting (§1245) Vinyl wall covering (§1245) Vinyl floor covering (§1245) Kitchen water piping, grease trap system, and steam lines, (§1245)	Landmark case setting precedent that criteria developed to ascertain whether property constituted eligible property for purposes of ITC is equally applicable to ascertain whether property constitutes § 1245 property for purposes of ACRS/MACRS. In AOD 1999-008, the IRS acquiesced in part regarding definition of tangible personal property and non-acquiesced in part

Date	Case Name/Citation	Asset	Comments
		Kitchen hoods and exhaust system (§1245) Patient corridor handrails (§1245) Over-bed fluorescent lights (§1250) Partitions/room dividers (§1245) Bathroom accessories (§1250) Acoustical ceilings (§1250) Steam boilers (§1250)	regarding determination of individual assets in dispute.
6/6/1997	Schrum v. Commissioner, 114 F.3d 1177 (4th Cir. 1997), aff'g in part and vac'g in part without published opinion, T.C. Memo. 1995-103, on remand from 33 F.3d 426 (4th Cir. 1994), aff'g in part and vac'g in part, T.C. Memo. 1993-124	Car wash facility structure (§1250) Plumbing system (§1245) Electrical system (§1245)	This is a Fourth Circuit case that follows the precedent in A.C. Monk and does not represent the predominant view of the issue.
11/4/1996	Boddie-Noelle Enterprises. Inc. v. United States, 36 Fed.Cl. 722 (1996), aff'd without published opinion, 132 F.3d 54 (Fed.Cir. 1997)	Suspended ceilings (§1250) Roof panels - mansard (§1250) Electrical connected to equipment (§1250) Plumbing connected to equipment (§1250) Kitchen HVAC (§1250) Decorative mirror (§1250) Drive-thru window units (§1250)	The court determined that any items expressly listed as a building or structural component in the regulations are excluded from being tangible personal property. This approach is precedent only for the Federal Claims Court and has not been followed by other courts.
8/13/1996	Walgreen Co. & Subs. v. Commissioner, T.C. Memo. 1996-374, on remand from 68 F.3d 1006 (7th Cir. 1995), rev'g 103 T.C. 582 (1994)	Partitions (drywall, glass) (§1250) Restroom partition (metal) (§1250) Doors, framing, millwork, metalwork, trimwork (§1250) Ceiling (drywall, acoustic) (§1250)	

Date	Case Name/Citation	Asset	Comments
		Lighting fixtures and wiring (not emergency/exit lighting) (§1250) Floor coverings (carpet, vinyl, or tile) (§1250) Decorative finishes, canopies, signs, concrete piers (§1245)	
3/7/1995	La Petite Academy v. United States, 95-1 USTC ¶ 50,193 (W.D.Mo. 1995), aff'd without published opinion, 72 F.3d 133 (8th Cir. 1995)	Wall panels - magnetic (§1250) Roof - mansard (§1250) Fencing - playground (§1250) Exterior façade lighting (§1250) Fire protection system (§1250) Heat and smoke detectors (§1250) Emergency/exit lights (§1250) Restroom accessories (§1250) Kitchen grease trap (§1250) Kitchen electrical service (§1250) Dumpster enclosure (fence and concrete pad) (§1250) Thermal recovery system (§1250) Doors – split (bypass) (§1250)	
12/30/1993	Albertson's, Inc. v. Commissioner, 38 F.3d 1046 (9th Cir. 1993), rev'g T.C. Memo. 1988-582, cert. denied 516 U.S. 807 (1995)	HVAC system (§1250)	
2/25/1993	Grinalds v. Commissioner, T.C. Memo. 1993-66	Air conditioning units (§1250) Partitions (§1250) Walls (interior) (§1250) Plumbing – restroom (§1250) Elec. conduit – restroom (§1250)	
5/27/1992	Texas Instruments Inc. v. Commissioner, T.C. Memo. 1992-306	Waste treatment facilities (§1245) Drywall partitions (§1250) Elec. switch gear structure (§1245) Water pump structure (§1250)	

Date	Case Name/Citation	Asset	Comments
		Water and fuel oil tanks (§1250) Lab and special rooms (§1250) Concrete floor & columns (§1245) Concrete slab floor and wood deck (§1250) Window wall partitions (§1250) Ceilings - suspended (§1250) A/C in telephone room (§1245) Plumbing for equipment (§1245) Emergency doors (§1250) Localized fire protection system (§1245) Sprinkler heads (§1250) Security fencing (§1245) Interior landscaping (§1245) Exterior landscaping (§1250) Electrical – substations and transformers (Cat. 1) (§1250) Electrical – high voltage system (Cat. 2) (§1250) Electrical – spare transformers, breakers, cable (Cat. 3) (§1250) Electrical – systems dedicated to equipment (Cat. 4) (§1245)	
4/28/1992	Publix Supermarkets, Inc. v. United States, 26 Cl.Ct. 161 (1992)	HVAC system (§1250)	
5/14/1991	Wood v. Commissioner, T.C. Memo. 1991-205	Solar water-heating equip. (§1245)	
1/9/1990	Morrison, Inc. v. Commissioner, 891 F.2d 857 (11th Cir. 1990), aff'g T.C. Memo. 1986-129	Emergency lighting (§1245) Kitchen elec. panel boards (§1245) Kitchen hand sinks (§1250) Kitchen water piping (§1245) Eliason doors (§1245) Restroom accessories (§1250) Decor window treatment (§1245)	In AOD 1991-19, the IRS acquiesced to the functional allocation approach based, in part, on the Morrison case.

Date	Case Name/Citation	Asset	Comments
		Lattice millwork (§1245) Vanity cabinets/counters (§1250) Customer line screen (§1245) Serving line concrete curb (§1250) Kitchen heat recovery unit (§1245) Floors - insulated (cooler, freezer, garbage room) (§1250) Garbage room (§1250) Kitchen walls & floor tiles (§1250) Kitchen air makeup unit (§1245) Kitchen drainage system (grease trap) (§1245) Electric water coolers (§1250) Chandeliers and dimmers (§1245) Kitchen hot water heater (§1245) Primary electric distribution system (§1245/§1250)	
11/22/1988	McManus v. United States, 863 F.2d 491 (7th Cir. 1988), aff'g 700 F. Supp. 994 (W.D.Wis. 1987)	Airplane hangar (§1250) Hangar doors & partitions (§1250)	
7/21/1988	Munford, Inc. v. Commissioner, 849 F.2d 1398 (11th Cir. 1988), aff'g 87 T.C. 463 (1986)	Truck loading platform (§1250) Rail loading platform (§1250) Refrigerated area (§1245)	
9/15/1987	Lukens, Inc. v. Commissioner, T.C. Memo. 1987-464	Craneway structures (§1245)	
1/20/1987	Metro National Corp. v. Commissioner, T.C. Memo. 1987-38	Partitions (gypsum drywall) (§1245) Partitions – glass storefront (§1245/§1250) Partitions – toilet/restroom (§1250)	

Date	Case Name/Citation	Asset	Comments
		False ceilings with lighting (§1250) Exterior security lighting (§1245) Interior grow lights (§1245) Exterior accent lighting (§1245) Cabinets and hardware (§1245) Sprinkler heads (§1250)	
11/13/1986	Piggly Wiggly Southern, Inc. v. Commissioner, 803 F.2d 1572 (11th Cir. 1986), aff'g 84 T.C. 739 (1985)	HVAC units (§1245)	In AOD 1988-22, the IRS non-acquiesced to the court not using the sole justification test for HVAC systems.
4/28/1986	Illinois Cereal Mills, Inc. v. Commissioner, 789 F.2d 1234 (7th Cir. 1986), aff'g T.C. Memo. 1983-469, cert. denied, 479 U.S. 995 (1986)	Electrical distribution system (§1245/§1250) (95%/5%)	In AOD 1988-20, the IRS non-acquiesced to the use of the functional allocation approach for electrical systems. In AOD 1991-19, the IRS acquiesced to the functional allocation approach.
11/4/1985	Mallinckrodt, Inc. v. Commissioner, 778 F.2d 402 (8th Cir. 1985), aff'g T.C. Memo. 1984-532	Partitions (gypsum drywall) (§1250)	
1/24/1985	Duaine v. Commissioner, T.C. Memo. 1985-39	Concrete foundation slab (§1250) Kitchen wall and floor tiles (§1250) Plumbing, gas lines, electrical conduits to equipment (§1245) Interior and exterior ornamental lighting fixtures (§1250)	
8/6/1984	Shoney's South, Inc. v. Commissioner, T.C. Memo. 1984-413	Chandeliers and lanterns (§1245)	In AOD 1986-48 the IRS non-acquiesced that certain lighting was decorative and thus eligible for the ITC.
6/17/1983	Consolidated Freightways, Inc. v. Commissioner, 708 F.2d 1385 (9th Cir.	Truck loading docks (§1250) Dock overhead doors (§1250) Dock lighting (§1250)	

Date	Case Name/Citation	Asset	Comments
	1983), aff'g in part and rev'g in part, 74 T.C. 768 (1980)		
8/27/1982	A.C. Monk & Co. v. United States, 686 F.2d 1058 (4th Cir. 1982), aff'g in part and rev'g in part, E.D.N.C. No. 78-126-CIV-4 (August 4, 1981), on remand to 577 F.Supp. 4 (E.D.N.C. 1983)	Louvered wall (§1245) Truck apron (concrete pad) (§1245) Restroom furnishings (§1250) Railroad concrete platform (§1250) Elec. distribution system (§1250) Green storage room (§1250) High bay portion of roof (§1250) Wiring for computer room (§1245) Environmental control rooms (§1245) Fire hose wall stations (§1250) Storage sheds (§1245)	Court used adaptability test for electrical systems (not functional allocation method). Opinion should be followed only in cases appealable to the Fourth Circuit.
5/26/1982	Circle K Corp. v. Commissioner, T.C. Memo. 1982-298	A/C units (roof) (§1250) Cold storage room (§1250)	
4/20/1981	Samis v. Commissioner, 76 T.C. 609 (1981)	Boiler structure (concrete) (§1250) Energy plant (§1250) A/C and heating system (§1250)	
4/28/1980	Scott Paper Co. v. Commissioner, 74 T.C. 137 (1980)	Primary electric distribution system (§1245/§1250) Secondary electric distribution system (§1245/§1250)	Landmark case setting forth functional allocation method for allocating components of an electrical distribution system into §§ 1245/1250 property.
6/18/1979	Dixie Manor, Inc. v. United States, 79-2 USTC ¶ 9469 (W.D.Ky. 1979), aff'd, in unpub. opinion, 652 F.2d 57 (6th Cir. 1981)	A/C & heating units (roof) (§1250) Partitions (drywall) (§1250)	
2/13/1978	Westroads, Inc. v. Commissioner, 69 T.C. 682 (1978)	Elec. generating equip. (§1245)	In AOD 1979-173, the IRS acquiesced to the result.

Date	Case Name/Citation	Asset	Comments
12/31/1975	Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664 (1975)	Outdoor signs (billboards) (§1245)	Landmark case putting forth factors for determining whether property is inherently permanent. In AOD 1977-142, the Service acquiesced to the criteria set forth for determining whether property is inherently permanent.
1/23/1974	Kramertown Co., Inc. v. Commissioner, 488 F.2d 728 (5th Cir. 1974), aff'g T.C. Memo. 1972-239	A/C & heating units (roof) (§1250)	
12/3/1973	Everhart v. Commissioner, 61 T.C. 328 (1973)	Sewage disposal system (§1250)	Property is structural component even though not directly attached to the building.
11/6/1973	King Radio Corp., Inc. v. United States, 486 F.2d 1091 (10th Cir. 1973), aff'g D.Kan., No. KC-3320 (Oct. 30, 1972)	Partitions: movable sys. (§1245) Partitions (ceiling height) (§1245) Partitions (5'6" height) (§1245) Doors (in partitions) (§1245)	In AOD 1972 WL 33204, the IRS recommended appeal of the Tax Court case. In AOD 1975-580, the IRS acquiesced to the Circuit Court case.
6/12/1973	Coors v. Commissioner, 60 T.C. 368 (1973)	Duct work (filter system) (§1250) Saw room (§1250) Valve-testing room (§1250)	
5/24/1972	Central Citrus Co. v. Commissioner, 58 T.C. 365 (1972)	Sweet rooms (§1245) Blowers and coolers (§1245) Electrical system (§1245/§1250) Elec. panel & transformer (§1250) Electrical outlets (§1250) Elec. distribution system: adapters, fuses, switches, relays (§1245) Lights: fluorescent, moisture-proof (§1245) Lights: spotlights & flood (§1245)	In AOD 1972 WL 33052, the IRS acquiesced to the decision. Note that there was a subsequent change in statute to replace the term "storage facility" with the narrower concept of a "facility used … for the bulk storage of fungible commodities."

Date	Case Name/Citation	Asset	Comments
		Lights: ballast and exterior (§1245)	
12/28/1970	Minot Federal Sav. & Loan Ass'n v. United States, 435 F.2d 1368 (8th Cir. 1970), aff'g 313 F. Supp. 294 (D.N.D. 1970)	Partitions: movable sys. (§1245)	Determination of structural component based on permanency test, not functional use test.
3/26/1970	Fort Walton Square, Inc. v. Commissioner, 54 T.C. 653 (1970)	A/C and heating system (§1250)	
10/27/1969	Ponderosa Mouldings Inc. v. Commissioner, 53 T.C. 92 (1969)	Sprinkler system (§1250)	
5/16/1968	Catron v. Commissioner, 50 T.C. 306 (1968)	Sorting and boxing room (§1250) Refrigerated room (§1245)	Landmark case that held that a building could be allocated into portions for purposes of the ITC. In AOD 1968 WL 16712, the IRS acquiesced in result only (not to the court's rationale). In AOD 1972 WL 33051, the IRS acquiesced to the rationale of the court.

4. Table 2: Case Law by CSI MasterFormat Divisions (2004 and 1995)

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
		Division 03 – Concrete			
030000	03000	Concrete slab floor		X	L.L. Bean
030000	03000	Concrete slab floor & wood deck		X	Texas Instruments
030000	03000	Concrete floor & columns	X		Texas Instruments
030000	03000	Waste treatment facilities	X		Texas Instruments
030000	03000	Truck loading platform		X	Munford
030000	03000	Truck loading dock		X	Consol. Freight.

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
030000	03000	Truck apron (concrete pad)	X		A.C. Monk
030000	03000	Railroad concrete platform		X	A.C. Monk
030000	03000	Rail loading platform		X	Munford
030000	03000	Floors - insulated (cooler, freezer, garbage room)		X	Morrison
030000 033000	03000 03300	Serving line concrete curb		X	Morrison
031000	03100	Concrete foundation slab		X	Duaine
		Division 04 – Masonry			
042000	04200	Car wash facility structure		X	Schrum
042000	04200	Boiler structure (concrete)		X	Samis
		Division 05 – Metals			
051000	05100	Craneway structures	X		Lukens
		Div. 06 – Wood, Plastics, & Comp.			
062000	06200	Finish carpentry		X	AmeriSouth
064000	06400	Millwork		X	AmeriSouth
064000	06400	Millwork, metalwork, trimwork		X	Walgreen
064400	06440	Lattice millwork	X		Morrison
066300	05720	Patient corridor handrails	X		HCA
		Div. 07 – Thermal & Moisture Prot.			
074000	13140	Roof and wall panels		X	L.L. Bean
074000	06170	Roof panels – Mansard		X	Boddie-Noelle
074000	06170	Roof – Mansard		X	La Petite Acad.
074000	05100	High bay portion of roof		X	A.C. Monk
		Division 08 – Openings			
081000	08100	Doors, framing		X	Walgreen
081000	08100	Emergency Doors		X	Texas Instruments
081000	08000	Doors (in partitions)	X		King Radio
083000	08300	Doors – split (bypass)		X	La Petite Acad.

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
083300	08330	Dock overhead doors		X	Consol. Freight.
083400	08344	Hangar doors		X	McManus
083800	08380	Eliason doors	X		Morrison
085000	08500	Interior windows & mirrors		X	AmeriSouth
085600	08582	Drive-thru window units		X	Boddie-Noelle
088300	08830	Decorative mirror		X	Boddie-Noelle
0884426	08970	Window wall partitions		X	Texas Instruments
0884426	08970	Partitions – glass storefront	X	X	Metro Nat'l Corp.
089100	15700	Louvered wall	X		A.C. Monk
		Division 09 – Finishes			
092000	09250	Wall panels – magnetic		X	La Petite Acad.
092000	09250	Walls (interior)		X	Grinalds
092000	09250	Partitions		X	Grinalds
092000	09250	Partitions (drywall, glass)		X	Walgreen
092000	09250	Drywall partitions		X	Texas Instruments
092000	09250	Partitions (gypsum drywall)	X		Metro Nat'l Corp.
092000	09250	Partitions (gypsum drywall)		X	Mallinckrodt
092000	09250	Partitions (drywall)		X	Dixie Manor
092000	09250	Customer line screen	X		Morrison
093000	09300	Kitchen walls and floor tiles		X	Morrison
093000	09300	Kitchen wall and floor tiles		X	Duaine
095000	09510	Acoustical ceilings		X	HCA
095000	09500	Ceilings (drywall, acoustic)		X	Walgreen
095000	09500	Suspended Ceilings		X	Boddie-Noelle
095000	09500	Ceilings - suspended		X	Texas Instruments
095000	09510	False ceilings with lighting		X	Metro Nat'l Corp.

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
096000	09680	Floor coverings (carpet, vinyl, tile)		X	Walgreen
096000	09680	Carpeting	X		HCA
096000	09680	Vinyl Floor Covering	X		HCA
097000	09720	Vinyl Wall Covering	X		HCA
099000	09900	Special painting		X	AmeriSouth
		Division 10 – Specialties			
101400	10426	Outdoor signs (billboards)	X		Whiteco
102000	10800	Restroom partition (metal)		X	Walgreen
102000	10800	Partitions – toilet/restroom		X	Metro Nat'l Corp.
102200	05300	Metal partitions		X	McManus
102200	10650	Partitions / Room dividers	X		HCA
102200	10630	Partitions: movable system	X		King Radio
102200	10630	Partitions (ceiling height)	X		King Radio
102200	10630	Partitions (5'6" height)	X		King Radio
102200	10630	Partitions: movable system	X		Minot
102800	10800	Bathroom accessories		X	HCA
102800	10800	Restroom accessories		X	Morrison
102800	10800	Restroom furnishings		X	A.C. Monk
102813	10800	Restroom accessories		X	La Petite Acad.
105600	13140	Storage rack system (also supports roof and walls)		X	L.L. Bean
107316	10536	Decorative finishes, canopies, signs, concrete piers	X		Walgreen
		Division 11 – Equipment			
113113	11450	Special HVAC – kitchen vent hoods		X	AmeriSouth
		Division 12 – Furnishings			
122000	16500	Décor window treatment	X		Morrison
123000	06400	Cabinets and hardware	X		Metro Nat'l Corp.
123500	06400	Vanity cabinets & counters		X	Morrison

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
		Div. 13 – Special Construction			
132000	13030	Garbage room		X	Morrison
132000	13030	Sorting and boxing room		X	Catron
132000	13030	Lab and special rooms		X	Texas Instruments
132000	13030	Saw room		X	Coors
132000	13030	Valve-testing room		X	Coors
132000	13030	Green storage room		X	A.C. Monk
132000	13120	Environmental control rooms	X		A.C. Monk
132000	13030	Sweet rooms	X		Central Citrus
132126	13030	Refrigerator area	X		Munford
132126	13030	Refrigerated room	X		Catron
132126	13030	Cold storage room		X	Circle K
133400	13120	Mezzanine system		X	L.L. Bean
133400	13120	Water pump structure		X	Texas Instruments
133400	13120	Elec. switch gear structure	X		Texas Instruments
133419	13120	Storage sheds	X		A.C. Monk
133419	13120	Airplane hangar		X	McManus
		Division 21 – Fire Suppression			
211100	15300	Fire protection system		X	L.L. Bean
211100	15300	Fire protection system		X	La Petite Acad.
211100	15300	Fire hose wall stations		X	A.C. Monk
211100	15300	Localized fire protection system	X		Texas Instruments
211100	15300	Sprinkler heads		X	Texas Instruments
211100	15300	Sprinkler system		X	Ponderosa
		Division 22 - Plumbing			

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
220000	15400	Kitchen water piping, grease trap system, and steam lines	X		HCA
220000	15400	Kitchen hot water heater	X		Morrison
220000	15400	Kitchen water piping	X		Morrison
220000	15400	Kitchen drainage sys. (grease trap)	X		Morrison
220000	15400	Kitchen hand sinks		X	Morrison
220000	15400	Plumbing – restroom		X	Grinalds
220000	15780	Thermal recovery system		X	La Petite Acad.
220000	15400	Plumbing connected to equipment		X	Boddie-Noelle
220000	15400	Plumbing for equipment	X		Texas Instruments
220000	15100	Plumbing to equipment	X		Duaine
220000	15100	Gas lines to equipment	X		Duaine
221100	15100	Plumbing system	X		Schrum
221200	13200	Water tanks		X	Texas Instruments
221300	11442	Kitchen grease trap		X	La Petite Acad.
223000	15480	Solar water-heating equipment	X		Wood
224000	15400	Special plumbing – dryer gas lines	X		AmeriSouth
224000	15400	Special plumbing – laundry drain and waste lines		X	AmeriSouth
224000	15400	Special plumbing – sinks and garbage disposals		X	AmeriSouth
224700	15412	Electric water coolers		X	Morrison
		Division 23 – HVAC			
230000	15510	Steam boilers		X	HCA
230000	15850	Kitchen hoods & exhaust system	X		HCA
230000	15780	Kitchen heat recovery unit	X		Morrison
230000	15850	Kitchen air makeup unit	X		Morrison

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
230000	15700	Kitchen HVAC		X	Boddie-Noelle
230000	15700	Air conditioning in telephone room	X		Texas Instruments
230000	15764	Heating/ventilation system		X	L.L. Bean
230000	15700	Air conditioning units		X	Grinalds
230000	15700	HVAC system		X	Albertson's
230000	15700	HVAC system		X	Publix
230000	15700	Air conditioning units (roof)		X	Circle K
230000	15700	Air conditioning/heating units (roof)		X	Dixie Manor
230000	15700	HVAC units	X		Piggly Wiggly
230000	15700	Blowers and coolers	X		Central Citrus
231300	13200	Fuel oil tanks		X	Texas Instruments
233000	15800	Special HVAC – dryer vents	X		AmeriSouth
233000	15800	Duct work (filter system)		X	Coors
235000 236000	15500 15600	Energy plant		X	Samis
236000	15600	Refrigeration system	X		SuperValu
237000	15700	Air conditioning/heating system		X	Samis
237000	15700	Air conditioning/heating units (roof)		X	Kramertown
237000	15700	Air conditioning/heating system		X	Fort Walton
		Division 26 – Electrical			
260000	16200	TV equipment and wiring	X		HCA
260000	16140	Electrical conduits to equipment	X		Duaine
260000	16140	Electrical system	X	X	Central Citrus
260000	16140	Elec. panel and transformer		X	Central Citrus
260000	16140	Electrical outlets		X	Central Citrus

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
260000	16200	Kitchen electrical service		X	La Petite Acad.
260000	16200	Elec. conduit – restroom		X	Grinalds
261000	16400	Electrical system		X	L.L. Bean
261000	16400	Primary & secondary elec. dist. sys.	X	X	HCA
261000	16400	Special elec. equip. & branch wiring	X		HCA
261000	16400	Primary electric distribution system	X	X	Morrison
261000	16400	Kitchen electric panel boards	X		Morrison
261000	16400	Electrical system	X		Schrum
261000	16400	Electrical distribution sys. (95%/5%)	X	X	Ill. Cereal Mills
261000	16400	Primary electric distribution system	X	X	Scott Paper
261000	16400	Secondary electric distribution sys.	X	X	Scott Paper
261000	16400	Electrical connected to equipment		X	Boddie-Noelle
261000	16400	Electrical distribution system		X	A.C. Monk
261000	16400	Wiring for computer room	X		A.C. Monk
261000	16400	Elec. distribution system: adapters, fuses, switches, relays	X		Central Citrus
261000	16400	Electrical – systems dedicated to equipment (Cat. 4)	X		Texas Instruments
261000	16400	Electrical – spare transformers, breakers, cable (Cat. 3)		X	Texas Instruments
261000	16400	Electrical – high voltage system (Cat. 2)		X	Texas Instruments
261100	16360	Electrical – substations and transformers (Cat. 1)		X	Texas Instruments
262000	16400	Special electric	X	X	AmeriSouth

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
263000	16220	Electrical generating equipment	X		Westroads
265000	16500	Lighting fixtures and wiring		X	Walgreen
265100	16510	Over-bed fluorescent lights		X	HCA
265100	16510	Int. & ext. ornamental light fixtures		X	Duaine
265100	16510	Dock lighting		X	Consol. Freight.
265100	16510	Exterior accent lighting	X		Metro Nat'l Corp.
265100	16510	Interior grow lights	X		Metro Nat'l Corp.
265100	16510	Chandeliers and dimmers	X		Morrison
265100	16510	Chandeliers and lanterns	X		Shoney's
265100	16510	Hanging lanterns	X		Shoney's
265100	16510	Lights: fluorescent & moisture-proof	X		Central Citrus
265100	16510	Lights: ballast and exterior	X		Central Citrus
265200	16530	Emergency lighting	X		Morrison
265200	16530	Emergency/exit lights		X	La Petite Acad.
265600	16520	Exterior façade lighting		X	La Petite Acad.
265600	16520	Exterior security lighting	X		Metro Nat'l Corp.
265600	16510	Lights: spotlights and flood lamps	X		Central Citrus
		Division 27 – Communication			
270000	16700	Telephone equip., wiring, and jacks	X		HCA
270000	16700	Intercom equip. and call system	X		HCA
		Div. 28 – Elec. Safety & Security			
283100	15300	Heat and smoke detectors		X	La Petite Acad.
		Division 31 – Earthwork			

CSI Master Format 2004 Classification	CSI Master Format 95 Classification	Asset	IRC §1245 Prop.	IRC §1250 Prop.	Case Name
311000	02200	Site prep and earthwork (nondep.)			AmeriSouth
		Division 32 – Ext. Improvements			
323000	02800	Trellises (§1245)	X		Trentadue
323100	02825	Security fencing	X		Texas Instruments
323100	02825	Fencing – playground		X	La Petite Acad.
323100	02825	Dumpster enclosure (fence & concrete pad)		X	La Petite Acad.
328000	02810	Sprinkler heads		X	Metro Nat'l Corp.
328423	02810	Underground irrigation system		X	Trentadue
329300	02930	Exterior landscaping		X	Texas Instruments
329300	02930	Interior landscaping	X		Texas Instruments
		Division 33 – Utilities			
331116	02510	Water distribution system		X	AmeriSouth
332100	02520	Well		X	Trentadue
333000	02530	Sewage disposal system		X	Everhart
333100	02530	Sanitary sewer system		X	AmeriSouth
335100	02550	Gas line		X	AmeriSouth
337100	02580	Site electric		X	AmeriSouth

5. Table 3: Listing of CSI MasterFormat Divisions (2004 and 1995)

MASTERFORMAT 2004 EDITION

The current MasterFormat Divisions are:

PROCUREMENT AND CONTRACTING REQUIREMENTS GROUP

- Division 00 — Procurement and Contracting Requirements

SPECIFICATIONS GROUP

General Requirements Subgroup

- Division 01 — General Requirements

Facility Construction Subgroup

- Division 02 — Existing Conditions (natural conditions)
- Division 03 — Concrete (footing)
- Division 04 — Masonry (concrete block/brick)
- Division 05 — Metals (beams)
- Division 06 — Wood, Plastics, and Composites (framing)
- Division 07 — Thermal and Moisture Protection (insulation water barrier)
- Division 08 — Openings (doorways)
- Division 09 — Finishes
- Division 10 — Specialties
- Division 11 — Equipment
- Division 12 — Furnishings
- Division 13 — Special Construction
- Division 14 — Conveying Equipment
- Division 15 — RESERVED FOR FUTURE EXPANSION
- Division 16 — RESERVED FOR FUTURE EXPANSION
- Division 17 — RESERVED FOR FUTURE EXPANSION
- Division 18 — RESERVED FOR FUTURE EXPANSION
- Division 19 — RESERVED FOR FUTURE EXPANSION

Facility Services Subgroup:

- Division 20 — RESERVED FOR FUTURE EXPANSION
- Division 21 — Fire Suppression
- Division 22 — Plumbing
- Division 23 — Heating Ventilating and Air Conditioning
- Division 24 — RESERVED FOR FUTURE EXPANSION
- Division 25 — Integrated Automation
- Division 26 — Electrical
- Division 27 — Communications
- Division 28 — Electronic Safety and Security
- Division 29 — RESERVED FOR FUTURE EXPANSION

Site and Infrastructure Subgroup:

- Division 30 — RESERVED FOR FUTURE EXPANSION
- Division 31 — Earthwork
- Division 32 — Exterior Improvements
- Division 33 — Utilities
- Division 34 — Transportation
- Division 35 — Waterway and Marine
- Division 36 — RESERVED FOR FUTURE EXPANSION
- Division 37 — RESERVED FOR FUTURE EXPANSION
- Division 38 — RESERVED FOR FUTURE EXPANSION
- Division 39 — RESERVED FOR FUTURE EXPANSION

Process Equipment Subgroup:

- Division 40 — Process Integration
- Division 41 — Material Processing and Handling Equipment
- Division 42 — Process Heating, Cooling, and Drying Equipment
- Division 43 — Process Gas and Liquid Handling, Purification and Storage Equipment
- Division 44 — Pollution and Waste Control Equipment
- Division 45 — Industry-Specific Manufacturing Equipment
- Division 46 — Water and Wastewater Equipment
- Division 47 — RESERVED FOR FUTURE EXPANSION
- Division 48 — Electrical Power Generation
- Division 49 — RESERVED FOR FUTURE EXPANSION

6. MASTER FORMAT 1995 EDITION

Before November 2004, MasterFormat was composed of 16 primary divisions:

- Division 01 — General Requirements
- Division 02 — Site Construction
- Division 03 — Concrete
- Division 04 — Masonry (concrete block)
- Division 05 — Metals(beams)
- Division 06 — Wood and Plastics
- Division 07 — Thermal and Moisture Protection
- Division 08 — Doors and Windows
- Division 09 — Finishes
- Division 10 — Specialties
- Division 11 — Equipment
- Division 12 — Furnishings
- Division 13 — Special Construction
- Division 14 — Conveying Systems
- Division 15 — Plumbing & Mechanical
- Division 16 — Electrical

E. Inherently Permanent Standard

1. Introduction

In determining whether a structure, or component of a structure, is inherently permanent, one must consider the governing code section defining the scope and nature of the structure. Chapter 2.L of this ATG discusses whether a structure is inherently permanent for cost recovery purposes under § 168. The analysis used for inherent permanency for cost recovery purposes under § 168 is not the same as for other code sections that use the "inherently permanent" concept. This includes the Uniform Capitalization (UNICAP) rules of § 263A (discussed in Chapter 6.A of this ATG) and the Domestic Production Deduction (DPD) rules of § 199. The "inherently permanent" rules for each of these other code sections are markedly different from those for cost recovery. Care should be taken when evaluating a cost segregation study that the correct "inherently permanent" rules are applied. To assist the examiner to recognize the differences between each code section, a brief summary of these provisions is presented below.

2. Inherently Permanent Standard Under § 168

The primary issue in cost segregation studies is the proper classification of assets as either § 1245 or § 1250 property. The definitions of property for purposes of §§ 1245 and 1250 are essential for determining eligibility for a number of other Code provisions (including §§ 167, 168, 179, and former § 48). Treas. Reg. § 1.1245-3 defines "tangible personal property," "other tangible property," "building," and "structural component" by reference to Treas. Reg. § 1.48-1. This regulation relates to former § 48 which was enacted in 1962 along with §§ 1245 and 1250. Former § 48 allowed an investment tax credit (ITC) based on the "applicable percentage" of the investment in eligible property placed in service during the taxable year. Eligible property included tangible personal property (other than heating or air conditioning units) and other tangible property (primarily machinery and equipment used in specific business activities) 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.

Treas. Reg. § 1.48-1(c) defines 'tangible personal property' as 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). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. 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 ITC. Further, all property that is in the nature of machinery (other than structural components of the building or other inherently permanent structure) is 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, is considered tangible personal property.

Treas. Reg. § 1.48-1(c) also provides that local law is not controlling for purposes of determining whether property is or is not “tangible” or “personal”. Thus, the fact that under local law property is held to be personal property or tangible property is not controlling. Conversely, property may be personal property for purposes of the ITC even though under local law the property is considered to be a fixture and therefore real property.

Treas. Reg. § 1.48-1(d) provides that in addition to tangible personal property, any other tangible property (but not including a building and its structural components) used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or which constitutes a research or storage facility used in connection with any of the foregoing activities, may qualify for the ITC. This regulation essentially provides that inherently permanent structures (but not a building and its structural components) used in certain business activities will be deemed eligible for the ITC.

Treas. Reg. § 1.48-1(e)(1) defines a "building" as any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, 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: (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 former § 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. Thus, the term “building” does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples.

Treas. Reg. § 1.48-1(e)(2) provides that "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.

In Revenue Ruling 75-178, 1975-1 C.B. 9, the Service stated, “the problem of classification of property as ‘personal’ or ‘inherently permanent’ should be made on the basis of the manner of attachment to the land or the structure and how permanently the property is designed to remain in place.” Thus, the test to be used to determine whether an asset is tangible personal property is the inherently permanent test.

The seminal case involving the determination of whether an asset is inherently permanent for purposes of § 168 and former § 48 is *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975). The Tax Court noted that “tangible personal property” is not intended to be defined narrowly nor to follow the rules of State law where fixation to the land is a basis for distinguishing personal property from other property. Based on an analysis of prior case law, the Tax Court put forth six questions designed to ascertain whether a particular asset qualifies as tangible personal property. These questions, also referred to as the "*Whiteco* factors," are:

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?
6. What is the manner of affixation of the property to the land?

It should be noted that movability itself is not determinative in measuring permanence. The *Whiteco* court held that affixation to land does not per se exclude the property from the category of tangible personal property. Inversely, in *L.L. Bean, Inc. v. Commissioner*, T.C. Memo. 1997-175, aff'd, 145 F.3d 53 (1st Cir. 1998), the court held that the mere fact that a structure is theoretically capable of being moved does not conclusively establish that it is not inherently permanent.

Examiners should also consider the following additional factors when addressing permanency (some of which may overlap with the *Whiteco* factors):

- the history of the item or similar items being moved;
- the manner in which an item is attached to a building or to the land;
- the weight and size of the item;
- the function and design of the item;
- the intent of the taxpayer in installing the item;
- the time, cost, manpower, and equipment required to move the components;
- the time, cost, manpower, and equipment required to reconfigure the existing space if the item is removed;
- the effect of the item’s removal on the building; and

- the extent the item can be reused after removal.

See *AmeriSouth XXXII, Ltd. V. Commissioner*, T.C. Memo. 2012-67; *Trentadue v. Commissioner*, 128 T.C. 91 (2007); *PDV America, Inc. and Subs. v. Commissioner*, T.C. Memo. 2004-118; *Hospital Corp. of America and Subs. v. Commissioner*, 109 T.C. 21 (1997).

Further detail and updates can be obtained from the Depreciable and Capital Expenditures Practice Network.

3. Inherently Permanent Standard Under § 263A

The uniform capitalization (UNICAP) rules require the capitalization of all direct costs and certain indirect costs properly allocable to real property and tangible personal property produced by the taxpayer. Included in this is the capitalization of interest expense when the taxpayer produces certain property. See § 263A(f) and Treas. Reg. § 1.263A-8. For tax years beginning after December 31, 2017, small business taxpayers (previously defined) are not required to capitalize costs including interest under § 263A.

Producers must capitalize costs (other than interest) whether incurred before, during, or after the production period of property. Pre-production costs are subject to capitalization if the property is held for future production or if it is reasonably likely that the property will be produced at a future date. Thus, costs of storing raw materials and carrying costs of realty held for development are required to be capitalized. Production period costs are costs incurred beginning on the date on which production of the property begins and ending on the date on which the property is ready to be placed in service or is ready to be held for sale. Post-production costs are costs incurred after the actual production and may include costs of storage, warehousing, insurance, materials, and handling.

In contrast, interest is only capitalized during the production period of property. Treas. Reg. §§ 1.263A-8 through 1.263A-15 provide guidance with respect to the capitalization of interest under § 263A(f). These regulations are effective for 1995 and after, or at taxpayer's election, 1994. For years prior to the effective date of these regulations, see Notice 88-99, 1988-2 C.B. 422, as well as the prior temporary regulations, which provide guidance with respect to the capitalization of interest.

For purposes of UNICAP, interest is capitalized with respect to each unit of designated property. Designated property is defined in § 263A(f)(1) and Treas. Reg. § 1.263A-8(b)(1). Designated property is any property that is produced that constitutes: i) real property; or ii) tangible personal property which meets any of the following criteria: A) property with a class life of 20 years or more that is not inventory in the hands of the taxpayer or a related person; B) property with an estimated production period exceeding 2 years; or C) property with an estimated production period exceeding 1 year and an estimated cost of production exceeding $1,000,000. Note that all real property is subject to the rules of § 263A(f); the listed criteria only apply to tangible personal property. The criteria are applied individually to each unit of property.

Treas. Reg. § 1.263A-8(c)(1) defines real property. Real property includes land, un-severed natural products of land, buildings, and inherently permanent structures. Any interest in real property, including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property. Real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Tenant improvements to a building that are inherently permanent are real property.

Treas. Reg. § 1.263A-8(c)(3) provides that inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Examples include swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. For purposes of this section, affixation to real property may be accomplished by weight alone.

Treas. Reg. § 1.263A-8(c)(3) further provides that property may constitute an inherently permanent structure even though it is not classified as a building for purposes of Treas. Reg. § 1.48-1(e). Additionally, any property that constitutes “other tangible property” under the principles of Treas. Reg. § 1.48-1(d) is treated as an inherently permanent structure.

Treas. Reg. § 1.263A-8(c)(4) provides that a structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is not real property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property. A structure may be an inherently permanent structure, and not property in the nature of machinery or essentially an item of machinery, even if the structure is necessary to operate or use, supports, or is otherwise associated with, machinery. The purpose of this regulation is to prevent the definition of “property in the nature of machinery” from including inherently permanent structures that support or are otherwise necessary to the operation of that machinery such as ski lift towers and offshore oil platforms.

Treas. Reg. § 1.263A-10(b) provides that real property includes any components of real property owned by the taxpayer that are functionally interdependent. Components of real property are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person.

4. Comparison of Inherently Permanent Standard Under §§ 168 and 263A

The principles and tests used to determine whether an item of property is tangible personal property under Treas. Reg. § 1.48-1(c) (and thus to determine whether the item qualifies as § 1245 property) do not apply in determining whether such item of property is tangible

personal property or real property for purposes of § 263A(f). IRS CCA 200648026. Accordingly, property classified as depreciable tangible personal property for purposes of § 168 can be either real property or tangible personal property for purposes of the "avoided cost" interest capitalization calculation under § 263A(f). A determination of whether interest is capitalized with respect to a unit of designated property is made under the principles of § 263A(f) and the regulations thereunder and is not controlled by the characterization of property for purposes of § 168.

Similarly, the classification of the property for purposes of § 263A(f) does not control its classification for purposes of cost recovery under § 168. Id. Interest capitalized under § 263A(f) is treated as a cost of the designated property produced; cost recovery is determined by the applicable Code and regulatory provisions relating to the use, sale, or disposition of property.

There are five primary aspects to how the definition of inherently permanent differs between §§ 168 and 263A.

First, whereas Treas. Reg. § 1.48-1(c) contains the principle that the classification of property under local law is irrelevant to the classification of property for purposes of the ITC (and § 1245 property), the local law characterization of an item of property can be a relevant consideration in the classification of property as either tangible personal property or real property for purposes of § 263A(f). IRS CCA 200648026.

Second, whereas the legislative intent regarding the ITC favors a broad construction of "tangible personal property," the legislative history of § 263A(f) contains nothing to indicate that Congress intended the broad construction of tangible personal property under the ITC to apply to interest capitalization under § 263A(f). IRS CCA 201211011.

Third, an item of property that does not qualify as a structural component under the ITC scheme because it does not relate to the operation or maintenance of a building, may constitute a structural component of the building (and thus real property) for purposes of § 263A since there is no requirement under § 1.263A-8(c) that the item of property relate to the operation and maintenance of a building. The property, however, still must otherwise possess sufficient indicia of being a structural component to be classified as such. IRS CCA 200648026.

Fourth, although the definition of inherently permanent structures in Treas. Reg. § 1.263A-8(c)(3) references "other tangible property" under Treas. Reg. § 1.48-1(d) as a type of inherently permanent structure, an item of property may be an inherently permanent structure for purposes of UNICAP even though it would not have been an inherently permanent structure (and thus not "other tangible property") for purposes of the ITC. IRS CCA 201211011.

Fifth, the specific nature of the limitations on the machinery exclusion in Treas. Reg. § 1.263A-8(c)(4) (as well as language in the preamble to the regulation) indicates that the provision was intended to reject a specific line of ITC cases and rulings that greatly expanded the definition of what constitutes property in the nature of machinery under

Treas. Reg. § 1.48-1(c). Thus, inherently permanent structures that support or are otherwise necessary to the operation of that machinery are inherently permanent for purposes of UNICAP. IRS CCA 201211011.

Within the context of a cost segregation study, sometimes building systems such as electrical distribution and plumbing systems are deemed to be "dual purpose" for cost recovery purposes. Thus, for purposes of § 168, the portion of the cost of the building system corresponding to the percentage allocable to equipment constitutes tangible personal property (§ 1245 property) whereas the portion corresponding to building operation and maintenance constitutes structural components (§ 1250 property). As stated above, however, the fact that costs are characterized as tangible personal property for purposes of § 168 is not sufficient in itself to establish that these costs do not constitute real property for purposes of capitalizing interest under § 263A(f). Building systems are functionally interdependent with the building in which they are installed such that a building and its building systems are part of the same unit of real property for purposes of Treas. Reg. § 1.263A-10. Splitting a building system into two units of property for purposes of § 263A(f) would be contrary to the functional interdependence test underlying the concept of unit of property in the avoided cost regulations. Moreover, no provision is made for real property components and tangible personal property components combining into a single property unit; a unit of property under Treas. Reg. § 1.263A-10 must either be a real property unit (consisting entirely of real property components) or a tangible personal property unit (consisting entirely of tangible personal property components). Accordingly, allocating the cost of a building system such as an electrical distribution or plumbing system between real property and tangible personal property is inconsistent with § 263A(f).

Further detail and updates can be obtained from the Inventory and 263A PN.

5. Inherently Permanent Standard Under § 199

The Domestic Production Deduction (DPD) was enacted effective for taxable years beginning after December 31, 2004 and was intended to motivate domestic economic growth. The DPD was repealed by the Tax Cuts and Jobs Act P.L. 115-97 (as amended by the Consolidated Appropriations Act, 2018, Public Law 115-141, § 101(c), 132 Stat. 348, 1151, 1156) for taxable years beginning after December 31, 2017. The DPD is determined by applying a percentage to the lesser of a taxpayer's qualified production activities income (QPAI) or taxable income. The applicable percentage is 3 percent for taxable years 2005 and 2006, 6 percent for taxable years 2007 through 2009, and 9 percent for taxable years beginning after 2009. § 199(a).

QPAI is determined by taking domestic production gross receipts (DPGR) less cost of goods sold (COGS) and other expenses allocable to such DPGR. DPGR includes gross receipts derived from any lease, rental, license, sale, exchange or other disposition of qualifying production property (QPP) which was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States. § 199(c)(4)(A)(i)(I). QPP means tangible personal property, computer software and sound recordings. § 199(c)(5). DPGR also includes gross receipts from the construction of real property in the United States by a taxpayer in the normal course of a construction trade or

business. § 199(c)(4)(A)(ii). DPGR also includes gross receipts from engineering or architectural services performed in the United States with respect to the construction of real property. § 199(c)(4)(A)(iii) and Treas. Reg. § 1.199-3(n).Treas. Reg. § 1.199-3(j)(2) defines tangible personal property as any tangible property other than land, real property described in Treas. Reg. § 1.199-3(m)(3), and property described in other sections of the regulation (computer software, sound recordings, qualified films, electricity, natural gas, and potable water). Property such as machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs that are contained in or attached to a building constitutes tangible personal property for purposes of § 199. In determining whether property is tangible personal property, local law is not controlling.

Treas. Reg. § 1.199-3(m)(3) defines real property as buildings (including items that are structural components of such buildings), inherently permanent structures (as defined in Treas. Reg. § 1.263A-8(c)(3)) other than machinery (as defined in Treas. Reg. § 1.263A-8(c)(4)) (including items that are structural components of such inherently permanent structures), inherently permanent land improvements, oil and gas wells, and infrastructure. Treas. Reg. § 1.199-3(m)(4) defines the term infrastructure to include roads, power lines, water systems, railroad spurs, communications facilities, sewers, sidewalks, cable, wiring, and inherently permanent oil and gas platforms. For purposes of § 199, structural components of building and inherently permanent structures include property such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Treas. Reg. § 1.199-3(m)(3).

Accordingly, the definition of an inherently permanent structure is the same for § 199 as it is for § 263A(f). In other words, the same rules that determine what constitutes an inherently permanent structure for UNICAP purposes described above also apply to determine whether property qualifies as QPP. The result of using these rules is that if property is determined to be an inherently permanent structure under Treas. Reg. § 1.263A-8(c)(3), it is real property for purposes of § 199 and Treas. Reg. § 1.199-3(m)(3), is not QPP, and the gross receipts and allocable expenses derived from the property can only be used to determine DPGR and QPAI if the taxpayer meets the rules in Treas. Reg. § 1.199-3(m)(6) related to deriving gross receipts from the construction of real property performed in the United States, or the rules in Treas. Reg. § 1.199-3(n) related to engineering or architectural services. Note that, per Treas. Reg. § 1.199-3(m)(6)(iii), DPGR derived from the construction of real property performed in the United States does not include gross receipts derived from the sale, exchange, or other disposition of real property acquired by the taxpayer even if the taxpayer originally constructed the property. In addition, DPGR derived from the construction of real property does not include gross receipts from the lease or rental of real property constructed by the taxpayer.

6. Comparison of Inherently Permanent Standard Under §§ 168 and 199

In IRS CCA 201302017, the Service considered whether a variety of outdoor advertising displays constituted inherently permanent structures and were therefore real property when determining QPP for purposes of § 199. It noted that the definition of an inherently permanent structure in Treas. Reg. § 1.263A-8(c)(3) establishes two basic criteria for an

inherently permanent structure: first, it is affixed to real property; second, it will ordinarily remain affixed for an indefinite period of time.

The term “affixed to real property” under § 1.263A-8(c)(3) is understood pursuant to its ordinary and common sense meaning, that is, physically connected or attached. Affixation to real property may be accomplished by weight alone. Embedding a structure in the ground can establish attachment to real property. Mounting a structure to a foundation also can accomplish adequate connection to real property. Similarly, affixation may be achieved when the means of connection secure a structure to real property to withstand severe weather conditions. If installation of the structure involves the use of construction machinery and equipment, attachment to real property may be indicated.

The term “ordinarily remain affixed for an indefinite period of time” under § 1.263A-8(c)(3) means that the structure will typically remain affixed to real property for the period during which the structure is expected to remain in operating condition and serve a useful function, in other words, the useful life inherent in the structure. In general, the structure is attached without any fixed plan to remove it at a particular date in the future, and the exact date when the structure will be removed is neither known nor knowable when it is affixed. Additionally, the possibility or occurrence of temporary or permanent removal from real property (such as from hurricane force winds) does not transform the intrinsically permanent nature of a structure.

Practices of an industry or taxpayer also may be instructive as to whether a particular structure or type of structure is inherently permanent. Therefore, a definite lease term may be ignored if it is customary for the industry to renew the lease until the structure’s inherent useful life is exhausted or the structure is no longer profitable. Lastly, the amount of time and expense involved in affixing the structure to be able to function also should be considered.

Unlike the *Whiteco* factors for determining whether an item of property is an inherently permanent structure for cost recovery purposes, for purposes of § 199 it is irrelevant that the means of connection permit removal without damage to the structure. For example, a structure attached by weight alone is likely removable without damage. Similarly, a structure bolted to a cement foundation that is embedded in the ground is likely removable without damage but nevertheless is connected to real property. Note, however, that the manner of affixation should sufficiently secure the structure so that it will remain in place to be able to perform its intended function.

In short, an item is an inherently permanent structure for purposes of § 199 “when it is attached to real property and will ordinarily remain connected to real property to be able to perform its intended function.” IRS CCA 201302017.

Further detail and updates concerning using the Inherently Permanent rules within § 199 can be obtained from the Corporate Income and Losses PN.

7. Conclusion

In determining whether a structure, or component of a structure, is inherently permanent, one must consider the context and governing code section. The analysis used to determine whether an item is inherently permanent for cost recovery purposes under § 168 (or for ITC purposes under former § 48) is not the same as the analysis for UNICAP purposes under § 263A and DPD purposes under § 199. As a consequence, the "inherently permanent" rules for cost recovery are markedly different from those for the other code sections.

For cost recovery purposes, the *Whiteco* factors were designed in light of legislative history indicating that "tangible personal property" was intended to be broadly defined and that the rules of State law where fixation to the land is a basis for distinguishing personal property from other property were not to be followed. Thus, the standard for determining whether an item of property is inherently permanent for purposes of cost recovery is relatively narrow. In contrast, the standard for whether an item is inherently permanent for purposes of UNICAP and DPD follows its ordinary and common sense meaning, namely that fixation to the land is sufficient provided the item of property will remain in operating condition and serve a useful function over the useful life inherent in the structure. Hence, the standard for determining whether an item of property is inherently permanent for purposes of UNICAP and DPD is broader than the standard for cost recovery. Care should be taken when evaluating a cost segregation study that the correct "inherently permanent" rules are applied.

F. Construction Process

1. Introduction

A cost segregation study is typically completed using information that was developed for the construction process. This information includes drawings, specifications, and supplier and contractor payment documents. To better understand how a cost segregation study is conducted, it is helpful to understand this process. The following discussion provides a general overview of this process, from the conceptual stage through the bidding, construction, payment, and completion stage of a project. Although there may be certain facts and circumstances in specific geographic locales that vary from what is presented here, the basic construction concepts are similar in all locales. For purposes of this discussion, it is assumed that a fee contractor, rather than an in-house labor force, performs the construction. For additional information and a glossary of construction terms, refer to the LB&I Construction Industry or the Construction Industry Audit Techniques Guide.

2. Stages in the Construction Process

The Construction Process is composed of six distinct stages; each of these stages is discussed below in more detail.

1. **Concept**

All construction projects begin with planning and design, also referred to as "architectural programming." Numerous overlapping steps occur during this conceptual or design phase, prior to actual construction of the project.

An architect is the primary designer of a building or project and controls the overall design, specifications, finished materials (e.g., brick, paint, carpet, wall covering, etc.), and other architectural features of the building. In addition, the architect supervises the engineers responsible for the structural, mechanical, electrical, lighting, plumbing and communications system design of the building. Engineers must always conform to the design requirements of the architect. Each member of the design team must also be licensed with the proper state licensing authorities where the facility is located.

Planning & Architectural Programming

During the initial stages of the design process, the architect(s) and engineer(s) have a number of client meetings to determine the purpose and objective of the proposed construction. The primary activities, for which the project is being constructed, as well as the relationships between spaces, are reviewed. Consideration is also given to how well the completed project relates to adjacent buildings (if any) and its surroundings. The preliminary programming produces a list of solutions, alternatives, feasibility studies and costs estimates. After a review of the programming statement, schematic plans are prepared.

Schematic Plans

Schematic plans are the first plans of a facility and show the interrelationship between spaces and activities. All of the parties (architects, engineers and the client) review the schematic plans and make recommendations, as necessary. Any changes are then incorporated into the final schematic plans. Revised schematic plans are also known as "preliminary plans," and provide a graphic view of the project, the refined details of how the project will look, and the relationship of all spaces.

Once the preliminary planning phase is complete, the project then enters a stage involving the preparation of contract bid documents and working drawings.

2. Contracts and Bid Documents

The construction contractor(s) are normally selected through a competitive bidding process, but may also be selected via negotiation. To solicit construction bids, the builder must provide potential bidders with: a) Working drawings and plans for the proposed structure, as well as b) Project specifications. These are called the “construction documents” and offer a complete and detailed set of information to communicate all the required items within a building project.

2a. Working Drawings

Contract/Working Drawings/Plans

All projects, whether they involve new construction or the expansion of an existing structure, require the preparation of contract documents. The contract working drawings and plans provide a pictorial representation of the construction work, and specify or lay out the designer's intentions for the facility. The drawings illustrate, among other things, the appearance, layout, equipment, and amenities of the project. These drawings show the architect's plan/design for the building's overall appearance, such as finish materials, floor plans, sizes and use of each building area. In contrast, engineers design the building's structural, mechanical, electrical, plumbing and communication systems.

The architect also begins to gather project data to deal with problems or situations that are expected to arise during the construction process, such as local zoning requirements, local infrastructure, traffic, environmental and population impact, acoustic, energy, lighting, and aesthetic considerations. Various consulting engineers may also be utilized to solve specific project problems.

The following are examples of the numerous drawing plans that may be involved in a construction project.

Architectural Drawings

The architectural drawings (or "Plans") indicate the layout of the project, such as floor plans, elevations, sections, and details of the construction and architectural finishes. These plans are typically numbered sequentially with the prefix "A" for "architectural." The most common type of an architectural plan is an overhead view of the spaces on a specific floor. These plans also indicate the length, width and various heights of the structure and floor elevations. Plans may show notes of specific construction information and may contain details on a specific portion of work.

Exterior elevations show the exterior and the exterior finishes, and are similar to photographs of the exterior. Architectural schedules on the plans indicate the door types, windows, hardware, plumbing, and light fixtures in each room.

In preparing the plans, the architect utilizes graphic symbols, instead of words, to indicate various facility conditions. These symbols indicate the various types of material, sizes, and room finishes to be used. Symbols may be shown on the plans themselves or in the legends of the plans. [A list of general symbols is shown in the Appendix of Plan Reading and Material Takeoff, by Wayne J. DelPico, published by R. S. Means Company.]

Site Plans

A civil engineer is responsible for the proper drainage of a site, as well as the design of land improvements, such as paving, curb and gutter design, retaining walls, and drainage culverts. Site plans prepared by the civil engineer indicate the existing and proposed grades of the land and the specific location of the facility on the land.

Structural Plans

The structural plans are prepared by structural engineers and show the structural design of a building. These plans incorporate foundation planning with considerations for rain, snow, wind, earthquakes, and other natural phenomena. Structural engineers design the facility for both "live" and "dead" loads of the building. Live loads consist of the people, furniture and other items that are not part of the building, but are supported by the building. Dead load is simply the weight of the building or structure itself.

Mechanical Plans

Mechanical plans are prepared by a mechanical engineer to show the design of the various mechanical systems in the building. These systems must be designed to incorporate the proper air conditioning, heating, and ventilation equipment, as well as adequate plumbing, to meet the needs for all of the building's designated activities.

Like the structural engineer, the mechanical engineer must design the mechanical building systems to meet building "loads". For example, office work produces a certain level of heat load, whereas cooking in a commercial kitchen may produce greater heat loads. The energy use of the air conditioning, heating, pumps, and other building equipment are monitored by the mechanical engineer and are considered when specifying building equipment for an efficiently designed building system. Mechanical plans are numbered with the prefixes "P" for "plumbing" and "H" for "heating, ventilating and air conditioning."

Electrical Plans

An electrical engineer prepares electrical plans to show the electrical distribution system for the efficient distribution of power in a building. The plan design includes the distribution of electrical power from the utility company and the distribution to power-specific equipment. Engineering design factors for the overall electrical "load" of a building must also be considered (e.g., proper sizing and arrangement of transformers, panel boards, circuits, wires, conduits and power to the various machines, equipment and activities in the building). Electrical engineers may also handle the lighting design requirements of the building, as well as specialty areas such as a central security monitoring system, a computerized control system, and fire and smoke management systems. Electrical plans are numbered with the prefix "E" for "electrical."

Communications

There may be several other sets of plans that detail the layout of special communications systems. For instance, the fire and security systems, network computers system, telephone and communications systems, media and entertainment systems could be shown on a separate set of plans. All of these plans could be included with the bid documents or be a separate contract all together. If there is a specific issue that arises during your examination of a cost segregation study that concerns one of these communications systems, be sure to ask for them in addition to the other sets of plans of your subject building.

2b. Specifications and Other Written Construction Documents

Contract Specifications

The second part of the contracts and bid documents stage is the preparation of project specifications, also known as "specs." Specs instruct the contractor on how to build the project, and consist of contract documents, the technical specifications of the materials and the quality of the materials to be installed, and the workmanship for installation of the materials. Given the amount of information that is required to be included, specs have to be organized in a coherent manner. The most widely accepted system for arranging construction specifications is the “CSI MasterFormat.” The CSI format, developed by the Construction Specification Institute, requires four categories of information: bidding requirements, contract forms, contract conditions, and technical specifications.

Bidding requirements

Bidding requirements describe the conditions of the bid to the owner, and encompass the Invitation to Bid, the Instructions to Bidders, the Information Available to Bidders, the Bid Forms and Attachments, and the Bid Security Forms. The type of contract between an owner and a contractor dictates the form of the bidding conditions.

Contract Form

Contract forms are divided into sections, including the Agreement, the Performance and Payment Bonds, and the Certificates.

Contract Conditions

The contract conditions include the General Conditions and Supplementary Conditions.

Technical Specifications

Technical specs are generally prepared for each specific project in the CSI MasterFormat (see below) and these include hundreds, perhaps thousands of individual items that will be installed in a project. The CSI MasterFormat have been modified (2004) to include many more divisions included for electrical and communication systems to accommodate current trades and systems now included in most buildings.

2b(i). Construction Specifications Institute (CSI) MasterFormat

The Construction Specifications Institute (CSI) is a national organization dedicated to the standardization and improvement of construction specifications. The CSI MasterFormat is a master list of numbers and titles classified by construction work results to standardize and facilitate communication within the construction industry. The MasterFormat system is widely used in the construction industry by architects, engineers, estimators, and contractors to organize detailed construction cost information.

Currently, the IRS most commonly sees the following system in cost segregation studies,

The CSI Format consists of 16 "Divisions of the Work", which are:

- Division 1 - General Requirements
- Division 2 - Site Work
- Division 3 - Concrete
- Division 4 - Masonry
- Division 5 - Metals
- Division 6 - Wood & Plastics
- Division 7 - Thermal & Moisture
- Division 8 - Doors & Windows
- Division 9 - Finishes
- Division 10 - Specialties
- Division 11 - Equipment
- Division 12 - Furnishings
- Division 13 - Special Construction
- Division 14 - Conveying Systems
- Division 15 - Mechanical
- Division 16 - Electrical

Each CSI Division is further sub-divided into three additional parts called General, Products, and Execution (Installation).

- General - explains the scope or the limits of work for a particular CSI Division and makes a correlation between the technical specifications and the general and supplementary conditions of the contract. The administrative portion for any trade (e.g., shop drawings) would also be found in this section.
- Products - lists the materials to be used, by name and model number, and explains the quality of materials and the basis for any substitution.
- Execution - explains the method of material installation, techniques to be used, and workmanship quality.

In 2004, the MasterFormat expanded from 16 Divisions to 50 Divisions, reflecting innovations in the construction industry. The 16 Division CSI MasterFormat was modified to include many more divisions and provide greater detail for work results to accommodate current trades and systems now included in most buildings. An example of the modification from 2004 includes a division for communication systems separate from the electrical division. The new CSI MasterFormat numbers and titles are intentionally structured for anticipated growth and expansion in the future, and some are reserved for future expansion.

The New Divisions are:

PROCUREMENT AND CONTRACTING REQUIREMENTS GROUP:

- Division 00 — Procurement and Contracting Requirements

SPECIFICATIONS GROUP

General Requirements Subgroup

- Division 01 — General Requirements

Facility Construction Subgroup

- Division 02 — Existing Conditions (natural conditions)
- Division 03 — Concrete (footing)
- Division 04 — Masonry (concrete block/brick)
- Division 05 — Metals (beams)
- Division 06 — Wood, Plastics, and Composites (framing)
- Division 07 — Thermal and Moisture Protection (insulation water barrier)
- Division 08 — Openings (doorways)
- Division 09 — Finishes
- Division 10 — Specialties
- Division 11 — Equipment
- Division 12 — Furnishings
- Division 13 — Special Construction
- Division 14 — Conveying Equipment
- Division 15 to 19 — RESERVED FOR FUTURE EXPANSION

Facility Services Subgroup:

- Division 20 — RESERVED FOR FUTURE EXPANSION
- Division 21 — Fire Suppression
- Division 22 — Plumbing
- Division 23 — Heating Ventilating and Air Conditioning
- Division 24 — RESERVED FOR FUTURE EXPANSION
- Division 25 — Integrated Automation
- Division 26 — Electrical
- Division 27 — Communications
- Division 28 — Electronic Safety and Security
- Division 29 — RESERVED FOR FUTURE EXPANSION

Site and Infrastructure Subgroup:

- Division 30 — RESERVED FOR FUTURE EXPANSION
- Division 31 — Earthwork
- Division 32 — Exterior Improvements
- Division 33 — Utilities
- Division 34 — Transportation
- Division 35 — Waterway and Marine
- Division 36 to 39 — RESERVED FOR FUTURE EXPANSION

Process Equipment Subgroup:

- Division 40 — Process Integration
- Division 41 — Material Processing and Handling Equipment
- Division 42 — Process Heating, Cooling, and Drying Equipment
- Division 43 — Process Gas and Liquid Handling, Purification and Storage Equipment
- Division 44 — Pollution Control Equipment
- Division 45 — Industry-Specific Manufacturing Equipment
- Division 46 — Water and Wastewater Equipment
- Division 47 — RESERVED FOR FUTURE EXPANSION
- Division 48 — Electrical Power Generation
- Division 49 — RESERVED FOR FUTURE EXPANSION

As Cost Segregation Professionals convert to this newer system, the IRS will see more studies incorporating the 50 Divisions. No matter which system is utilized in the cost segregation study, it is important to note that this is just one method of organizing the abundance of information (labor and materials) needed in a construction project. The examiner should always look at the underlying information to verify the accuracy of the cost segregation study.

2b (ii). AIA Construction Documents

The American Institute of Architects (AIA) is a nationally recognized professional organization of architects. AIA has developed standardized contract documents for building design and construction that are universally accepted in the building design and construction industry. These AIA Contract Documents are organized by the following series:

A-Series – Owner/Contractor Agreements

B-Series – Owner/Architect Agreements

C-Series – Other Agreements

D-Series – Miscellaneous Documents

E-Series – Exhibits

F-Series – Reserved

G-Series – Contract Administration and Project Management Forms

AIA Document A201, General Conditions of the Contract for Construction

The general conditions establish the legal terms and conditions that will govern the construction of the project and address everything involved in the project from minor items to critical items. The general conditions include a number of provisions that determine the

respective rights and responsibilities of the owner and contractor. AIA Document A201 is a standardized document that provides the legal basis and description of the following contract items:

- General Provisions
- Owner
- Contractor
- Administration of the Contract
- Subcontractors
- Construction by the Owner or by separate Contractors
- Changes in the Work
- Time
- Payments and Completion
- Protection of Persons and Property
- Insurance and Bonds
- Uncovering and Correction of Work
- Miscellaneous Provisions
- Termination and Suspension of the Contract

Document A201 provides legal definitions of the elements in the construction process, the items that will be provided by the contractor, and details how to prepare material submittals, shop drawings, and progress payment requests.

3. Bidding

The third stage of the construction process is bidding. Once an owner determines that a project is feasible and that construction financing is available, the owner will solicit bids or proposals from general contractors and/or specialty contractors. Owners generally use trade publications and newspapers to invite contractors to bid on a construction job. A copy of "The Notice to Contractors" will be shown in the project's specifications, providing contractors with the bidding procedures.

The following is the sequence of events to prepare a contract bid:

1. The contractor obtains a copy of the plans and specifications from the owner to prepare a formal estimate of the construction cost or bid (experienced construction personnel prepare the bids).
2. The contractor reviews the contract plans and specifications to determine how to build the project and to consider all the limitations or conditions the owner requires for the project.
3. The contractor solicits bids from subcontractors, estimates their direct material and labor costs, and evaluates the ultimate profit potential of the contract. The amount of the bid covers the estimated costs and a profit for the construction project.
4. The owner evaluates all of the submitted bids and then awards the contract.

5. The contract document and specs contain the project start and completion dates, the progress billing procedures, the insurance requirements, and other pertinent information.

The preparation of a bid is the first step in the cost control system of a construction project. The agreed-upon bid price then becomes the budget by which the actual expenditures are measured and drawn against. The object of a cost control system is to provide the general contractor and/or owner with information regarding actual project costs versus the anticipated or budgeted costs. These cost comparisons become essential for internal control purposes.

Standard cost manuals, such as the "R.S. Means Building Construction Cost Data," are used by a general contractor to compute a bid. These guides contain a compilation of cost data for each phase of construction. There are also construction cost data guides for both union and non-union wage rates. If the IRS examiner needs to estimate construction costs as part of the analysis of a study, it is important to use the proper wage rates.

Subcontractors bid jobs in much the same way that a general contractor does. A subcontractor may also solicit bids from sub-subcontractors for specialty construction.

Working drawings and specifications provide information to allow general contractors to estimate the project's construction costs. Along with using their own estimators, a contractor usually has the subcontractor's and the material supplier's information readily available. If necessary, a general contractor can perform the preliminary details and/or shop to estimate the proper costs to construct various parts of a building. The general contractor gathers all the information from his estimators and subcontractors and then adds in an amount for overhead and profit. This final cost estimate is used in the competitive bidding for the construction of a project.

The cost estimate of a building or project is broken down and organized by the construction divisions shown in the specifications. The cost estimate is further detailed by trade and by item. The general contractor may also have a bank of information to estimate labor and material costs. Otherwise, the contractor will rely on any of several cost estimating manuals (e.g., R. S. Means Building Construction Cost Data (highly detailed), Marshall Valuation Services, etc.).

While bidding is the most common method used to select a general contractor, negotiation may also be used, especially in a situation where an owner has worked with a contractor in the past and a relationship of trust has been established. In a negotiated situation, the profit of the contractor is often a percentage of the total construction cost and this percentage is agreed to with the owner.

4. Construction (Field Work)

The fourth stage of the construction process, called fieldwork, is the actual construction of the project. Fieldwork is broken down into building permits, subcontractors, scheduling subcontractors, shop drawings, project submissions, and change orders.

Building Permits

Before construction can begin, the appropriate municipality must issue a building permit. Specifications and blueprints must be provided to the municipality's building department, along with the application for a permit. The period of time for a permit to be approved can be lengthy, especially in the case of new construction. The general contractor or owner may also be required to submit results of soil testing, environmental impact studies, and any other necessary testing or studies. Sometimes, a public hearing is mandated if there is opposition to the project. In most cases, a permit is issued within a few months. The cost of the permit and any related studies may be the responsibility of either the owner or the general contractor.

Construction projects must also follow the standards of the applicable building code. A building inspector will be involved at various construction stages to verify that the project is being constructed according to municipal code.

Subcontractors

Subcontractors range from a one-man operation to nationwide, publicly traded corporations, or divisions of larger corporations. Subcontractors are distinguished from general contractors by their limited scope of work, which usually involves specialized skills, knowledge, or ability. Subcontractors, which include plumbers, electricians, framers, and concrete workers, generally enter into contracts with the general contractor and may provide the raw materials used in their specialty areas. The general contractor, not the owner of the property, pays the subcontractors. Materials purchased by the subcontractors are generally delivered directly to the job site. The subcontractors' work may either be completed in stages or continuously.

Scheduling of Subcontractors

The general contractor schedules the subcontractor's work so that the construction runs smoothly and is completed on schedule. The general contractor is also responsible for scheduling the subcontractor in such a way that one subcontractor does not hold up another. This order on subcontractor sequencing is known as the "critical path."

The following is an example of the sequence in scheduling subcontractors for a small project:

1. Clear the land (which may include demolition of existing structures)
2. Excavate the land (which may include digging holes and leveling)
3. Pour the foundation
4. Frame steel and/or concrete
5. Rough framing
6. Rough electrical
7. Concrete flooring
8. Roofing
9. Heating and air conditioning

10. Ductwork for heating and air conditioning
11. Elevators and/or escalators
12. Sprinklers and other safety equipment
13. Install electrical fixtures
14. Insulate and weather strip
15. Frame windows and door sashes
16. Install tile and marble
17. Install suspended acoustical ceilings
18. Install toilets, sinks and other plumbing fixtures
19. Paint walls (inside and out)

Shop Drawings

Working drawings only include enough detail to show the general contractor the overall layout of the building. The individual specialty trades and suppliers use working drawings to produce shop drawings for items such as granite finishing, cabinets and countertops, structural steel, etc. Shop drawings detail the specific building components and are usually produced after the final design phase but before the beginning of the construction phase. Drawings are prepared in accordance with the instructions on Document A201. The architect/engineer will also check each shop drawing for precise measurements and for compliance with the intended building design.

Project Submissions

Project submissions are an important part of the construction process. Each installed building item must receive the architect's approval to ensure that the item or product is in conformance with technical specifications. Project submissions illustrate each item's intended use, function, method of attachment or installation requirements, and placed-in-service date. When the project starts, the architect and /or engineer monitors the contractor's progress and often approves the progress payments made to the contractors. The architect/engineer may also make modifications to the building plans as needed.

Change Orders

Change orders are the written contract revisions that increase or decrease the total contract price. Change order documents contain the change order number, change order date, a description of the change, and the amount of the change order. Contractors, based on the terms of the contract, may also issue orders.

5. Construction Payments

The fifth stage of the construction process is the construction payments stage. When a contractor completes a prescribed amount of work, the owner pays the contractor for the completed work, and records the payments on their books (CIP or WIP accounts).

Specifications for Payment

The following AIA Documents are normally used in the contractor progress payment process:

AIA G701 – Change Order

AIA G702 – Application and Certificate for Payment

AIA G703 – Continuation Sheet

The specifications for contract payments are shown in Document A201, under the “General Conditions for Construction Contracts”, and contain AIA Forms G701 (utilized for change orders) and G702. Form G702 requires that the contractor break down the bid into various parts of work. The project designer (architect or engineer) critically reviews Form G702 schedule of values prepared by the contractor and either accepts or rejects them. The close scrutiny of this form is due to the future release of funds that will be used to pay for the progress (and ultimately the completion) of construction. This form also provides the first basis for the construction cost control on a project. The architect and/or engineer have a legal and fiduciary responsibility for the accuracy of the cost allocations. The architect and the owner also want an adequate and timely distribution of funds to ensure smooth progress payments and to ensure that there will be the necessary funds to pay for the completion of the last portion of the project.

It is also to the contractor’s benefit that items of construction be broken into as many parts as possible. The more individual items of work the contractor can identify and complete, the more items of work will be entitled for billing and request of payment. Typical schedules of values on Form G702 may be 15 to 20 pages long and may contain hundreds, if not thousands, of individual cost items.

The contractor submits Form G702 to request payment on a regular basis. The contractor completes Form G702 by listing the total construction cost for each item of work completed to date. The amount previously paid for the work and the amount accomplished in the current billing period are subtracted from the total amount to arrive at the amount of money remaining, minus a retainage for the completion of the work.

It is extremely important for the IRS examiner to analyze the G702 and G703 documents. These documents are prepared by a third party (which provides an element of objectivity) and includes a detailed breakdown and analysis of the construction costs.

Change Orders

The architect/engineer may make modifications or change orders to the construction plans as needed. Change orders should be reviewed for any agreed changes to the payment schedule.

Unit Costs

In some contracts, there is a schedule of unit costs or prices used in the construction of the building. CSI MasterFormat Division 01 in the 16 Division format or Division 00 in the new

50 Division format typically provides for unit prices to be revealed in the bidding documents. The IRS examiner should verify that there is a schedule of Unit Prices in the contract documents and request a copy.

Owner's Records

Most Corporate Taxpayers must keep records of their payments in a sub ledger for construction-in-process (CIP) or work-in-process (WIP) type costs to comply with GAAP requirements. All payments made by a company are recorded on their general ledger (GL). The payment records are transferred and held to the appropriate sub ledger until the project is completed. When the building project is placed in service, the taxpayer moves or transfers the costs to their fixed asset or depreciation schedule and begins cost recovery for the project for both book and tax purposes. The IRS examiner should request all relevant costs in these accounts for the cost segregation project under examination.

6. Completion

The final phase of the construction process is known as the completion stage, and it readies the building for occupancy.

Record Drawings (previously called As-Built's)

After a facility or project is completed, the architect and contractor prepare a set of plans known as record drawings. These drawings represent exactly how the facility was constructed and they also incorporate all the changes to the original construction drawings. It is very important that the IRS examiner reviews these record drawings; these drawings represent the actual construction of the project.

Notice of Partial Completion

In some instances, the owner may desire to occupy a portion of the completed building. In that case, local building officials conduct an inspection to determine if that portion of the facility meets all building codes and is safe to be occupied. If approval is granted, a "Certificate/Notice of Partial Occupancy" is issued.

Notice of Substantial Completion

Local building officials issue this notice when 95 % of the construction is complete.

Notice of Completion/Certificate of Occupancy

A "Notice of Completion" is requested by the contractor/owner when the building is 100% complete. The project must pass a final inspection by local building officials for the "Notice of Completion" and the "Certificate of Occupancy" to be issued. These documents are recorded at the office of the local recorder and the property will be then appraised for property tax purposes.

Taxpayer Places the Asset in Service – Begins Depreciation

The costs for the project are recorded in the taxpayer's CIP or WIP sub ledger, and held in this suspense account until the costs can be recovered. Once the project is placed in service, depreciation can begin. For the taxpayer's recordation of the project, in their books and records, depreciation begins when the costs in the CIP are transferred into a fixed asset account or to a depreciation schedule (See CCA 20140202F). The IRS examiner should request these records from the taxpayer.

3. Other Project Delivery Methods

While design-bid-build is probably the most common delivery method used for construction projects today, there are other methods. The differences between the various project delivery methods mainly stem from how the parties organize their participation and responsibilities to complete the project. While the responsibilities of the parties may vary based on the specific project delivery method, the contract documents that guide construction and the contractor payment process are normally similar in all project delivery methods. The two methods an examiner is most likely to encounter, besides design-bid-build, are construction management and design-build.

Construction Management – This project delivery method is very similar to the design-bid-build method, but the management and construction oversight duties ordinarily performed by the general contractor are performed by a construction manager. The construction manager does not perform any of the actual construction work as a general contractor does, but only manages the construction.

Design-Build – This is a project delivery method in which the owner contracts with a single entity to perform both the design and the construction of the project. The Design-Builder either employs their own licensed architects and engineers to perform the design duties or they contract these duties out to the appropriate third-parties. There are no separate architect and contractor as in design-bid-build.

G. Information Document Requests

1. Introduction

Appropriate documentation is needed to support the conclusions in a cost segregation study. Once an examination has revealed the use of cost segregation techniques, the examiner needs to review the supporting documentation to determine whether an examination is warranted and, if so, the scope of the examination.

The use of appropriate issue focused Information Document Requests (IDR's) will facilitate the identification of available records for review and the solicitation of records from the taxpayer. It will also set in writing a mutually agreeable timeframe for when the information should be provided. The sample IDR language below is intended as a suggestion for obtaining records. One or more IDR's may need to be issued and examiners should tailor the language to each specific case and follow the Large Business and International (LB&I) directives. For additional information on the IDR process see the following directives and training:

- LB&I-04-0214-004 Updated Guidance for Examiners on Information Document Requests Enforcement Process dated 2/28/14 incorporates and supersedes:
- LB&I-04-0613-004 Large Business and International Directive on Information Document Requests Process dated 6/18/13
- LB&I-04-0113-009 Large Business and International Directive on Information Document Requests Enforcement Process dated 11/4/13

2. IDR G.1 Purpose – To Identify the Participants and their Respective Roles in the Preparation of a Cost Segregation Study/Analysis

Please provide documentation to support all changes to the cost recovery deductions indicated on the Cost Segregation reports.

Please provide the Engagement Letter/Letter of Understanding between Consultant and Taxpayer, Inc., that shows the extent of the Cost Segregation engagement, the steps taken to gather information, and the way in which the work was to be reported.

Additionally, a conference is requested with a representative from Consultant to describe the Cost Segregation process and to answer questions concerning the style and general cost computations. It is expected that a telephone conference will be suitable, provided the Engagement Letter/Letter of Understanding has been furnished.

3. IDR G.2 Purpose – not Identify the Specific Properties Subject to Cost Segregation Study/Analysis

Please provide the names and locations of properties visited and inspected by Consultant for use in its Cost Segregation analysis.

Note to examiner: By reviewing the same properties visited by Consultant, a better understanding of the Cost Segregation Report is achieved.

4. IDR G.3 Purpose – To Locate the Source of Property Blueprints and Drawings

Please provide access to the construction drawings and specifications used by Consultant to perform its Cost Segregation Study. It is not necessary to duplicate the drawings. If the construction drawings are in hard-copy format, please provide access to them in a location where the drawings may be reviewed. If they are in an electronic format, a copy should be provided with the information requested in 6.7.4. (all related workpapers).

5. IDR G.4 Purpose – To Obtain a Copy of the Cost Segregation Study

Please provide a copy of the complete Cost Segregation Study, to include all schedules, spreadsheets, and attachments referred to in the Study.

Please locate the related workpapers for the Cost Segregation Study and hold available for review.

6. IDR G.5 Purpose – To Obtain a Copy of the Study Computations and Formulae

The Cost Segregation Study is described as containing numerous spreadsheets and schedules used in arriving at the summary recommendations. Please provide a machine sensible copy of the data files used in preparing and printing the spreadsheets and schedules.

Please include a description of the software used in preparing the spreadsheets and schedules.

Please provide an index to the machine sensible files, (or other description of the file titles and how the files are identified). If the machine sensible copy is a visual copy, or value only copy, then an additional description and presentation of the mathematical formulae used to perform the computations is also requested.

7. IDR G.6 Purpose – To Ask Specific Questions about Segregated Properties

The blueprint review is complete. Specific questions about the study remain.

With regard to the "Quantity Take Off" schedules prepared by Consultant for the properties, there are certain unidentified assets that would fit into more than one MACRS class, depending upon location and use in the taxpayer's business. Please provide a copy of the detailed listing of the Consultant's selected assets, showing use and location for:

- Receptacles in Kitchen
- Junction Boxes in Kitchen
- Disconnect Switches in the Kitchen
- Receptacles in Offices
- Junction Boxes in Offices
- Circuit Breakers in Offices
- Receptacles in Lab areas
- Junction Boxes in Lab areas
- Floor Drains in Kitchen
- Sinks in Kitchen
- 3" pipe in Lab areas
- 1" pipe in Lab areas

These assets were opined to have shorter lives than the building lives.

8. IDR G.7 Purpose – Request for Specific Items and Amounts

Please provide copies of all construction contracts, addenda, purchase orders, change orders (including the Contract Bid breakdowns) for each item listed below. Note: The Property Unit Numbers and Descriptions were obtained from the formal Cost Segregation Analysis.

Category	Description	Amount
A	Exterior Façades - sec. 1245	$1,203,000
B	Interior Decorations - sec 1245	3,069,000
C	Interior Decor - 1245	1,458,000
D	Interior Columns - 1245	180,000
E	Wallpaper	1,039,000
F	Signage	1,967,000
G	Property Utilities	1,902,000
H	Room Locking Systems	772,000
I	Backup Generator	814,000
J	Equipment Connects - Rooms	1,338,000
K	Ceiling Decorations	390,000
L	Equipment Connects - Kitchen	422,000
M	Equipment Connects - Mech. Room	1,338,000
N	Equipment Connects - Jacuzzi	62,000
O	Kitchen Exhaust	114,000
P	Equipment - Display Room	830,000
Q	Sound Room - Display Room	189,000
R	Millwork and Trim	2,811,000
S	Interior Decorative Lighting	334,000
T	Interior Dec. Lighting - Connects	861,000

Note: Include all progress payment requests along with the architect's or construction manager's certification of the percentage completion (e.g., Application and Certificate for Payment – AIA Form G-702).

H. IRC §§ 179, 179D and Bonus Depreciation

1. Recent Law

The PATH Act of 2015, the Tax Cuts and Jobs Act (TCJA) of 2017, and the Coronavirus Aid, Relief, and Economic Security (CARES) Act all made significant changes to IRC § 179, MACRS, and the § 168(k) bonus depreciation provisions. For changes to § 168(k), the PATH Act applied to property placed in service after December 31, 2015. So, it affected tax years 2016 and 2017, and the TCJA applied to property acquired and placed in service after September 27, 2017. The CARES Act made retroactive changes to the recovery period of Qualified Improvement Property (QIP) from 39-years to 15-years (GDS) and from 40-years to 20-years (ADS), for property placed in service after 12/31/17. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA) made the IRC §179D deduction permanent. TCDTRA also retroactively changed the ADS recovery period from 40 to 30 years for certain residential rental property placed in service before January 1, 2018, held by an electing real property trade or business as defined in § 163(j)(7)(B), and not previously subject to ADS. For more information on this change, see Rev. Proc. 2021-28.

2. IRC § 179 Deduction

Taxpayers, other than estates, trusts and certain non-corporate lessors, may elect to deduct the cost of their IRC § 179 property in the year in which it is placed in service, subject to limitations. The aggregate amount of the cost of § 179 property that a taxpayer can elect to deduct under § 179 is limited to a maximum dollar limit that is adjusted annually for inflation (for tax years beginning in 2020 - $1,040,000 and 2021 - $1,050,000) and a dollar limitation on the total cost of § 179 property placed in service during that taxable year (Investment threshold limit) that is adjusted annually for inflation (for tax years beginning in 2020, $2,590,000 and 2021 - $2,620,000). The dollar limit for the tax year is reduced (but not below 0) by the amount by which the cost of § 179 property placed in service during the tax year exceeds the Investment threshold limit for that tax year. The total cost that a taxpayer can deduct in the tax year after applying the § 179 dollar limitation is limited to the amount of taxable income derived from a taxpayer's active conduct of any trade or business during the tax year. Section 179 property generally means any tangible property that is described in section 179(d)(1) that is acquired by purchase for use in the active conduct of the taxpayer's trade or business. Section 179 property includes:

- Tangible property (to which IRC § 168 applies) which is § 1245 property, such as, machinery and equipment; property contained in or attached to a building (other than structural components), such as refrigerators, grocery store counters, office equipment, printing presses, testing equipment, and signs; gasoline storage tanks

and pumps at retail service stations; and livestock, including horses, cattle, hogs, sheep, goats, and mink and other furbearing animals.

- Depreciable portable air conditioning and heating units which are § 1245 property placed in service in tax years beginning after 12/31/2015.
- Depreciable tangible property used predominantly to furnish lodging or in connection with furnishing lodging and which is section 1245 property placed in service in tax years beginning after 12/31/2017.
- Computer software (as defined in IRC § 197(e)(3)(B)) that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, and to which section 167 applies.
- Qualified real property- At the election of the taxpayer, qualified real property (as defined in IRC § 179(e)). The definition of qualified real property has changed over the years from qualified leasehold improvement property (QLIP), qualified retail improvement property (QRIP) and qualified restaurant property (QRP) to, for property placed in service in tax years beginning after December 31, 2017: (1) qualified improvement property (QIP) described in IRC § 168(e)(6); and (2) certain improvements to nonresidential real property that were placed in service after the date such property was first placed in service. These improvements are**:** heating, ventilation, and air conditioning property (HVAC); roofs; fire protection and alarm systems; and security systems (IRC § 179(e)(2)).

Taxpayers claiming the IRC § 179 deduction must reduce the depreciable basis of the § 179 property by the amount of its cost that the taxpayer elected to deduct (See Treas. Reg. § 1.179-1(f)). This reduction is done prior to computing additional first year depreciation under IRC § 168(k) and depreciation under IRC § 168.

IRC § 179 Qualified Real Property

Placed In Service Range	Qualified Real Property 179 (QRP179)	Qualified Leasehold Improvement Property (QLIP)	Qualified Restaurant Property (QRP)	Qualified Retail Improvement Property (QRIP)	Qualified Improvement Property (QIP)
Tax years beginning after 2009 and before 2018	Yes*	Yes	Yes	Yes	No
Tax years beginning after 2017	Yes**	No	No	No	Yes

*** QRP179 was defined as QLIP, QRP, and QRIP placed in service in tax years beginning after 2009 and before 2018**

**** QRP179 placed in service in tax years beginning after December 31, 2017, is defined under § 179(e) as QIP under § 168(e)(6) and also the following improvements to nonresidential real property placed in service after the date such property was first placed in service: heating, ventilating, & air conditioning (HVAC); roofs; fire protection and alarm systems; and security systems.**

Additional 179 Property

Placed In Service Range	Tangible Property (to which § 168 applies) That Is 1245 Property	1245 Property Used to Furnish Lodging	1245 Portable Air Conditioning and Heating Units
Tax years beginning after 2009 and before 2016	Yes	No	No
Tax years beginning after 2015 and before 2018	Yes	No	Yes
Tax years beginning after 2017	Yes	Yes	Yes

3. IRC § 179D Deduction

Building Owners and Lessors may deduct the cost of Energy Efficient Commercial Building Property (EECBP) installed in their buildings up to a maximum $1.80/sf of the building. Similar to the IRC § 179 deduction, taxpayers claiming the IRC § 179D deduction must reduce the depreciable basis of the EECBP by the amount of its cost that the taxpayer elected to deduct (See IRC § 179D(e)). This reduction is done prior to computing additional first year depreciation under IRC § 168(k) and depreciation under IRC § 168.

4. Bonus Depreciation – In General

Cost segregation studies are used by taxpayers most commonly to identify portions of real property that are separate tangible personal properties subject to shorter depreciable recovery periods. Some of these properties may also qualify for additional first-year

depreciation, commonly referred to as “bonus” depreciation. Bonus depreciation allows taxpayers to deduct a specified percentage (*e.g.*, 30, 50, or 100 percent) of depreciation in the year the qualifying property is placed in service. The adjusted basis of the qualifying property is reduced by the allowable amount of bonus depreciation before the remaining depreciation deductions are computed for the placed-in-service year and subsequent years.

Eligible Property - To qualify for 20, 30, 40, 50, 60, 80, or 100 percent bonus depreciation, the original use of the property must begin with the taxpayer (except for certain used property acquired and placed in service after September 27, 2017) and the property must be: 1) MACRS property with a recovery period of 20 years or less, 2) computer software as defined in, and depreciated under, § 167(f)(1), 3) water utility property as defined in § 168(e)(5), 4) qualified leasehold improvement property placed in service prior to 1/1/2016, or qualified improvement property placed in service after 12/31/2015 and before1/1/2018, 5) a qualified film or television production after 9/27/2017, 6) a qualified live theatrical production after 9/27/2017, or 7) a specified plant (if elected). Certain acquisition requirements and placed in service dates must also be met to qualify for 20, 30, 40, 50, 60, 80, or 100 percent bonus depreciation, and are discussed in more detail below.

Original Use of the Property - The term “original use” means the first use to which the property itself is put, whether or not that use corresponds to the use of the property by the taxpayer. The original use of the property by the taxpayer begins on the date the taxpayer uses the property primarily in its trade or business or for the production of income. Generally, this would be the date the property is placed in service. However, if a taxpayer initially acquires new tangible personal property and holds it as inventory primarily for sale to customers, but subsequently withdraws the property from inventory and uses it in their trade or business, the taxpayer is considered the original user of that property. A cost segregation study may also identify certain costs incurred by a taxpayer to acquire or construct reconditioned or rebuilt tangible personal property that is used in the real property. The cost to acquire or construct the reconditioned or rebuilt tangible personal property does not satisfy the original use requirement. Determining if tangible personal property is reconditioned or rebuilt is a question of fact, but property that contains used parts is not treated as reconditioned or rebuilt if the cost of the used parts is no more than 20 percent of the total cost of the property, whether the property is acquired or constructed by the taxpayer.

Used Property - For qualified property acquired and placed in service after September 27, 2017, eligible property is expanded to include certain used depreciable property. Used property is eligible for the bonus depreciation deduction if it meets the following requirements: (1) the property was not used (that is, no depreciable interest was held in the property) by the taxpayer or a predecessor at any time prior to the acquisition. Pursuant to Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1), this is determined by taking into account only the five calendar years immediately before the current calendar year in which the property is placed in service, without taking into account the applicable convention; (2) the acquisition of the property meets the related party and carryover basis requirements of IRC § 179(d)(2)(A), (B), and (C) and Treas. Reg. § 1.179-4(c)(1)(ii), (iii), and (iv), or (c)(2); and (3) the acquisition of the property meets the cost requirements of IRC § 179(d)(3) and Treas.

Reg. § 1.179-4(d). However, any QIP previously placed in service by the seller of a nonresidential building is not eligible used property to the taxpayer that purchases the building because the improvement is not made by the taxpayer that purchased the building. IRC § 168(e)(6) and Treas. Reg. § 1.168(b)-1(a)(5)(i)(A).

Qualified Leasehold Improvement Property - A cost segregation study may also identify the cost of leasehold improvement property placed in service before 2018. Qualified leasehold improvement property is any improvement to the interior portion of a building (CCA 201310028) that is nonresidential real property if the following three conditions are satisfied:

1. It must be made under a lease by the lessee, sub-lessee, or lessor of that portion;
2. The portion must be set for occupancy by the lessee or sub-lessee; and
3. The improvement must be placed in service more than three years after the date the building was first placed in service.

Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

Qualified leasehold improvement property (QLIP) is eligible for the bonus depreciation per statute, see 168(k)(3) prior to 2016. However, for the purposes of the bonus depreciation, for property placed in service after December 31, 2015, QLIP was replaced by qualified improvement property. QLIP is eliminated for property placed in service after 12/31/2017.

Qualified Retail Improvement Property and Qualified Restaurant Property

Qualified retail improvement property (QRIP) and qualified restaurant property (QRP) have a recovery period of 15 years, but they are generally ineligible for bonus depreciation unless the property also meets the definition of QLIP. Note: QRP acquired and placed in service in 2008 was eligible for bonus depreciation.

For property placed in service after 2008, QRP is defined in IRC § 168(e)(7) (in effect before the enactment of TCJA), as any IRC § 1250 property which is a building or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. For property placed in service after December 31, 2017, QRP is no longer defined.

For property placed in service after December 31, 2017, QRIP is no longer defined. For property placed in service after 2008, QRIP is defined in IRC § 168(e)(8) (in effect before the enactment of TCJA) as any improvement to an interior portion of a building which is nonresidential real property if –

1. Such portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and
2. Such improvement is placed in service more than three years after the building was first placed in service by any person. IRC § 168(e)(8)(A)(ii); Treas. Reg. § 1.168(k)-

1(c)).

Like qualified leasehold improvement property, QRIP does not include the enlargement of the building, any elevator or escalator, structural components benefiting a common area, or the internal structural framework of the building.

QRIP and QRP are eliminated for property placed in service after 12/31/2017.

Qualified Improvement Property (QIP)

Property qualifying for the bonus depreciation as defined in IRC § 168(k)(2)(A) includes "qualified improvement property" (QIP) placed in service after December 31, 2015 and before January 1, 2018. It was created to allow certain improvements to the interior of an existing building to be eligible for the bonus depreciation regardless of the presence of a lease for that property. QIP was defined in IRC § 168(k)(3) as any improvement to an interior portion of a building which is nonresidential real property (39 year recovery period) if such improvement is placed in service after the date such building was first placed in service. Similar to qualified leasehold improvement property, QIP does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

NOTE: This provision allowed bonus depreciation for QIP without regard to whether the improvements are property subject to a lease and removes the requirement that the improvement must be placed in service more than three years after the date the building was first placed in service. (PATH Act P.L. 114-113)

The TCJA (P.L. 115-97) eliminated QIP placed in service after 12/31/2017 from IRC § 168(k) as eligible property for bonus depreciation. The TCJA added the definition of QIP to the Classification of Property IRC § 168(e)(6), yet no property class was specified. As such, QIP placed in service after 12/31/2017 was classified by default as nonresidential real property with a 39-year recovery period under GDS.

The CARES Act (P.L. 116-136) provided a technical correction for QIP. The recovery period for QIP placed in service after December 31, 2017, was reduced from 39 years to 15 years for GDS by the addition of IRC § 168(e)(3)(E)(vii) thereby making it eligible for bonus depreciation. The ADS recovery period for QIP placed in service after December 31, 2017 was also reduced from 40 years to 20 years. The definition of QIP in IRC § 168(e)(6) was also amended to provide that the improvements must be "made by the taxpayer." These changes were made retroactive to January 1, 2018, as if they were included in the TCJA. As a result, taxpayers that depreciated QIP that was placed in service after December 31, 2017 using a GDS 39-year recovery period or an ADS 40-year recovery period are on an impermissible method of accounting. Revenue Procedure 2020-25 provides guidance allowing eligible taxpayers to change their method of depreciating QIP that was placed in service after December 31, 2017, in the taxable years ending in 2018, 2019, or 2020.

5. Acquisition Requirements and Placed in Service Dates

Note, as of the date of this writing, bonus depreciation is not available for property placed in service after December 31, 2026 (December 31, 2027 for long production period property and specified aircraft).

Pre-2005 30% Bonus Depreciation – Acquisition Requirements and Placed in Service Dates

To qualify for 30% bonus depreciation as in effect before the enactment of the Economic Stimulus Act of 2008 (Pre-2005 30%), the property must be placed in service by the taxpayer after September 10, 2001 and before January 1, 2005 (note that for 20%, 30%, 40%, 50%, 60%, 80%, and 100% bonus depreciation, special placed in service rules apply to long production period property and specified aircraft).

One of two alternative acquisition requirements must also be met:

1. The first requirement is met if the property is acquired by the taxpayer after September 10, 2001, and before January 1, 2005, but only if no written binding contract for the acquisition was in effect before September 11, 2001; or
2. The second requirement is met if the property is acquired by the taxpayer pursuant to a written binding contract entered into after September 10, 2001, and before January 1, 2005.

50% Bonus Depreciation – Acquisition Requirements and Placed in Service Dates

50% bonus depreciation is allowable for qualifying property placed in service during three different time periods:

1. Property placed in service after May 5, 2003 and before January 1, 2005;
2. Property placed in service after December 31, 2007 and before September 9, 2010; and
3. Property placed in service after December 31, 2011 and before January 1, 2018.

NOTE: Property placed in service after December 31, 2004 and before January 1, 2008 generally is not eligible for bonus depreciation.

For property placed in service after May 5, 2003 and before January 1, 2005, one of two alternative acquisition requirements must also be met:

1. The first requirement is met if the property is acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition was in effect before May 6, 2003; or
2. The second requirement is met if the property is acquired by the taxpayer pursuant to a written binding contract entered into after May 5, 2003, and before January 1, 2005.

For property placed in service after December 31, 2007 and before September 9, 2010, one of two alternative acquisition requirements must also be met:

1. The first requirement is met if the property is acquired by the taxpayer after December 31, 2007, and before September 9, 2010, but only if no written binding contract for the acquisition was in effect before January 1, 2008; or
2. The second requirement is met if the property is acquired by the taxpayer pursuant to a written binding contract entered into after December 31, 2007, and before September 9, 2010.

For property placed in service after December 31, 2011 (December 31, 2012, in the case of long production period property and specified aircraft) and before January 1, 2016, one of two alternative acquisition requirements must also be met:

1. The first requirement is met if the property is acquired by the taxpayer after December 31, 2007, and before January 1, 2016, but only if no written binding contract for the acquisition was in effect before January 1, 2008; or
2. The second requirement is met if the property is acquired by the taxpayer pursuant to a written binding contract entered into after December 31, 2007, and before January 1, 2016.

NOTE: Bonus depreciation is increased from 50% to 100% for qualified property acquired after September 27, 2017, and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, in the case of long production period property and specified aircraft).

100% Bonus Depreciation (after 9/8/2010 and before 1/1/2012) – Acquisition Requirements and Placed in Service Dates

As part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Congress added § 168(k)(5). As a result of this Act, certain 50% qualified property that is acquired by the taxpayer after September 8, 2010, and before January 1, 2012 (January 1, 2013, in the case of long production period property and specified aircraft), and that is placed in service by the taxpayer after September 8, 2010, and before January 1, 2012 (January 1, 2013, in the case of long production period property and specified aircraft) is eligible for 100% bonus depreciation.

To qualify for 100% bonus depreciation, the property must meet one of the following two alternative acquisition requirements:

1. The first requirement is met if the property is acquired by the taxpayer after September 8, 2010 and before January 1, 2012 (January 1, 2013, in the case of long production period property and specified aircraft); or
2. The second requirement is met if the property is acquired by the taxpayer pursuant to a written binding contract entered into after September 8, 2010, and before January 1, 2012.

Section 4.02 of Rev. Proc. 2011-26, 2011-16 I.R.B. 664, provides a limited exception to the above rule, which allows taxpayers to elect to treat all qualified property of any particular class of property, acquired during their tax year that includes September 9, 2010, as subject to the 50% bonus depreciation rather than the 100% bonus depreciation allowed for property acquired after September 8, 2010, without regard to whether the property was acquired before or after September 8, 2010.

6. Bonus Depreciation Rates After 9/27/2017

Portion of Basis of Qualified Property Acquired before Sept**.**

Placed in Service Year	**Bonus Depreciation Percentage - Qualified Property in General/Specified Plants**	**Bonus Depreciation Percentage - Longer Production Period Property and Certain Aircraft**
Sept. 28, 2017 − Dec. 31, 2017	50 percent	50 percent
2018	40 percent	50 percent
2019	30 percent	40 percent
2020	None	30 percent
2021 and thereafter	None	None

Portion of Basis of Qualified Property Acquired after Sept

Placed in service Year	**Bonus Depreciation Percentage - Qualified Property in General/Specified Plants**	**Bonus Depreciation Percentage - Longer Production Period Property and Certain Aircraft**
Sept. 28, 2017 − Dec. 31, 2022	100 percent	100 percent
2023	80 percent	100 percent
2024	60 percent	80 percent
2025	40 percent	60 percent
2026	20 percent	40 percent
2027	None	20 percent
2028 and thereafter	None	None

7. Acquisition Requirement – In General

The bonus depreciation regulations provide special rules for determining the timing of a taxpayer's acquisition of qualifying property. One set of rules addresses acquired property and the other set deals with self-constructed property. Both sets of rules can apply in the context of a cost segregation study.

Acquisition Requirement - Acquired Property

As discussed above, a cost segregation study may identify certain acquired tangible property that potentially qualifies for bonus depreciation. This can include tangible personal property that is acquired by the taxpayer and used in the construction by the taxpayer (or a third party under contract with the taxpayer) of new real property, or the expansion, refreshment, or restoration of the taxpayer's existing real property. Provided it is otherwise qualifying property (e.g., MACRS property having a recovery period of 20 years or less, etc.), tangible personal property that is acquired under a written binding contract qualifies for bonus depreciation (i) if the placed in service dates and either of the two alternative acquisition requirements are met for the pre-2005 30%, pre-2016 50%, or 9/9/2010 - 12/31/2011 100% bonus depreciation, respectively, or (ii) if the placed in service dates are met for the post-2015 30%, 40% and 50% bonus depreciation, respectively, and, if applicable, the acquisition requirements are met for the post-2015 30% and 40% bonus depreciation for long production period property and specified aircraft.

The acquisition date requirement for 100% bonus depreciation is met if the property is acquired by the taxpayer after September 27, 2017, or is acquired by the taxpayer pursuant to a written binding contract entered into by the taxpayer after September 27, 2017. See Treas. Reg. § 1.168(k)-2(b)(5)(ii)(A).

Acquisition Requirement - Self-Constructed Property

Similarly, a cost segregation study may identify certain self-constructed tangible personal property that potentially qualifies for bonus depreciation. This can include tangible personal property that is manufactured, constructed, or produced by the taxpayer and used in the construction by the taxpayer (or a third party under contract with the taxpayer) of new real property, or in the expansion, refreshment, or restoration of the taxpayer's existing real property used in its trade or business or for the production of income.

If a taxpayer manufactures, constructs, or produces property for use in its trade or business or for the production of income, the acquisition requirement is satisfied if the taxpayer begins manufacturing, constructing, or producing the property during the following dates:

1. After September 10, 2001 and before January 1, 2005 for pre-2005 30% property;
2. After May 5, 2003 and before January 1, 2005 for 50% property under § 168(k)(4) as in effect before the enactment of the Economic Stimulus Act of 2008;
3. After December 31, 2007 and before September 9, 2010, or after December 31, 2011 and before January 1, 2016 for 50% property;
4. After September 8, 2010 and before January 1, 2012 for 100% property; and
5. For qualified property placed in service after December 31, 2015, there is no date-

sensitive acquisition requirement, except that certain property having longer production periods must be acquired by the taxpayer before January 1, 2019, or January 1, 2020, as applicable depending on the phase down percentage.

6. After September 27, 2017 for 20%, 40%, 60%, 80%, or 100% property

Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into before the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or for its production of income is considered to be manufactured, constructed, or produced by the taxpayer

Treas. Reg. § 1.168(k)-1(b)(4)(iii)(B)(*1*) provides that the manufacture, construction, or production of property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances. Alternatively, the taxpayer may choose to determine when physical work of a significant nature begins in accordance with the safe harbor rule provided in Treas. Reg. § 1.168(k)-1(b)(4)(iii)(B)(*2*). Under this safe harbor rule, physical work of a significant nature does not begin before more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching) is incurred by an accrual basis taxpayer or paid by a cash basis taxpayer. When property is manufactured, constructed, or produced for the taxpayer by another person, this safe harbor rule must be satisfied by the taxpayer. A taxpayer chooses to apply the safe harbor rule by filing an income tax return consistent with the safe harbor rule for the placed-in-service year of the property that determines when physical work of a significant nature begins.

See also Treas. Reg. § 1.168(k)-2(b)(5)(iv)(B) for property acquired after September 27, 2017.

Components of Larger Self-Constructed Properties - General Rules

- If a written binding contract is entered into to acquire a component of a larger self-constructed property before the relevant acquisition date (for the 30%, 40%, 50%, or 100% property respectively, as described above), or the manufacture, construction, or production of a self-constructed component begins before the relevant acquisition date, neither the acquired or self-constructed component qualifies for bonus depreciation, even though the larger self-constructed property may qualify. See Example 6 of Treas. Reg. § 1.168(k)-1(b)(4)(v).
- If the manufacture, construction, or production of a larger self-constructed property begins before the relevant acquisition date, neither the larger self-constructed property nor any of the acquired or self-constructed components are eligible to be treated as qualified property for bonus depreciation purposes, regardless of when the component is acquired or when construction begins on the component. See Example 7 of Treas. Reg. § 1.168(k)-1(b)(4)(v).
- If a binding contract to acquire a component is entered into after the relevant

acquisition date, or the manufacture, construction, or production of a self-constructed component begins after the relevant acquisition date, but the manufacture, construction, or production of the larger self-constructed property does not begin before the close of the relevant acquisition period, the component itself would qualify for bonus depreciation under the acquisition rules even though the larger self-constructed property does not. See Example 13 of Treas. Reg. § 1.168(k)-1(b)(4)(v).

See also Treas. Reg. § 1.168(k)-2(b)(5)(iv)(C) for property acquired after September 27, 2017.

Components of Larger Self-Constructed Properties – Exception to the Acquisition Date Requirement

A taxpayer may elect to treat one or more components acquired or self-constructed after September 27, 2017, of certain larger self-constructed property as being eligible for the 100% bonus depreciation under the TCJA. The larger self-constructed property must be property for which the manufacture, construction, or production began before September 28, 2017, property described in Treas. Reg. § 1.168(k)-2(b)(2)(i)(A), (B), (C), or (D) but the requirement that the property has to be acquired after September 27, 2017, is disregarded, and property that meets the requirements in Treas. Reg. § 1.168(k)-2(b), determined without regard to the acquisition date requirement in Treas. Reg. § 1.168(k)-2(b)(5). However, the election is not available for components of larger self-constructed property if the taxpayer elected out of bonus depreciation for the class of property in which the larger self-constructed property is included, or if such property is not eligible for any bonus depreciation under section 168(k); for example, section 168(k)(9) excludes property used by rate-regulated utilities and firms (primarily automobile dealerships) with “floor plan financing indebtedness” as defined under section 163(j) and placed in service by the taxpayer in any tax year beginning after December 31, 2017. Treas. Reg. § 1.168(k)-2(c).

If a taxpayer constructs a building that is residential rental property or nonresidential real property under IRC §168(e)(2), or an improvement to such property, all property constructed as part of that property and that is described in Treas. Reg. §1.168(k)-2(b)(2)(i)(A), (B), (C), or (D) is taken together as the larger self-constructed property for purposes of the component election. To be eligible, the construction of all such property of the building must begin before September 28, 2017, and any eligible component, as determined under Treas. Reg. § 1.168(k)-2(c)(3) of such property is eligible for the component election.

Components of Larger Self-Constructed Properties – Special Rule for 100% Bonus Property (after 9/8/2010 and before 1/1/2012)

There are two limited exceptions to the general rules above with respect to 100% bonus depreciation for qualified property that is acquired by the taxpayer after September 8, 2010, and before January 1, 2012 (January 1, 2013, in the case of long production period property and specified aircraft), and that is placed in service by the taxpayer after September 8, 2010, and before January 1, 2012 (January 1, 2013, in the case of long production period property and specified aircraft):

- First, the otherwise qualifying components of a larger self-constructed property are not required to be acquired by the taxpayer under a written binding contract pursuant to section 3.02(2)(a) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664; and
- Second, in contrast to the general rule that denies qualified property treatment to both the components and the larger self-constructed property, where the larger self-constructed property does not meet the relevant acquisition date or placed in service date requirements, taxpayers may elect to treat any otherwise qualifying acquired or self-constructed components of a non-qualifying larger self-constructed property as eligible for the 100% first-year depreciation deduction. Under this election, the component must be qualified property and must be acquired or self-constructed by the taxpayer after September 8, 2010, and before January 1, 2012 (before January 1, 2013, in the case of long production period property and specified aircraft). Section 3.02(2)(b) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664.

Section 3.02(2)(b) of Rev. Proc. 2011-26, 2011-16 I.R.B. 664, also provides the applicable election procedures. The election must be made by the due date (including extensions) of the federal tax return for the taxpayer's taxable year in which the larger self-constructed property is placed in service by the taxpayer. The election is made by attaching a statement to that return indicating that the taxpayer is making the election provided in Section 3.02(2)(b) of Rev. Proc. 2011-26. The attached statement must also indicate whether the taxpayer is making the election for all, or only a portion of, the components eligible under the rule. Finally, relief is available for taxpayers who have already filed their federal tax returns (on or before April 18, 2011) for the taxable year in which the larger self-constructed property was placed in service. Therefore, taxpayers receive an automatic six month extension from the due date of its return (excluding extensions) to make the election to treat the qualifying components of non-qualifying larger self-constructed property as property eligible for the 100% bonus depreciation allowance.

8. Chief Counsel Guidance on the Application of Bonus Depreciation Regulations to a Cost Segregation Study – FAA 20140202F

In a building construction project, the building (including its structural components) is not eligible for bonus depreciation because buildings generally have a MACRS recovery period of greater than 20 years. However, the § 1245 properties identified in a cost segregation study generally meet the MACRS recovery period requirement (20 years or less), but each § 1245 property must also meet the other bonus requirements to determine its eligibility for bonus depreciation (including the original use, acquisition, and placed in service requirements).

In Field Attorney Advice (FAA) 20140202F (1/10/2014), the IRS concluded that the taxpayer is required to separately identify the properties associated with a building construction project to determine which assets constitute “qualified property.” Each property is to be analyzed under the rules of § 168(k) to determine its eligibility for bonus depreciation. The taxpayer has the burden of proof to show which properties are subject to bonus depreciation. This FAA states that the first step in determining whether a property is eligible for bonus depreciation is to determine whether it is “qualified property.” As discussed above, the § 168(k) and regulations thereunder define qualified property for

bonus depreciation purposes. Significantly, the plain language of § 168(k)(2)(A) makes it clear that eligibility for bonus depreciation in the context of components of real property is determined with reference to factors related to each property at issue rather than with reference to the project at issue. This means a taxpayer cannot argue that a property qualifies for bonus depreciation simply because the "project" to which said property relates qualifies (based on contract date, acquisition date and placed in service date of the "project"). Rather, a taxpayer is required to separately identify the properties associated with a project to determine which assets constitute "qualified property." Taxpayers may do this by performing a cost segregation study, which properly identifies separate § 1245 property constructed in conjunction with § 1250 property. Only after the properties are segregated can the individual properties be considered for bonus depreciation eligibility.

The taxpayer in the FAA acquired a number of properties based on the terms of a building construction contract with a third-party contractor. As discussed above, property that is constructed for the taxpayer by another person under a written binding contract that is entered into before the construction of the property begins is considered to be self-constructed by the taxpayer. The taxpayer accounted for its entitlement to bonus depreciation based on a cost segregation study. The cost segregation study identified a number of separately identifiable properties including sidewalks, paving, and landscaping. These properties have a MACRS recovery period of less than 20 years so they, if new, would be qualified property and eligible for bonus depreciation as long as they meet the other requirements of the regulations. The "building" also has other separately identifiable properties. An example is "decorative lighting" which includes the fixtures, lamps, and electrical wiring to the lighting as well as the direct cost of the installation of the lighting and the indirect cost of the design. All of these costs together would be included in the cost basis of the "decorative lighting", which would be qualified properties (as long as the lighting is new) because their recovery period would be 20 years or less, depending on the Asset Class of Rev. Proc. 87-56 applicable to the taxpayer's business activity in which the decorative lighting is primarily used.

After performing the cost segregation study and identifying each property, the next step is to determine whether the property meets the other requirements of the bonus depreciation regulations, including the acquisition requirement. As discussed above, self-constructed property is acquired when construction begins on that property. The determination of when construction begins generally depends on the facts and circumstances, but a taxpayer may choose to determine when construction begins in accordance with the safe harbor rule provided in the regulations. Under this safe harbor rule, construction does not begin before more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching) is incurred by an accrual basis taxpayer or paid by a cash basis taxpayer. When property is manufactured, constructed or produced for the taxpayer by another person, as in the present case, this safe harbor rule must be satisfied by the taxpayer.

The taxpayer in the FAA chose to apply the 10% safe harbor rule i to determine when construction began on the properties identified in its cost segregation study. Because the taxpayer used the accrual method of accounting for the acquisition of property pursuant to § 461, the taxpayer needed to determine when 10% of the cost of each property was

incurred. Generally, a liability is incurred for the acquisition of property under the regulations when all events have occurred fixing the liability and economic performance has occurred. In the case of property acquired, economic performance occurs when the property is delivered or accepted, or when title to the property passes to the taxpayer. In this case, the taxpayer's liability for each qualified property was incurred when the taxpayer accepted the property after the third-party contractor submitted a pay application. Pay applications were used as the formal certification from the third-party contractor which showed the total contract amount, the amount of the construction completed and a completion figure. As each request for a progress payment was made by the contractor, the taxpayer reviewed the amount, ascertained that the work had been completed and met the standards set forth in the contracts, accepted the work, and soon afterwards, released the progress payment as provided under the contract. At the point when taxpayer accepted the work, the all events test and the economic performance test is met. With each acceptance, the taxpayer incurred costs for that property.

However, the FAA holds that the taxpayer did not meet its burden of proof that the 10% safe harbor was met, and as a result, the taxpayer was not entitled to bonus depreciation on any of the qualified properties identified in the cost segregation study. Neither the pay applications nor the cost segregation study provided by the taxpayer clearly indicated when the costs of any of the separately identifiable properties were incurred. Specifically, as the pay applications were not broken down to the individual properties, it was not possible to determine when the total costs of separate properties, such as the landscaping, business signage, or decorative items, were incurred. The burden is on the taxpayer to prove which separately identifiable property, if any, was acquired under the safe harbor rules after December 31, 2007.

9. Method of Accounting Issues Related to Bonus Depreciation

Unless the taxpayer elects out of bonus depreciation, they are required to deduct the 20%, 30%, 40%, 50%, 60%, 80%, or 100% bonus depreciation on qualified property depending on the year the property is placed in service. Accordingly, the adjusted basis of the qualified property must be reduced by the amount of allowable bonus depreciation before computing the depreciation deduction for that property under § 167(f)(1) or § 168, as applicable, for the placed-in-service year and for all subsequent taxable years. A taxpayer that fails to make the proper election not to deduct bonus depreciation and doesn't deduct bonus depreciation on its filed return is using an impermissible method of accounting.

Cost segregation studies performed contemporaneously with the taxable year that qualified property is placed in service should allow enough time before the tax return for that year is filed to determine the amount of bonus depreciation and depreciation allowable on that property. On the other hand, when a cost segregation study is performed after the tax return is filed for the year the qualified property is placed in service, the taxpayer probably did not claim bonus depreciation on that property, and as a consequence is using an impermissible method of accounting. Generally, taxpayers can file an amended tax return for the property's placed-in-service year to claim the bonus depreciation and adjust the depreciation allowable on the qualified property, provided that the amended tax return is filed before the taxpayer files its tax return for the first taxable year succeeding the placed-

in-service year. However, if the first taxable year succeeding the placed-in-service year is already filed before the cost segregation study is performed and the qualified property is identified, the taxpayer has adopted an impermissible method of accounting and must change from an impermissible method to a permissible method by filing a Form 3115. If this occurs, please contact the Deductible and Capital Expenditure (DCE) or the Method of Accounting and Timing (MAT) Practice Networks for assistance. See the following Revenue Procedures for additional guidance:

1. Rev. Proc. 2008-52 applies to tax years ending on or after December 31, 2007 and before April 30, 2010.Appendix Section 6.01 allows the taxpayer to file an amended return for the property's placed-in-service year provided that the amended return is filed before the taxpayer files its tax return for the first taxable year succeeding the placed-in-service year. Alternatively, the taxpayer can change from an impermissible method of accounting to a permissible method by filing a Form 3115 for the first taxable year succeeding the placed-in-service year.
2. Rev. Proc. 2011-14, Appendix Section 6.01, provides similar rules for a year of change ending on or after April 30, 2010.
3. The following Revenue Procedures contain the List of Automatic Changes and provide similar rules in Section 6.01:

Revenue Procedure	Year of change ending on or after;
2015-14	May 31, 2014
2016-29	September 30, 2015
2017-30	August 31, 2016
2018-31	September 30, 2017
2019-43	November 8, 2019
2022-14	January 31, 2022

4. Rev. Proc. 2011-26 provides a special rule for a taxpayer that did not claim the 50% additional first year depreciation for some or all of the qualified property placed in service by the taxpayer after December 31, 2009, on its federal tax return for its taxable year beginning in 2009 and ending in 2010 (2009 taxable year), or its taxable year of less than 12 months beginning and ending in 2010 (2010 short taxable year).

   If Rev. Proc. 2011-26 applies, the taxpayer can claim the additional first year depreciation for that property by filing either:

   - An amended federal tax return for the 2009 taxable year or the 2010 short taxable year, as applicable, before the taxpayer files its federal tax return for the first taxable year succeeding the 2009 taxable year or the 2010 short taxable year, or
   - A Form 3115 with the taxpayer's timely filed federal tax return for the first or second taxable year succeeding the 2009 taxable year or the 2010 short taxable year, as applicable, provided the taxpayer owns the property as of the first day of the year of change.

Under Rev. Proc. 2011-26, taxpayers who do not retroactively elect bonus depreciation by claiming the 50% bonus depreciation deduction on their 2009 or 2010 short taxable year, or by filing an amended return or a Form 3115 as described above, are deemed to have elected to not deduct 50% bonus depreciation for a class of qualified property. Further, if a

taxpayer is deemed to have elected not to apply the 50% bonus depreciation retroactively, the deemed election out applies to both 2009 qualified property and 2010 qualified property of the same class, including property in the same class acquired by the taxpayer after September 8, 2010 that would have qualified for 100% bonus depreciation.

10. Election Out of Bonus Depreciation

In general, taxpayers may elect out of bonus depreciation for any qualifying property placed in service during the taxable year. The election applies to all property of the same property class that is placed in service by the taxpayer in the same year. For bonus depreciation purposes, eligible property is in one of the classes described in § 168(k)(2)(A): MACRS property with a recovery period of 20 years or less, computer software defined in, and depreciated under, § 167(f)(1), water utility property as defined in § 168(e)(5), qualified leasehold improvement property placed in service before 1/1/2016, or qualified improvement property placed in service after 12/31/2015 and before 1/1/2018. Pursuant to Treas. Reg. § 1.168(k)-1(e)(2) and Treas. Reg. § 1.168(k)-2(f)(1)(ii), the class "MACRS property with a recovery period of 20 years or less" is further broken down to each class of property described in § 168(e) (e.g., 5-year property). The election may be revoked only with the consent of the Commissioner, obtained by requesting a private letter ruling. However, Treas. Reg. § 301.9100-2(b) provides an automatic extension of 6 months from the due date if the taxpayer timely filed its return for the placed-in-service year for the class of property during which the taxpayer may file an amended tax return to revoke the election out of bonus depreciation for that class of property.

For qualified property placed in service after September 27, 2017, or December 31, 2017 in the case of qualified improvement property, eligible taxpayers may revoke an election out of bonus depreciation for a limited period of time, by filing an amended return or Form 3115. See Revenue Procedure 2020-25 and Revenue Procedure 2020-50.

If the election to forego the bonus depreciation deduction is made, all property in the same class of property and placed in service in the same taxable year is deemed to be non-qualifying property, and no bonus depreciation is allowable for any property in that same property class and placed in service during that same taxable year. Accordingly, if a taxpayer identifies tangible personal property in a cost segregation study that would otherwise qualify for bonus depreciation, but that property was placed in service in the same taxable year and is in the same class of property as a property for which the taxpayer elected out of bonus depreciation, then the tangible personal property identified in the study is deemed to be non-qualifying property.

Additionally, for tax years beginning before January 1, 2018, corporations may elect under § 168(k)(4) to accelerate the use of alternative minimum tax (AMT) credits in lieu of bonus depreciation. Note, for tax years beginning after 2017, § 168(k)(4) is repealed.

Chapter 7 Industry Specific Guidance

The Contact information for internal communications regarding the various matrices have been updated. Questions concerning these directives should be directed to the Deductible and Capital Expenditures (DCE) Practice Network.

A. Casinos

Field Directive on Asset Class and Depreciation for Casino Construction Costs

LMSB-04-0706-005
July 11, 2006

MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTOR, FIELD SPECIALISTS, LMSB
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE, LMSB
DIVISION COUNSEL, LMSB
DIRECTOR, COMPLIANCE, SBSE

FROM: JoAnn Bank /s/ JoAnn G. Bank
Acting Industry Director, Communications, Technology & Media

SUBJECT: Field Directive on Asset Class and Depreciation for Casino Construction Costs

INTRODUCTION

This memorandum is intended to provide direction to effectively utilize resources in the classification and examination of a taxpayer who is recovering construction costs through depreciation of tangible property used in connection with a hotel/casino property.

RECOMMENDATIONS

The matrix included in this document contains recommendations for the categorization and lives of various hotel/casino assets. If the taxpayer's tax return position for these assets is consistent with these recommendations, no adjustments should be made to categorizations and lives. If the taxpayer reports assets differently, then adjustments should be considered.

EFFECT ON OTHER GUIDANCE

This directive should be applied in the context of other applicable depreciation principles. For example, normal examination procedures should be followed to determine whether all appropriate costs, including IRC § 263A expenses, have been associated with a particular asset. Examiners are encouraged to exercise their professional judgment when developing and resolving factual issues.

This memorandum is not an official pronouncement of the law or the Service's position and cannot be used, cited, or relied upon as such.

CONTACTS

If you have any questions, please have a member of your staff contact the Deductible and Capital Expenditures (DCE) Practice Network.

Attachments

cc: Commissioner, LMSB
Deputy Commissioner, LMSB
Director, Performance, Quality and Audit Assistance

LMSB Directive on Cost Segregation in the Gaming Industry

This matrix, which is part of the Cost Segregation Audit Techniques Guide, is intended to provide direction to effectively utilize resources in the classification and examination of property used in the operation of a casino/hotel property. General fact patterns specific to this industry have been considered in the classification of these assets and may not be applicable to other industries. Similarly, asset classification guidance issued for other industries is based on the general fact pattern for that industry and may not be applicable to a casino/hotel business situation. For example, for asset classification of restaurants located within a casino, refer to the industry directive for restaurants. For examination techniques and historical background related to this issue, refer to the Cost Segregation Audit Techniques Guide.

NOTE: In the case of certain leasehold improvement property, the classifications in this directive are superseded to the extent that the American Jobs Creation Act of 2004 modifies IRC Section 168. Thus, a 15-year straight line recovery period should replace the recovery period shown in the following matrix if the asset is “qualified leasehold improvement property" (as defined in IRC Section 168(e)(6)) placed in service by the taxpayer after 10/22/04 and before 1/1/08.

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Ceilings	Dropped or lowered ceilings with decorative finishes (such as ornamental polished gold and copper metal panels suspended from the finished ceiling or glued to soffits or lowered drywall ceiling systems). The suspension grids are hung by hanger wires from hooks or eyes set in the floor above or bottom of the roof, and attached to walls with nails or screws. Components such as lighting fixtures and air conditioning registers are placed on the grid. The ceilings conceal plumbing, wiring, sprinkler systems and air conditioning ducts. Includes grid systems where the actual building ceiling above the suspended ceiling can be seen. The actual building ceiling is generally painted a dark color so as to hide the various conduit, wires, and mechanical systems hanging from it.	§ 1250	39 years (40 years for purposes of § 168 (g))
Doors and Door Locks	Interior and exterior doors, regardless of decoration, including but not limited to, double opening doors, overhead doors, revolving doors, entrance security gates, roll-up or sliding wire mesh or steel grills and gates, and door hardware (such as doorknobs, closers, kick plates, hinges, locks, automatic openers, etc.). Includes hotel guest room computerized door locks. Includes encoders, computers, and other associated hardware of the computerized lock system.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area (“Eliason”-type door). For example, flexible doors, clear	§ 1245	5 years (57.0 Distributive

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	curtains, or strip curtains used between stock areas and selling areas.		Trades and Services)
Electrical Hook-ups (includes duplex, fourplex, junction box, conduit/wiring and allocation of panels)	Includes electrical outlets of general applicability and accessibility located in *Accounting and Administrative Offices, Ballrooms, "Back of House" areas, Pre-function areas, and Support areas* (such as shop areas, engineering and construction offices). Includes but is not limited to outlets connected to copy machines, fax machines, personal computers, break rooms, coffee rooms, lounges, etc.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Includes electrical outlets located in hotel guest rooms and guest bathrooms of general applicability and accessibility (includes bathroom GFI outlet).	§ 1250	39 years (40 years for purposes of § 168 (g))
	Includes electrical outlets specifically associated to particular items of machinery and equipment located in the Casino area. Includes ATM machines, slot machines, and other gaming related equipment. Also includes all electrical hook-ups associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, *1987-2 CB 674,* such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
	Includes electrical outlets specifically associated to a particular item of machinery or equipment located in *Conference Rooms, Guest Rooms, Public Facility areas, Meeting Rooms, and Support Areas*, but not in the Casino/Theater area. Examples include equipment in Exercise rooms, ice machines, vending machines, audio visual equipment, televisions (and the riser conduit and wiring), garbage disposals, refrigerators, and workbenches.	§ 1245	5 years (57.0 Distributive Trades and Services)
Exit Signs	Signs posted along exit routes that indicate the direction of travel to the nearest exit. These signs typically read "EXIT" and may have distinctive colors, illumination, or arrows indicating the direction to the exit.	§ 1250	39 years (40 years for purposes of § 168 (g))
Facades – Exterior	Decorative exterior wall covering of the hotel/casino complex to help create the theme for the hotel/casino complex. Generally, consists of a synthetic plaster, or stucco, that is cemented, or in some cases, bolted on in the form of a panel, to the frames of the exterior walls of the buildings.	§ 1250	39 years (40 years for purposes of § 168 (g))

ASSET		DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Facades – Interior	**Interior Columns**	Includes finishes on interior columns that are affixed with permanent adhesive or nailed or screwed in place. Examples include marble tile, millwork and other coverings cemented, mudded, or grouted to the column.	§ 1250	39 years (40 years for purposes of § 168 (g))
		Includes finishes on interior columns that are not permanently attached and not intended to be permanent. Located in the Casino area. Also includes interior columns associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
		Includes finishes on interior columns that are not permanently attached and not intended to be permanent. Not located in the Casino/Theater area.	§ 1245	5 years (57.0 Distributive Trades and Services)
	False Balcony	Finishes generally made of millwork or wrought iron (forged balconies and gates) and located in the Casino area. Also includes false balconies associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
		Finishes generally made of millwork or wrought iron (forged balconies and gates). Not located in the Casino/Theater area.	§ 1245	5 years (57.0 Distributive Trades and Services)
	Storefronts	Includes the framework, sheetrock, or any other component that comprises the framing of the storefront walls.	§ 1250	39 years (40 years for purposes of § 168 (g))
		Includes storefronts made primarily of synthetic materials (foam, fiberglass, cast stone, or glass reinforced concrete) that are affixed with permanent adhesive or nailed or screwed in place. Also includes costs relating to the exposed millwork, trim molding and lining around doors, windows, and baseboards. See also **Wall Coverings and Millwork.**	§ 1250	39 years (40 years for purposes of § 168 (g))

ASSET		DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Facades – Interior (continued)	**Storefronts (continued)**	Includes 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. Located in the Casino area. Also includes storefronts associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
		Includes 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. Not located in the Casino/Theater area.	§ 1245	5 years (57.0 Distributive Trades and Services)
	Painted Ceilings	Includes painted ceilings applied with spray guns and brushes (regardless of theme or design).	§ 1250	39 years (40 years for purposes of § 168 (g))
		Includes *custom* painted ceilings designed on computers, transferred to canvases, and hand-painted with acrylics (fire-retardant materials).	§ 1250	39 years (40 years for purposes of § 168 (g))
		Includes painted ceilings designed on computers, transferred to canvases, and hand-painted with acrylics that are not permanently attached and not intended to be permanent and located in the Casino area. Also includes painted ceilings that are not permanently attached associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
		Includes painted ceilings designed on computers, transferred to canvases, and hand-painted with acrylics that are not permanently attached and not intended to be permanent. Not located in the Casino/Theater area.	§ 1245	5 years (57.0 Distributive Trades and Services)

ASSET		DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Facades – Interior (continued)	**Rockscape**	Includes rock finishes made of synthetic materials (such as interior fountains containing waterproofed liners and molded rockscape features) and decorative stonework embedded in walls that are an integral part of a buildings structural shell. Includes non-load bearing rockscape and decorative stonework embedded in walls (regardless of height) that divide or create rooms or provide traffic control where the rockscape and stonework cannot be 1) readily removed and remain in substantially the same condition after removal as before, or 2) moved and reused, stored or sold in its entirety.	§ 1250	39 years (40 years for purposes of § 168 (g))
		Includes rockscape and decorative stonework that do not function as part of the building and would be considered as non-structural theme elements that function merely as ornamentation.	§ 1245	5 years (57.0 Distributive Trades and Services)

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Fire Protection & Alarm Systems	Includes sensing devices, computer controls, sprinkler heads, piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and wall mounted fire extinguishers necessary for the protection of the building.	§ 1250	39 years (40 years for purposes of § 168 (g)
Fire Protection Equipment	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.	§ 1245	5 years (57.0 Distributive Trades and Services)
Floor Covering	Includes floor covering that is affixed with permanent adhesive or nailed or screwed in place. Examples include ceramic or quarry tile, marble, paving brick, most vinyl coverings and other coverings cemented, mudded, or grouted to the floor; epoxy or sealers; and wood flooring.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Includes floor covering that is not permanently attached and not intended to be permanent, such as vinyl composition tile (VCT) installed with strippable adhesive, sheet vinyl, and carpeting, and located in the Casino area. Also includes floor covering that is not	§ 1245	7 years (79.0 Recreation)

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	permanently attached associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.		
Floor Covering (continued)	Includes floor covering that is not permanently attached and not intended to be permanent, such as vinyl composition tile (VCT) installed with strippable adhesive, sheet vinyl, and carpeting, but not located in the Casino/Theater area.	§ 1245	5 years (57.0 Distributive Trades and Services)
Floors	Includes concrete slabs and other floor systems. Floors include special treatments applied to or otherwise a permanent part of the floor. For example, "super flat" finish, sloped drainage basins, raised perimeter, serving line curb, or cooler, freezer and garbage room floors.	§ 1250	39 years (40 years for purposes of § 168 (g))
Furniture - Guest Room	Includes furniture unique to guest rooms and distinguishable from office furniture. For example, beds, dressers, armoires, and night-tables. See also **Furniture- Office**.	§ 1245	5 years (57.0 Distributive Trades and Services)
Furniture – Office (includes Communication Equipment and Hook-ups)	Includes desk, chair, credenza, file cabinet, table (whether located in *Administrative Areas or Guest Rooms*) and other furniture such as workstations. Also includes communication equipment and related hook-ups.	§ 1245	7 years (00.11 Office Furniture and Fixtures)
Generators	Emergency power generators for building related operations (emergency/safety systems).	§ 1250	39 years (40 years for purposes of § 168 (g))
	Depreciable assets, whether such assets are section 1245 property or 1250 property, used in the production and/or distribution of electricity with rated total capacity in excess of 500 Kilowatts and/or assets used in the production and/or distribution of steam with rated total capacity in excess of 12,500 pounds per hour for use by the taxpayer in its industrial manufacturing process or plant activity and not ordinarily available for sale to others. Does not include buildings and structural components as defined in section 1.48-1(e) of the regulations. See **Asset Class 00.4 (Rev. Proc. 87-56)**. Note* asset class 00.4 includes both section 1245 and 1250 property per Rev. Proc. 87-56.	See Note*	15 years (00.4 Industrial Steam and Electric Generation and/or Distribution Systems)
	Emergency power generators for casino operations. (See **Cost Segregation Audit Techniques Guide** for allocation examples)	§ 1245	7 years (79.0 Recreation)
Kitchen Equipment Hook-ups	Encompasses the electrical distribution system of the kitchen. Refer to the industry directive for **Restaurants - Kitchen Equipment Hook-up.**	§ 1245	5 years (57.0 Distributive

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
			Trades and Services)
Light Fixtures – Interior	Includes lighting such as recessed and lay-in lighting, night lighting, and exit lighting, as well as decorative lighting fixtures that provide substantially all the artificial illumination (*primary* source of lighting). Includes guest room lighting, wall sconces (bathroom, guest room, and hallway), hallway chandeliers, and all electrical connections associated with these fixtures, such as power junction boxes, riser conduit, and wiring.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Includes decorative light fixtures such as chandeliers, wall sconces, down lighting, neon lighting, column lights which are decorative in nature and not necessary for the operation of the building and located in the Casino area plus cost of all wiring and electrical connections associated with these fixtures. Also includes all decorative lighting fixtures associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
	Includes decorative light fixtures, such as neon lights, table lamps, or track lighting, which are decorative in nature and not necessary for the operation of the building and not located in the Casino/Theater area. In other words, if the decorative lighting were turned off, the other sources of lighting would provide sufficient light for operation of the building. If the decorative lighting is the *primary* source of lighting, then it is section 1250 property.	§ 1245	5 years (57.0 Distributive Trades and Services)
Light Fixtures – Exterior	Exterior lighting (whether decorative or not) to the extent that the lighting relates to the maintenance or operation of the building. This category includes building mounted lighting to illuminate walkways, entrances, parking, etc.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Pole mounted or freestanding outdoor lighting system to illuminate sidewalks, parking or recreation areas. See also **Poles & Pylons**. Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.	See Note*	15 years (00.3 Land Improvement)
	Removable plant grow lights or removable lighting that highlights *only* the landscaping or building exterior (but not parking areas or walkways) and does not relate to the maintenance or operation of the building.	§ 1245	5 years (57.0 Distributive Trades and Services)
Loading Dock	Includes bumpers, permanently installed dock levelers, plates, seals, lights, canopies, and overhead doors used in the receiving and shipping of merchandise.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Includes items such as compactors, conveyors, hoists and/or balers.	§ 1245	5 years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
			(57.0 Distributive Trades and Services)
Millwork – General Building or Structural	Includes millwork that is made of finished wood for example, doors and frames, window frames, sashes, porch work, mantels, panel work, stairways, and special woodwork. Includes pre-built wooden items brought to the site for installation and items constructed on site such as restroom cabinets, door jambs, moldings, trim, etc.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Corner Guards and Wall Guards (includes guards made of stainless steel, e.g., diamond plate)	§ 1250	39 years (40 years for purposes of § 168 (g))
Millwork - Decorative	Includes decorative finish carpentry in a Casino area. Examples include detailed crown moldings, lattice work placed over finished walls or ceilings, and cabinets. The decorative millwork serves to enhance the overall décor of the Casino area and is not related to the operation of the building. Cabinets and counters in a restroom are excluded from this category; see **Restroom Accessories.** Also includes decorative millwork associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
	Includes decorative finish carpentry in the *hotel and retail* areas. Examples include detailed crown moldings, lattice work placed over finished walls or ceilings, and cabinets. The decorative millwork serves to enhance the overall décor of the hotel and retail areas and is not related to the operation of the building. Cabinets and counters in a restroom are excluded from this category; see **Restroom Accessories.**	§ 1245	5 years (57.0 Distributive Trades and Services)
Poles & Pylons	Light poles for parking areas and other poles poured in concrete footings or bolt-mounted for signage, flags, etc. Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56. See also **Pylon Sign – Exterior** and **Light Fixtures – Exterior**.	See Note*	15 years (00.3 Land Improvement)
Pools & Pool Equipment	Includes swimming pools and pool equipment (and spas attached to the swimming pools) that are contained within, on, or attached to a building.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Includes exterior swimming pools and pool equipment (and spas attached to the swimming pools) that are built on land. Note* asset class 00.3 Land	See Note*	15 years (00.3 Land Improvement)

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.		
Pylon Sign - Exterior	Pylons made of concrete, brick, wood frame, stucco, or similar materials usually set in the ground or on a concrete foundation, and usually used for signage. Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56. See also **Poles & Pylons**	See Note*	15 years (00.3 Land Improvement)
	Includes only the sign face and/or message screen and related components.	§ 1245	5 years (57.0 Distributive Trades and Services)
Restroom-Accessories	Includes paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, handrails, grab bars, mirrors, shelves, vanity cabinets, counters and ashtrays and other items generally found in public restrooms that are built into or mounted on walls or partitions.	§ 1250	39 years (40 years for purposes of § 168 (g))
Restroom Partitions	Includes shop made and standard manufacture toilet partitions, typically metal, but may be plastic or other materials.	§ 1250	39 years (40 years for purposes of § 168 (g))
Security Equipment	Includes security equipment for the protection of the building and its contents, including the building exterior and grounds, from theft or vandalism and protection of employees and guests from assault. Examples include security cameras, recorders, monitors and related equipment (including those located in the elevator and elevator lobbies); building exterior and interior motion detectors; security lighting; alarm systems; security systems and related junction boxes, wiring, and conduit).	§ 1250	39 years (40 years for purposes of § 168 (g)
Security Equipment (continued)	Includes surveillance cameras, recorders, monitors and related equipment, the primary purpose of which is to surveil gaming activities and to minimize theft in the Casino area. Also includes surveillance equipment associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
	Includes electronic article surveillance systems including surveillance cameras, recorders, monitors and related equipment, the primary purpose of which is to minimize theft in the *retail* areas. Does not include the Casino/Theater area.	§ 1245	5 years (57.0 Distributive Trades and Services)

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Signs	Exit signs, restroom identifiers, room numbers, and other signs relating to the operation or maintenance of a building. See also **Exit Signs**.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Includes interior signs used to display gaming related activities such as keno, slots, video poker, etc. Also includes interior signs associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
	Includes interior signs used to display directories of names or indicate the location of business functions and departments, (registration desk, buffet, retail shops, etc.), but not associated with the Casino/Theater activities. Not related to the operation or maintenance of a building. Also includes exterior signs used to display names, symbols, directions, etc. For pylon signs, includes only the sign face and related dedicated wiring. See also **Pylon Sign – Exterior**.	§ 1245	5 years (57.0 Distributive Trades and Services)
Site Grading & Excavation	Non-depreciable land preparation costs, in general, include the one-time cost of demolition, clearing and grubbing, blasting, site stripping, fill or excavation, dewatering, and grading to allow development of land. Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. Stripping is the removal of the topsoil to provide a stable surface for site and building improvements. The grading of land involves moving soil for the purpose of producing a more level surface to allow development of the land. These costs would not have to be incurred again if the building was repaired, rebuilt, or even torn down and replaced with some other type of building.		Land
Site Grading & Excavation (continued)	Clearing, grading, excavating and removal costs directly associated with the construction of buildings and building components are part of the cost of construction of the building and depreciated over the life of the building.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements are part of the cost of construction of the improvements and depreciated over the life of the associated asset. **Note*** asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.	See Note*	15 years (00.3 Land Improvement)
Site Utilities	Systems that are used to distribute utility services from the property line to the casino complex. Includes water, sanitary sewers, gas and electrical services.	§ 1250	39 years (40 years for purposes of § 168 (g)

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	Storm Piping (for draining the site of rainwater). Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.	See Note*	15 years (00.3 Land Improvement)
Site Work	Site work includes curbing, paving, general site improvements, fencing, landscaping, roads, sewers, sidewalks, site drainage and all other site improvements not directly related to the building. **Note*** asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56. See **Site Utilities** for sanitary sewers.	See Note*	15 years (00.3 Land Improvement)
Spa Hook-ups	Includes Jacuzzi, Whirlpools, and bathtubs located in Guest Rooms and Suites.	§ 1250	39 years (40 years for purposes of § 168 (g))
	Includes Jacuzzi and Whirlpools located in the *Hotel Spa/Fitness Center*. Does not include spa hook-ups that may be associated with swimming pools or pool equipment. See also **Pools & Pool Equipment**.	§ 1245	5 years (57.0 Distributive Trades and Services)
Wall Coverings	Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick and other finishes affixed with mortar, cement or grout; paneling, wainscoting and other wood finishes affixed with nails, screws or permanent adhesives; and sanitary kitchen wall panels such as fiberglass, stainless steel and plastic wall panels.	§ 1250	39 years (40 years for purposes of § 168 (g))
Wall Coverings (continued)	Includes strippable wall paper and vinyl that causes no damage to the underlying wall or wall surface and located in the Casino area. For purposes of this directive, such wallpaper is considered not permanently attached or intended to be permanent. Also includes strippable wall coverings associated with the activities described in Asset Class 79.0 of Rev. Proc. 87-56, such as Theater and Showroom.	§ 1245	7 years (79.0 Recreation)
Wall Coverings (continued)	Includes strippable wallpaper and vinyl that causes no damage to the underlying wall or wall surface and located in the *hotel and retail* areas. For purposes of this directive, such wallpaper is considered not permanently attached or intended to be permanent.	§ 1245	5 years (57.0 Distributive Trades and Services)

B. Restaurants

Field Directive on the Planning and Examination of Cost Segregation Issues in the Restaurant Industry

December 27, 2004

MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTORS, FIELD OPERATIONS, LMSB
DIRECTOR, FIELD SPECIALISTS, LMSB
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE, LMSB
DIRECTOR, COMPLIANCE, SBSE

FROM: /s/ Henry V. Singleton
Industry Director

/s/ Steve Burgess
Director, Examination, SBSE

SUBJECT: Field Directive on the Planning and Examination of Cost Segregation Issues in the Restaurant Industry

INTRODUCTION

This memorandum is intended to provide direction to effectively utilize resources in the classification and examination of a taxpayer who is recovering costs through depreciation of tangible property used in the operation of a restaurant business. This LMSB Directive is not an official pronouncement of the law or the position of the Service and cannot be used, cited or relied upon as such.

The American Jobs Creation Act of 2004, enacted October 22, 2004, modifies I.R.C. §168. This development has been incorporated into the guidelines through the note to Exhibit A. In addition, this directive has been modified in content and format to conform to the Field Directive issued for the retail industry on December 16, 2004.

BACKGROUND

The crux of cost segregation is determining whether an asset is I.R.C. §1245 property (shorter cost recovery period property, 5 or 7 years) or §1250 property (longer cost recovery period property, 39, 31.5 or 15 years). The most common example of §1245 property is depreciable personal property, such as equipment. The most common examples of §1250 property are buildings and building components, which generally are not §1245 property.[1]

The difference in recovery periods has placed the Internal Revenue Service and taxpayers in adversarial positions in determining whether an asset is §1245 or §1250 property. Frequently, this causes the excessive expenditure of examination resources. The Director for the Retailers, Food, Pharmaceuticals and Healthcare Industry chartered a working group to address the most efficient way to approach cost segregation issues

[1] I.R.C. Section 1245 can apply to certain qualified recovery nonresidential real estate placed in service after 1980 and before 1987. See I.R.C. Section 1245(a)(5).

specific to the restaurant industry. The group produced the attached matrix and related definitions as a tool to reduce unnecessary disputes and foster consistent audit treatment.

PLANNING AND EXAMINATION GUIDANCE

Attached Exhibit A is a matrix recommending the categorization and general depreciation system recovery period of various restaurant assets. (For recovery periods under IRC §168(g) alternative depreciation system see Revenue Procedure 87-56, 1987-2 CB 674.) If the taxpayer's tax return position for these assets is consistent with the recommendations in Exhibit A, examiners should not make adjustments to categorization and lives. If the taxpayer reports assets differently, then adjustments should be considered. The Industry intends to update Exhibit A regularly.

See the Cost Segregation Audit Techniques Guide for additional guidance. See also Revenue Procedure 2002-12, I.R.B. 2002-3, 374 (Jan. 07, 2002), for the proper treatment of smallwares.

If you have any questions, please contact the Deductible and Capital Expenditures (DCE) Practice Network.

Attachments: Exhibit A

LMSB DIRECTIVE ON COST SEGREGATION IN THE RESTAURANT INDUSTRY
EXHIBIT A

NOTE: In the case of certain leasehold improvements and restaurant property, the classifications in this directive are superseded to the extent that the American Jobs Creation Act of 2004 modifies IRC Section 168. Thus, a 15-year straight line recovery period should replace the recovery period shown in the following matrix if the asset is "qualified leasehold improvement property" (as defined in IRC Section 168(e)(6)) or "qualified restaurant property" (as defined in IRC Section 168(e)(7)) placed in service by the taxpayer after October 22, 2004 and before January 1, 2008.

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Beverage Equipment	Equipment for storage and preparation of beverages and beverage delivery systems. Beverage equipment includes the refrigerators, coolers, dispensing systems, and the dedicated electrical, tubing or piping for such equipment. The dispensing system may be gravity, pump or gas driven.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Canopies & Awnings	Readily removable overhang or covering, often of canvas or plastic, used to provide shade or cover over a storefront, window, or door; or used inside a structure to identify a particular area. Examples include applications over an exterior door or window, or attached to interior walls or suspended from ceilings to identify a buffet line or bar area of the restaurant. Does not include canopies that are an integral part of a building's structural shell, such as in the casino industry, or over docks.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Ceilings	Includes all interior ceilings regardless of finish or décor, e.g. drywall or plaster ceilings, acoustic ceilings, suspended ceilings (including all hangers, frames, grids, and tiles or panels), decorative metal or tin finishes, kitchen plastic panels, decorative panels, etc.	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Computers	Processors (CPU), direct access storage device (DASD), tape drives, desktop and laptop computers, CRT, terminals, monitors, printers, and other peripheral equipment. Excludes Point of Sale (POS) systems and computers that are an integral part of other equipment (e.g., fire detection, heating, cooling, or energy management systems, etc.).	§ 1245	00.12 Information Systems – 5 Years
Concrete Foundations & Footings	Includes formwork, reinforcement, concrete block, and pre-cast or cast-in-place work related to foundations and footings necessary for the proper setting of the building.	§ 1250	Building or Building Component – 39 Years
	Foundations or footings for signs, light poles, canopies and other land improvements (except buildings).	§ 1250	00.3 Land Improvements – 15 Years
Data Handling Equipment	Includes adding and accounting machines, calculators, copiers and duplicating machines. Excludes computers and computer peripheral equipment, see **Computers**.	§ 1245	00.13 Data Handling Equipment, except Computers – 5 Years
Doors	Interior and exterior doors, regardless of decoration, including but not limited to, double opening doors, overhead doors, revolving doors, mall entrance security gates, roll-up or sliding wire mesh or steel grills and gates, and door hardware (such as doorknobs, closers, kick plates, hinges, locks, automatic openers, etc.).	§ 1250	Building or Building Component – 39 Years
	Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area. For example, Eliason doors providing easy access between the kitchen and dining areas.	§ 1245	57.0 Distributive Trades and Services – 5 Years
Doors – Air Curtains	Air doors or curtains are air systems located above doors and windows that circulate air to stabilize environments and save energy by minimizing the heated/air conditioned air loss through open doorways and windows. They also effectively repel flying insects, dust, and pollutants.	§ 1250	Building or Building Component – 39 Years
Drive-Through Equipment	Drive-through equipment includes order taking, food delivery and payment processing systems whether mechanical or electronic. Excludes building elements such as doors, bays, or windows. See also **Walls – Exterior**, and **Windows** for drive-through bays and windows.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Electrical	Includes all components of the building electrical system used in the operation or maintenance of the building or necessary to provide general building services such as electrical outlets of general	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	applicability and accessibility, lighting, heating, ventilation, air conditioning and electrical wiring. See also **Kitchen Equipment Hook-ups.**		
	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. Does not include electrical outlets of general applicability and accessibility. See Chapter 5 of the Cost Segregation Audit Techniques Guide for allocation examples.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Elevators & Escalators	Elevators and escalators, which include handrails and smoke baffles, are permanently affixed to the building and intended to remain in place. They relate to the operation or maintenance of the building and are structural components.	§ 1250	Building or Building Component – 39 Years
Equipment Installation	Expenses incurred in the installation of furnishings and restaurant equipment. Some examples include booths, tables, counters and interior theme décor.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Exit Signs	Signs posted along exit routes that indicate the direction of travel to the nearest exit. These signs typically read "EXIT" and may have distinctive colors, illumination, or arrows indicating the direction to the exit.	§ 1250	Building or Building Component – 39 Years
Fire Protection & Alarm Systems	Includes sensing devices, computer controls, sprinkler heads, piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and wall mounted fire extinguishers necessary for the protection of the building.	§ 1250	Building or Building Component – 39 Years
Fire Protection Equipment	Includes special fire detection or suppression systems located in equipment hoods or 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.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Fireplaces	Includes masonry and gas fireplaces, flues, chimneys and other components of built-in fireplaces.	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Floor Coverings	Floor covering affixed with permanent adhesive, nailed, or screwed in place. Examples include ceramic or quarry tile, marble, paving brick, and other coverings cemented, mudded, or grouted to the floor; epoxy or sealers; and wood flooring.	§ 1250	Building or Building Component – 39 Years
	Floor covering that is installed by means of strippable adhesives. For the restaurant industry, all carpeting will be treated as not permanently attached and not intended to be permanent. Excludes rugs or tapestries that are considered artwork and do not suffer wear and tear (e.g. Persian rugs that may appreciate are considered artwork).	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Floors	Includes concrete slabs and other floor systems. Floors include special treatments applied to or otherwise a permanent part of the floor. For example, "superflat" finish, sloped drainage basins, raised perimeter, serving line curb, or cooler, freezer and garbage room floors.	§ 1250	Building or Building Component – 39 Years
Food Storage & Preparation Equipment	Food storage, cleaning, preparation, and delivery systems including all machinery, equipment, furniture and fixtures used to process food items from storage through delivery to the customer.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Heating Ventilating & Air Conditioning (HVAC)	Includes all components of a central heating, ventilating and air conditioning system not specifically identified elsewhere. HVAC systems that are installed not only to meet the temperature and humidity requirements of machinery, but are also installed for additional significant purposes, such as customer comfort and ventilation, are building components.	§ 1250	Building or Building Component – 39 Years
	Only separate kitchen HVAC units that meet the sole justification test are included (i.e., 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.) Kitchen HVAC may meet the sole justification 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. Includes refrigeration units, condensers, compressors, accumulators, coolers, pumps, connecting pipes, and wiring for the mechanical equipment for climate controlled rooms such as walk-in freezers and coolers. Allocation of HVAC is not appropriate.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Kitchen Equipment Hook-ups	Includes separate water lines from the incoming water main to equipment (such as steam trays, cooking vessels, or ice machines), gas lines from the building's main gas line to equipment (such as fryers or ovens), and special drain lines from equipment (such as refrigerator or dishwasher) to the drain. Also includes ventilation system or kitchen air makeup unit solely to maintain specific ventilation requirements essential for operation of kitchen equipment, equipment exhaust hoods, and electric outlets and conduit extending back to the circuit box to provide a localized power source for specialized equipment. For example, a dishwasher requires electric and plumbing hook-ups, electrical from the dishwasher to the source of electricity (such as an outlet or junction box), and plumbing to connect the dishwasher to the water line and the drain. Excludes outlets of general applicability and accessibility or kitchen hand sink plumbing; see also **Electrical, HVAC,** and **Plumbing**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Light Fixtures – Interior	Includes lighting such as recessed and lay-in lighting, night lighting, and exit lighting, as well as decorative lighting fixtures that provide substantially all the artificial illumination in the building or along building walkways. For emergency and exit lighting, see **Fire Protection & Alarm Systems**.	§ 1250	Building or Building Component – 39 Years
	Decorative light fixtures are light fixtures, such as neon lights or track lighting, which are decorative in nature and not necessary for the operation of the building. In other words, if the decorative lighting were turned off, the other sources of lighting would provide sufficient light for operation of the building. If the decorative lighting is the *primary* source of lighting, then it is section 1250 property.	§ 1245	57.0 Distributive Trades and Services - 5 Years
Light Fixtures – Exterior	Exterior lighting whether decorative or not is considered section 1250 property to the extent that the lighting relates to the maintenance or operation of the building. Includes building mounted lighting to illuminate walkways, entrances, parking, etc.	§ 1250	Building or Building Component – 39 Years
	Pole mounted or freestanding outdoor lighting system to illuminate sidewalks, parking or recreation areas. See also **Poles & Pylons**. **Note*** asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.	See Note*	00.3 Land Improvements – 15 Years
	Plant grow lights or lighting that highlights *only* the landscaping or building exterior (but not parking areas or walkways) does not relate to the maintenance or operation of the building.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Millwork – Decorative	Decorative millwork is the decorative finish carpentry in the restaurant. Examples include detailed crown moldings, lattice work placed over finished walls or ceilings, cabinets and counters. The decorative millwork serves to enhance the overall theme of the restaurant and is not related to the operation of the building. Excludes cabinets and counters in a restroom; see **Restroom Accessories**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Millwork – General Building or Structural	General millwork is all building materials made of finished wood (e.g., doors and frames, window frames, sashes, porch work, mantels, panel work, stairways, and special woodwork). Includes pre-built wooden items brought to the site for installation and items constructed on site such as restroom cabinets, door jambs, moldings, trim, etc.	§ 1250	Building or Building Component – 39 Years
Office Furnishings	Includes desk, chair, credenza, file cabinet, table, or other furniture such as workstations. Also includes telephone equipment, fax machines, and other communications equipment. Does not include communications equipment included in other asset classes in Rev. Proc. 87-56.	§ 1245	00.11 Office Furniture, Fixtures, and Equipment – 7 Years
Parking Lots	Grade level surface parking area usually constructed of asphalt, brick, concrete, stone or similar material. Category includes bumper blocks, curb cuts, curb work, striping, landscape islands, perimeter fences, and sidewalks.	§ 1250	00.3 Land Improvements –15 Years
Plumbing	All piping, drains, sprinkler mains, valves, sprinkler heads, water flow switches, restroom plumbing fixtures (e.g. toilets) and piping, kitchen hand sinks, electric water coolers, and all other components of a building plumbing system (water or gas) not specifically identified elsewhere. Excludes water or gas connections directly to appliances or kitchen drainage and kitchen hot water heater; see **Kitchen Equipment Hook-ups**.	§ 1250	Building or Building Component – 39 Years
	Includes water, gas, or refrigerant hook-ups directly connected to appliances or equipment, eyewash stations, kitchen drainage, and kitchen hot water heater. For example, a dishwasher would require special water hook-up.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Point of Sale (POS) Systems	A register or terminal based data collection system used to control and record all sales. Includes cash registers, computerized sales systems, and related peripheral equipment. See also **Electrical** for hook-ups.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Poles & Pylons	Light poles for parking areas and other poles poured in concrete footings or bolt-mounted for signage, flags, etc. **Note*** asset class 00.3 Land	See Note*	00.3 Land Improvements –

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	Improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.		15 Years
Restaurant Décor Accessories	Decorative mobile props such as playground equipment, potted plants, hanging mirrors, ceiling fans, and theme related props (such as coat of arms, sporting equipment or memorabilia, artifacts, pictures, plaques, etc., excluding non-depreciable artwork, antiques or collectibles).	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Restaurant Furniture	Includes furniture unique to restaurants and distinguishable from office furniture. For example, a high stool in a bar, dining room table and chairs, booths, lockers, or benches. See also **Office Furnishings**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Restaurant Non-structural Theme Elements	Interior non-load bearing decorative structures. These are items that do not function as part of the building and are not integrated with building elements such as wiring, plumbing or ventilation. For example, a model castle constructed of gypsum board or plaster and wood studs would be considered a non-structural theme element that functions merely as ornamentation. Excludes a half wall whose function is to provide traffic control or space subdivision, see **Walls - Interior Partitions**. Excludes decorative ceilings, see **Ceilings**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Restroom Accessories	Includes paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, grab bars, mirrors, shelves, vanity cabinets, counters, ashtrays, baby changing stations, and other items generally found in public restrooms that are built into or mounted on walls or partitions.	§ 1250	Building or Building Component – 39 Years
Restroom Partitions	Includes shop made and standard manufacture toilet partitions, typically metal, but may be plastic or other materials.	§ 1250	Building or Building Component – 39 Years
Roof	All elements of the roof including but not limited to joists, rafters, deck, shingles, vapor barrier, skylights, trusses, girders and gutters. Determination of whether decorative elements of a roof (e.g. false dormers, mansard) constitute structural building components depends on their integration with the overall roof not their load bearing capacity. If removal of the decorative element results in the direct exposure of building components to water, snow, wind, or moisture damage, or if the decorative element houses lighting fixtures, wiring, or other structural components, then the decorative elements	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	are part of the overall roof system and are structural components of the building.		
Security Systems	Includes security equipment for the protection of the building (and its contents) from burglary or vandalism and protection of employees from assault. Examples include window and door locks; card key access systems; keyless entry systems; security cameras, recorders, monitors and related equipment; perimeter and interior building motion detectors; security lighting; alarm systems; and security system wiring and conduit.	§ 1250	Building or Building Component – 39 Years
Signs	Exit signs, restroom identifiers and other signs relating to the operation or maintenance of a building.	§ 1250	Building or Building Component – 39 Years
	Interior and Exterior Signs used for menu display or theme identity. For pylon signs, includes only sign face. See also **Poles & Pylons**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Site Preparation, Grading, & Excavation	In general, land preparation costs include one-time cost of clearing and grubbing, site stripping, fill or excavation, and grading to allow development of land. Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. Stripping is the removal of the topsoil to provide a stable surface for site and building improvements. The grading of land involves moving soil to produce a more level surface to allow development of the land.		Land
	Clearing, grading, excavating and removal costs directly associated with the construction of buildings and building components are part of the cost of construction of the building.	§ 1250	Building or Building Component – 39 Years
	Clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements are part of the cost of construction of the improvements.	§ 1250	00.3 Land Improvements – 15 Years
Site Utilities	Site utilities are the systems that are used to distribute utility services from the property line to the restaurant building. Includes water, sanitary sewer, gas, and electrical services.	§ 1250	Building or Building Component – 39 Years
Site Work	Site work includes curbing, paving, general site improvements, fencing, landscaping, roads, sewers, sidewalks, site drainage and all other site improvements not directly related to the building. For sanitary sewers, see **Site Utilities**.	§ 1250	00.3 Land Improvements – 15 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Sound Systems	Equipment and apparatus, including wiring, used to provide amplified music or sound. For example, public address by way of paging a customer or background music. Excludes applications linked to fire protection and alarm systems.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Stonework	Exterior decorative stonework embedded in half walls, such as patio half walls, that are an integral part of a building's structural shell. Such half walls relate to the operation or maintenance of the building.	§ 1250	Building or Building Component – 39 Years
	Includes patio stonework imbedded in the ground or applied to exterior half walls that are not an integral part of the building's structural shell.	§ 1250	00.3 Land Improvements – 15 Years
Trash Enclosures	Enclosures for waste receptacles that are attached to the building. Typically constructed of the same materials as the building shell with either interior or exterior access. These trash enclosures are an integral part of the building shell and cannot be moved without damage to the underlying building.	§ 1250	Building or Building Component – 39 Years
	Freestanding enclosures for waste receptacles, typically constructed on a concrete pad with its posts set in the concrete. Serves both safety and decorative functions.	§ 1250	00.3 Land Improvements – 15 Years
Upholstery	Any material used in the coverage and protection of furnishings.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Wall Coverings	Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick and other finishes affixed with mortar, cement or grout; paneling, wainscoting and other wood finishes affixed with nails, screws or permanent adhesives; and sanitary kitchen wall panels such as Fiberglass Reinforced Plastic (FRP), stainless steel or plastic wall panels.	§ 1250	Building or Building Component – 39 Years
	Strippable wallpaper that causes no damage to the underlying wall or wall surface.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Walls – Exterior	Includes all exterior walls and building support regardless of construction materials. Exterior walls may include columns, posts, beams, girders, curtain walls, tilt up panels, studs, framing, sheetrock, insulation, windows, doors, exterior façade, brick, masonry, etc. Also includes drive-through bay, windows, and doors.	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Walls - Interior Partitions	Includes all load bearing interior partitions regardless of construction. Also includes non-load bearing partitions regardless of height (typically constructed of studs and sheetrock or other materials) that divide or create rooms or provide traffic control. Includes rough carpentry and plaster, dry wall or gypsum board, and other finishes.	§ 1250	Building or Building Component – 39 Years
	Interior walls where the partition 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 its entirety.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Windows	Exterior windows, including store front windows, drive-through service and carousel windows, and vestibule.	§ 1250	Building or Building Component – 39 Years
Window Treatments	Window treatments such as drapes, curtains, louvers, blinds, post construction tinting or interior decorative theme décor that are readily removable.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

A. Retail Industries

Field Directive on the Planning and Examination of Cost Segregation Issues in the Retail Industry

December 16, 2004

MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTORS, FIELD OPERATIONS, LMSB
DIRECTOR, FIELD SPECIALISTS, LMSB
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE, LMSB
AREA DIRECTORS, SBSE

FROM: /s/ Henry V. Singleton
Industry Director, Retailers, Food, Pharmaceuticals & Healthcare

/s/ Steve Burgess
Director, Examination, SBSE

SUBJECT: Field Directive on the Planning and Examination of Cost Segregation Issues in the Retail Industry

INTRODUCTION

This memorandum is intended to provide direction to effectively utilize resources in the classification and examination of a taxpayer who is recovering costs through depreciation of tangible property used in the operation of a retail business. This Directive is not an official pronouncement of the law or the position of the Service and cannot be used, cited or relied upon as such.

BACKGROUND

The crux of cost segregation is determining whether an asset is I.R.C. §1245 property (shorter cost recovery period property, 5 or 7 years) or §1250 property (longer cost recovery period property, 39, 31.5 or 15 years). The most common example of §1245 property is depreciable personal property, such as equipment. The most common examples of §1250 property are buildings and building components, which generally are not §1245 property.[2]

The difference in recovery periods has placed the Internal Revenue Service and taxpayers in adversarial positions in determining whether an asset is §1245 or §1250 property. Frequently, this causes the excessive expenditure of examination resources. The Director for the Retailers, Food, Pharmaceuticals and Healthcare Industry chartered a working group to address the most efficient way to approach cost segregation issues specific to the retail industry. The group produced the attached matrix and related definitions as a tool to reduce unnecessary disputes and foster consistent audit treatment.

PLANNING AND EXAMINATION GUIDANCE

Attached Retail Exhibit A is a matrix recommending the categorization and general depreciation system recovery period of various retail assets. (For recovery periods under IRC §168(g) alternative depreciation

[2] I.R.C. §1245 can apply to certain qualified recovery nonresidential real estate placed in service after 1980 and before 1987. See I.R.C. §1245 (a) (5).

system, see Revenue Procedure 87-56, 1987-2 CB 674). If the taxpayer's tax return position for these assets is consistent with the recommendations in Retail Exhibit A, examiners should not make adjustments to categorization and lives. If the taxpayer reports assets differently, then adjustments should be considered. The Industry intends to update Retail Exhibit A regularly.

See also the Cost Segregation Audit Techniques Guide.

If you have any questions, please contact the Deductible and Capital Expenditures (DCE) Practice Network.

Attachments: Exhibit A

This matrix, which is part of the Cost Segregation Audit Techniques Guide, is intended to provide direction to effectively utilize resources in the classification and examination of property used in the operation of a retail business such as a department or grocery store. General fact patterns specific to this industry have been considered in the classification of these assets and may not be applicable to other industries. Similarly, asset classification guidance issued for other industries is based on the general fact pattern for that industry and may not be applicable to a retail business situation. For example, for asset classification of restaurants located within a retail store, refer to the industry directive for restaurants. For examination techniques and historical background related to this issue, refer to the Cost Segregation Audit Techniques Guide.

NOTE: In the case of certain leasehold improvement property, the classifications in this directive are superseded to the extent that the American Jobs Creation Act of 2004 modifies IRC Section 168. Thus, a 15-year straight line recovery period should replace the recovery period shown in the following matrix if the asset is "qualified leasehold improvement property" (as defined in IRC Section 168(e)(6)) placed in service by the taxpayer after 10/22/04 and before 01/01/08.

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Awnings & Canopies	Readily removable overhang or covering, often of canvas or plastic, used to provide shade or cover over a storefront, window, or door; or used inside a structure to identify a particular department or selling area. Examples include applications over an exterior door or window, or attached to interior walls or suspended from ceilings for bakery, deli, floral, meat, or produce departments. Also includes canopies designed to protect customers and gasoline fueling equipment from weather conditions and to act as advertising displays that are anchored with bolts and are not attached to buildings or other structures. Does not include canopies that are an integral part of a building's structural shell, such as in the casino industry, or over docks. See also **Concrete Foundations & Footings** and **Loading Docks**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Beverage Equipment	Equipment for storage and preparation of beverages and beverage delivery systems. Beverage equipment includes the refrigerators, coolers, dispensing systems, and the dedicated electrical, tubing or piping for such equipment. The dispensing system may be gravity, pump or gas driven. See also **Refrigerated Structures**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Ceilings	Includes all interior ceilings regardless of finish or décor; e.g. drywall or plaster ceilings, acoustic ceilings, suspended ceilings (including hangers, frames, grids and tiles or panels), decorative metal or tin finishes, plastic	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	panels, decorative panels, etc. See also **Awnings & Canopies, Millwork - Decorative** and **Millwork - General Building or Structural**.		
Computers	Processors (CPU), direct access storage device (DASD), tape drives, desktop and laptop computers, CRT, terminals, monitors, printers, and other peripheral equipment. Excludes Point of Sale (POS) systems and computers that are an integral part of other equipment (e.g. fire detection, heating, cooling, or energy management systems, etc.).	§ 1245	00.12 Information Systems – 5 Years
Concrete Foundations & Footings	Includes formwork, reinforcement, concrete block, and pre-cast or cast-in-place work related to foundations and footings necessary for the proper setting of the building.	§ 1250	Building or Building Component – 39 Years
	Foundations or footings for signs, light poles, and other land improvements (except buildings).	§ 1250	00.3 Land Improvements – 15 Years
	The supporting concrete footings used to anchor gasoline pump canopies are inherently permanent structures and are classified as land improvements.	§ 1250	57.1 Distributive Trades and Services – 15 years
Data Handling Equipment	Includes adding and accounting machines, calculators, copiers, and duplicating machines. Excludes computers and computer peripheral equipment, see **Computers**.	§ 1245	00.13 Data Handling Equipment, except Computers – 5 Years
Doors	Interior and exterior doors, regardless of decoration, including but not limited to, double opening doors, overhead doors, revolving doors, mall entrance security gates, roll-up or sliding wire mesh or steel grills and gates, and door hardware (such as doorknobs, closers, kick plates, hinges, locks, automatic openers, etc.).	§ 1250	Building or Building Component – 39 Years
	Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area. For example, flexible doors, or clear or strip curtains used between stock and selling areas.	§ 1245	57.0 Distributive Trades and Services – 5 Years
Doors - Air Curtains	Air doors or curtains are air systems located above doors and windows that circulate air to stabilize environments and save energy by minimizing the heated/air conditioned air loss through open doorways and windows. They also effectively repel flying insects, dust, and pollutants.	§ 1250	Building or Building Component – 39 Years
Drive-Through Equipment	Drive-through equipment includes order taking, merchandise delivery, and payment processing systems whether mechanical or electronic. Excludes building	§ 1245	57.0 Distributive

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	elements such as doors, bays, or windows. See also **Walls – Exterior**, and **Windows** for drive-through bays and windows.		Trades and Services -- 5 Years
Electrical	Includes all components of the building electrical system used in the operation or maintenance of the building or necessary to provide general building services such as electrical outlets of general applicability and accessibility, lighting, heating, ventilation, air conditioning, and electrical wiring.	§ 1250	Building or Building Component – 39 Years
	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. Does not include electrical outlets of general applicability and accessibility. See Chapter 5 of the Cost Segregation Audit Techniques Guide for allocation examples.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Elevators and Escalators	Elevators and escalators, which include handrails and smoke baffles, are permanently affixed to the building and intended to remain in place. They relate to the operation or maintenance of the building and are structural components.	§ 1250	Building or Building Component – 39 Years
Energy Management Systems	Energy management systems control all energy-using systems in a building, automatically checking occupancy schedules, reading temperatures, and re-circuiting light levels, causing all heating, cooling and lighting equipment to operate so as to minimize energy costs. Includes, for example, detection devices such as smoke, motion and infrared devices, photocells, foil and contact switches, pressure switches, proximity alarms, sensors, alarm transmitting controls, data gathering panels, demand controllers, thermostats, computer controls, outside air economizers, occupancy sensors, electronic ballasts, and all related wiring and conduit. May also provide for fire and burglary protection.	§ 1250	Building or Building Component – 39 Years
Exit Signs	Signs posted along exit routes that indicate the direction of travel to the nearest exit. These signs typically read "EXIT" and may have distinctive colors, illumination, or arrows indicating the direction to the exit.	§ 1250	Building or Building Component – 39 Years
Fire Protection & Alarm Systems	Includes sensing devices, computer controls, sprinkler heads, piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and wall mounted fire extinguishers necessary for the protection of the building.	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Fire Protection Equipment	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.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Floor Coverings	Floor covering affixed with permanent adhesive, nailed, or screwed in place. Examples include ceramic or quarry tile, marble, paving brick, and other coverings cemented, mudded, or grouted to the floor; epoxy or sealers; and wood flooring.	§ 1250	Building or Building Component – 39 Years
	Floor covering that is installed by means of strippable adhesives. For the retail industry, all vinyl composition tile (VCT), sheet vinyl, and carpeting will be treated as not permanently attached and not intended to be permanent. Also includes flooring that is frequently moved and reused to create a department theme or seasonal display.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Floors	Includes concrete slabs and other floor systems. Floors include special treatments applied to or otherwise a permanent part of the floor. For example, "superflat" finish, sloped drainage basins, raised perimeter, serving line curb, or cooler, freezer and garbage room floors.	§ 1250	Building or Building Component – 39 Years
Heating, Ventilating & Air Conditioning (HVAC)	Includes all components of a central heating, ventilating and air conditioning system not specifically identified elsewhere. HVAC systems that are installed not only to meet the temperature and humidity requirements of machinery, but are also installed for additional significant purposes, such as customer comfort and ventilation, are building components.	§ 1250	Building or Building Component – 39 Years
	Only separate HVAC units that meet the sole justification test are included (i.e., 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.) HVAC may meet the sole justification 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. Includes refrigeration units, condensers, compressors, accumulators, coolers, pumps, connecting pipes, and wiring for the mechanical equipment for climate controlled rooms, walk-in freezers, coolers, humidors and ripening rooms. Allocation of HVAC is not appropriate. See also **Refrigerated Structures, Refrigeration Equipment,** and **Ripening Rooms**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Kiosks	A small retail outlet, often prefabricated, which acts like a fixed retail outlet yet is not permanent. Kiosks may be used to retail merchandise such as newspapers and magazines, film and digital images, and food and	§ 1245	57.0 Distributive Trades and Services -

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	beverages. Kiosks are also present in shopping centers or malls where they function as temporary or portable retail outlets for a variety of merchandise.		5 Years
Light Fixtures – Interior	Includes lighting such as recessed and lay-in lighting, night lighting, and exit lighting, as well as decorative lighting fixtures that provide substantially all the artificial illumination in the building or along building walkways. For emergency and exit lighting, see **Fire Protection & Alarm Systems.**	§ 1250	Building or Building Component – 39 Years
	Decorative light fixtures are light fixtures, such as neon lights or track lighting, which are decorative in nature and not necessary for the operation of the building. In other words, if the decorative lighting were turned off, the other sources of lighting would provide sufficient light for operation of the building. If the decorative lighting is the *primary* source of lighting, then it is section 1250 property.	§ 1245	57.0 Distributive Trades and Services - 5 Years
Light Fixtures - Exterior	Exterior lighting whether decorative or not is considered section 1250 property to the extent that the lighting relates to the maintenance or operation of the building. This category includes building mounted lighting to illuminate walkways, entrances, parking, etc.	§ 1250	Building or Building Component – 39 Years
	Pole mounted or freestanding outdoor lighting system to illuminate sidewalks, parking or recreation areas. See also **Poles & Pylons**. **Note*** asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.	See Note*	00.3 Land Improvements – 15 Years
	Plant grow lights or lighting that highlights *only* the landscaping or building exterior (but not parking areas or walkways) does not relate to the maintenance or operation of the building.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Loading Docks	Includes bumpers, permanently installed dock levelers, plates, seals, lights, canopies, and overhead doors used in the receiving and shipping of merchandise.	§ 1250	Building or Building Component – 39 Years
	Includes items such as compactors, conveyors, hoists and balers.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Millwork - Decorative	Decorative millwork is the decorative finish carpentry in a retail selling area. Examples include detailed crown moldings, lattice work placed over finished walls or ceilings, cabinets, cashwraps, counters and toppers. The decorative millwork serves to enhance the overall décor of the retail store and is not related to the operation of the building. Cabinets and counters in a restroom are	§ 1245	57.0 Distributive Trades and Services -- 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	excluded from this category; see **Restroom Accessories**.		
Millwork - General Building or Structural	General millwork is all building materials made of finished wood (e.g., doors and frames, window frames, sashes, porch work, mantels, panel work, stairways, and special woodwork). Includes pre-built wooden items brought to the site for installation and items constructed on site such as restroom cabinets, door jambs, moldings, trim, etc.	§ 1250	Building or Building Component – 39 Years
Office Furnishings	Includes desk, chair, credenza, file cabinet, table or other furniture such as workstations. Also includes telephone equipment, fax machines, and other communications equipment. Does not include communications equipment included in other asset classes in Rev. Proc. 87-56.	§ 1245	00.11 Office Furniture, Fixtures, and Equipment – 7 Years
Parking Lots	Grade level surface parking area usually constructed of asphalt, brick, concrete, stone or similar material. Category includes bumper blocks, curb cuts, curb work, striping, landscape islands, perimeter fences, and sidewalks.	§ 1250	00.3 Land Improvements – 15 Years
Parking Structures	Any structure or edifice the purpose of which is to provide parking space. Includes, for example, garages, parking ramps, or other parking structures.	§ 1250	Building or Building Component – 39 Years
Plumbing	All piping, drains, sprinkler mains, valves, sprinkler heads, water flow switches, restroom plumbing fixtures (e.g. toilets) and piping, kitchen hand sinks, electric water coolers, and all other components of a building plumbing system (water or gas) not specifically identified elsewhere.	§ 1250	Building or Building Component – 39 Years
	Includes water, gas, or refrigerant hook-ups directly connected to appliances or equipment, eyewash stations, kitchen drainage, and kitchen hot water heater. For example, a hair salon in a retail outlet would require special hair washing sinks and water hook-up for the sinks.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Point of Sale (POS) Systems	A register or terminal based data collection system used to control and record all sales (cash, charge, COD, gift cards, layaway, etc.) at the point of sale. Includes cash registers, computerized sales systems and related peripheral equipment, satellite systems, scanners, and wands. See also **Electrical** for hook-ups.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Poles & Pylons	Light poles for parking areas and other poles poured in concrete footings or bolt-mounted for signage, flags, etc. **Note*** asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56. See also **Signs** and **Light Fixtures – Exterior**.	See Note*	00.3 Land Improvements – 15 Years
Refrigeration Equipment	Includes refrigeration units, condensers, compressors, accumulators, coolers, pumps, connecting pipes, and associated wiring. Refrigeration equipment is commonly	§ 1245	57.0 Distributive

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	found in climate controlled rooms, walk-in freezers, coolers, humidors, and ripening rooms.		Trades and Services -- 5 Years
Refrigerated Structures	Includes structural components such as walls, floors, ceilings, and insulation to construct a climate controlled structure, room or facility such as a cold storage warehouse, walk-in freezer, cooler, garbage room, or humidor. See also **Refrigeration Equipment**.	§ 1250	Building or Building Component – 39 Years
	A portable structure installed inside the building, consisting of prefabricated panels mounted on a movable framework. Portable structures are designed to be able to be disassembled and moved. See also **Refrigeration Equipment**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Restaurant – In Store	See Restaurant Industry Directive. For retail situations that include a restaurant or other food preparation property within a store, such as a deli or snack bar, the facts are similar to those considered in the industry directive on restaurants and that directive may be relied upon for asset classification.		
Restroom Accessories	Includes paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, handrails, grab bars, mirrors, shelves, vanity cabinets, counters, ashtrays, baby changing stations, and other items generally found in public restrooms that are built into or mounted on walls or partitions.	§ 1250	Building or Building Component – 39 Years
Restroom Partitions	Includes shop made and standard manufacture toilet partitions, typically metal, but may be plastic or other materials.	§ 1250	Building or Building Component – 39 Years
Retail Accessories	Accessories used to better display merchandise that are not held for sale. Includes assets such as audio/video display devices, artwork (if depreciable), holiday decorations, lamps, mirrors, pictures, plaques, potted plants, and decorative mobile props (such as coat of arms, sporting equipment or memorabilia, etc., excluding non-depreciable art, antiques or collectibles).	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Retail Conveying Equipment	Includes assets such as belt or roller conveyors and pneumatic tube systems used to distribute retail merchandise.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Retail Equipment	Includes assets such as sewing machines, tackers, ironing equipment, pressing tables, steam presses, pinning machines, price mark guns, marking machines, work benches, power tools, check writers, endorsing	§ 1245	57.0 Distributive Trades and Services --

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	machines, paper cutters, perforators, postage meters, money sorters, coin counting and dispensing equipment, and shopping carts.		5 Years
Retail Fixtures	Includes assets such as back cases or islands, cabinets, cubes, deli cases, end caps, floor stands, garment racks, gondolas, grid systems, mannequins, refrigerator/freezer cases, shelving, sign holders or stands, show cases, wall display units and other retail fixtures (such as dressing or fitting room partitions) needed in the business operation that are not a building component.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Retail Furniture	Includes furniture unique to retail stores and distinguishable from office furniture. For example, a high stool in a cosmetic department, a shoe department footstool, a hair salon barber chair, or a bench outside a dressing room. See also **Office Furnishings**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Ripening Rooms	Special enclosed equipment boxes used to ripen produce by circulating special gases. The rooms are large boxes with special doors and large airplane-type propellers, which circulate the gases used to ripen the produce. The boxes are housed within a distribution center warehouse. These specialized facilities are considered to be part of the retail distribution equipment because they have a special retail purpose and cannot be used for any other purpose. The boxes are not a part of the building structure.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Roof	All elements of the roof including but not limited to joists, rafters, deck, shingles, vapor barrier, skylights, trusses, girders, and gutters. Determination of whether decorative elements of a roof (e.g. false dormers, mansard) constitute structural building components depends on their integration with the overall roof, not their load bearing capacity. If removal of the decorative element results in the direct exposure of building components to water, snow, wind, or moisture damage, or if the decorative element houses lighting fixtures, wiring, or other structural components, then the decorative elements are part of the overall roof system and are structural components of the building.	§ 1250	Building or Building Component – 39 Years
Security Systems	Includes security equipment for the protection of the building (and its contents) from burglary or vandalism and protection of employees from assault. Examples include window and door locks; card key access systems; keyless entry systems; security cameras, recorders, monitors and related equipment; perimeter and interior building motion detectors; security lighting; alarm systems; and security system wiring and conduit.	§ 1250	Building or Building Component -- 39 Years
	Electronic article surveillance systems including electronic gates, surveillance cameras, recorders, monitors and related equipment, the primary purpose of which is to	§ 1245	57.0 Distributive

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	minimize merchandise shrinkage due to theft. Also includes teller-style pass-through windows, security booths, and bulletproof enclosures generally located in the cash office and customer service areas.		Trades and Services -- 5 Years
Signs	Exit signs, restroom identifiers, room numbers, and other signs relating to the operation or maintenance of a building.	§ 1250	Building or Building Component – 39 Years
	Interior and exterior signs used for display or theme identity. For example, interior signs to identify departments or exterior signs to display trade names or trade symbols. For pylon signs, includes only sign face. See also **Poles & Pylons**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Site Preparation, Grading & Excavation	In general, land preparation costs include the one-time cost of clearing and grubbing, site stripping, fill or excavation, and grading to allow development of land. Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. Stripping is the removal of the topsoil to provide a stable surface for site and building improvements. The grading of land involves moving soil for the purpose of producing a more level surface to allow development of the land.		Land
	Clearing, grading, excavating and removal costs directly associated with the construction of buildings and building components are part of the cost of construction of the building and depreciated over the life of the building.	§ 1250	Building or Building Component – 39 Years
	Clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements are part of the cost of construction of the improvements and depreciated over the life of the associated asset.	§ 1250	00.3 Land Improvements – 15 Years
Site Utilities	Site utilities are the systems that are used to distribute utility services from the property line to the retail building. Includes water, sanitary sewer, gas and electrical services.	§ 1250	Building or Building Component – 39 Years
Site Work	Site work includes curbing, paving, general site improvements, fencing, landscaping, roads, sewers, sidewalks, site drainage and all other site improvements not directly related to the building. For sanitary sewers, see **Site Utilities**.	§ 1250	00.3 Land Improvements – 15 Years
Sound Systems	Equipment and apparatus, including wiring, used to provide amplified sound or music. For example, public address by way of paging a customer or background music. Excludes applications linked to fire protection and alarm systems.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Trash Enclosures	Enclosures for waste receptacles that are attached to the building. Typically constructed of the same materials as the building shell with either interior or exterior access. These trash enclosures are an integral part of the building shell and cannot be moved without damage to the underlying building.	§ 1250	Building or Building Component – 39 Years
	Freestanding enclosures for waste receptacles, typically constructed on a concrete pad with its posts set in the concrete. Serves both safety and decorative functions.	§ 1250	00.3 Land Improvements – 15 Years
Wall Coverings	Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick and other finishes affixed with mortar, cement or grout; paneling, wainscoting and other wood finishes affixed with nails, screws or permanent adhesives; and sanitary kitchen wall panels such as fiberglass, stainless steel and plastic wall panels.	§ 1250	Building or Building Component – 39 Years
	Strippable wallpaper that causes no damage to the underlying wall or wall surface.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Walls – Exterior	Includes all exterior walls and building support regardless of construction materials. Exterior walls may include columns, posts, beams, girders, curtain walls, tilt up panels, studs, framing, sheetrock, insulation, windows, doors, exterior façade, brick, masonry, etc. Also includes drive-through bay, windows, and doors.	§ 1250	Building or Building Component – 39 Years
Walls – Interior Partitions	Includes all load bearing interior partitions regardless of construction. Also includes non-load bearing partitions regardless of height (typically constructed of studs and sheetrock or other materials) that divide or create rooms or provide traffic control. Includes rough carpentry and plaster, dry wall or gypsum board, and other finishes.	§ 1250	Building or Building Component – 39 Years
	Interior walls for merchandise display where the partition 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.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Windows	Exterior windows, including store front windows, drive-through service and carousel windows, and vestibule.	§ 1250	Building or Building Component – 39 Years
Window Treatments	Window treatments such as drapes, curtains, louver, blinds, post construction tinting and interior decorative theme décor which are readily removable.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

D. Pharmaceutical and Biotechnology

Field Directive on the Planning and Examination of Cost Segregation Issues in the Biotech/Pharmaceutical Industry

November 28, 2005

MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTORS, FIELD OPERATIONS, LMSB
DIRECTOR, FIELD SPECIALISTS, LMSB
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE, LMSB
AREA DIRECTORS, SBSE

FROM: /s/ Henry V. Singleton
Industry Director, Retailers, Food, Pharmaceuticals & Healthcare

/s/ Steve Burgess
Director, Examination, SBSE

SUBJECT: Field Directive on the Planning and Examination of Cost Segregation Issues in the Biotech/Pharmaceutical Industry

INTRODUCTION

This memorandum is intended to provide direction to effectively utilize resources in the classification and examination of a taxpayer who is recovering costs through depreciation of tangible property used in the Biotech/Pharmaceutical Industry. This Directive is not an official pronouncement of the law or the position of the Service and cannot be used, cited or relied upon as such.

BACKGROUND

The crux of cost segregation is determining whether an asset is I.R.C. §1245 property (shorter cost recovery period property) or §1250 property (longer cost recovery period property). The most common example of §1245 property is depreciable personal property, such as equipment. The most common examples of §1250 property are buildings and building components, which generally are not §1245 property.

The difference in recovery periods has placed the Internal Revenue Service and taxpayers in adversarial positions in determining whether an asset is §1245 or §1250 property. Frequently, this causes the excessive expenditure of examination resources. The Director for the Retailers, Food, Pharmaceuticals and Healthcare Industry chartered a working group to address the most efficient way to approach cost segregation issues specific to the Biotech/Pharmaceutical industry. The group produced the attached matrix and related definitions as a tool to reduce unnecessary disputes and foster consistent audit treatment.

PLANNING AND EXAMINATION GUIDANCE

The Biotech/Pharmaceutical industry matrix recommending the categorization and general depreciation system recovery period of various assets is attached as Exhibit A. (For recovery periods under IRC §168(g) alternative depreciation system, see Revenue Procedure 87-56, 1987-2 CB 674). If the taxpayer's tax return position for these assets is consistent with the recommendations in Biotech/Pharmaceutical matrix (Exhibit A), examiners should not make adjustments to categorization and recovery periods. If the taxpayer reports assets differently, then adjustments should be considered. The Industry intends to update the Biotech/Pharmaceutical matrix (Exhibit A) regularly.

See also the Cost Segregation Audit Techniques Guide. Refer especially to Appendix Chapter 6.3, which provides examples and general rules for asset classification.

If you have any questions, please contact the Deductible and Capital Expenditures (DCE) Practice Network.

LMSB DIRECTIVE ON COST SEGREGATION IN THE BIOTECH /PHARMACEUTICAL INDUSTRY

EXHIBIT A

This matrix, which is part of the Cost Segregation Audit Techniques Guide, is intended to provide direction to effectively utilize resources in the classification and examination of property used in the Biotech/Pharmaceutical industry. General fact patterns specific to this industry have been considered in the classification of these assets and may not be applicable to other industries. Similarly, asset classification guidance issued for other industries is based on the general fact pattern for that industry and may not be applicable to the Biotech/Pharmaceutical industry. For example, for asset classification of restaurants located within a pharmaceutical manufacturing plant, refer to the industry directive for restaurants. For examination techniques and historical background related to this issue, refer to the Cost Segregation Audit Techniques Guide.

CAUTION: In the case of certain leasehold improvement property, the classifications in this directive are superseded to the extent that the American Jobs Creation Act of 2004 modifies IRC Section 168. Thus, a 15-year straight line recovery period should replace the recovery period shown in the following matrix if the asset is “qualified leasehold improvement property" (as defined in IRC Section 168(e)(6)) placed in service by the taxpayer after 10/22/04 and before 1/1/08.

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
Awnings & Canopies	1245	Readily removable overhangs or coverings, often of canvas or plastic, used to provide shade or cover over exterior doors or windows. Does not include canopies that are an integral part of a building’s structural shell, such as in the casino industry or over docks. See also Concrete Foundations & Footings and Loading Docks.	Personal Property with No Class Life - 7 Years
Breakrooms / Pantries / Lunchrooms	1250	A space within the building used for employee breaks, lunches, etc.	Building or Building Component – 39 Years
Breakrooms / Pantries / Lunchrooms	1245	Equipment such as tables, chairs, dishwashers, stoves, ovens, microwaves, toasters, coffee machines, refrigerators, and freezers.	Personal Property with No Class Life - 7 Years
Bridges & Tunnels	1250 / 1245	Depreciable improvements directly to or added to land, whether such improvements are section 1245 or 1250. Includes bridges and tunnels and all construction required for their completion (such as excavation, backfill, footings, foundations, piers, stone base, paving, etc.).	00.3 - Land Improvements but see Note 2 for exceptions
Ceilings	1250	All interior ceilings regardless of finish or décor; e.g., drywall or plaster, acoustic, suspended, (including	Building or Building

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
		hangers, frames, grids, and tiles or panels), decorative metal or tin, plastic or decorative panels, clouds, etc. See also Clean Room / Climate Controlled Areas.	Component – 39 Years
Clean Room / Climate Controlled Areas	1250	Areas created by fully enclosed walls, floors, ceilings, wall and floor coverings, doors, and windows. These are designed to remain in place indefinitely, require substantial time and effort to construct or remove, and integrated into the building's design. These areas are climate controlled for air cleanliness, or temperature or humidity. See also HVAC, Electrical, Plumbing, Gas & Sewer, Ceilings, Floors, Walls, Windows, Doors, Wall Coverings, and Floor Coverings.	Building or Building Component – 39 Years
Clean Room / Climate Controlled Areas – Special Equipment	1245	Special items installed to achieve a controlled environment (air cleanliness, temperature, or humidity) and to operate the facilities in a clean room / climate controlled area (such as special variable power outlets; electric power, air, and vacuum lines; duct work; special air handling units and HEPA filters; refrigeration units, steam boilers, and temperature controls). Does not include building systems used in the operation or maintenance of the building or necessary to provide general building services.	Personal Property - Note 1
Computers	1245	Processors (CPU), direct access storage device (DASD), tape drives, desktop and laptop computers, CRT, terminals, monitors, printers, and other peripheral equipment. Excludes process equipment control systems and computers that are an integral part of building structural components (e.g., fire detection, heating, cooling, or energy management systems, etc.).	00.12 Information Systems – 5 Years
Concrete	1250	Foundations & Footings Foundations and footings necessary for the proper setting of the building. Excavation and backfill for building foundations. Excavation and backfill for special equipment foundations where contained within the footprint of the building. Includes formwork, reinforcement, concrete block, and pre-cast or cast-in-place work.	Building or Building Component – 39 Years
Concrete Foundations & Footings	1250	Foundations and footings for signs, light poles, and other land improvements (except buildings). Includes excavation, backfill, formwork, reinforcement, concrete block, and pre-cast or cast-in-place work.	00.3 - Land Improvements but see Note 2 for exceptions
Concrete Foundations & Footings	1245	A foundation, pad, or footing for machinery or equipment that is so specially designed that it is in essence a part of the machinery or equipment. Any	Personal Property - Note 1

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
		function as a building component must be strictly incidental to the function as an essential part of the item of machinery or equipment that necessitated the special design of the foundation. Increased thickness alone is not sufficient to show that the foundation, pad, or footing is so specially designed that it is in essence a part of the machinery or equipment it supports. Excavation and backfill are not included where the foundation, pad, or footing is contained within the footprint of the building. Includes formwork, reinforcement, concrete block, and pre-cast or cast-in-place work.	
Data Handling Equipment	1245	Adding and accounting machines, calculators, copiers, and duplicating machines. Excludes computers and computer peripheral equipment. See also Computers.	00.13 Data Handling Equipment, except Computers – 5 Years
Doors	1250	Interior and exterior doors, regardless of decoration (including but not limited to, double opening doors, overhead doors, revolving doors, entrance security gates, or fire doors) and associated hardware (such as doorknobs, closers, kick plates, hinges, locks, automatic openers, etc.).	Building or Building Component – 39 Years
Electrical	1250	All components of a building's or other inherently permanent structure's electrical distribution system(s) used in the operation or maintenance of the building or necessary to provide general building services (such as lighting, heating, ventilation, air conditioning, etc.), electrical outlets of general applicability and accessibility, and electrical wiring.	Building or Building Component – 39 Years
Electrical	1245	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 building's or other inherently permanent structure's electrical distribution system(s). Does not include electrical outlets of general applicability and accessibility. See Chapter 5 of the Cost Segregation Audit Techniques Guide for allocation examples.	Personal Property - Note 1
Electrical – Light Fixtures - Exterior	1250	Exterior lighting whether decorative or not is considered section 1250 property to the extent that the lighting relates to the operation or maintenance of the building. This category includes building	Building or Building Component – 39 Years

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
		mounted lighting to illuminate walkways, entrances, parking, etc.	
Electrical – Light Fixtures - Exterior	1245	Lighting that highlights only the landscaping or building exterior (but not parking areas or walkways) and does not relate to the operation or maintenance of the building.	Personal Property with No Class Life - 7 Years
Electrical – Light Fixtures - Exterior	1250 / 1245	Pole mounted or freestanding outdoor lighting system to illuminate sidewalks, parking or recreation areas See also, Poles & Pylons	00.3 - Land Improvements but see Note 2 for exceptions
Electrical – Light Fixtures - Interior	1250	Includes lighting such as recessed and lay-in lighting, night lighting, and exit lighting, as well as decorative lighting fixtures that provide substantially all the artificial illumination in the building or along building walkways. For emergency and exit lighting, see Fire Protection & Alarm Systems.	Building or Building Component – 39 Years
Electrical – Light Fixtures - Interior	1245	Light fixtures, such as neon, track lighting, or grow lights which are decorative in nature and not necessary for the operation or maintenance of the building. If the decorative lighting were turned off, the other sources of lighting would provide sufficient light for operation or maintenance of the building. If the decorative lighting is the primary source of lighting, then it is section 1250 property.	Personal Property with No Class Life - 7 Years
Electrical – Light Fixtures - Special Use	1245	Special light fixtures which are necessary to and used directly with a specific item of machinery or equipment, manufacturing process, or research and experimentation activity. Does not include light fixtures that relate to the operation or maintenance of the building.	Personal Property - Note 1
Elevators & Escalators	1250	Elevators and escalators, including all components thereof (e.g., handrails and smoke baffles), which are permanently affixed to the building and designed to remain in place. They relate to the operation or maintenance of the building and are structural components.	Building or Building Component – 39 Years
Energy Management Systems	1250	Energy management systems to monitor or maximize the efficiency of building systems (such as HVAC, lighting, fire protection and security systems) by starting and stopping the systems, raising and lowering temperatures, regulating dampers and valves, adjusting lighting levels, alerting employees to problems, etc. Includes detection devices such as smoke, motion, and infrared devices, photocells, foil and contact switches, pressure switches, proximity alarms, sensors, alarm transmitting controls, data gathering panels, demand controllers, thermostats,	Building or Building Component – 39 Years

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
		computer controls, outside air economizers, occupancy sensors, electronic ballasts, and all related wiring and conduit.	
Energy Management Systems	1245	Energy management systems to monitor or maximize the efficiency of non-building systems by starting and stopping process equipment, regulating equipment air handlers, detecting chemical leaks or equipment operating temperatures, monitoring power quality, etc. Includes sensors, alarm transmitting controls, data gathering panels, demand controllers, thermostats, computer controls, outside air economizers, and related wiring and conduit for the non-building energy management system.	Personal Property - Note 1
Fencing, Retaining Walls, Screen Walls, Fountains & Other Land Improvements	1250 / 1245	Depreciable improvements directly to or added to land, whether such improvements are section 1245 or 1250 property. Examples include fences; canals; waterways; drainage facilities; sewers (not including municipal sewers in Class 51); retaining walls; water falls, and fountains; holding, settling, or detention ponds; and irrigation systems.	00.3 - Land Improvements but see Note 2 for exceptions
Fire Protection & Alarm Systems	1250	Fire protection and alarm systems for the protection of the building. Includes sensing devices, computer controls, sprinkler heads, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and cabinets (regardless of mounting) holding fire-fighting equipment such as fire extinguishers, fire hoses, etc.	Building or Building Component – 39 Years
Fire Protection Equipment	1245	Special fire detection or suppression systems (such as Halon or Carbon Dioxide, etc.) directly associated with a piece of equipment or process. Fire extinguishers and related fire extinguisher cabinets designed and used for protection against a particular hazard created by a business activity. See Restaurant Industry Directive for restaurants, cafeterias, or other commercial food preparation areas.	Personal Property - Note 1
Floor Coverings	1250	Floor covering affixed with permanent adhesive, nailed, or screwed in place. Includes marble, paving brick, ceramic or quarry tile, and other coverings cemented, mudded, or grouted to the floor; vinyl composition tile (VCT), sheet vinyl, carpeting, or wood attached with permanent adhesive, nails, or screws; and paint, epoxy, coatings and sealers directly applied to the floor.	Building or Building Component – 39 Years

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
Floor Coverings	1245	Floor covering that is installed by means of strippable adhesives and 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 its entirety.	Personal Property - Note 1
Floors	1250	Includes concrete slabs and other floor systems. Floors include special treatments applied to or otherwise a permanent part of the floor. For example, "super-flat" finish, sloped drainage basins, raised perimeter, cooler, freezer and garbage room floors. Does not include special foundations - see Concrete Foundations & Footings.	Building or Building Component – 39 Years
Floors	1245	Raised false floors located in a limited area and installed over an existing floor to accommodate specific equipment. Such floors are a necessary part of the installation and operation of the specific equipment they accommodate. Removal of these floors does not result in extensive renovations or loss of functionality within the building.	Personal Property - Note 1
Gas & Sewer	1250	All components of a building's or other inherently permanent structure's natural gas distribution system and sewer collection system used in the operation or maintenance of the building or necessary to provide general building services, e.g., hot water and hot air (natural gas) and waste removal (sewer).	Building or Building Component – 39 Years
Gas & Sewer	1245	Special natural gas and sewer 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. Includes dedicated piping, valves, and hook-ups by which machinery and equipment are connected to the building's or other inherently permanent structure's natural gas distribution system(s) or sewer collection system(s). Does not include natural gas or sewer connections of general applicability and accessibility.	Personal Property - Note 1
Gas & Sewer - Special Gas Systems	1245	Special gas systems separate from the building's or other inherently permanent structure's natural gas system which are used in a manufacturing process or research and experimentation activity. Special gas would include carbon dioxide, pure oxygen, nitrogen, argon, etc. Includes filters, tanks, pumps, specialized piping, valves, and end use connections.	Personal Property - Note 1
Gas & Sewer - Special Waste Systems	1245	Special waste or sewer systems separate from the building's or other inherently permanent structure's sewer collection system which are used in a	Personal Property - Note 1

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
		manufacturing process or research and experimentation activity. Special waste would include toxic, bio-hazard, nuclear, and medical. Includes filters, tanks, pumps, specialized piping and valves.	
Heating, Ventilating, Air Conditioning (HVAC)	1250	All components of a building's or other inherently permanent structure's central heating, ventilating and air conditioning distribution system(s) used in the operation or maintenance of the building or necessary to provide general building services such as forced cool and hot air, ventilation, ductwork, air handlers, exchangers, baffles. HVAC systems that are installed not only to meet the temperature and humidity requirements of machinery, but are also installed for additional significant purposes, such as employee comfort and ventilation, are building components.	Building or Building Component – 39 Years
Heating, Ventilating, Air Conditioning (HVAC)	1245	Special and separate HVAC units that meet the sole justification test are included (i.e., 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 used in connection with research or experimentation). HVAC may meet the sole justification 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. Includes refrigeration units, condensers, compressors, accumulators, coolers, pumps, connecting pipes, and wiring for the mechanical equipment for climate controlled rooms, walk-in freezers, and coolers. See also Clean Room / Climate Controlled Areas. **Allocation of HVAC is not appropriate.**	Personal Property - Note 1
HVAC - Hot or Chilled Water Systems	1250	All components of a building's or other inherently permanent structure's hot or chilled water system(s) used in the operation or maintenance of the building or necessary to provide general building services associated with the heating, ventilating, and air conditioning system(s). Includes boilers, chillers and cooling towers, pumps, valves, heat exchangers, air handling units, piping (both source and return), etc. See also Heating, Ventilating, Air Conditioning (HVAC).	Building or Building Component – 39 Years
Industrial Steam & Electric	1250 / 1245	Depreciable assets, whether such assets are section 1245 property or 1250 property, used in the	00.4 in Rev. Proc. 87-

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
Generating Systems		production and/or distribution of electricity with rated total capacity in excess of 500 Kilowatts and/or assets used in the production and/or distribution of steam with rated total capacity in excess of 12,500 pounds per hour for use by the taxpayer in its industrial manufacturing process or plant activity and not ordinarily available for sale to others. Does not include buildings and structural components as defined in section 1.48-1(e) of the regulations. See Asset Class	56. 00.4 Industrial Steam and Electric Generation and/or Distribution Systems - 15 Years
Interstitial Areas, Catwalks and Mezzanines	1250	Interstitial areas created by fully enclosed decks and walls between functional floors of a building, catwalks and mezzanines that provide access to various sections or levels of the building, or provide more than incidental working space. Designed to remain in place indefinitely, require substantial time and effort to construct or remove and integrated into building design.	Building or Building Component – 39 Years
Interstitial Areas, Catwalks and Mezzanines	1245	Interstitial areas created by fully enclosed decks and walls between functional floors of a building, catwalks and mezzanines designed and constructed only to provide access to inspect, repair, or operate specific items of machinery or equipment.	Personal Property - Note 1
Landscaping & Shrubbery	1250 / 1245	Depreciable improvements directly to or added to land, whether such improvements are section 1245 or 1250 property. Examples include landscaping, shrubbery, trees, and sod.	00.3 - Land Improvements but see Note 2 for exceptions
Loading Docks	1250	Bumpers, permanently installed dock levelers, plates, seals, lights, canopies, docks, and overhead doors used in the receiving and shipping of supplies and raw materials, work in process, and finished products inventories.	Building or Building Component – 39 Years
Machinery & Equipment	1245	Tangible personal property, not covered elsewhere, which is in the nature of machinery or equipment. Includes a structure which is essentially an item of machinery or equipment 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 designed 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. Includes such structures as oil and gas storage tanks, grain	Personal Property - Note 1

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
		storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples. Does not include structural components of a building or other inherently permanent structure. See also Plumbing; Electrical; Heating, Ventilating, Air Conditioning (HVAC); and Elevators & Escalators.	
Millwork	1250	General millwork is all building materials made of finished wood (e.g., doors and frames, window frames, sashes, porch work, mantels, panel work, stairways, and special woodwork). Includes pre-built wooden items brought to the site for installation and items constructed on site (such as restroom cabinets, door jambs, moldings, trim, etc.).	Building or Building Component – 39 Years
Millwork	1245	Decorative millwork is the decorative finish carpentry in a building. Examples include detailed crown moldings, and lattice work placed over finished walls or ceilings. The decorative millwork serves to enhance the overall décor of the building and is not related to the operation of the building. Excludes cabinets and counters in a restroom. See also Restroom Accessories.	Personal Property with No Class Life - 7 Years
Office Furnishings	1245	Desks, chairs, credenzas, file cabinets, tables, bookcases, coat racks, projection screens, and other office furniture such as workstations. Also includes telephone equipment, fax machines, and other communications equipment. Does not include communications equipment included in other asset classes in Rev. Proc. 87-56.	00.11 Office Furniture, Fixtures, and Equipment – 7 Years
Parking Lots	1250 / 1245	Depreciable improvements directly to or added to land, whether such improvements are section 1245 or 1250. Grade level surface parking and base area usually constructed of asphalt, brick, concrete, stone or similar material. Also includes bumper blocks, curb cuts, curb work, striping, concrete landscape islands, truck parking ramps and staging areas, and traffic control systems (such as traffic lights and detectors, card readers, parking equipment, etc.). See also Roadways.	00.3 - Land Improvements but see Note 2 for exceptions
Parking Structures	1250	Any structure or edifice the purpose of which is to provide parking space. Includes garages, parking ramps, or other parking structures.	Building or Building Component – 39 Years
Plumbing	1250	All components of a building's or other inherently permanent structure's plumbing distribution system(s) used in the operation or maintenance of the building or necessary to provide general building services such as drains, valves, water flow	Building or Building Component – 39 Years

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
		switches, restroom plumbing fixtures (e.g., toilets) and piping, electric water coolers, and sprinkler mains and heads. See also Gas & Sewer.	
Plumbing	1245	Special plumbing 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. Includes dedicated piping, valves, and hook-ups by which machinery and equipment is connected to the building's or other inherently permanent structure's plumbing distribution system(s). Does not include plumbing hook-ups of general applicability and accessibility.	Personal Property - Note 1
Plumbing – Special Water Systems	1245	Special water systems separate from the building's or other inherently permanent structure's plumbing systems which are used to produce specialty water such as deionized water (DI) or water for injection (WFI) which is required in a manufacturing process or research and experimentation activity. Includes filters, tanks, pumps, specialized piping, valves, and end use connections.	Personal Property - Note 1
Poles & Pylons	1250 / 1245	Poles made of metal or similar material usually set in concrete footings or bolt-mounted to concrete piers. Their use is for supporting parking area lights, signage, flags, etc. Pylons made of concrete, brick, wood frame and stucco, or similar materials usually set in the ground or on a concrete foundation, and usually used for signage. Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56. See also Signs and Electrical – Light Fixtures – Exterior.	00.3 - Land Improvements but see Note 2 for exceptions
Restaurant / Cafeteria - In Facility		Facilities that include a restaurant, cafeteria or other commercial food preparation property such as a deli or snack bar.	See Restaurant Industry Directive
Restroom Accessories	1250	Paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, handrails, grab bars, mirrors, shelves, vanity cabinets, counters, ashtrays, and other items that are built into or mounted on walls or partitions.	Building or Building Component – 39 Years
Restroom Partitions	1250	Shop made and standard manufacture toilet partitions.	Building or Building Component – 39 Years

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
Retail Store – In Facility		A retail store or employee outlet, used to sell merchandise (such as company products, newspapers, magazines, film and digital images, etc.).	See Retail Industry Directive
Roadways	1250 / 1245	Depreciable improvements directly to or added to land, whether such improvements are section 1245 or 1250. Grade level driveways, roads, and base areas usually constructed of asphalt, brick, concrete, stone or similar material. Also includes guard rails, curb cuts, and curb work.	00.3 - Land Improvements but see Note 2 for exceptions
Roof	1250	All elements of the roof including but not limited to joists, rafters, deck, shingles, vapor barrier, skylights, trusses, girders, and gutters. Determination of whether decorative elements of a roof (e.g., false dormers, mansard) constitute structural building components depends on their integration with the overall roof, not their load bearing capacity. If removal of the decorative element results in the direct exposure of building components to water, snow, wind, or moisture damage, or if the decorative element houses lighting fixtures, wiring, or other structural components, then the decorative elements are part of the overall roof system and are structural components of the building.	Building or Building Component – 39 Years
Security Systems	1250	Security equipment for the protection of the building (and its contents) from burglary or vandalism and protection of employees from assault. Examples include window and door locks; card key access systems; keyless entry systems; security cameras, recorders, monitors and related equipment; perimeter and interior building motion detectors; security lighting; alarm systems; and security system wiring and conduit.	Building or Building Component – 39 Years
Security Systems	1245	Electronic surveillance systems used to track and monitor tangible items, e.g., raw materials, work in process, and finished products inventories. Includes scanners, electronic gates, surveillance cameras, recorders, monitors and related equipment.	Personal Property - Note 1
Sidewalks & Curbs	1250 / 1245	Depreciable improvements directly to or added to land, whether such improvements are section 1245 or 1250. Sidewalks and curbs are usually constructed of concrete, asphalt, stone or similar material.	00.3 - Land Improvements but see Note 2 for exceptions
Signs	1250	Exit signs, restroom identifiers, room numbers, fire lanes, building identification, and other signs relating to the operation or maintenance of a building.	Building or Building Component – 39 Years

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
Signs	1245	Interior signs used to display directories of names, departments, etc. Not related to the operation or maintenance of a building. Exterior signs used to display names, symbols, directions, etc. For pylon signs, includes only the sign face and related dedicated wiring. See also Poles & Pylons.	Personal Property with No Class Life - 7 Years
Site Preparation, Grading & Excavation	N/A	Non-depreciable land preparation costs, in general, include the one-time cost of demolition, clearing and grubbing, blasting, site stripping, fill or excavation, dewatering, and grading to allow development of land. Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. Stripping is the removal of the topsoil to provide a stable surface for site and building improvements. The grading of land involves moving soil for the purpose of producing a more level surface to allow development of the land. These costs would not have to be reincurred if the building was repaired, rebuilt, or even torn down and replaced with some other type of building.	Land - Not Depreciable
Site Preparation, Grading & Excavation	1250	Depreciable clearing, grading, excavating and removal costs directly associated with and necessary for the proper setting of the building and building components are part of the cost of construction of the building. See also Concrete Foundations & Footings.	Building or Building Component – 39 Years
Site Preparation, Grading & Excavation	1250	Depreciable clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements are part of the cost of construction of the improvements.	00.3 - Land Improvements but see Note 2 for exceptions
Site Utilities	1250	Site utilities begin where the responsibility rests with the taxpayer and not the utility company which is providing the service. Site utilities end at either a building or other permanent structure. Site utilities also include any distribution systems between buildings or other permanent structures. The cost of the site utilities would not have to be reincurred if the building or other permanent structure was repaired, rebuilt, or even torn down and replaced with some other type of building. Typically the utilities provided would be electricity, natural gas, water, sewer, and steam. See also Electrical, Plumbing, and Gas & Sewer.	Building or Building Component – 39 Years
Site Utilities	1250	Drainage facilities and sewers that are not municipal sewers.	00.3 - Land Improvements but see Note 2 for exceptions

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
Sound Systems	1245	Equipment and apparatus, including wiring, used to provide amplified sound or music (e.g., public address by way of a paging system or background music). Excludes applications linked to fire protection and alarm systems.	Personal Property With No Class Life - 7 Years
Trash Enclosures	1250	Enclosures attached to the building for waste receptacles. Typically constructed of the same materials as the building shell with either interior or exterior access. These trash enclosures are an integral part of the building shell and cannot be moved without damage to the underlying building.	Building or Building Component – 39 Years
Trash Enclosures	1250	Freestanding enclosures, typically constructed on a concrete pad with its posts set in the concrete, for waste receptacles. Serves both safety and decorative functions.	00.3 - Land Improvements but see Note 2 for exceptions
Wall Coverings	1250	Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick, and other finishes affixed with mortar, cement, or grout; paneling, wainscoting, and other wood finishes affixed with nails, screws, or permanent adhesives; sanitary finishes such as Fiberglass Reinforced Plastic (FRP), stainless steel, or plastic; sound absorbing or fabric wall panels; and wall protection (such as bumpers, corner guards, etc.).	Building or Building Component – 39 Years
Wall Coverings	1245	Strippable wallpaper that causes no damage to the underlying wall or wall surface.	Personal Property with No Class Life - 7 Years
Walls - Exterior	1250	All exterior walls and building support regardless of construction materials. Exterior walls may include columns, posts, beams, girders, curtain walls, tilt up panels, studs, framing, sheetrock, insulation, windows, doors, exterior façade, brick, masonry, etc.	Building or Building Component – 39 Years
Walls - Interior	1250	All load bearing interior partitions regardless of construction. Also includes non-load bearing partitions regardless of height (typically constructed of studs and sheetrock or other materials) that divide or create rooms or provide traffic control. Includes rough carpentry and finishes such as plaster, dry wall, gypsum board, concrete block, glass, or metal.	Building or Building Component – 39 Years
Walls - Interior	1245	Interior walls where the partition 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.	Personal Property with No Class Life - 7 Years

ASSET	PROPERTY TYPE	DESCRIPTION	RECOVERY PERIOD
Window Treatments	1245	Window treatments which are readily removable such as drapes, curtains, louvers, blinds, post construction tinting, etc.	Personal Property with No Class Life - 7 Years
Windows	1250	Exterior and interior windows.	Building or Building Component – 39 Years

NOTES

Note 1: The recovery period depends on the use of the property. See the Cost Segregation Audit Techniques Guide Appendix Chapter 6.3 for examples and application of the asset classification rules of Revenue Procedure 87-56 activity classes 01.1 to 80.0 or "Certain Property for Which Recovery Periods Assigned" letters A through E at the end of Revenue Procedure 87-56.

Note 2: Land improvements are included in some activity classes in Revenue Procedure 87-56. See the Cost Segregation Audit Techniques Guide Appendix Chapter 6.3 for examples and application of the asset classification rules of Revenue Procedure 87-56.

CAUTION: In the case of certain leasehold improvement property, the classifications in this directive are superseded to the extent that the American Jobs Creation Act of 2004 modifies IRC Section 168. Thus, a 15-year straight line recovery period should replace the recovery period shown in the above matrix if the asset is “qualified leasehold improvement property" (as defined in IRC Section 168(e)(6)) placed in service by the taxpayer after 10/22/04 and before 1/1/08.

E. Auto Dealership Industry

Field Directive on the Planning and Examination of Cost Segregation Issues in the Auto Dealership Industry

LMSB Control No. 4-0208-006
Impacted IRM 4.51.5
February 25, 2008

MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE, LMSB
DIRECTOR, FIELD SPECIALISTS, LMSB
DIRECTOR, INTERNATIONAL COMPLIANCE, LMSB
LMSB AREA COUNSEL

FROM: /s/ Charlie Brantley
Industry Director, Heavy Manufacturing and Transportation

SUBJECT: Field Directive on the Planning and Examination of Cost Segregation Issues in the Auto Dealership Industry

INTRODUCTION

This Directive is intended to provide technical guidance to effectively reduce exam time and taxpayer burden. The matrix contained in attachment A is a new chapter in the Cost Segregation Audit Technique Guide. This matrix will provide assistance to agents in the classification and examination of a taxpayer who is recovering costs through depreciation of tangible property used in the Auto Dealership Industry.

BACKGROUND

The crux of cost segregation is determining whether an asset is I.R.C. §1245 property (shorter cost recovery period property) or §1250 property (longer cost recovery period property). The most common example of §1245 property is depreciable personal property, such as equipment. The most common examples of §1250 property are buildings and building components, which generally are not §1245 property.[3]

The difference in recovery periods has placed the Internal Revenue Service and taxpayers in adversarial positions in determining whether an asset is §1245 or §1250 property. Frequently, this causes the excessive expenditure of examination resources. The Director for the Heavy Manufacturing and Transportation Industry chartered a working group to address the most efficient way to approach cost segregation issues specific to the Auto Dealership Industry. The group produced the attached matrix and related definitions as a tool to reduce unnecessary disputes and foster consistent audit treatment.

ISSUE TRACKING

[3] I.R.C. §1245 can apply to certain qualified recovery nonresidential real estate placed in service after 1980 and before 1987. See I.R.C. §1245(a)(5).

UIL Code 168-20-00 Classification of Property.

PLANNING AND EXAMINATION RISK ANALYSIS

The Auto Dealership Industry Matrix recommending the categorization and general depreciation system recovery period of various assets is attached as Exhibit A. (for recovery periods under IRC §168(g) alternative depreciation system, see Revenue Procedure 87-56, 1987-2 CB 674). If the taxpayer's tax return position for these assets is consistent with the recommendations in Auto Dealership Matrix (Exhibit A), examiners should not make adjustments to categorization and recovery periods. If the taxpayer reports assets differently, then adjustments should be considered.

Please consider the Cost Segregation Audit Techniques Guide in its entirety. Refer especially to Appendix Chapter 6.3, which provides examples and general rules for asset classification.

INTERNAL COMMUNICATIONS

Questions regarding the development of the Cost Segregation issue for Auto Dealerships should be addressed to the Deductible and Capital Expenditures (DCE) Practice Network. **his LMSB Directive is not an official pronouncement of the law or the position of the Service and cannot be used, cited or relied upon as such.**

Attachment: Exhibit A

Attachment

LMSB DIRECTIVE ON COST SEGREGATION IN THE AUTO DEALERSHIP INDUSTRY

EXHIBIT A

This matrix, which is part of the Cost Segregation Audit Techniques Guide, is intended to provide direction to effectively utilize resources in the classification and examination of property used in the operation of an Auto Dealership. General fact patterns specific to this industry have been considered in the classification of these assets and may not be applicable to other industries. Similarly, asset classification guidance issued for other industries is based on the general fact pattern for that industry and may not be applicable to an Auto Dealership situation. For examination techniques and historical background related to this issue, refer to the Cost Segregation Audit Techniques Guide.

NOTE: In the case of certain leasehold improvement property, the classifications in this directive are superseded to the extent that the American Jobs Creation Act of 2004 modifies IRC Section 168. Thus, a 15-year straight line recovery period should replace the recovery period shown in the following matrix if the asset is "qualified leasehold improvement property" (as defined in IRC Section 168(e)(6)) placed in service by the taxpayer after 10/22/04 and before 1/1/08.

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Awnings & Canopies	Readily removable overhang or covering, often of canvas or plastic, used to provide shade or cover over a storefront, a window, or a door; or used inside a structure to identify a particular department or selling area. Also includes canopies designed to	§ 1245	57.0 Distributive Trades and Services -- 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	protect employees and gasoline fueling equipment from weather conditions and to act as advertising displays that are anchored with bolts and are not attached to buildings or other structures. Does not include permanent canopies that are an integral part of a building's structural shell, such as porte-cochere (covered entrances for vehicle drive-up) and porticos (covered porches), or over docks. See also **Concrete Foundations & Footings, Loading Docks,** and **Signs**.		
Bollards & Guardrails	Bollards (heavy steel posts generally filled with concrete) and Guardrails mounted in a concrete foundation or sturdily affixed to the ground so as to create a protective barrier around areas of the building vulnerable to vehicle traffic such as Service Bay doors, glass storefront partitions, doors, door frames, HVAC components, building corners, etc. Bollards and Guardrails can be located inside or outside the building are permanently attached and are intended to be permanent. (Placement to protect the building).	§ 1250	Building or Building Component – 39 Years
	Bollards (heavy steel posts generally filled with concrete) and Guardrails mounted in the ground or concrete to protect machinery and equipment from vehicular damage, or to prevent vehicles from trespassing onto specific areas. Placement to protect land improvements and non-building items such as signs, sign poles, flagpoles, trees, as well as inventories of autos and trucks. Bollard and Guardrails are permanently attached and intended to be permanent. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.**	*See Note**	00.3 Land Improvements – 15 Years
Bollards & Guardrails	Bollards (heavy steel posts) and Guardrails, not permanently attached and not intended to be permanent, placed near machinery and equipment inside buildings that can be damaged by vehicular traffic. Bollards and Guardrails withstand vehicular impact and protect personal property items such as: forklift recharging stations, service write-up station, hazardous material storage racks, service department air compressors, etc.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Cabinetry	Includes cabinets and counters constructed or installed within buildings that relate to the general operation and maintenance of the building. For example, cabinets and counters used to house or enclose electrical equipment, plumbing components, sinks, fire protection systems, and other structural	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	elements of a building which are designed to remain in place. Includes counters and cabinets in restrooms, **Employee Break Areas, Employee Coffee Bars, and Office Areas**. See also **Restroom Accessories.**		
	Includes cabinets and counters related to the retail activity and not related to the operation and maintenance of the building. For example: retail counters and cabinets, display shelving and cabinets, customer reception counter, **Customer Lounge Area** cabinets and counters, **Sales Area** cabinets and counters, parts counters, etc. See also **Retail Fixtures** and **Office Furniture.**	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Computers	Processors (CPU), direct access storage device (DASD), tape drives, desktop and laptop computers, CRT, terminals, monitors, printers, and other peripheral equipment. Excludes Point of Sale (POS) systems and computers that are an integral part of other equipment (e.g. fire detection, heating, cooling, or energy management systems, etc.). See also **Point of Sale (POS) Systems.**	§ 1245	00.12 Information Systems – 5 Years
Concrete Foundations & Footings	Foundations and footings necessary for the proper setting of the building. Excavation and backfill for building foundations. Excavation and backfill for special equipment foundations where contained within the footprint of the building. Includes formwork, reinforcement, concrete block, and pre-cast or cast-in-place work.	§ 1250	Building or Building Component – 39 Years
	Foundations or footings for signs, light poles, and other land improvements (except buildings). Includes excavation, backfill, formwork, reinforcement, concrete block, and pre-cast or cast-in-place work. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.**	See **Note***	00.3 Land Improvements – 15 Years
Concrete Foundations & Footings	A foundation, pad, or footing for machinery or equipment that is so specially designed that it is in essence a part of the machinery or equipment. Any function as a building component must be strictly incidental to the function as an essential part of the item of machinery or equipment that necessitated the special design of the foundation. Increased thickness of the building's slab alone is not sufficient to show that the foundation, pad, or footing is so specially designed that it is in essence a part of the machinery or equipment it supports. Excavation and backfill are not included where the foundation, pad, or footing is contained within the footprint of the building. Includes formwork, reinforcement, concrete block, and pre-cast or cast-in-place work.	§ 1245	57.0 Distributive Trades and Services – 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Data Handling Equipment	Includes adding and accounting machines, calculators, copiers, and duplicating machines. Excludes computers and computer peripheral equipment.	§ 1245	00.13 Data Handling Equipment, except Computers – 5 Years
Doors	Interior and exterior doors, regardless of decoration, including but not limited to, double opening doors, fire doors and fire containment safety doors, overhead and roll-up doors, revolving doors, roll-up or sliding wire mesh or steel grills, **Service Bay** doors, and related door hardware (such as doorknobs, closers, kick plates, hinges, locks, automatic openers, computerized door locks, etc.). See also **Millwork.**	§ 1250	Building or Building Component – 39 Years
	Special lightweight, double action doors installed to prevent accidents in a heavily trafficked area. For example, flexible doors, or clear or strip curtains used between stock and selling areas.	§ 1245	57.0 Distributive Trades and Services – 5 Years
Electrical	Includes all components of the building electrical system used in the operation or maintenance of the building or necessary to provide general building services such as electrical outlets of general applicability and accessibility, lighting, heating, ventilation, air conditioning, and electrical wiring. Includes but is not limited to general purpose outlets connected to copy machines, fax machines, personal computers, and general purpose outlets in the **Break Rooms, Coffee Rooms, Lounges**, etc.	§ 1250	Building or Building Component – 39 Years
Electrical	Includes electrical outlets specifically associated to a particular item of machinery or equipment located in the **Service Department, Body Shop, and Showroom**. 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. Does not include electrical outlets of general applicability and accessibility. See Chapter 5 of the Cost Segregation Audit Techniques Guide for allocation examples. Examples include: Dedicated electrical service to lifts, jacks and *Service Bay* equipment; paint booths; car washes; oil change stations; frame straightening equipment and **Body Shop** equipment. Also includes dedicated electrical to **Customer Areas**, such as suspended television monitors.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Elevators and Escalators	Elevators and escalators, which include handrails and smoke baffles, are permanently affixed to the building and intended to remain in place. They relate to the operation or maintenance of the building and are structural components. Includes elevators to move autos in multi-story dealerships.	§ 1250	Building or Building Component – 39 Years
Energy Management Systems	Energy management systems control all energy-using systems in a building, automatically checking occupancy schedules, reading temperatures, and re-circuiting light levels, causing all heating, cooling and lighting equipment to operate so as to minimize energy costs. Includes, for example, detection devices such as smoke, motion and infrared devices, photocells, foil and contact switches, pressure switches, proximity alarms, sensors, alarm transmitting controls, data gathering panels, demand controllers, thermostats, computer controls, outside air economizers, occupancy sensors, electronic ballasts, and all related wiring and conduit. May also provide for fire and burglary protection.	§ 1250	Building or Building Component – 39 Years
Exit Signs	Signs posted along exit routes within buildings that indicate the direction of travel to the nearest exit. These signs typically read "EXIT" and may have distinctive colors, illumination, or arrows indicating the direction to the exit.	§ 1250	Building or Building Component – 39 Years
Fire Protection & Alarm Systems	Includes sensing devices, computer controls, sprinkler heads, piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency lighting and signage, and wall mounted fire extinguishers necessary for the protection of the building.	§ 1250	Building or Building Component – 39 Years
Fire Protection Equipment	Includes special fire detection or suppression systems directly associated with a piece of equipment and designed and used for protection against a particular hazard created by the business activity (such as in the **Body Shop**).	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Floor Coverings	Floor covering affixed with permanent adhesive, nailed, or screwed in place. Examples include ceramic or quarry tile, marble, paving brick, and other coverings cemented, mudded, or grouted to the floor; epoxy or sealers; and wood flooring.	§ 1250	Building or Building Component – 39 Years
	Floor covering that is installed by means of strippable adhesives. For the auto dealership industry, all vinyl composition tile (VCT), sheet vinyl, and carpeting will be treated as not permanently attached and not intended to be permanent.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Floors	Includes concrete slabs and other floor systems. Floors include special treatments applied to or otherwise a permanent part of the floor. For example, reflective flooring, express lube and reconditioning area floors, and epoxy floor paint or sealant applied directly to the concrete slab to keep a sealed, water and oil resistant, easy-to-clean surface. See also **Floor Coverings.**	§ 1250	Building or Building Component – 39 Years
Floor Pits & Trenches	Work areas built at a lower level than the garage floor to allow technicians to stand beneath the vehicles while working. These floor pits allow the technician to service a vehicle from below (for example, to change automotive oil, radiator and transmission fluids). Work areas include pits and trenches with concrete floors and walls with overhead access to vehicles. Some of these floor pits resemble full basements allowing multiple technicians access to vehicles above.	§ 1250	Building or Building Component – 39 Years
	Equipment included in the floor pits & trenches such as lifts, trays, and piping for supply fluid systems; waste fluid recovery and containment systems; and automotive fluid waste tanks.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Heating, Ventilating & Air Conditioning (HVAC)	Includes all components of a central heating, ventilating and air conditioning system not specifically identified elsewhere. HVAC systems that are installed not only to meet the temperature and humidity requirements of machinery, but are also installed for additional significant purposes, such as customer comfort and ventilation, are building components.	§ 1250	Building or Building Component – 39 Years
	Only separate HVAC units that meet the sole justification test are included (i.e., 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 paint). For example, special ventilation for paint booths; **Body Shop and Service Area** exhaust removal systems. Allocation of HVAC is not appropriate.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Inventory Display Equipment	Includes inventory displays that are permanently added to the land. Examples include concrete ramps and pedestals, and exterior "turntable" displays that are permanently affixed, etc. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.**	**See Note***	00.3 Land Improvements – 15 Years
	Includes inventory displays that are not permanently added to the land and intended to be moved.	§ 1245	57.0 Distributive

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	Examples include metal ramps, portable “turntable” displays, etc.		Trades and Services -- 5 Years
Landscaping & Shrubbery	Landscaping that will not be replaced contemporaneously with a related depreciable asset or that will not be destroyed when the related depreciable asset is replaced. Examples include landscaping, shrubbery, trees, plant foliage, or sod placed around the perimeter of the tract of land.		Land
	Landscaping that will be replaced contemporaneously with a related depreciable asset or that will be destroyed when the related depreciable asset is replaced. Examples include depreciable landscaping, shrubbery, trees, plant foliage, or sod placed around the parking lot in outdoor **Sales Area**. Includes associated irrigation systems (sprinkler systems). **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.**	**See Note***	00.3 Land Improvements – 15 Years
Light Fixtures - Interior	Includes lighting such as recessed and lay-in lighting, night lighting, and exit lighting, as well as decorative lighting fixtures that provide substantially all the artificial illumination in the building or along building walkways. For emergency and exit lighting, see **Fire Protection & Alarm Systems.**	§ 1250	Building or Building Component – 39 Years
	Special display lighting specifically for highlighting automobiles in the **Showroom**, or highlighting displays of merchandise, decorative lighting, and specific task lighting in the service area. Decorative light fixtures are light fixtures, such as neon lights or track lighting, which are decorative in nature and not necessary for the operation of the building. If the decorative or task lighting were turned off, the other sources of lighting would provide sufficient light for operation of the building. If the decorative or task lighting is the **primary** source of lighting, then it is section 1250 property.	§ 1245	57.0 Distributive Trades and Services - 5 Years
Light Fixtures - Exterior	Exterior lighting is considered section 1250 property to the extent that the lighting relates to the maintenance or operation of the building. This category includes building mounted lighting to illuminate walkways, entrances, parking, etc. (whether decorative or not).	§ 1250	Building or Building Component – 39 Years
	Pole mounted or freestanding outdoor lighting system to illuminate sidewalks, **Employee Parking Area, Customer Parking Area, and Product Display Parking Areas.** See also **Poles**.	**See Note***	00.3 Land Improvements – 15 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56. The Revenue Procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. An asset described in both an asset and an activity category is classified in the asset category**.**		
	Exterior lighting that highlights the merchandise and building exterior, for example a floodlight, spotlight, and uplighting which do not illuminate parking areas or walkways. Does not include the pole mounted lighting systems used to illuminate **Employee Parking Area, Customer Parking Area, and Product Display Parking Areas**. See also **Poles**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Loading Docks	Includes bumpers, permanently installed dock levelers, plates, seals, lights, canopies, and overhead doors used in the receiving and shipping of merchandise. See also **Awnings & Canopies**.	§ 1250	Building or Building Component – 39 Years
	Includes equipment such as compactors, conveyors, hoists and balers.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Machinery & Equipment	Tangible personal property not covered elsewhere, which is in the nature of machinery or equipment. Includes, for example, machinery and equipment located in the **Body Shop, Parts Department and Service Departments** such as paint booths; exhaust systems; air compressors; pneumatic tools systems (including support equipment such as piping and related pumps); tanks and related pumps; automotive fluid and waste fluid recovery systems; above-ground lifts; car wash systems, etc. Does not include structural components of a building or other inherently permanent structure. See also **Concrete Foundation & Footings; Electrical;** and **Plumbing.**	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Millwork	General millwork is all building materials made of finished wood (e.g., doors and frames, window frames, sashes, porch work, mantels, panel work, stairways, and special woodwork). Includes pre-built wooden items brought to the site for installation and items constructed on site such as restroom cabinets, door jambs, moldings, trim, etc.	§ 1250	Building or Building Component – 39 Years
	Decorative millwork is the decorative finish carpentry in the building. Examples include detailed crown	§ 1245	57.0 Distributive

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	moldings, lattice work placed over finished walls or ceilings, and merchandise display cabinets. The decorative millwork serves to enhance the overall décor of the dealership and is not related to the operation of the building. Cabinets and counters in the restroom are excluded from this category. See also **Cabinetry** and **Restroom Accessories**.		Trades and Services -- 5 Years
Office – Furniture (includes Communication Equipment and Hook-ups)	Includes desks, chairs, cashiers safes, credenzas, file cabinets, tables (or other furniture such as workstations and the **Sales Manager's office tower)** and shelving, including cost of shelves in record storage room. Also includes telephone equipment, fax machines, and other communications equipment. Does not include communications equipment included in other asset classes in Rev. Proc. 87-56.	§ 1245	00.11 Office Furniture, Fixtures, and Equipment – 7 Years
Parking Lots	Depreciable improvements directly to or added to land, whether such improvements are section 1245 or 1250. Grade level surface parking and base area usually constructed of asphalt, brick, concrete, stone or similar material. Also includes bumper blocks, curb cuts, curb work, striping, concrete landscape islands, gates, fences, truck parking ramps and staging areas, and traffic control systems (such as traffic lights and detectors, card readers, parking equipment, etc.). Includes *Employee* **Parking, Customer Parking, and New and Used Vehicle Parking Areas.** **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.** The Revenue Procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. An asset described in both an asset and an activity category is classified in the asset category.	**See Note***	00.3 Land Improvements – 15 Years
Parking Structures	Any structure or edifice the purpose of which is to provide parking space. Includes, for example, garages, parking ramps, or other parking structures.	§ 1250	Building or Building Component – 39 Years
Plumbing	All piping, drains, sprinkler mains, valves, sprinkler heads, water flow switches, restroom plumbing fixtures (e.g. toilets) and piping, sinks, electric water coolers, and all other components of a building plumbing system (water or gas) not specifically identified elsewhere. Includes floor drains which ultimately lead to the municipal sewer system or site septic system.	§ 1250	Building or Building Component – 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	Special plumbing 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. Includes dedicated piping, valves, and hook-ups by which machinery and equipment is connected to the building or other inherently permanent structure's plumbing distribution system(s). Example includes plumbing hook-ups to the car wash system. Does not include plumbing hook-ups of general applicability and accessibility. See also **Floor Pits & Trenches**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Point of Sale (POS) Systems	A register or terminal based data collection system used to control and record all sales (cash, charge, COD, gift cards, layaway, etc.) at the point of sale. Includes cash registers, computerized sales systems and related peripheral equipment, satellite systems, scanners, and wands. See also **Electrical** for hook-ups.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Poles	Light poles for parking areas and other poles poured in concrete footings or bolt-mounted for signage, flags, etc. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.** See also **Bollards & Guardrails; Signs;** and **Light Fixtures – Exterior**.	**See Note***	00.3 Land Improvements – 15 Years
Premise (Pylon) Sign - Exterior	Pylons made of concrete, brick, wood frame, stucco, or similar materials usually set in the ground or on a concrete foundation, and usually used for signage. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56**. See also **Poles.**	**See Note***	00.3 Land Improvements – 15 Years
	Includes only the sign face and/or message screen and related components. Includes brand displays and dealership brand image enhancements.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Restroom Accessories	Includes paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, handrails, grab bars, mirrors, shelves, vanity cabinets, counters, ashtrays, baby changing stations, and other items generally found in public restrooms that are built into or mounted on walls or partitions.	§ 1250	Building or Building Component – 39 Years
Restroom Partitions	Includes shop made and standard manufacture toilet partitions, typically metal, but may be plastic, sheetrock, wall board, or other materials.	§ 1250	Building or Building Component –

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
			39 Years
Retail Accessories	Accessories used to better display merchandise, advertising, and brochures that are not held for sale. Includes assets such as audio/video display devices, graphic rear projection displays, artwork (if depreciable), **Showroom** displays, decorative mobile props, holiday decorations, lamps, mirrors, pictures, plaques, potted plants, and props (such as sporting equipment or memorabilia, etc.). Does not include non-depreciable art, antiques, or collectibles).	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Retail Fixtures	Includes assets such as the retail counter space within the **Body Shop**, shelving to store parts and supplies, mechanical retrieval system or equipment for parts and supplies, clocks, including time clocks, counter space related to the **Parts Department**, including retail counter space and cashier, etc., shelving systems, shelf racks in the **Service Department** tool room, counter space within the **Service Department** (including dispatcher counter and parts counter for technicians) and other dealership fixtures needed in the business operation that are not a building component. Also includes fixtures and shelving for vehicle brand clothing and accessory **Retail Shop**, children's **Play Area** improvements for customers, fixtures for inventory information centers, and express lube after care business fixtures.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Roof	All elements of the roof including but not limited to joists, rafters, deck, shingles, vapor barrier, skylights, trusses, girders, and gutters. Determination of whether decorative elements of a roof (e.g. false dormers, mansard) constitute structural building components depends on their integration with the overall roof, not their load bearing capacity. If removal of the decorative element results in the direct exposure of building components to water, snow, wind, or moisture damage, or if the decorative element houses lighting fixtures, wiring, or other structural components, then the decorative elements are part of the overall roof system and are structural components of the building.	§ 1250	Building or Building Component – 39 Years
Security Systems	Includes security equipment for the protection of the building (and its contents) from burglary or vandalism and protection of employees from assault. Examples include window and door locks; card key access systems; keyless entry systems; security cameras, recorders, monitors and related equipment; perimeter and interior building motion detectors; security	§ 1250	Building or Building Component -- 39 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	lighting; alarm systems; and security system wiring and conduit.		
	Electronic surveillance systems used to track and monitor tangible items, e.g., devices used to protect New and Used automobile inventory. Includes scanners, electronic gates, surveillance cameras, recorders, monitors and related equipment.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Sidewalks & Curbs	Depreciable improvements directly to or added to land, whether such improvements are section 1245 or 1250. Sidewalks and curbs are usually constructed of concrete, asphalt, stone or similar material. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.**	**See Note***	00.3 Land Improvements – 15 Years
Signs	Exit signs, restroom identifiers, room numbers, and other signs relating to the operation or maintenance of a building. See also **Exit Signs.**	§ 1250	Building or Building Component – 39 Years
	Interior and exterior signs used to display brand or theme identity. For example, interior signs to identify departments or exterior signs to display trade names or trade symbols. For pylon signs, includes only sign face. See also **Poles** and **Premise (Pylon) Sign - Exterior**.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Site Preparation Grading & Excavation	In general, land preparation costs include the one-time cost of clearing and grubbing, site stripping, mucking, and fill or excavation to allow development of land. Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. Stripping is the removal of the topsoil to provide a stable surface for site and building improvements. Mucking is the removal of unstable soils and materials to insure a solid base for intended improvements. The grading of land involves moving soil for the purpose of producing a more level surface to allow development of the land.		Land
	Clearing, grading, excavating and removal costs directly associated with the construction of buildings and building components are part of the cost of construction of the building and depreciated over the life of the building. This includes building the showroom facility on a mound foundation for higher visibility and enhanced visual impact for the dealership building.	§ 1250	Building or Building Component – 39 Years
	Clearing, grading, excavating and removal costs directly associated with the construction of sidewalks, parking areas, roadways and other depreciable land improvements are part of the cost of construction of the improvements and depreciated over the life of the	**See Note***	00.3 Land Improvements – 15 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
	associated asset. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.**		
Site Utilities	Site utilities are the systems that are used to distribute utility services from the property line to the building. Includes water, sanitary sewer, gas, electrical services, and data and communication lines.	§ 1250	Building or Building Component – 39 Years
Site Work	Site work includes curbing, paving, general site improvements, fencing, depreciable landscaping, roads, sewers, sidewalks, site drainage and all other site improvements, such as storm water retention basins, not directly related to the building. See also **Landscaping & Shrubbery**. For sanitary sewers, see **Site Utilities**. Does not include land preparation costs, see also **Site Preparation Grading & Excavation**. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.**	**See Note***	00.3 Land Improvements – 15 Years
Sound Systems	Equipment and apparatus, including wiring, used to provide amplified sound or music. For example, public address by way of paging a customer or employee. Excludes applications linked to fire protection and alarm systems.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Trash Enclosures	Enclosures for waste receptacles that are attached to the building. Typically constructed of the same materials as the building shell with either interior or exterior access. These trash enclosures are an integral part of the building shell and cannot be moved without damage to the underlying building.	§ 1250	Building or Building Component – 39 Years
	Freestanding enclosures for waste receptacles, typically constructed on a concrete pad with its posts set in the concrete. Serves both safety and decorative functions. **Note* asset class 00.3 Land improvements includes both section 1245 and 1250 property per Rev. Proc. 87-56.**	**See Note***	00.3 Land Improvements – 15 Years
Wall Coverings	Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick and other finishes affixed with mortar, cement or grout; paneling, wainscoting and other wood finishes affixed with nails, screws or permanent adhesives; and wall panels such as fiberglass, stainless steel and plastic wall panels.	§ 1250	Building or Building Component – 39 Years
	Strippable wallpaper that causes no damage to the underlying wall or wall surface.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

ASSET	DESCRIPTION	PROPERTY TYPE	RECOVERY PERIOD
Walls – Exterior	Includes all exterior walls and building support regardless of construction materials. Exterior walls may include columns, posts, beams, girders, curtain walls, tilt up panels, studs, framing, sheetrock, insulation, windows, doors, exterior façade, brick, masonry, etc. Also includes drive-through bay, windows, and doors.	§ 1250	Building or Building Component – 39 Years
Walls – Interior Partitions	Includes all load bearing interior partitions regardless of construction. Also includes non-load bearing partitions regardless of height (typically constructed of studs and sheetrock or other materials) that divide or create rooms or provide traffic control. Includes rough carpentry and plaster, dry wall or gypsum board, and other finishes.	§ 1250	Building or Building Component – 39 Years
Walls - Interior Partitions	Interior walls where the partition can be 1) readily removed and remain in substantially the same condition after removal as before, or 2) intended to be moved and reused, stored, or sold in their entirety.	§ 1245	57.0 Distributive Trades and Services -- 5 Years
Windows	Exterior windows, including store front windows, and exterior glass partitions. Includes interior glass partitions from floor to ceiling or as a part of an interior wall.	§ 1250	Building or Building Component – 39 Years
Window Treatments	Window treatments such as drapes, curtains, louver, blinds, post construction tinting and interior decorative theme décor which are readily removable.	§ 1245	57.0 Distributive Trades and Services -- 5 Years

F. Auto Manufacturing Industry

Asset Classification for Cost Segregation in the Motor Vehicle Manufacturing Industry - Exhibit A

CSI MasterFormat Division

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Bollards & Guardrails - Building	3, 5	03, 05	§ 1250	Includes bollards (metal or concrete posts) and guardrails mounted in a concrete foundation or sturdily affixed to the ground or building so as to create a protective barrier around parts of the building such as doors, door frames, HVAC components, building corners, etc., that are vulnerable to vehicular or other traffic. They are attached in a manner reflecting that they are intended to be permanent. The purpose of the Bollard or Guardrail is to protect the building occupants, the building, or the building structural components.	Nonresidential Real Property 39 Year
Bollards & Guardrails - Equipment	3, 5	03, 05	§ 1245	Includes bollards (metal or concrete posts) and guardrails, not permanently attached and not intended to be permanent, placed near machinery and equipment inside buildings that can be damaged by vehicular or other traffic. Bollards and guardrails withstand vehicular impact and protect personal property items such as: forklift recharging stations, hazardous material storage racks, air compressor stations, etc. The purpose of the bollards or guardrails is to protect personal property or manufacturing machinery.	37.11 Manufacture of Motor Vehicles - 7 Year
Bollards & Guardrails - Site	3, 5	03, 05	Asset class 00.3 includes both § 1245	Includes bollards (metal or concrete posts) and guardrails mounted in the ground or concrete to protect machinery	00.3 Land Improvement - 15 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
			and § 1250 property.	and equipment from vehicular damage, or to prevent vehicles from trespassing onto specific areas. Placement to protect land improvements and non-building items such as signs, sign poles, flagpoles, trees, as well as inventories of autos and trucks. Bollard and guardrails are permanently attached and intended to be permanent. The purpose of the bollards or guardrails is to protect land improvements.	
Catwalks and Mezzanines - Building	3, 5	03, 05	§ 1250	Includes decks and walks placed in the interstitial spaces located between functional floors of a building, catwalks and mezzanines that provide access to various sections or levels of the building, or provide more than incidental working space. These are generally designed to remain in place indefinitely, are integrated into the building design, and require substantial time and effort to construct or remove. See also Stairs and Handrails - Building.	Nonresidential Real Property - 39 Year
Catwalks and Mezzanines - Equipment Access	3, 5	03, 05	§ 1245	Includes catwalks and mezzanines designed and constructed only to provide access to inspect, repair, or operate specific items of process machinery or equipment. See also Stairs and Handrails - Equipment Access.	37.11 Manufacture of Motor Vehicles - 7 Year
Ceilings	7	07	§ 1250	Includes all interior ceilings regardless of finish or d被r; e.g., drywall or plaster, acoustic, suspended, (including hangers, frames, grids, and tiles or panels), decorative metal or tin, plastic or decorative panels, etc. See also Climate Controlled Areas	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Chilled Water System - Building	15	23, 42	§ 1250	Chilled Water Systems are closed water systems that provide chilled water for cooling and comfort systems and include any and all components required for a complete and operable system including chillers, cooling towers, pumps, chilled water piping and associated piping components such as valves, fittings, hangers, supports and insulation. Building Chilled Water systems provide chilled water for building operation and maintenance purposes, such as HVAC.	Nonresidential Real Property - 39 Year
Chilled Water System – Process	15	23, 42	§ 1245	Process Chilled Water Systems are separate and distinct chilled water systems dedicated to process equipment or process uses and include any and all components required for a complete and operable chilled water system. To be considered a dedicated process chilled water system the chiller must be directly associated with the process equipment or process uses.	37.11 Manufacture of Motor Vehicles - 7 Year
Climate Controlled Areas – Special Equipment	13	13	§ 1245	Equipment that satisfies the sole justification test of Treasury Regulation section 1.48-1(e)(2) and installed to control the environment (air cleanliness, temperature, or humidity) which is essential for the operation of the manufacturing equipment of a climate controlled area such as a Paint Shop or Clean Room (including dedicated variable power outlets; electric power, air, and vacuum lines; duct work, air handling units dedicated to controlling the environment, HEPA filters, refrigeration units, steam boilers, and temperature controls that meet the sole justification test). Does not	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				include building systems used in the operation or maintenance of the overall building or to provide general building services. See also HVAC, Process Piping Systems, & Electrical Power.	
Climate Controlled Areas – Special Rooms	13	13	§ 1250	Includes structural components such as walls, floors, ceilings, wall and floor coverings, doors, lighting, and windows used to create a climate controlled area such as a Paint Shop or Clean Room. These are designed to remain in place indefinitely, require substantial time and effort to construct or remove, and are integrated into the building's design. These areas are climate controlled for air cleanliness, temperature or humidity. Includes high speed or rapid rise doors.	Nonresidential Real Property - 39 Year
Communications Equipment	16	27	§ 1245	Includes any office communications equipment and any related connecting cables and wiring. See also Office Furniture	00.11 Office Furniture, Fixtures, and Equipment - 7 Year
Computers	16	27	§ 1245	Includes computers and their peripheral equipment used in administering normal business transactions and the maintenance of business records, their retrieval and analysis. Does not include any equipment that is an integral part of other equipment that is included in other asset classes under Rev. Proc. 87-56 such as computers used primarily for process or production control, and point of sale computer systems. Also does not include equipment of a kind used primarily for amusement or entertainment of the user.	00.12 Information Systems - 5 Year
Concrete Foundations &	3	03	§ 1250	Building foundations and footings of the building. Includes excavation and backfill for	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Footings - Building				building footings and foundations, but does not include site grading costs. See also Grading	
Concrete Foundations & Footings - Land Improvements	3	03	Asset class 00.3 includes both § 1245 and §1250 property.	Foundations and footings for signs, light poles, and other land improvements (except buildings). Includes excavation, backfill, formwork, reinforcement, concrete block, and pre-cast or cast-in-place work, but does not include site grading costs. See also Grading	00.3 Land Improvement - 15 Year
Concrete Foundations & Footings - Machinery & Equipment	3	03	§ 1245	A foundation, pad, pit, trench, or footing for machinery or equipment that is designed to meet the specific structural support requirements of the machinery and equipment (i.e. physical weight, stability, structural stresses, vibration dampening) and that is in essence a part of the machinery or equipment. Any function as a building component must be strictly incidental to the function as an essential part of the item of machinery or equipment that necessitated the specific design of the foundation, pad, pit, trench or footing. Increased thickness and/or changes in floor elevation alone are not sufficient to show that the foundation, pad, or footing is so specially designed that it is in essence a part of the machinery or equipment it supports. Excavation and backfill are not included where the foundation, pad, or footing is contained within the footprint of the building. See Concrete Foundations and Footings - Buildings. Includes formwork, reinforcement, concrete block, and pre-cast or cast-in-place work. Does not include site	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				grading costs. For excavation and grading costs, see also Grading.	
Data Handling Equipment	11	11, 40, 45	§ 1245	Adding and accounting machines, calculators, copiers, and duplicating machines. Excludes computers and computer peripheral equipment. See also Computers	00.13 Data Handling Equipment, except Computers - 5 Year
Doors and Door Locks	8	08	§ 1250	Interior and exterior doors, regardless of decoration and location, including but not limited to overhead doors, revolving doors, entrance security gates, roll-up or sliding wire mesh or steel grills and gates, high-speed or rapid-rise doors made of fabric and door hardware (such as doorknobs, closers, kick plates, hinges, locks, automatic openers, etc.). Includes motors and closers used to operate the door and activators and controllers used to control the operation of the door. Includes computerized door locks, encoders, computers, and other associated hardware of the computerized lock system.	Nonresidential Real Property - 39 Year
Electrical Distribution - Branch Circuits - Building	16	26	§ 1250	Includes all components of a building's or other inherently permanent structure's branch circuits, whether located inside or outside of the building, used in the operation or maintenance of the building or to provide general building services (such as lighting, heating, ventilation, air conditioning, etc.). Includes electrical outlets of general applicability and accessibility, and electrical wiring.	Nonresidential Real Property - 39 Year
Electrical Distribution - Branch Circuits – Process M&E	16	26	§ 1245	Special electrical connections which are necessary to and used directly with a specific item of machinery or equipment or connections between specific	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				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 building's or other inherently permanent structure's Electrical Distribution ^ system(s). Does not include electrical outlets of general applicability and accessibility. See EDS Chapter 8 of the Cost Segregation Audit Techniques Guide for allocation examples.	
Electrical Distribution - Branch Circuits - Site Lighting	16	26	Asset class 00.3 includes both § 1245 and § 1250 property.	Electrical branch circuit to power outdoor lighting systems for sidewalks, parking or recreation areas or for sump pumps. Includes exterior power receptacles not attached to the building, or other non-process and non-building land improvement equipment.	00.3 Land Improvement - 15 Year
Electrical Distribution - Primary Power – Building	16	26	§ 1250	Includes the §1250 building power portion of the costs of the primary power distribution system from the point at which the NEC Nameplate rating is not more than 500 KVA, including the costs of all transformers, switchgear, conduits, feeder cables & wires, over-current protection, grounding and disconnect equipment, main distribution panels, securing and connecting equipment directly connected to the service entrance equipment to and including the primary power distribution panels, that portion being determined by all downstream electrical load usage in kilo-Volt Amps (KVA).	Nonresidential Real Property - 39 Year
Electrical Distribution - Primary Power – Process M&E	16	26	§ 1245	Includes the §1245 process machinery and equipment power portion of the costs of the primary power distribution system from the point at which	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				the NEC Nameplate rating is not more than 500 KVA, including the costs of all transformers, switchgear, conduits, feeder cables & wires, over-current protection, grounding and disconnect equipment, main distribution panels, securing and connecting equipment directly connected to the service entrance equipment to and including the primary power distribution panels, that portion being determined by all downstream electrical load usage in kilo-Volt Amps (KVA).	
Electrical Distribution - Secondary Power – Building	16	26	§1250	Includes the §1250 building power portion of the costs of the secondary power distribution system from the point at which the NEC Nameplate rating is not more than 500 KVA, including the costs of all transformers, panels and subpanels, conduits, feeder cables & wires, over-current protection, grounding and disconnect equipment, securing and connecting equipment directly connected to the main distribution panels to the point of the branch circuit panels, that portion being determined by all downstream electrical load usage in kilo-Volt Amps (KVA).	Nonresidential Real Property - 39 Year
Electrical Distribution - Secondary Power – Process M&E	16	26	§1245	Includes the §1245 process machinery and equipment power portion of the costs of the secondary power distribution system from the point at which the NEC Nameplate rating is not more than 500 KVA that portion being determined by all downstream electrical load usage in kilo-Volt Amps (KVA).	37.11 Manufacture of Motor Vehicles - 7 Year
Electrical Distribution – Service	16	26	§ 1250	The portion of the electrical distribution system immediately downstream from the Power	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Entrance - Building				Company Meter, at the electrical service entrance, if the NEC Nameplate rating is not more than 500 KVA. The portion of the costs for all transformers, switchgear, conduits, feeder cables & wires, over-current protection, grounding and disconnect equipment, securing and connecting equipment owned and maintained by the taxpayer that are located inside or outside of the buildings, whether overhead or underground, which are directly connected to the utility company's service and to the point of primary power system distribution, that feeds the electrical load of the §1250 building equipment as determined by all downstream electrical load usage in kilo-Volt Amps (KVA). See also Site Utilities - Building - Electrical.	
Electrical Distribution - Service Entrance - Process M&E	16	26	§ 1245	The portion of the Electrical Distribution ^ system immediately downstream from the Power Company Meter, at the electrical service entrance, if the NEC Nameplate rating is not more than 500 KVA the portion of the costs for all transformers, switchgear, conduits, feeder cables & wires, over-current protection, grounding and disconnect equipment, securing and connecting equipment owned and maintained by the taxpayer that are located inside or outside of the buildings, whether overhead or underground, which are directly connected to the utility company's service and to the point of primary power system distribution, that is allocable to the process and manufacturing	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				equipment as determined by all downstream electrical load usage in kilo-Volt Amps (KVA).	
Electrical Generation and/or Distribution - Industrial - in Excess of 500 KVA	15, 16	28, 48	§ 1250 / § 1245	Depreciable assets, whether such assets are §1245 property or §1250 property, used in the production and/or distribution of electricity with rated total capacity in excess of 500 KVA (National Electric Code (NEC) Nameplate Rating) for use by the taxpayer in its industrial manufacturing process or plant activity and not ordinarily available for sale to others. Does not include buildings and structural components as defined in section 1.48-1(e) of the regulations. NOTE: Assets used to generate and/or distribute electricity of the type described above but of lesser rated capacity are not included in this asset class, but are elsewhere specified. NOTE: When Power Factor =1, then kilowatts = kilovolt amperes. See also Electrical Power - Steam Boiler / Piping Systems rated below 12,500 lbs/hr capacity	00.4 Industrial Steam and Electric Generation and/or Distribution Systems - 15 Year
Electrical Generation and/or Distribution - Industrial - not more than 500 KVA	15, 16	28, 48	§ 1245	Depreciable assets used in the production and/or distribution of electricity with rated total capacity not more than 500 KVA (National Electric Code (NEC) Nameplate Rating) for use by the taxpayer in its industrial manufacturing process or plant activity and not ordinarily available for sale to others. Does not include electrical generation or distribution equipment to power assets for the operation or maintenance of the building or to provide general building services. Does not include buildings and structural components as defined in	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				section 1.48-1(e) of the regulations. NOTE: When a Power Factor =1, then kilowatts = kilovolt amperes. See also Electrical Power - Steam Boiler / Piping Systems rated below 12,500 lbs/hr capacity	
Elevators & Escalators	14	14	§ 1250	Elevators and escalators, including all components thereof (e.g. Elevator guide rails, cab, doors, control button plates. Escalator balustrades, moving handrails, safety strips, comb plates in floor, smoke baffles at ceiling opening) which are permanently affixed to the building and designed to remain in place. They relate to the operation or maintenance of the building and are structural components. NOTE: Smoke Baffles are small partitions that hang straight down from the edge of the ceilings around openings to trap smoke for better smoke detection.	Nonresidential Real Property - 39 Year
Energy Management Systems - Building	15	23, 25	§ 1250	Energy management systems that monitor or maximize the efficiency of building systems such as HVAC, lighting, fire protection, and security systems, by starting and stopping the systems, raising and lowering temperatures, regulating dampers and valves, adjusting lighting levels, alerting employees to problems, etc. Includes detection devices such as smoke, motion, and infrared devices, photocells, foil and contact switches, pressure switches, proximity alarms, sensors, alarm transmitting controls, data gathering panels, demand controllers, thermostats, outside air economizers, computer controls, and all related wiring and conduit.	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Energy Management Systems - Process M&E	15	23, 25	§ 1245	Energy management systems that monitor or maximize the efficiency of equipment and machinery by starting and stopping process equipment, detecting gas, fluid or chemical leaks or equipment operating temperatures, monitoring power quality, etc. Includes sensors, alarm transmitting controls, data gathering panels, computer controls, and related wiring and conduit for the energy management system.	37.11 Manufacture of Motor Vehicles - 7 Year
Fire Alarm Systems	13	28	§ 1250	The fire alarm system is the electric or electronic system that detects and alerts the occupants of the building to fires. The system is designed to protect the building and building occupants and is required for normal building operation and maintenance. Includes all of the components that are required for the proper operation of the fire alarm system such as smoke, heat and flame sensing or detection devices, alarm system computers and associated cabling, hand pulls, visual and audible alarm warning devices, alarm control panels, emergency lighting, and exit signage.	Nonresidential Real Property - 39 Year
Fire Protection / Suppression - Special Equipment	10	Specific Division 10 44 00	§1250 / §1245	Fire protection special equipment includes hand-held fire extinguishers and fire extinguisher cabinets. Fire extinguishers and cabinets designed and installed to protect the building are required for normal building operation and maintenance and are building components. Fire extinguishers designed and installed to protect a specific item of equipment or process are personal property.	Building Component - 39 Year OR, Personal Property - 7 Year (depending on use)

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Fire Protection / Suppression Systems - Building	15	21	§ 1250	Fire protection/suppression systems are the mechanical piping systems that provide water for automatic sprinkler systems to limit and extinguish fires occurring in the building and are designed for the protection of the building and its occupants. Building fire protection/suppression piping systems may include wet, dry, deluge, and pre-action fire protection piping systems. Includes all of the components required for a properly operating system (both inside and outside of the building) such as fire protection piping, fittings, valves, hangers and supports, sprinkler heads, fire water pumps, fire water tanks, fire water mains, flow switches, hydrants, post-indicator valves, fire hoses, and fire hose stations.	Nonresidential Real Property - 39 Year
Fire Protection / Suppression Systems - Process M&E	15	21	§ 1245	Process fire protection/suppression systems are separate and distinct systems that are designed and installed to protect a specific piece of equipment or process. These systems are not required for normal building operation and maintenance, do not provide general building services and are installed in addition to the normal building fire protection/suppression system. These systems may be either water or non-water based. Water-based systems may contain any of the components ordinarily included in a building fire protection piping system. Non-water-based systems may utilize fire suppression agents such as Dry-chemical, Halon, carbon dioxide, Inergen, FE-13, Ansul, FM-200, or Aqueous	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				Film-Forming Foam and include any and all components that are required for the proper operation of the system. The intent and purpose of the process fire protection/suppression system is to protect equipment or processes, not the building.	
Floor Covering - Permanent	9	09	§ 1250	Includes floor covering that is affixed with permanent adhesive or nailed or screwed in place like wood flooring. Other examples include ceramic tile, quarry tile, stone, marble, or other coverings that are cemented, mudded, or grouted to the under-floor. Also includes paint, epoxy, sealers or solvent-based floor coatings.	Nonresidential Real Property - 39 Year
Floor Covering - Readily Removable	9	09	§ 1245	Includes floor covering that is installed by means of strippable adhesives and can be readily removed without damaging the underlying floor. Includes vinyl composition tile (VCT), sheet vinyl, and carpeting.	37.11 Manufacture of Motor Vehicles - 7 Year
Floors – Access Flooring	10	09	§ 1245	Raised false floors located in a limited area and installed over an existing floor to accommodate specific equipment. Such floors are a necessary part of the installation and operation of the specific equipment they accommodate. Removal of these floors does not result in extensive renovations or loss of functionality within the building.	37.11 Manufacture of Motor Vehicles - 7 Year
Floors – Concrete	3	03	§1250	Includes concrete slabs and other floor systems. Includes features such as sloped drainage basins, raised perimeters, and insulated floors. Also includes treatments applied to, or otherwise made a permanent part, of the floor such as "super flat" finish and "metal shake" hardeners. Does not include special foundations - see	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				Concrete Foundations & Footings.	
Gate House	13	13	§ 1250	Typically located at the entrance to the plant site that is designed for truck traffic. All incoming and departing trucks check-in at the gate house. The facility provides workspace for monitoring trucks and cargos, and includes building features and utility connections.	Nonresidential Real Property - 39 Year
Guard Shack/Guard Booth	13	13	§ 1245	Free standing kiosk type structure typically pre-fabricated and constructed of aluminum and glass. Designed to provide shelter from the elements, but not workspace. Although the shacks can remain in place for extended duration, also can be moved based on needs of outdoor security.	37.11 Manufacture of Motor Vehicles - 7 Year
HVAC (Heating, Ventilating and Air Conditioning) - Building	15	23, 42	§ 1250	Heating, ventilating, and air conditioning (HVAC) systems are the mechanical systems that control the temperature, humidity, cleanliness, and circulation of the air within a space as required by the occupants, a process, or a product and include any and all components required for a complete and operable system, including air handling units, fans, chillers, boilers, furnaces, piping, ductwork, hydronic heating or cooling systems, fuel oil tanks and piping, and any other required component. Building HVAC systems serve the operation or maintenance of the building, provide general building ventilation, heating, or cooling and are building structural components. Combination HVAC systems that serve both building and process functions but do not satisfy the “sole justification” test of	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				Treasury Regulation §1.48-1(e)(2) are building components. (See HVAC (Heating, Ventilating and Air Conditioning) - Process	
HVAC (Heating, Ventilating and Air Conditioning) - Process	15	23, 42	§ 1245	Process HVAC systems are separate and distinct HVAC systems that satisfy the sole justification test of Treasury Regulation §1.48-1(e)(2) (i.e. the HVAC system is installed solely to meet the temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials). An HVAC system may meet the sole justification 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. See also CLIMATE CONTROLLED AREAS-SPECIAL EQUIPMENT.	37.11 Manufacture of Motor Vehicles - 7 Year
Land Improvements	2, 3	32	Asset class 00.3 includes both §1245 and §1250 property.	Includes improvements directly to or added to land, whether such improvements are section 1245 property or section 1250 property, provided such improvements are depreciable. Examples of such assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers (not including municipal sewers in Class 51), wharves and docks, bridges, fences, landscaping, shrubbery, or radio and television transmitting towers. Includes other tangible property that qualifies under section 1.48-1(d). E51Excludes land improvements that are explicitly included in any other class, and buildings and structural components as defined in section 1.48-1(e) of	00.3 Land Improvement - 15 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				the regulations. Excludes public utility initial clearing and grading land improvements. Also excludes a structure that is essentially an item of machinery or equipment or a structure that houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) of the Code, if the use of the structure is so closely related to the use of the property that the structure clearly can be expected to be replaced when the property it initially houses is replaced, is included in the asset guideline class appropriate to the equipment to which it is related. See also Bollards; Concrete Foundations; Site Lighting; Land Preparation; Parking Lots; Roadways, Curbs, & Sidewalks; Signs; Site Work; Site Utilities; Storage Area; Storage Tanks; Test Track; Tunnels; and Utility Overpasses.	
Land Preparation - Finish Grading – Land Improvements	2	31	Asset class 00.3 includes both § 1245 and § 1250 property.	Includes land preparation costs so closely associated with depreciable assets that they would be retired, abandoned, or replaced contemporaneously with the depreciable asset. Includes excavation and finish grading associated with roads, sidewalks, parking lots, and other paved areas. See also Land Improvements.	00.3 Land Improvement - 15 Year
Land Preparation - Finish Grading -Building	2	31	§ 1250	Includes land preparation costs so closely associated with depreciable assets that they would be retired, abandoned, or replaced contemporaneously with the depreciable asset. Includes excavation and finish grading associated with buildings and building foundation elements (e.g., footings, slabs, etc.).	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Land Preparation - General Grading	2	31	LAND	Land preparation costs include clearing and grubbing, site stripping, mucking, blasting, fill or excavation, dewatering, and grading to allow development of land. Clearing and grubbing is the removal of debris, brush, trees, etc. from the site. Site stripping is the removal of the topsoil to provide a stable surface for site and building improvements. Mucking is the removal of unstable soils and materials to insure a solid base for intended improvements. General grading involves moving soil for the purpose of producing a more level surface. These costs generally would not have to be re-incurred if the building was repaired, rebuilt, or torn down and replaced with some other type of building. Includes costs to level the area within the building footprint as well as the general site, roadways, parking, and all other site features. General grading does not include fine grading for buildings, roads, sidewalks, parking, and other paved areas.	Land – Non-depreciable+F55
Light Fixtures - Building	16	26	§ 1250	Includes lighting such as recessed, lay-in lighting, night lighting, and exit lighting, as well as decorative lighting that provides or contributes to the artificial illumination level to serve building operation and maintenance. Also includes exterior lighting fixtures mounted on the building to illuminate walkways, entrances, etc. For emergency and exit lighting, see Fire Alarm Systems.	Nonresidential Real Property - 39 Year
Light Fixtures – Decorative/ Special Fixture	16	26+C131	§ 1245	Includes light fixtures such as neon, track lighting, or grow lights which are decorative in nature and not necessary for the	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				operation or maintenance of the building. If the decorative lighting were turned off, the other sources of lighting would provide sufficient light for operation or maintenance of the building. Also includes exterior light fixtures that highlight only the landscaping or building exterior. If the decorative lighting is the primary source of lighting, then it is section 1250 property.	
Light Fixtures - Process M&E Lighting	16	26	§ 1245	Light fixtures which are necessary to and used directly with a specific item of machinery or equipment in the manufacturing process. Does not include light fixtures that relate to the operation or maintenance of the building. Examples include light fixtures installed at the equipment to provide additional illumination required to inspect products, read gauges and instrumentation or to perform specific manufacturing tasks.	37.11 Manufacture of Motor Vehicles - 7 Year
Light Fixtures - Site Lighting - Inherently Permanent	16	26	Asset class 00.3 includes both § 1245 and § 1250 property.	Includes pole mounted or freestanding outdoor lighting system permanently set in the ground to illuminate sidewalks, parking, or recreation areas. The supports may or may not be embedded in a concrete foundation. See also Signs - Pylon.	00.3 Land Improvement - 15 Year
Light Fixtures - Site Lighting - Non-inherently Permanent	16	26	§ 1245	Includes pole mounted or freestanding outdoor lighting system that is not permanently attached to the ground or to a concrete foundation to illuminate sidewalks, parking or recreation areas. See also Poles and Signs - Pylon.	37.11 Manufacture of Motor Vehicles - 7 Year
Lightning Protection & Grounding	13	26	§ 1250 / § 1245	Includes conductive materials to ground properties while attracting lightning strikes and redirecting it away from buildings	Nonresidential Real Property per IRC 168(c) and as further defined in

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				and other improvements. The lightning protection and grounding assets are components of the properties to which they are affixed. Accordingly, lightning protection and grounding assets affixed to buildings are treated as buildings; lightning protection and grounding assets affixed to land improvements are treated as land improvements.	IRC 168(e)(2)(B) - 39 Year Or Class 00.3 - 15 YEAR
Loading Dock	11	11	§ 1250	Includes bumpers, permanently installed dock levelers, plates, seals, lights, canopies, docks, trailer restraining systems, and overhead doors used in the receiving and shipping of goods and supplies.	Nonresidential Real Property - 39 Year
Machinery & Equipment	3, 10, 11, 13	11, 13, 14, 41,43, 44, 45, 46	§ 1245	Includes assets used in the manufacture and assembly of finished automobiles, trucks, trailers, motor homes, and buses. Also includes property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) even though located outside a building, such as, for example, a gasoline pump, hydraulic car lift, or automatic vending machine.	37.11 Manufacture of Motor Vehicles - 7 Year
Machinery & Equipment - Special Tools			§ 1245	Includes assets defined as "special tools" such as jigs, dies, fixtures, molds, patterns, gauges, and specialty transfer and shipping devices, owned by manufacturers of motor vehicles and used in qualified activities as defined in asset class 37.11, Manufacture of Motor Vehicles. Special tools are specifically designed for the production or processing of particular motor vehicle components, products, or parts, and have no significant utilitarian value, and cannot be	37.12 Manufacture of Motor Vehicles - 3 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				adapted to further or different use, after changes or improvements are made in the design of the particular part produced by the special tools. Does not include general purpose small tools such as wrenches and drills, both hand and power-driven, and other general purpose equipment such as conveyors, transfer equipment, and materials handling devices.	
Millwork - Decorative	6	06	§ 1245	Decorative millwork is the decorative finish carpentry in the building. Examples include detailed crown moldings, lattice work placed over finished walls or ceilings, and merchandise display cabinets. The decorative millwork serves to enhance the overall decor and is not related to the operation of the building. Does not include cabinets and counters located in restrooms. See Restroom Accessories	37.11 Manufacture of Motor Vehicles - 7 Year
Millwork - General	6	06	§ 1250	General millwork includes building components made of finished wood (e.g., doors and frames, window frames, sashes, porch work, mantels, panel work, stairways, and finish woodwork). Includes pre-built wooden items brought to the site for installation and items constructed on site such as restroom cabinets, door jambs, moldings, trim, etc.	Nonresidential Real Property - 39 Year
Office Furniture	12	12	§ 1245	Includes furniture and fixtures that are not a structural component of a building. Includes such assets as desks, files, safes, and communications equipment. Does not include communications equipment that is included in other classes.	00.11 Office Furniture, Fixtures, and Equipment - 7 Year
Office Partitions and Cubicles	12	12	§1245	Includes small re-usable partitions that are frequently relocated and re-used.	00.11 Office Furniture, Fixtures, and

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
					Equipment - 7 YEAR
Parking Lots	3	32	Asset class 00.3 includes both §1245 and §1250 property.	Includes ground level surface parking and base area usually constructed of asphalt, brick, concrete, stone or similar material. Also includes bumper blocks, curb cuts, curb work, striping, concrete landscape islands, truck parking ramps and staging areas, and traffic control systems (such as traffic lights and detectors, card readers, parking equipment, etc.). See also Roadways, Curbs, and Sidewalks.	00.3 Land Improvement - 15 Year
Parking Structures	3	03	§ 1250	Any structure or edifice the purpose of which is to provide parking space. Includes, for example, open-air garages, parking ramps, or other parking structures.	Nonresidential Real Property - 39 Year
Pits, trenches, special floor levels – conveyance equipment	3, 14	03, 41	§ 1250	Includes pits, trenches, floors, walls and other building components that accommodate conveyance systems or process machinery. For example, manufacturing plants may include conveyors that run almost the full length of the building that are installed on a recessed floor (or trench) so that the products being manufactured move along the conveyor from station to station at the normal floor level allowing workers to step on and off the conveyor without having to climb steps. The recessed flooring and trench walls designed to accommodate the conveyors constitute structural building components. Does not include building structural components specially designed to meet the specific structural support requirements of machinery and equipment. Usually constructed	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				of concrete. See also Concrete Foundations & Footings.	
Pits, trenches, special floor levels – Machinery & Equipment	3	03	§ 1245	Includes pits, trenches, floors, and walls specially designed to meet the specific structural support requirements of machinery and equipment (i.e. physical weight, stability, structural stresses, vibration dampening). Increased thickness and/or changes in floor elevation alone are not sufficient to show that the foundation, pad, or footing is so specially designed that it is in essence a part of the machinery or equipment it supports. Usually constructed of concrete. See also Concrete Foundations & Footings	37.11 Manufacture of Motor Vehicles - 7 Year
Plumbing Systems - Building	15	22	§ 1250	Plumbing systems include the mechanical systems that supply water to the facility through hot and cold water distribution piping systems, remove liquid-borne wastes from the facility through storm and sanitary sewer piping systems, and supply natural gas to building equipment through natural gas distribution piping systems. Building plumbing systems consist of all of the components of the plumbing system serving the operation or maintenance of the building or necessary to provide general building services. Includes such components as plumbing fixtures (e.g., toilets, urinals, lavatories, sinks, etc.); electric water coolers; hot water heaters; and associated piping components such as fittings, valves, traps, drains, roof drains, hangers, supports, insulation, etc.	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Plumbing Systems - Process	15	22, 40, 43	§ 1245	Process plumbing systems are separate plumbing systems which are necessary to and used directly with a specific item of machinery or equipment or a process. Process plumbing systems do not include plumbing hook-ups, natural gas distribution systems, or sewer systems that are of general building applicability and accessibility. Process plumbing systems may include such components as filters; tanks; pumps; and specialized piping along with associated piping components such as fittings, valves, traps, drains, hangers, supports, and insulation. Process plumbing systems may include dedicated water systems separate from the building's plumbing systems which are used to produce specialty water required in a manufacturing process, such as deionized water (DI) and water for injection (WFI). Process plumbing may include dedicated natural gas distribution piping serving process machinery and equipment from the point at which connections are branched from the building's natural gas distribution system(s) to the equipment.	37.11 Manufacture of Motor Vehicles - 7 Year
Process Conveyance Systems	14	14	§ 1245	Includes property used in the transporting or moving of raw materials, work in progress, and finished products. Examples include equipment specifically related to the process, lifts, part retrieval systems, etc. Usually associated with a manufacturing or assembly line. Examples of finished products are automobiles, trucks, trailers, motor homes, and busses. Does	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				not include structural components of a building or other inherently permanent structure. See Machinery and Equipment. Does not include pits, trenches, & floors.	
Process Piping Systems	15	40, 43	§ 1245	Process piping systems are the mechanical piping systems whose function is to convey and distribute the fluids used for the manufacturing processes. Process piping systems are separate and distinct from the plumbing or piping systems used to provide general building services and may include piping systems for compressed air, vacuum, painting, lubricants, or other materials used in the manufacturing process. Process piping systems may include such components as filters; tanks; pumps; vacuum pumps; compressors; and specialized piping along with associated piping components such as fittings, valves, traps, drains, hangers, supports, and insulation.	37.11 Manufacture of Motor Vehicles - 7 Year
Qualified Technological Equipment	16	27	§1245	Includes any computer or peripheral equipment, any high technology telephone station equipment, and any high technology medical equipment. Does not include any equipment which is an integral part of other property which is not a computer. Does not include typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment. Also does not include equipment of a kind used primarily for amusement or entertainment of the user. See also Computers.	Section 168(e)(3)(B)(iv) - 5 Year
Railroad Grading and Tunnel Bore	11	31	§1250 / §1245	Includes all improvements resulting from excavations	Section 168(c) - 50 Year SL

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				(including tunneling), construction of embankments, clearings, diversions of roads and streams, sodding of slopes, and similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.	
Railroad Tracks	2	34	§1250 / §1245	Siding or spur (rails, ties, switches) leading to the manufacturing site from the main rail lines.	Section 168(e)(3)(C)(i) - 7 Year
Restroom Accessories	10	10	§ 1250	Includes paper towel dispensers, electric hand dryers, towel racks or holders, cup dispensers, purse shelves, toilet paper holders, soap dispensers or holders, lotion dispensers, sanitary napkin dispensers and waste receptacles, coat hooks, handrails, grab bars, mirrors, shelves, vanity cabinets, counters, ashtrays, baby changing stations, and other items generally found in public restrooms that are built into or mounted on walls or partitions.	Nonresidential Real Property - 39 Year
Restroom Partitions	10	10	§ 1250	Includes shop-made and standard manufacture toilet partitions, typically metal, but may be plastic or other materials.	Nonresidential Real Property - 39 Year
Roadways, Curbs, and Sidewalks	3	31	Asset class 00.3 includes both §1245 and §1250 property.	Includes grade level driveways, roads, and base areas usually constructed of asphalt, brick, concrete, stone or similar material. Also includes guard rails, curbs, curb cuts, curb work, and sidewalks. Does not include test track roadways.	00.3 Land Improvement - 15 Year
Roof	3, 4, 5, 6, 7, 8	03, 04, 05, 06, 07, 08	§ 1250	Includes elements of the roof including joists, rafters, deck, shingles, vapor barrier, skylights, trusses, girders, flashings, gutters, and drains. Decorative elements of a roof (e.g., false dormers, mansard) may	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				constitute structural building components depending on their integration with the overall roof, not their load bearing capacity. If the decorative element houses structural components such as wiring or lighting fixtures, or if removal of the decorative element results in the direct exposure of building components to elements or moisture damage, then the decorative elements are part of the overall roof system and are structural components of the building. Usually constructed of concrete, metals, masonry, etc.	
Security Systems - Buildings	13	28	§1250	Includes security equipment for the protection of the building and its contents from burglary or vandalism as well as protection of employees from assault. Examples include window and door locks; card key access systems; keyless entry systems; security cameras, recorders, monitors and related equipment; perimeter and interior building motion detectors; security lighting; alarm systems; and security system wiring and conduit.	Nonresidential Real Property - 39 Year
Security Systems - Product/Inventory	13	28	§ 1245	Electronic systems used to track and monitor tangible items, (i.e., raw materials, work in process, and finished products inventories). Includes electronic tags, electronic gates, scanners, recorders, and related equipment.	37.11 Manufacture of Motor Vehicles - 7 Year
Signs	10	10	§ 1245	Includes signs used to display directories of names or indicate the location of business functions and departments. Also includes neon and other decorative signs.	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Signs – Building	10	10	§ 1250	Includes safety signs, restroom identifiers, room numbers, and other signs relating to the operation or maintenance of a building. Includes signs posted along evacuation routes in buildings that indicate the direction of travel to the nearest exit. These signs typically read "EXIT" and may have distinctive colors, illumination, or arrows indicating the direction of the exit. See also Fire Protection Systems	Nonresidential Real Property - 39 Year
Signs – Freestanding	10	10	Asset class 00.3 includes both §1245 and §1250 property.	Includes freestanding exterior signs used to direct traffic and parking that are set in the ground. See also Signs - Pylon or Billboard	00.3 Land Improvement - 15 Year
Signs - Pylon or Billboard - Electronic Face	10	10	§ 1245	Includes only the electronic sign face and/or message screen and related components. Includes brand displays and company brand image enhancements. Does not include sign support structure.	37.11 Manufacture of Motor Vehicles - 7 Year
Signs - Pylon or Billboard - Inherently Permanent	3, 5, 10	03, 05, 10	Asset class 00.3 includes both §1245 and §1250 property.	Includes signs and supports made of concrete, brick, wood frame, stucco, or similar materials usually permanently set in the ground. The supports may or may not be embedded in a concrete foundation.	00.3 Land Improvement - 15 Year
Signs - Pylon or Billboard - Non-inherently Permanent	3, 5, 10	03, 05, 10	§ 1245	Includes signs and supports made of concrete, brick, wood frame, stucco, or similar materials that are not permanently attached to the ground or to a concrete foundation.	37.11 Manufacture of Motor Vehicles - 7 Year
Site Utilities - Electrical - Building	2	33	§ 1250	See the category "Electrical Distribution - Service Entrance - Building"	Nonresidential Real Property - 39 Year
Site Utilities - Electrical - Process	2	33	§ 1245	See the category "Electrical Distribution - Service Entrance - Process M&E"	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
Site Utilities - Natural Gas System - Building	2	33	§ 1250	Site Natural Gas Systems convey natural gas from the point of connection with the gas utility supplier gas main to the building and include any and all piping, valves and other components required for a complete and operable system. Building Site Natural Gas Systems provide gas for comfort heating, domestic water heating or other uses that serve the operation or maintenance of the building or necessary to provide general building services	Nonresidential Real Property - 39 Year
Site Utilities - Natural Gas System – Process	2	33	§ 1245	Process Site Natural Gas Systems are separate and distinct systems that are necessary to and used directly with a specific item of machinery or equipment or a process. Does not include components that are of general building applicability and accessibility.	37.11 Manufacture of Motor Vehicles - 7 Year
Site Utilities - Sanitary Sewer System - Building	2	33	§ 1250	Site Sanitary Sewer Systems convey domestic wastewater and/or industrial wastewater from the building to the pretreatment or treatment plant or to the point of connection with the municipal sanitary sewer system and include any and all piping, manholes, lift stations (including pumps and pump controls), and other structures or components required for a complete and operable system. Building Site Sanitary Sewer Systems convey domestic wastewater that serve the operation or maintenance of the building or necessary to provide general building services.	Nonresidential Real Property - 39 Year
Site Utilities - Sanitary Sewer System - Process	2		§ 1245	Process Site Sanitary Sewer Systems are separate and distinct systems that are necessary to and used directly with a specific item of machinery	37.11 Manufacture of Motor Vehicles - 7 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				or equipment or a process. Does not include components that are of general building applicability and accessibility.	
Site Utilities - Storm Sewer System	2	33	Asset class 00.3 includes both § 1245 and § 1250 property.	Site Storm Sewer Systems convey storm water from the property site to the point of disposal (such as a detention or retention pond) or to the point of connection with the municipal storm sewer system and include all piping, gutter or curb inlets, catch basins, manholes, flared end sections, and any other structures or components required for a complete and operable system. Excludes gutters, downspouts, and drainage piping within the footprint of the building.	00.3 Land Improvement - 15 Year
Site Utilities - Water System - Building	2	33	§ 1250	Site Water Systems convey water from the point of connection with the water utility provider water main to the building and include any and all piping, valves, post-indicator valves, fire hydrants, and other components required for a complete and operable system. Also may include on site water wells (including well pumps and associated components). Building Site Water Systems provide water for domestic uses such as restrooms and building fire protection systems that serve the operation or maintenance of the building or necessary to provide general building services.	Nonresidential Real Property - 39 Year
Site Utilities - Water System - Irrigation	2	33	Asset class 00.3 includes both § 1245 and § 1250 property.	Irrigation Site Water Systems provide water for irrigation/sprinklers for lawn and landscaping areas as well as for pressure washing paved and concrete surfaces. Also may include on site water wells (including well pumps and	00.3 Land Improvement - 1 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				associated components) and Artesian wells. See also Land Improvements.	
Site Utilities - Water System - Process	2	33	§ 1245	Process Site Water Systems are separate and distinct systems that are necessary to and used directly with a specific item of machinery or equipment or a process. Does not include components that are of general building applicability and accessibility.	37.11 Manufacture of Motor Vehicles - 7 Year
Site Work & Site Improvements	2	32	Asset class 00.3 includes both § 1245 and § 1250 property.	See Land Preparation; Land Improvements.	00.3 Land Improvement - 15 Year
Stairs and Handrails - Building	3, 5	03, 05	§ 1250	A structure consisting of a flight of steps leading from one floor or level to another and related to the operation or maintenance of a building. Includes railings and hand railings. See also Catwalks and Mezzanines - Building.	Nonresidential Real Property - 39 Year
Stairs and Handrails - Equipment Access	3, 5	03, 05	§ 1245	A structure consisting of a flight of steps designed and constructed only to provide access to inspect, repair, or operate specific items of machinery or equipment. Includes railings and hand railings. See also Catwalks and Mezzanines - Equipment Access.	37.11 Manufacture of Motor Vehicles - 7 Year
Steam Generation - Steam Boiler / Piping Systems rated above 12,500 lbs/hr capacity	15, 16	28, 48	§ 1250 / § 1245	Depreciable assets, whether such assets are §1245 property or §1250 property, used in the production and/or distribution of steam with rated total capacity in excess of 12,500 pounds per hour for use by the taxpayer in its industrial manufacturing process or plant activity and not ordinarily available for sale to others. Does not include buildings and structural components as defined in	00.4 Distribution Systems - 15 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				section 1.48-1(e) of the regulations. Does not include steam and chemical recovery boiler systems utilized for the recovery and regeneration of chemicals used in the manufacturing process.	
Steam Generation - Steam Boiler / Piping Systems rated not more than 12,500 lbs/hr capacity - Building	15	15	§ 1250	Steam Boiler / Piping systems are systems used for generating and distributing steam for building and/or other uses and include any and all components required for a complete and operable system including boilers, heat exchangers, steam traps, feed water pumps, condensate pumps, and associated piping components such as valves, fittings, hangers, supports and insulation. Building Steam Boiler / Piping Systems provide steam for building operation and maintenance purposes or for general building services, such as comfort heating.	Nonresidential Real Property - 39 Year
Steam Generation - Steam Boiler / Piping Systems rated not more than 12,500 lbs/hr capacity - Process	15	23, 42	§ 1245	Process Steam Boiler / Piping Systems are separate and distinct systems for generating and distributing steam to equipment or process uses. To be considered a dedicated Process Steam Boiler / Piping System the boiler must be directly connected to the process equipment and must not provide for more than incidental building use through its steam supply and condensate return piping loops. Does not include components that are of general building applicability.	37.11 Manufacture of Motor Vehicles - 7 Year
Storage Area - Exterior - Goods	2	32	Asset class 00.3 includes both §1245 and §1250 property.	Includes an exterior paved, fenced, and gated area (sometimes covered for weather protection), and associated improvements used for storing materials and finished goods	00.3 Land Improvement - 15 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				and products. Does not include areas within a building; storage buildings; or warehouses.	
Storage Area - Exterior - Waste	2	32	Asset class 00.3 includes both §1245 and §1250 property.	Areas for general waste storage. Includes exterior paved, fenced and gated areas (sometimes covered for weather protection), and associated improvements used for storing waste materials including dumpsters, drums of liquid waste, and other waste materials. May include paved areas typically with berms to contain any spills from waste being stored. Does not include areas within a building; storage buildings; or warehouses.	00.3 Land Improvement - 15 Year
Storage Tanks - Not Inherently Permanent	3, 13	23, 33	§ 1245	Includes indoor or outdoor tanks, or storage vessels that are not inherently permanent and that can hold, store, or dispense solid or liquid materials. Includes dispensing pumps, piping, valves, leak detection systems, and containment dikes.	37.11 Manufacture of Motor Vehicles - 7 Year
Storage Tanks – Inherently Permanent	3, 13	23, 33	Asset class 00.3 includes both §1245 and §1250 property.	Includes above ground or underground storage tanks that are inherently permanent. Includes dispensing pumps, piping, valves, leak detection systems, and containment dikes.	00.3 Land Improvement - 15 Year
Test Track - Product Quality Testing	2	32	Asset class 00.3 includes both §1245 and §1250 property.	Test track located at manufacturing plant site used to test newly completed vehicles. Testing may include acceleration, vibration, braking, cornering, handling, etc. Includes paving, bridges, ramps, guard rails, privacy fencing, gates, and any other related items.	00.3 Land Improvement - 15 Year
Test Track - Research	2	32	§ 1245	Test track located at manufacturing plant site, technical research center, or remotely; and that is used solely for the performance of research and experimentation. Testing may include research associated	Section 168(e)(3)(B)(v) - 5 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				with the development of new and unique engine, transmission, suspension, steering, or braking systems, etc. Includes paving, bridges, ramps, guard rails, privacy fencing, gates, and any other related items.	
Tunnels - Work/Access	2	32	Asset class 00.3 includes both §1245 and §1250 property.	Customary below grade construction under the factory floor in the nature of tunnels that permit the movement of workers from one point to another point along the process line. Tunnels may also lead from one building or structure to another building or structure. Features may include walkways, lighting, HVAC, stairs, handrails, exit signs, electrical outlets, and work space. Tunnels are more than press pits, but less than building basements.	00.3 Land Improvement - 15 Year
Utility Overpass Structures	2, 5	02, 05	Asset class 00.3 includes both §1245 and §1250 property.	Includes self-supporting pipe bridge structures (similar to a trestle) that provide elevated support for utility lines or similar items between two locations.	00.3 Land Improvement - 15 Year
Wall Coverings - Nonpermanent	9	09	§ 1245	Includes strippable wallpaper affixed by means of an adhesive that causes no damage to the underlying wall or wall surface upon removal.	37.11 Manufacture of Motor Vehicles - 7 Year
Wall Coverings - Permanent	9	09	§ 1250	Includes interior and exterior paint; ceramic or quarry tile, marble, stone, brick, and other finishes affixed with mortar, cement, or grout; paneling, wainscoting, and other wood finishes affixed with nails, screws, or permanent adhesives; sanitary finishes such as Fiberglass Reinforced Plastic (FRP), stainless steel, or plastic; sound absorbing or fabric wall panels; and wall	Nonresidential Real Property - 39 Year

ASSET	1995	2004	PROPERTY TYPE	DESCRIPTION	ASSET CLASS/ RECOVERY
				protection (such as bumpers, corner guards, etc.).	
Walls – Exterior	3, 4, 5, 6	03, 04, 05, 06	§ 1250	Includes all exterior walls and building support regardless of construction materials. Exterior walls may include columns, posts, beams, girders, tilt up panels, studs, framing, sheetrock, insulation, windows, doors, exterior facade, brick, masonry, etc.	Nonresidential Real Property - 39 Year
Walls – Interior	6, 9	06, 09	§ 1250	Includes all load bearing interior partitions regardless of construction. Also includes non-load bearing partitions regardless of height (typically constructed of studs and sheetrock or other materials) that cannot be readily removed and incur damage upon removal. Includes rough carpentry and finishes such as plaster, dry wall, gypsum board, concrete block, glass, or metal.	Nonresidential Real Property - 39 Year
Walls – Movable Partition	6,9	06, 09	§ 1245	Includes interior walls where the partition can be readily removed and remain in substantially the same condition after removal. Also, can be moved and reused, stored, or sold in their entirety.	37.11 Manufacture of Motor Vehicles - 7 Year
Window Treatments	12	12	§ 1245	Window treatments include drapes, curtains, louver, blinds, post construction tinting and interior decorative theme decor which are readily removable.	37.11 Manufacture of Motor Vehicles - 7 Year
Windows	8	08	§ 1250	Exterior windows, including office and facility windows, and exterior glass partitions expansion joints and moisture barriers.	Nonresidential Real Property - 39 Year

^See Chapter 8.1 of the Cost Segregation Audit Techniques Guide for Functional Allocation of the Electrical Distribution System

Chapter 8 Issue Specific Guidace

Electrical Distribution System

1. Introduction

This chapter provides procedures for the proper allocation of a building's electrical distribution system (EDS) in connection with a cost segregation study. To properly identify, separate and allocate the costs of a building's overall EDS, various sources of information are relied on such as engineering design practices and terminology, case law, and IRS guidance.

The method discussed herein, the functional allocation approach, has been developed over decades by various courts. See Section III, Legal Background.

Although this chapter utilizes/references the functional allocation approach, a taxpayer may use other methods to reasonably allocate a building's EDS to § 1245 property or § 1250 property. If a taxpayer properly uses the functional allocation approach outlined within this chapter to allocate the costs associated with a building's EDS, the allocation should not be challenged and no adjustments to categorization and lives of the various components of the EDS are necessary.

If the taxpayer either purports to follow the functional allocation method, but its method differs from that outlined within this chapter, or allocates the costs of its EDS under a method other than the functional allocation method, the examiner should risk assess the position and determine if further examination is warranted. In such case, advice from an Engineer should be requested.

Note 1.1: Examiners should carefully consider the extent to which a detailed examination of this issue is viable without engineering support.

2. Definitions and Building Electrical System Illustration

The following definitions were derived from published court decisions with some additional industry terms for clarification.

Connected Load – an Industry term used for the actual power required by the specific circuit to safely operate the attached end-use equipment. This is the unfactored load of the branch circuit but is the load to which the Demand Factor is applied to get the Demand Load. See Section IV of this chapter.

Demand Load - an Industry term used for the factored load for the design of the overall electrical system of a building. The demand factors used are applied to the EDS portions of the electrical system (NEC Article 220) and are a key part in the design and cost of a building's EDS. See Section IV of this chapter.

Functional Allocation Approach – term coined by courts to describe how a building's EDS is allocated proportionally by electrical Demand Load to the various items served. This approach was first utilized in the case of *Scott Paper v. Commissioner*, 74 T.C. 137 (1980) to allocate the EDS between § 1245 property and § 1250 property.

Overall Electrical System – the entire electrical system of a building that includes the Primary EDS, the Secondary EDS, and the branch circuits including the wires that provide the connections to the end-use equipment "hook-ups."

The following terms are for the various portions of a building's overall electrical system, defined below and shown on Figure 2.1:

Primary EDS – the electrical equipment that receives the electrical service from the outside source (power utility company) to the main distribution panels (MDPs) and transformers (also known as "switchgear" on large building projects), that deliver power at the correct voltages to the secondary EDS. This includes large feeder circuits, power service entrance equipment, transformers, and conduit. In some instances, motor control centers, power transfer switches and meters are included.

Secondary EDS – the electrical equipment that brings the electrical power from the MDP to the local distribution panels that feed the branch circuits. There are typically several distribution panels in a building facility, each one constituting a part of the secondary EDS for its specific function or location. (There are two separate systems shown in the Figure 2.1, L1 – "Lighting" and P1- "Power.") This includes feeder circuits leading from the MDP to the secondary distribution panels and any transformers in between. It also includes subpanels, whose power is fed from a secondary distribution panel, for servicing specific equipment in areas such as kitchens, laundry rooms or even specialty lighting panels.

For small buildings, the power from the electrical utility generally feeds directly to a main electrical panel instead of an MDP or transformer, thus eliminating the primary and secondary designation. In any case, the EDS should be allocated in the same manner, by design load of the end-user equipment as defined below.

Branch Circuits – the electrical connections between a distribution or subpanel and the final electrical device. This includes wire and conduit, junction boxes, wall switches, cut-off switches, duplex outlets (receptacles), quad outlets, specific NEMA outlets (alternate plug configurations), and special connections to lights, appliances, and end-use equipment. Branch circuits are not part of the building EDS.

Hook-Ups – the labor and materials necessary to make an electrical connection from the power source to the end-use equipment. This could be as simple as the act of plugging an electrical plug into an electrical outlet, or a more complex task like "hard wiring" appliance motors to junction boxes (j-boxes) or connecting light fixtures with flexible conduit and wiring to a j-box connected to a three-way electrical on/off switch. Hook-ups are not part of the building EDS.

End-use equipment "consumptive devices" – the actual equipment, machinery, or appliances to which the overall electrical system provides power. This could include process equipment (such as manufacturing machinery), building equipment (such as lighting, HVAC and outlets for general accessibility), or other personal property (such as computers, printers, ovens, lamps etc.). This equipment is not part of the building EDS.

Note 2.1:
Risk Analysis Item – Some buildings and facilities may not have a substantial amount of cost in the EDS, such as in a renovation of an existing building. Therefore, a risk assessment should always be made to see if the project warrants such in-depth analysis.

3. Legal Background

This section provides a brief overview of the legal principles involved in understanding the functional allocation approach of EDS to § 1245 and § 1250 property.

Tangible property can be divided into "§ 1250 property" and "§ 1245 property" under the Internal Revenue Code (IRC). "§ 1250 property" is any real property, other than § 1245 property, which is, or has been, of a character subject to the allowance for depreciation provided in § 167. "§ 1245 property" includes any property that is of a character subject to the allowance for depreciation under § 167 and is, among other things, either personal property or other tangible property (not including a building or its structural components) used as an integral part of certain specified activities. The regulations under §§ 1250 and 1245 reference the regulations under former § 48 (pertaining to the Investment Tax Credit (ITC), which was eliminated in 1990) for definitions of the terms "tangible personal property," "other tangible property," "building," and "structural components" (Treas. Reg. § 1.48-1).

The depreciation deduction provided by § 167 for tangible property placed in service after 1986 generally is determined under § 168, the Modified Accelerated Cost Recovery System (MACRS). Courts have determined that the tests developed to ascertain whether property constituted tangible personal property for purposes of ITC equally are applicable to decide whether the property constitutes tangible personal property for purposes of MACRS. Accordingly, to the extent a property item would have qualified as tangible personal property for ITC that property also will qualify as tangible personal property for purposes of MACRS.

In *Scott Paper Co. v. Commissioner*, 74 T.C. 137 (1980), the court allowed an allocation of a paper plant facility's overall electrical systems between: 1) property qualifying for the ITC because it was or related to tangible personal property (i.e., § 1245 property), or 2) property not qualifying for the ITC because it was related to the operation or maintenance of a building (i.e., § 1250 property). The allocation was based on the power demand or design "load" (expressed in kilo-Volt amperes or kVA) of the machinery and equipment for which it was designed. Thus, the power demand of the end-user machinery and equipment forms the basis for the functional allocation approach.

The Fourth Circuit rejected the functional allocation approach in *A.C. Monk and Co., Inc. v. United States*, 686 F.2d 1058 (4th Cir. 1982), and held that the proper approach was to determine whether the electrical system had more general uses than simply operating specific items of machinery. Thus, if the wiring and other components of the electrical system could be reasonably adapted to more general uses, they were structural components of the building. The Federal Claims Court takes a third approach in determining whether any portion of the EDS is allocable to § 1245 property. In *Boddie-Noell Enterprises, Inc. v. United States*, 36 Fed. Cl. 722, 740-1 (1996), aff'd without opinion by 132 F.3d 54 (Fed. Cl. 1997), the court took the approach that since "electric wiring and lighting fixtures" are explicitly mentioned as in § 1.48-1(e)(2) as structural components, no portion of the EDS is allocable to § 1245 property. These alternate approaches, however, have not been followed by other courts.

In *Illinois Cereal Mills, Inc. v. Commissioner*, 789 F.2d 1234 (7th Cir. 1986), the Seventh Circuit affirmed the opinion of the Tax Court and its use of the functional allocation approach. The U.S. Supreme Court denied certiorari in *Illinois Cereal Mills, Inc. v. Commissioner* 479 U.S. 995 (1986), concerning the different methodologies in the two Circuit Courts. Therefore, the conflicting opinions of the Seventh Circuit for *Illinois Cereal Mills* and the Fourth Circuit for *A.C. Monk* remain intact.

In *Morrison, Inc. v. Commissioner*, T.C. Memo 1986-129, the court dealt in part with the primary EDS of cafeteria buildings. The court allowed a portion of the primary electric as tangible personal property for purposes of the ITC. In its findings, the Tax Court again followed the functional allocation approach it espoused in *Scott Paper*. On appeal, *Morrison, Inc. v. Commissioner*, 891 F.2d 857 (11th Cir. 1990), the Circuit Court concluded that the Tax Court correctly used the "functional allocation approach" and held as follows, at 863:

First, we accept Morrison's argument that taxpayers can claim investment tax credit on a percentage basis. In this regard, we adopt the reasoning in *Illinois Cereal* and reject the reasoning in *Monk*. … Second, we adopt the Tax Court's method of focusing on the ultimate use of electricity distributed by Morrison's primary electrical systems. … Third, the Tax Court's method is consistent with the investment tax credit's purpose.

Subsequent to the Eleventh Circuit's opinion in *Morrison*, in 1991 the IRS revised an AOD on *Illinois Cereal Mills*, AOD 1991-019. In the AOD, the Commissioner stated:

In view of the Eleventh Circuit's rejection of the *Monk* standard in favor of the functional allocation method approved by the Seventh Circuit in *Illinois Cereal*, and the Supreme Court's rejection of the government's petition for certiorari in *Illinois Cereal*, further litigation of this issue is not warranted. Accordingly, the IRS will not challenge the functional allocation approach set forth in *Scott Paper* to determine the eligibility of electrical systems of a building to qualify as § 38 property.

In *Hospital Corporation of America v. Commissioner*, 109 T.C. 21 (1997), the court found that the standards for determining the categorization of property under ACRS and MACRS were the same as for the ITC, at 55:

We conclude that the tests developed to ascertain whether property constituted tangible personal property for purposes of ITC equally are applicable to decide whether the property constitutes tangible personal property for purposes of MACRS. Accordingly, we conclude that, to the extent a disputed property item would have qualified as tangible personal property for ITC, that property also will qualify as tangible personal property for purposes of ACRS and MACRS.

Next, the court in *HCA* found that the functional allocation approach was proper for the primary and secondary electric systems, at 63-64. Subsequently, the IRS issued an Action on Decision for *HCA*, 1999-008 (August 30, 1999), in which the IRS acquiesced in the court's decision to the extent that it held that the tests developed under prior law for ITC purposes could be used to distinguish § 1245 property from § 1250 property for depreciation purposes. However, the IRS did not agree with the conclusions reached by the court with respect to the various items of property at issue in the case.

4. Functional Allocation – Illustration

Step 1 of the audit, as outlined in *Scott Paper*, is to determine whether the components of the EDS are inherently permanent structures by applying the six-factor *Whiteco* test. See *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975). Accordingly, one needs to determine whether each component constitutes "tangible personal property" or "other tangible property," rather than a "building," or a "structural component." See *Morrison*, 891 F.2d at 860-861.

Step 2 of the audit is to determine if the EDS serves the operation and maintenance of a building or if it serves to supply power for the taxpayer's tangible personal property or other tangible property. It is possible that the EDS, or certain components thereof, may serve both purposes.

Step 3 of the audit is to use the functional allocation approach as illustrated below. All of the types of property served by the EDS must be analyzed and their costs should be allocated proportionally by electrical demand load to the various items served. The building's electrical design plans must be studied to perform this step.

Step 4 of the audit is to record and tally the electrical demand load for every item of § 1245 property as well as every item of § 1250 property. Once the entire electrical demand load is totaled, the proportion of § 1245 property versus § 1250 property of the EDS can be determined.

Please note that there are vast differences in the physical characteristics and engineering design criteria between a large manufacturing plant and a public building such as an office building, retail store, or restaurant.

NOTE 4.1: It is highly advised to verify the total cost of the EDS before applying resources and personnel to perform the following tasks. In certain instances, the total costs of the system may not warrant significant resources allocated to such an in-depth analysis.

NOTE 4.2: The electrical drawings or "Plans" of the building contain vital information for this approach. The electrical panel schedules and the "Electrical Load Summary" or "Calculation" (per the National Electric Code (NEC)) are required to be included in the electrical drawings and should be used as source documents for all calculations. All Watts or volt-amps should reconcile to the totals shown on the calculation or panels.

It is NOT appropriate to use a residual method to analyze the loads of the building. It is highly recommended that a qualified and knowledgeable person, such as an engineer, perform the analysis.

A. Load Analysis Located on Electrical Plans:

Generally, there is a table included on the plans for a building facility that will provide the total amount of power intended to be used by the facility. This table shows the load requirements of National Electric Code (NEC) Article 220 "Branch-Circuit, Feeder, and Service Calculations" and is referred to in the industry as the "Electrical Load Calculation." The city or municipality typically requires this calculation in the plan review stage before the project is approved for construction by the city. The building contractor typically cannot begin construction without this information.

This table serves many functions: 1) it lets the municipality know the amount of power the facility is intended to use for the proper permits and fees to be set on a project; 2) the local power company must be aware of the power consumption of the facility to know how, or if, it will affect the local power grid thereby getting sufficient time to make the proper preparations, if needed; and 3) the designers of the electrical system of the facility and the electrical engineers use this information to properly size the necessary equipment so the capacity of the system is adequate to provide for the power requirements of the building and also the required fire code and safety standards.

The Electrical Load Schedule or Calculation is typically located with the electrical drawings of the building's plans or "Blueprints" as commonly known. Usually it is on or close to the "One-Line Diagram" of the entire building's power system or is included on the Electrical Panel Schedules. The following table shows an example of an electrical load calculation for a large supermarket with a restaurant, bakery, deli, and other areas.

I. Table 4.1:

Electrical Load Calculation
Large Supermarket

Load Description	Connect Watts	Demand Factor	Demand Load
Heating and Air Conditioning (HVAC)	1,320,000	100%	1,320,000
Refrigerator & Freezer Equipment	700,000	100%	700,000
Lunch Counter/Restaurant	125,000	50%	62,500
Customer Service and Office	105,000	70%	73,500
Interior Lighting	85,000	100%	85,000
Bakery/Deli Department	120,000	50%	60,000

Load Description	Connect Watts	Demand Factor	Demand Load
Generator Back-Up Emerg. Power	55,000	100%	55,000
Display Signs/Exterior Lighting	46,000	100%	46,000
Cardboard Balers	51,000	100%	51,000
Misc. Backroom Items	60,000	70%	42,000
Meat Cutting Department (Butcher)	50,000	70%	35,000
Trash Compactors	21,000	100%	21,000
Cash Registers	15,000	80%	12,000
Rolling Refrigerated Cases (Floor Receptacles)	4,000	20%	800
Totals	**2,757,000**		**2,563,800**

This schedule shows the “Connected” Watts which is the power required if the item were to run at 100% capacity. The “Demand Factor” is a diversity factor applied to the power usage of that equipment for the design of the feeders and other parts of the EDS. The NEC Article 220 provides guideline Demand Factors (diversity factors or percentages) that are to be used as a minimum for calculating a demand load on the feeders and service of a building, or the EDS (see Note 4.2a.). All states and municipalities in the U.S. have adopted some version of the NEC as the minimum requirement for electrical construction in their region.

In the electrical design industry, “Demand Load” means the factored load for the design of the overall electrical system. In general, the items that require full 100% demand load are the dedicated pieces of equipment that are: 1) necessary to operate at all times, at near full capacity during operation; or 2) required by the NEC to be designed at full capacity. The lower “demand” percentages are placed on non-crucial equipment that may only be turned on part of the time during the operation of the facility. For example, not every outlet in a building will have equipment plugged into it at all times, or there may be equipment plugged in but turned off, and there may also be many outlets that remain entirely unused. The NEC specifies a minimum Demand Factor to be applied, about 50-70%, which is intended to approximate real-world scenarios, but still allow for safe operation of the entire system.

NOTE 4.2a: These Demand Factors are not used for designing the branch circuits which must comply with the required circuit design in NEC Article 220 Part I. However, the Demand Factors are applied to feeders and service (EDS) under specific NEC tables and rules as covered in NEC Article 220 Parts II, III, and IV.

The total demand load determines the size and type of electrical power service required to supply the facility. This information is also used to specify the proper sizes of the electrical equipment; conductors (wires), circuit breakers, transformers, switchgear, capacitors, conduit, etc., so the system will work safely during peak operating hours of the facility. The size of the equipment directly affects the cost of the equipment installed, and is the primary focus of the proper basis of § 1245 property in the functional allocation approach.

NOTE 4.3:
An energy usage study, measured in kilowatt-hours (kWh), which is performed for energy

efficiency purposes by measuring the amount of energy used within a specified period, is a completely different study from the demand load analysis performed when designing and sizing building electrical equipment. The energy efficiency study should **not** be used as part of the functional allocation approach.

B. Watts versus Volt-Amperes – Power Factor

The load calculation in *Scott Paper* is illustrated with units of kilovolt-amperes (kVA). The typical electrical load schedule for a building may be seen with units in kVA or in kilowatts (kW), or both.

The difference is something called a power factor. The kilowatts can be easily converted to kVA by the simple formula:

Kilowatts = kilovolt-Amperes X Power Factor,

Or simply:

kW = kVA x pf

For the purposes of this chapter, the power factors will be assumed to equal “1”; therefore kW will equal kVA.

Accordingly, an analysis of a building’s EDS using units in kVA or in kW will yield the same results. However, the units may not be mixed and one must be consistent with the unit used.

C. Item Cost versus Electrical Load

The costs of the individual portions of the building overall electrical system are usually addressed in the cost segregation study. These costs are either estimated using costing data or are taken directly from general or electrical contractor payment records.

The costs of the individual branch circuits for the end-use equipment are usually addressed in the detailed estimate of the cost segregation study. The circuits to the qualified § 1245 property are typically identified and are allocated to that property.

The total costs of the entire building’s EDS, including all the transformers, panels, subpanels, feeder circuits, etc., must be distinguished in the cost segregation study and must reconcile with the amount actually paid by the taxpayer for the corresponding electrical system.

The functional allocation approach uses the electrical loads, not the costs of the specified circuits, to determine the proper portion of the EDS that is allocable to § 1245 property.

As an example, for the supermarket electrical load calculation in Table 4.1, the cost segregation study shows $2,500,000 in costs for the entire electrical contract for the project. This is verified on the Taxpayer’s cost records for the construction project. A study of the individual items in the Electrical Contract reveal that the primary EDS costs are

$500,000, the secondary EDS costs are $500,000, the branch circuits are $1.1 million, and the various hook-ups to the end-use equipment are $400,000.

The cost that will be involved in the functional allocation is the $1,000,000 for the combined primary and secondary distribution system costs. The asset classification of the remaining $1.5 million of the electrical contract consisting of branch circuit and equipment hook-up costs identified in the cost segregation study follow the same recovery period as the dedicated end-use equipment or as the building if they relate to the operation thereof.

D. Example 1 – Large Supermarket

Steps 1 and 2. Using the electrical load calculation in Table 4.1, the field examination of the grocery store facility and an end-use analysis from the information on the electrical plans for the building show the following facts:

- The exhaust fans for the kitchen pull 100,000 of the Connected Watts of the HVAC's total 1,320,000 Connected Watts. Therefore, the HVAC load must be split between § 1245 and § 1250 property.
- The Refrigerator & Freezer Compressors were found to qualify as § 1245 property, as well as the Display Signs/Exterior Lighting, Cardboard Balers, Trash Compactors and Cash Registers. These loads do not need to be split; they are all for § 1245 property.
- For the Lunch Counter/Restaurant, only 35,000 of the 125,000 Connected Watts are dedicated to qualifying § 1245 property. The remainder are for general use and do not qualify as § 1245 property. The Lunch Counter/Restaurant load should be split between § 1245 and § 1250 property.
- The Customer Service/Office end-use equipment was all found to be electrical outlets for general use and accessibility and should remain as § 1250 property. The Interior Lighting, Generator, and Backroom electrical were all found to be for § 1250 property as well. These loads do not need to be split, they are all for § 1250 property.
- In the meat cutting department, 30,000 of the 50,000 total Watts were found to be for dedicated § 1245 equipment, the remainder are for electrical outlets of general use and do not qualify as § 1245 property. This item load should be split between § 1245 and § 1250 property.
- The circuits for the floor outlets labeled as "Rolling Refr. Cases" served also for regular maintenance equipment such as floor polishers, and vacuums. The IRS and the Taxpayer agree that this item should be split 50/50 as § 1245 and § 1250 property. Therefore, this item load should be split between § 1245 and § 1250 property.

Step 3. Table 4.2, below, shows the resulting Personal Property/Real Property split for each line item on the Load Calculation of Table 4.1. The functional allocation calculation concentrates on the demand loads. Therefore, the connected loads should be multiplied by the corresponding Demand Factor to achieve the Demand Watts. The total Demand for this project is 2,563,800 Watts.

Each line item is allocated to either Personal Property (§ 1245 property) or Real Property (§ 1250 property) based on their qualifying demand loads. The line items that required splitting and allocation between personal property and real property are shown on Table 4.2 with the § 1245 property in italics. The Load % shown on the table is the items portion of the total 2,563,800 Demand Watts.

Taking the HVAC as an example, the total Connected Watts is 1,320,000 with a Demand Factor of 100%. The 100,000 Watts for the kitchen exhaust fans is separated as qualified § 1245 personal property and the remaining 1,220,000 Watts is for § 1250 real property.

These are both proportioned to the total Demand Watts to calculate their percent allocation:

Load % for 1250 HVAC;
Demand Watts HVAC/Total Demand Watts Building = 1,220,000 ÷ 2,563,800 = 47.6%

Load % for Kitchen Equipment;
Demand Watts Kt. Equip/Tot. Demand Watts Building = 100,000 ÷ 2,563,800 = 3.9%

Each line item on the Load Calculation is allocated according to the facts and circumstances found in the examination. The results are shown on Table 4.2.

Step 4. Each load line item was examined and the demand load for the § 1245 property was separated from the demand load for the § 1250 property. The segregated totals are shown on the bottom of Table 4.2. The total portion of the electrical load determined to be for the § 1245 property is 38.4%.

Applying this percentage to the total cost of the building primary and secondary EDS, $1,000,000, yields the correct basis of the § 1245 portion of the EDS:

Cost of Electrical Distribution System	**X**	**Percent as Personal Property**	**=**	**Basis of Personal Property, Electrical Dist. Syst.**
$1,000,000	X	38.4%	=	$384,000

The remaining EDS costs, 61.6% or $616,000 would be allocated to § 1250 property.

Therefore, the functional allocation of the building's EDS yields:

§ 1245 Property $384,000 + § 1250 Property $616,000 = Total Cost Elect. Dist. System $1,000,000

These totals are then added to the results of the branch circuit and equipment hook up allocation to get the total § 1245 and 1250 allocation of the entire electrical portion of the building project

II. Table 4.2 - 1250/1245 Analysis of Large Supermarket

Load Description	Connected Watts	Demand Factor	Demand Watts	Load %	Personal Property	Real Property
Heat, Vent., & Air Cond. (HVAC)	**1,220,000**	**100%**	**1,220,000**	**47.6%**		**47.6%**
Kitchen Exhaust Fan	100,000	100%	100,000	3.9%	3.9%	
Refrigerator & Freezer Equip. – Compressors	**700,000**	**100%**	**700,000**	**27.3%**	**27.3%**	
Lunch Counter/Restaurant	90,000	50%	45,000	1.8%		1.8%
Dedicated Circuits to Kitchen Equip.	35,000	50%	17,500	0.7%	0.7%	
Customer Service/Office	**105,000**	**70%**	**73,500**	**2.9%**		**2.9%**
Dedicated Circuits to Office Equip.	-	70%	-	0.0%	0.0%	
Interior Lighting	**85,000**	**100%**	**85,000**	**3.3%**		**3.3%**
Bakery/Deli Department	**90,000**	**50%**	**45,000**	**1.8%**		**1.8%**
Dedicated Circuits to Deli Equip.	30,000	50%	15,000	0.6%	0.6%	
Generator Back-Up Emerg. Power	**55,000**	**100%**	**55,000**	**2.1%**		**2.1%**
Display Signs/Ext. Lighting	**46,000**	**100%**	**46,000**	**1.8%**	**1.8%**	
Cardboard Balers	**51,000**	**100%**	**51,000**	**2.0%**	**2.0%**	
Misc. Backroom Items	**60,000**	**70%**	**42,000**	**1.6%**		**1.6%**
Meat Cutting/Seafood Dept.	**20,000**	**70%**	**14,000**	**0.5%**		**0.5%**
Dedicated Circuits to Meat Equip.	30,000	70%	21,000	0.8%	0.8%	
Trash Compactors	**21,000**	**100%**	**21,000**	**0.8%**	**0.8%**	
Cash Registers	**15,000**	**80%**	**12,000**	**0.5%**	**0.5%**	
Rolling Refr. Floor Recpts.	**2,000**	**20%**	**400**	**0.01%**		**0.01%**
Dedicated Receptacles - 1245	2,000	20%	400	0.01%	0.01%	
Totals	**2,757,000**		**2,563,800**	**100.00%**	**38.4%**	**61.6%**

E. Asset Classification for § 1245 property portion of the EDS

Once the functional allocation of the EDS is complete, you will need to determine the depreciation deduction for the § 1245 property portion of the EDS. The depreciation deduction for tangible property placed in service after 1986 generally is determined under § 168 using a prescribed depreciation method, recovery period, and convention. The applicable recovery period is determined by reference to class life or by statute.

Revenue Procedure 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under § 168. The revenue procedure establishes two broad categories of depreciable assets: 1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and 2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property can be described in both an asset category (asset classes 00.11 through 00.4) and an activity class (asset classes 01.1 through 80.0), in which case the item is classified in the asset category. See *Norwest Corp. & Subs. v. Commissioner*, 111 T.C. 105 (1998) (items described in both an asset and an activity category should be placed in the asset category).

If a particular asset is used in more than one activity, the cost of the asset is not allocated between the two activities. Rather, the total cost of the asset will be classified according to the activity in which the asset is primarily used, regardless of whether the activity is insubstantial in relation to all the taxpayer's activities. For example, if a taxpayer operates a hotel/casino, decorative lighting used in the casino area would be classified in activity class 79.0, Recreation, with a 7-year recovery period whereas decorative lighting used in the hotel lobby area would be classified in activity class 57.0, Distributive Trades and Services, with a 5-year recovery period. Also, for depreciation purposes, the lessor of assets generally classifies such assets according to the activity they are primarily used in by the lessee.

5. Summary

The Courts have accepted the functional allocation approach and have used it in different types of buildings. The appropriate application of this approach is complex and labor intensive. It entails:

Determining the proper cost of the specific parts of the overall EDS, includes the hook-ups, branch circuits, various sections of the secondary EDS, and the primary EDS, analyzing the over-all electrical demand load for the building, and allocating the primary and secondary EDS to § 1245 and § 1250 appropriately.

The costs of the hook-ups and branch circuits that service building related items, such as HVAC, power outlets for general use, lighting, and other building services, should be recovered over the recovery period of the building. The costs of the hook-ups and branch circuits that supply power to dedicated machinery and equipment used as an integral part of the taxpayer's business should be recovered over the appropriate recovery periods of the equipment that they serve based on § 168 and Rev. Proc. 87-56.

The primary and secondary EDS components of a building or other inherently permanent structure used in the operation or maintenance of the building or necessary to provide general building services (such as lighting, heating, ventilation, air conditioning, etc.), including electrical outlets of general applicability and accessibility, are § 1250 property and are recovered over the same recovery period as the building.

Examiners are encouraged to risk assess the taxpayer's EDS allocation using the analyses discussed in this chapter to verify that the claimed functional allocation method is applied correctly and that it yields the appropriate percentage for § 1245 property portion of the EDS of the building.

If the taxpayer uses a correct functional allocation approach as illustrated in this chapter to define which parts of a building's primary and secondary EDS were designed to service § 1245 property, the examiner should not challenge the use of the functional allocation approach.

B. Stand-Alone Open-Air Parking Structures

1. Introduction

The IRS and the taxpayer agree that stand-alone open-air parking structures are inherently permanent. Accordingly, the issue is whether these parking structures are buildings or land improvements for depreciation purposes. Taxpayer asserts that the parking structures are land improvements with a 15-year recovery period and 150% declining balance method of depreciation (under GDS) while the IRS asserts that the parking structures are buildings with a 39-year recovery period and straight-line method of depreciation (under GDS).

The specialized Uniform Issue List (UIL) code for this issue regarding the proper classification of a stand-alone open-air parking structure is: 168.20-00.

2. Description of Stand-Alone Open-Air Parking Structures

Open-air parking structures have been constructed since the mid-1950s. Stand-alone open-air parking structures typically provide multi-level parking accessed by a ramp system. These parking structures have at least two sides that are approximately 50 percent open to the outside because they were designed to eliminate the need for heating and ventilation systems. Aside from those vehicles parked on the top level, the vehicles are protected from sun, rain and snow. Moreover, drivers and passengers are protected from these elements as well as from ice and to some degree, wind. In almost all parking structures, the top, exposed level has the fewest vehicles.

The parking structures are normally constructed of concrete and supported by steel-reinforced concrete pillars. The garages have foundations, concrete decks, steel-reinforced concrete support pillars, partial walls, concrete ramps connecting each floor, concrete wheel stops, bollards, and guardrails. Some have underground parking levels, which have full walls. The parking structures typically have hydraulic elevators and internal stairwells (every parking structure is required by the Uniform Building Code to have a minimum of two means of egress (stairs) which are separated from each other). The elevator mechanical systems (hydraulics and motors) are housed in an equipment room located adjacent to the elevators.

The parking structures also have interior lighting (pole-mounted lighting on the top level), security cameras, fire sprinklers (depending on the height and area of the structure), and

signage to facilitate safe and speedy evacuations during an emergency. While fires in parking structures are generally more related to the vehicles parked within them than to the typical structural materials, the fire system (if required by code provisions) is usually comprised of the fire alarm wiring, pull stations, strobes, annunciators, and exit signage. Many parking structures have a separate area or room for electric metering and switching.

3. Applicable Tax Law

§ 168 set forth the MACRS depreciation system. MACRS generally applies to tangible property placed in service after December 31, 1986. § 168(a) provides that the depreciation deduction provided by § 167(a) for any tangible property is determined by using the applicable depreciation method, recovery period, and convention. Under MACRS, the recovery period of property is determined by reference to its class life or by statute.

Nonresidential real property is § 1250 property that is not (1) residential rental property or (2) property with a class life of less than 27.5 years. § 168(e)(2)(B). § 1250 property is any real property (other than § 1245 property, as defined in § 1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in §§ 167, 168(i)(12) and 1250(c). The cost of nonresidential real property placed in service after May 12, 1993, is generally recovered over 39 years.

Taxpayers argue that stand-alone open-air parking structures are land improvements, with a recovery period generally of 15 years. Land improvements are defined in Rev. Proc. 87-56, 1987 2 C.B. 687 (Asset Class 00.3), which states, “Includes improvements directly to or added to land, whether such improvements are § 1245 property or § 1250 property, provided such improvements are depreciable. Examples of such assets include sidewalks, roads, canals, waterways, drainage facilities, sewers (not including municipal sewers in Class 51), wharves and docks, bridges, fences, landscaping, shrubbery, or radio and television transmitting towers. Does not include land improvements that are explicitly included in any other class, and buildings and structural components as defined in § 1.48-1(e) of the regulations....”

Therefore, if these parking structures are buildings, they are not land improvements.

The determination of whether a structure constitutes a building is based on the definition of a building in Treas. Reg. § 1.48-1(e)(1). The regulation provides, “The term ‘building’ generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, **parking**, 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. …” [emphasis added]

In *Yellow Freight System, Inc. v. Commissioner*, 538 F.2d 790, 795-796 (8th Cir. 1976), the court noted, “This regulation conforms to the congressional understanding of the term “building,” see The Technical Explanation of the Bill, U.S. Code Cong. & Admin. News pp. 3439, 3456 (1962), and follows Congress' intent that the term “building” be given its commonly accepted meaning.” Thus, for depreciation purposes, the term “building” is given its commonly accepted meaning.

The regulation has been interpreted by various courts to include an appearance test and a function test. The first part of the definition ("any structure or edifice enclosing a space within its walls, and usually covered by a roof") is known as the appearance test. The second part of the definition ("the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space") is known as the function test.

Taxpayers and the Service disagree on whether a stand-alone, open-air parking structure satisfies this two-part definition of a "building" under Treas. Reg. § 1.48-1(e)(1).

4. Parties Positions

Taxpayers contend that the parking structures, if not connected to an actual building, are land improvements with a 15-year recovery period. However, Taxpayers agree that parking structures connected to a building have a 39-year recovery period.

Taxpayers argue that stand-alone, open-air parking structures do not meet the definition of a building because they fail the appearance test. Specifically, taxpayers argue that a stand-alone, open-air parking structures fail the appearance test because they: 1) do not contain walls or a roof for the specific purpose of sheltering people or vehicles; 2) are open to the elements (weather); and 3) do not have many of the structural components of a building and/or do not share structural supporting elements with a building.

Taxpayers further argue that stand-alone, open-air parking structures do not meet the definition of a building because they fail the function test. They argue that courts analyze the function test by determining whether the structure provides more-than-incidental shelter or working space for humans or machinery, which is more than merely incidental to the principal function of the structure. Taxpayers assert that the structures do not provide shelter for significant machinery and the limited human activity in the structures is incidental to the garage's principal function of temporary vehicle storage. Furthermore, for functional purposes, taxpayers analogize the structures to paved surface parking lots that happen to be stacked one atop the other.

The Service's position is that stand-alone, open-air parking structures constitute buildings with a 39-year recovery period.

The Service argues that stand-alone, open-air parking structures fall within the definition of a "building" because they satisfy the appearance test. Treas. Reg. § 1.48-1(e)(1) states that the term "building" generally means a structure enclosing a space within its walls, and usually covered by a roof. The regulation section does not require a structure to have walls or a roof to be classified as a building. However, the Service asserts that a stand-alone, open-air parking structure does enclose a space within its walls. Even though the structures' exterior walls do not extend from floor to ceiling, the partial, exterior walls separate the structure from the surrounding area and enclose vehicles within it. Moreover, stand-alone open-air parking structures possess structural components that are naturally associated with a "building."

The Service further argues that stand-alone, open-air parking structures fall within the definition of a building because they satisfy the function test. Treas. Reg. § 1.48-1(e)(1) provides that a structure constitutes a building if the purpose of the structure is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The regulation section does not require a structure to meet all possible building functions to satisfy the function test. In the current case, the parking structures at issue clearly provide parking space, which is one of the functions specifically enumerated in Treas. Reg. § 1.48-1(e)(1). Furthermore, the structures shelter the parked vehicles from sun and precipitation.

5. Analysis

Treas. Reg. § 1.48-1(e) is clear and unambiguous in providing that the term "building" includes structures such as garages, and structures the purpose of which is to provide parking space. Since garages and parking structures are explicitly included in the definition of a building under Treas. Reg. § 1.48-1(e), this should end the inquiry as to whether a parking structure is considered a building.

Although it is clear and unambiguous that garages and parking structures constitute buildings under Treas. Reg. § 1.48-1(e), taxpayers attempt to introduce ambiguity into the definition of a building with regard to parking structures. The paragraphs below address the arguments raised by taxpayers.

III. Function Test

The function test under Treas. Reg. § 48-1(e)(1) requires the structure or edifice to provide shelter or housing, or to provide working, office, parking, display, or sales space. The stand-alone open-air parking structures clearly provide parking space. Taxpayers may argue that the parking structures fail the function test because they do not provide workspace or shelter. However, Treas. Reg. § 1.48-1(e)(1) does not require a structure to meet all of the possible building functions and does clearly state that providing a parking space is a building function. Further, open-air parking structures do provide shelter for the vehicles from sun and precipitation, especially those located in the interior portion of the structure. They similarly provide shelter for drivers and passengers when entering and exiting the vehicles.

IV. Appearance Test

The appearance test under Treas. Reg. § 1.48-1(e)(1) requires a structure or edifice enclosing a space within its walls, and usually covered by a roof. A stand-alone open-air parking structure clearly encloses a space within its walls. The walls of a parking structure separate the parking structure from the surrounding area and enclose vehicles within the structure. While it is not mandatory that a structure have a roof under Treas. Reg. § 1.48-1(e)(1), the top level of a stand-alone open-air parking structure is simply a useable roof.

Taxpayers argue that stand-alone open-air parking structures are different than normal parking garages, and that these structures do not meet the definition of a building because they fail the appearance test. As mentioned above, taxpayers argue that the stand-alone

open-air parking structures fail the appearance test because they: 1) do not contain walls or a roof for the specific purpose of sheltering people or vehicles; 2) are open to the elements (weather); and 3) do not have many of the structural components of a building or do not share structural supporting elements with a building.

1. Walls or Roof

To support their no roof theory, taxpayers claim that each new level in the parking structure does not constitute a roof for the level below. However, the levels constitute something like a ceiling, much the same way each floor in any other building serves as a ceiling for the level below. Lighting, signage and, if required, fire systems are attached to the bottom side of each new level. The only level that does not have a ceiling is the rarely-used top level. The top level is simply a useable roof, much like a rooftop deck on an apartment building.

Even stand-alone open-air parking structures normally have walls, although the exterior walls do not extend to the ceiling except when required for support. The walls are necessary to prevent cars from driving off the side. A number of cases have held that walls are not necessary. See *Consolidated Freightways, Inc. v. Commissioner*, 708 F.2d 1385 (9th Cir. 1983), affg. in relevant part 74 T.C. 768 (1980) (loading docks without permanent walls were buildings under the appearance test; this result applies even if there were no overhead doors.); *Yellow Freight System, Inc. v. Commissioner*, 538 F.2d 790, 795-796 (8th Cir. 1976) (similarly; lack of clearly discernible walls was not controlling); Rev. Rul. 79-406, 1979-2 C.B. 18 (car wash is a building, despite lack of exterior walls on two sides of the structure).

2. Open to Elements

Even stand-alone open-air parking structures are not entirely open to the elements — they have a roof and partial walls. These walls may not extend to the ceiling but are high enough to shield vehicles from most precipitation and some wind. The properties in *Consolidated Freightways* and *Yellow Freight System* were classified as buildings despite the lack of permanent walls. These parking structures are large enough so that only those vehicles closest to the edges may get wet if it rains. It is true that these parking structures usually lack heat and air conditioning, but the lack of temperature control cannot be sufficient to establish that a structure is not a building.

3. Structural Components or Structural Supporting Components

The taxpayers sometimes argue that stand-alone open-air parking structures do not have many of the structural components of a building provided under Treas. Reg. § 1.48-1(e)(2) and, therefore, are not a building. Parking structures have walls, floors, elevators, stairs, sprinkler systems, fire escapes, and electric wiring and lighting fixtures. While these parking structures lack some of the structural components listed in Treas. Reg. § 1.48-1(e)(2), the regulation does not require that all listed structural components are needed in a structure to classify it as a building.

The taxpayers also sometimes state that stand-alone open-air parking structures do not share structural supporting elements with a building. They apparently make this statement

because they are aware that property may be other property and not a building but still be treated as a structural component of a building. *Illinois Cereal Mills, Inc. v. Commissioner*, 789 F.2d 1234, 1239 (7th Cir. 1986). Taxpayers, however, typically agree that if an open-air parking structure shares a wall or other structural supporting elements with another building, then it should be classified as a building. Moreover, the position of the Service is that the parking structures are themselves buildings such that the Service does not argue that the parking structures are structural components of buildings.

Taxpayers do not cite any support for their position that a structure, which functions as a building, is not a building.

Finally, properly maintained and built open-air parking structures can be expected to perform well for 25 to more than 40 years.

6. Penalty

An accuracy-related penalty for a substantial understatement of income tax should be considered if the understatement is substantial; and as an alternative, in the light of the lack of support for the taxpayer position, an accuracy-related penalty for negligence or disregard of rules or regulations should be strongly considered.

V. Substantial Understatement

§ 6662(b)(2) imposes a twenty percent accuracy-related penalty that applies to any substantial understatement of income tax. § 6662(d) defines substantial understatement differently for corporations (other than S corporations and personal holding companies) from the definition for non-corporate taxpayers. For corporations, there is a substantial understatement for a taxable year if the understatement exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (ii) $10,000,000. § 6662(d)(1)(B). For S corporations, personal holding companies, and all non-corporate taxpayers, there is a substantial understatement if the amount of the understatement exceeds the greater of (i) 10 percent of the tax required to be shown on the return for the taxable year, or (ii) $5,000. See § 6662(d)(1)(A).

For purposes of § 6662(d)(1), the term understatement means the excess of (i) the amount of tax required to be shown on the return, over (ii) the amount of tax imposed which is shown on the return, reduced by any rebate (within the meaning of § 6211(b)(2)). § 6662(d)(2). To the extent that a taxpayer has substantial authority for the reported tax treatment or adequately discloses that treatment in the return or on a statement attached to the return and there is a reasonable basis for the tax treatment of the item, the amount of the understatement is reduced. See § 6662(d)(2)(B).

Where a substantial understatement exists, its proof is a matter of establishing that the amount of tax required to be shown on the return exceeds the amount of tax shown on the return (reduced by any rebates), and whether the difference surpasses the relevant threshold provided in § 6662(d)(1)(A) or (B). This proof is simpler than making the case for the accuracy-related penalty for negligence or disregard, discussed below, and should be pursued where the facts support its assertion.

VI. Negligence

§ 6662(b)(1) imposes a twenty percent accuracy-related penalty that applies to the portion of any underpayment of tax attributable to negligence or disregard of rules or regulations.

Negligence under § 6662 includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), aff'g 43 T.C. 168 (1964); *Neely v. Commissioner*, 85 T.C. 934, 947 (1985). Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. A return position that has a reasonable basis as defined in Treas. Reg. § 1.6662-3(b)(3) is not attributable to negligence. See Treas. Reg. § 1.6662-3(b)(1). A reasonable basis is a greater standard than merely arguable or merely a colorable claim. See Treas. Reg. § 1.6662-3(b)(3).

Disregard of rules or regulations "includes any careless, reckless or intentional disregard." See § 6662(c) and Treas. Reg. § 1.6662-3(b)(2). The term rules or regulations include provisions of the Internal Revenue Code, temporary and final regulations, and revenue rulings and notices (other than notices of proposed rulemaking). See Treas. Reg. § 1.6662-3(b)(2). A disregard is careless if the taxpayer fails to exercise reasonable diligence to determine the correctness of a return position that is contrary to a rule of regulation, reckless when a taxpayer makes little or no effort to determine whether a rule or regulation exists, and intentional if the taxpayer knows of the disregarded rule or regulation. *Id.* Outside the reportable transaction context, a taxpayer has not disregarded a rule or regulation when taking a position contrary to a ruling or notice if the taxpayer's position has a realistic possibility of being sustained on its merits. *Id.*

VII. Burden of Production and Proof

The taxpayer has the ultimate burden of proof in overcoming the presumption that the Service's determination of an accuracy-related penalty is correct. *Marcello*, 380 F.2d at 507. With respect to examinations commencing after July 22, 1998, however, the Service must first meet the burden of production with respect to the imposition of additions to tax and penalties; and to meet that burden, the Service must produce evidence sufficient to show that imposing the penalty is appropriate, but the Service need not introduce evidence regarding reasonable cause, reasonable basis, substantial authority, or similar provisions. See § 7491(c) and *Higbee v. Commissioner*, 116 T.C. 438, 446 (2002).

VIII. Analysis

The Service is unaware of any authority that suggests a stand-alone open-air parking structure is not a building. While taxpayers attack the IRS' position, they offer no affirmative justification for their position nor do they explain why a parking structure, which is an inherently permanent structure, is not a building. In fact, a parking structure is so commonly regarded as a building that to argue otherwise is frivolous.

Taxpayers attempt to distinguish the parking structures at issue to avoid classification as a building. To distinguish the parking structures, taxpayers may argue that stand-alone open-air parking structures lack the physical features of a building. For example, taxpayers may suggest that the walls of a parking structure do not provide enclosure. On the contrary, the walls separate the parking structure from the surrounding area, enclosing vehicles within the structure. Taxpayers may also argue that the components of a stand-alone open-air parking structure are not unique to buildings or that parking structures do not contain all Treas. Reg. § 1.48-1(e)(2) structural components. Arguing that components are not exclusive to buildings does not prevent a parking structure from being a building nor justify taxpayers' position that stand-alone open-air parking structures are not buildings. Additionally, all structural components listed in the regulation are not required to classify a structure as a building.

Taxpayers may further argue that a stand-alone open-air parking structure fails the function test because it does not provide workspace or shelter. However, Treas. Reg. § 1.48-1(e)(1) does not require that a building qualify under all possible building functions and specifically designates parking as a building function. Taxpayers may further argue that the floors of a parking garage provide a similar sheltering function as a canopy over a parking lot. Having a similar function as a canopy does not mean a parking structure is not a building because a canopy is not a building. The classification of one does not affect the classification of the other. For example, the purpose of a sundial and the purpose of a digital clock are both to tell time. However, the fact that a sundial is not an electric device does not mean a digital wristwatch is not an electric device.

Taxpayers can present no arguments that reasonably justify treating the stand-alone open-air parking structures as anything other than a building. Adopting an argument so lacking in legal foundation is negligent under § 6662, and ignoring the dictates of Treas. Reg. 1.48-1(e)(1) demonstrates disregard of that regulation.

IX. § 6664 Reasonable Cause Exception

§ 6664(c) provides an exception to the imposition of any § 6662 penalty if the taxpayer shows that there was reasonable cause and the taxpayer acted in good faith. See also Treas. Reg. 1.6664-4(a). The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all relevant facts and circumstances. See Treas. Reg. § 1.6664-4(b)(1). All relevant facts and circumstances, including the nature of the tax investment, the complexity of the tax issues, the independence of a tax advisor, the competence of a tax advisor, the sophistication of the taxpayer, and the quality of an opinion, must be developed to evaluate an assertion that a taxpayer acted with reasonable cause and in good faith. *See* IRM 20.1.5.6.1(7).

Generally, the most important factor in determining whether the taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's effort to assess the proper tax liability. For example, an isolated computational or transcription error generally is not inconsistent with reasonable cause and good faith See Treas. Reg. § 1.6664-4(b)(1) for guidance and additional examples, and also consider *Larson v. Commissioner*, T.C. Memo. 2002-295.

Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication and education of the taxpayer. See Treas. Reg. § 1.6664-4(b)(1). The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws, at the time the return was filed, are all relevant in deciding whether the taxpayer acted with reasonable cause. See *Kees v. Commissioner*, T.C. Memo. 1999-41. If the taxpayer is misguided, unsophisticated in tax law, and acts in good faith, a penalty is not warranted. See *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988); cf. *Spears v. Commissioner*, T.C. Memo. 1996-341, aff'd, 98-1 USTC 50,108 (2d Cir. 1997) (Court was un-convinced by the claim of highly sophisticated, able, and successful investors that they acted reasonably in failing to inquire about their investment and simply relying on offering circulars and accountant, despite warnings in offering materials and explanations by accountant about limitations of accountant's investigation, stating “In each case, these taxpayers knew or should have known better.”).

Reliance upon a tax opinion provided by a professional tax advisor may serve as a basis for the reasonable cause and good faith exception to the accuracy-related penalty. See Treas. Reg. § 1.6664-4(c)(1). The reliance, however, must be objectively reasonable. *Id*. For example, the taxpayer must supply the professional with all the necessary information to assess the tax matter, and the advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. See Treas. Reg. § 1.6664-4(c)(1)(i).

In *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122, 205-11 (D. Conn. 2004), the court concluded that a legal opinion did not provide a taxpayer with reasonable cause where (1) the taxpayer did not receive the written opinion prior to filing its tax return, and the record did not establish the taxpayer's receipt of an earlier oral opinion upon which it would have been reasonable to rely; (2) the opinion was based upon unreasonable assumptions; (3) the opinion did not adequately analyze the applicable law; and (4) the taxpayer's partners did not adequately review the opinion to determine whether it could be reasonably relied upon. In addition, the court concluded that the taxpayer's lack of good faith was evidenced by its decision to attempt to conceal the losses reported from the transaction by netting them against gains on its return. *Id*. at 211-12.

The fact that a taxpayer consulted an independent tax advisor is not, standing alone, conclusive evidence of reasonable cause and good faith if additional facts suggest that the advice is not dependable. See *Spears*, T.C. Memo. 1996-341. For example, a taxpayer may not rely on an independent tax adviser if the taxpayer knew or should have known that the tax adviser lacked sufficient expertise, the taxpayer did not provide the adviser with all necessary information, or the information the adviser was provided was not accurate. See

Spears, T.C. Memo. 1996-341; *Pessin v. Commissioner*, 59 T.C. 473, 488-489 (1972). Additionally, the analysis provided to the taxpayer must be reasonable in light of the experience, knowledge and education of the taxpayer. See Treas. Reg. § 1.6664-4(b)(1).

Finally, a taxpayer may not establish reasonable cause and good faith by relying on an opinion or advice that a regulation is invalid unless the taxpayer adequately disclosed the position that the regulation was invalid in accord with Treas. Reg. § 1.6662-3(c)(2). See Treas. Reg. § 1.6664-4(c)(1)(iii).

The reasonable cause and good faith exception to the accuracy-related penalties requires analysis of all the facts and circumstances, but in the light of the lack of support for the taxpayer position that the open-air parking structures are land improvements depreciable over 15 years and a regulation stating that these structures are buildings and thus depreciable over 39 years, the potential for the reasonable cause and good faith defense should not dissuade the Service from asserting the accuracy-related penalty.

7. Summary

The IRS and the taxpayer agree that stand-alone open-air parking structures are inherently permanent. The issue in dispute is whether these parking structures are buildings or land improvements for depreciation purposes. The taxpayer asserts that the parking structures are land improvements with a 15-year recovery period (under GDS) while the IRS asserts that the parking structures are buildings with a 39-year recovery period (under GDS).

Treas. Reg. § 1.48-1(e) is clear and unambiguous in providing that the term “building” includes structures such as garages and structures the purpose of which is to provide parking space. Since garages and parking structures are explicitly included in the definition of a building under Treas. Reg. § 1.48-1(e), this should really be the end of the inquiry as to whether a parking structure is considered a building.

Taxpayers argue that the regulation is ambiguous and that a stand-alone, open-air parking structure does not satisfy the two-part definition of a “building”, namely the appearance test and the function test. Taxpayers, however, have not cited any support for their position that a structure, which appears and functions as a building is not a building. The Service is unaware of any authority that suggests a stand-alone open-air parking structure is not a building.

Taxpayers can present no arguments that reasonably justify treating a stand-alone open-air parking structure as anything other than a building. While taxpayers attack the IRS' position, they offer no affirmative justification for their position. Given the lack of support for the taxpayer position, an accuracy-related penalty under § 6662 for a substantial understatement (if applicable) and in the alternative for negligence or disregard of rules or regulations should be strongly considered.