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HOW TO ALLOCATE BASIS OF COMMERCIAL REAL ESTATE TO ACHIEVE MAXIMUM DEPRECIATION DEDUCTIONS

Because commercial realty is depreciated using the straight line method over a long recovery period of 39 years, it is critical for buyers of commercial property (as well as owners making substantial improvements) to make sure they are depreciating all they can, and are taking advantage of the few remaining opportunities for accelerated depreciation. Here's a review of how the basis of commercial realty should be allocated for best tax results.

BUILDING VS. LAND

A purchaser will want to allocate as much of the purchase price as possible to the depreciable improvements rather than to the nondepreciable land. How should the allocation be made? The regulations merely specify that (1) the purchase price allocation must be based on the ratio of the depreciable improvements' value at acquisition to the entire property's value at that time, and (2) if the purchase is part of an applicable asset acquisition under Code Sec. 1060, the allocation can't exceed the consideration allotted to the property under the Code Sec. 1060 regulations.

The Tax Court has repeatedly ruled that the tax assessor's valuation or a mortgage appraisal may be used to allocate the purchase price between land and building. However, IRS says a taxpayer cannot allocate his cost basis in land and buildings solely according to their assessed values for property tax purposes when better evidence, such as an engineering report, exists to establish fair market value.

The prudent taxpayer should obtain a formal building vs. land valuation based on acceptable appraisal standards.

UNEARTHING DEPRECIATION DEDUCTIONS FROM LAND-RELATED COSTS

A significant part of a property's acquisition, construction or reconstruction cost may be allocable to land-related improvements such as landscaping, shrubbery, sidewalks, roads within the property, and fences. Such land improvements, if not explicitly included in another class, and not certain public utility land improvements, are placed in Class 00.3 and are assigned a 20-year class life. That means these land improvements may be depreciated over 15 years using 150% declining balance depreciation under MACRS. However, IRS says a taxpayer may depreciate only that part of the landscaping that is immediately adjacent to buildings, reasoning that only this portion would be destroyed if the buildings themselves were destroyed or replaced. The balance of the landscaping is capitalized and added to the basis of the land. IRS also has ruled that the costs for a roadway grading that would be retired contemporaneously with a building are depreciable. Using the same reasoning, IRS recently ruled that the cost of building or rebuilding "modern greens" of a golf course is depreciable over 15 years. The ruling concludes that the tiles and pipes are depreciable because they have a determinable useful life. The land preparation above them, (gravel, rootzone layer and turfgrass) will

be destroyed when the tiles and pipes are replaced and thus these costs also are depreciable.

The lesson to be learned is that it's critical to obtain a detailed appraisal that not only allocates costs to land-related items, but also breaks down the landscaping into depreciable and nondepreciable elements.

CARVING OUT NON-COMPONENT PORTIONS OF A BUILDING

Commercial buildings and their structural components are depreciated as one unit over 39 years. However, commercial property often contains elements that are not structural components and therefore are separately depreciable over a shorter recovery period using accelerated depreciation. In the *Hospital Corp of America & Subsidiaries* case, the Tax Court has held that a non-component portion of a building that was treated by the courts as personal property (rather than a building or a structural component) under prior law's repealed investment tax credit (ITC) also is tangible personal property for MACRS depreciation purposes. IRS acquiesced in the *Hospital Corp of America* holding that the tests developed under the ITC are applicable in determining whether an asset is a structural component for purposes of ACRS and MACRS depreciation. IRS nonacquiesced, however, to the way in which the Tax Court applied this principle to specific items.

The following building items were held to be personal property rather than structural components for ITC purposes. Thus, that portion of acquisition cost properly allocable—by formal appraisal—to these items should be depreciable separately over a shorter recovery period than the commercial building itself.

! MOVABLE AND REMOVABLE PARTITIONS

The interior office or store space in many commercial structures is divided with partitions rather than with permanent walls. Although these partitions are attached to permanent building members, or are placed in metal channels anchored to the floor and ceiling, they are personal property if:

1. They can be readily and economically removed and reused without doing more than minor damage to the partition or the building;
2. It is more economical to remove and reuse the partitions than to destroy them and put in new ones; and,
3. It is reasonable to expect that partitions will in fact be moved to suit tenants (or changing business needs).

Similarly, the Tax court held in *Hospital Corp of America* that accordion-style non-load-bearing room partitions are tangible personal property. IRS has ruled that movable partitions that are not a permanent part of a building are tangible personal property for ITC purposes.

! EXTERIOR ORNAMENTATION

In a statement quoted by the courts, the Senate Finance Committee Report to P.L. 95-600 declared that “false balconies and other exterior ornamentation that have no more than an incidental relationship to the operation or maintenance of a building” are personal property. More recently, the Tax Court said a restaurant chain’s “decor finishes, primarily [its] decorative canopy system including the concrete foundation, concrete piers, lumber and signs attached thereto” belonged in Asset Class 57.0 for ACRS purposes. Under MACRS, Class 57.0 assets (defined the same way for MACRS as for ACRS) are 5-year property.

! CARPETING

The purchaser or owner of an office building will often rip out used carpeting and install new wall-to-wall carpeting. Where it is installed by fastening to wood strips along the wall, the carpeting is personal property rather than a structural component. IRS has ruled privately this applies to carpeting no matter how permanently installed, where it can be removed without requiring resurfacing or restorative work to the floor and where it can be reused and/or reinstalled if desired at another location. In *Hospital Corp. of America*, the Tax Court held that carpeting attached to the floor by a general purpose latex adhesive also is tangible personal property. It even held that a hospital's vinyl floor coverings were tangible personal property.

! SOLAR ENERGY EQUIPMENT

The Tax Court has held that solar water-heating equipment, integrated with, but not replacing the conventional system, is tangible personal property for ITC purposes, where it was easily and cheaply removable without damage to the building.

! ELECTRICAL AND PLUMBING SYSTEMS

Electrical or plumbing facilities (including a sprinkler system) relating generally to the overall operation of a building are structural components. However, special electrical or plumbing connections that are necessary for and are used directly with or between particular machines or equipment aren't structural components but are essentially items of machinery or equipment.

In *Hospital Corp. of America*, the Tax Court held that where an electrical or plumbing item (e.g., an electrical outlet or other branch electrical system item) services only equipment that is used in the taxpayer's business (and not used for building maintenance or operation), the entire item isn't a structural component and is depreciated over 5 years. Thus, plumbing connections weren't structural components where they:

1. Didn't relate to general building plumbing,
2. Carried water and steam directly to specific items of hospital kitchen equipment, (dishwashers, coffee urns, braising pans, ice makers) and to x-ray equipment; and,
3. Were necessary for the operation of that equipment.

Under the Tax Court's reasoning, the cost of similar plumbing connections in structures built to house facilities such as restaurants also should be depreciable over five years. The Tax Court in *Hospital Corp. of America* also categorized as tangible personal property the branch electrical systems servicing specialized items such as illuminated emergency entrance and front entrance signs and kitchen equipment, and similarly held that internal communications equipment (wiring, conduit, junction boxes, outlets, etc.) necessary for the operation of hospital intercom, dictation, paging, and nurse call systems were tangible personal property eligible for 5-year depreciation.

! METHOD OF DEPRECIATION FOR NON-STRUCTURAL ELEMENTS OF BUILDING

In general, tangible personal property with no class life is depreciated over 7 years using 200% declining balance depreciation. However, another recovery period may apply if the asset is placed in a special class. For example, tangible personal property which includes "assets used in wholesale or retail trade, personal and professional services is 5-year

property under MACRS.

! EXPENSING DEDUCTIONS

“Non-component” portions of a building should qualify for expensing under Code Sec. 179 , which requires eligible property to be (1) a tangible asset that would otherwise be depreciable; (2) acquired by purchase for use in the active conduct of a trade or business; and (3) personal property under Code Sec. 1245(a)(3). Personal property is defined the same way as tangible personal property was defined for ITC purposes. Note that expensing is not available for air conditioning, heating units, or property used predominantly to furnish lodging or in connection with the furnishing of lodging. However, the following types of property qualify as Code Sec. 179 property:

1. Personal property that is used in a nonlodging commercial facility available to the non-lodging public on the same basis as to lodgers.
2. Personal property used by a hotel or motel in connection with the business of furnishing lodging, where most of the accommodations are used by transients.
3. Energy property. In the commercial building context, this is property that uses solar energy to generate electricity or to heat, cool or provide hot water for a structure. If the taxpayer didn't construct, reconstruct or erect the equipment, its original use must begin with him.

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