

# **BUS 225H – Taxation of Property Transactions**

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## **Week 1 Reading**

- Introduction to Property Transactions
- Nature of Relevant Tax Rules
- Definitions
- Forms of Ownership
- Depreciation
- In-Class Questions



## Introduction

There are many ways to classify property. Examples include:

- Tangible versus intangible
- Depreciable versus non-depreciable
- Real versus personal
- Business versus personal use
- Taxable versus non-taxable (such as for sales tax purposes)

The readings for Week #1 provide an introduction to some of the different definitions, challenges in applying them, the importance of the definitions, and the different forms of ownership for property.

### Examples of Issues of Classifying Property for Depreciation Purposes

**Note:** Unless otherwise noted, the text for any ruling is the full text of that document.

#### Revenue Ruling 74-265

Advice has been requested whether land preparation consisting of shrubbery and other elements of landscaping is depreciable property for Federal income tax purposes, under the circumstances set forth below.

The taxpayer constructed and operated a garden-type apartment complex situated on several acres of land. The surrounding area was landscaped according to an architect's plan to conform it to the general design of the apartment complex. The expenditures for landscaping included the cost of top soil, seeding, clearing and grading, and planting of perennial shrubbery and ornamental trees around the perimeter of the tract of land and also immediately adjacent to the buildings. The replacement of such apartment buildings after the expiration of their useful lives will destroy the immediately adjacent landscaping, consisting of perennial shrubbery and ornamental trees.

Section 167 of the Internal Revenue Code of 1954 sets forth the general rule that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or of property held for the production of income.

Section 1.167(a)-2 of the Income Tax Regulations provides, in part, that the depreciation allowance does not apply to land apart from the improvements or physical developments added to it, generally because land has no determinable useful life. Land preparation may be subject to the depreciation allowance, however, if it is closely associated with depreciable assets so that it is possible to establish a determinable period over which the preparation will be useful in a particular trade or business.

A useful life for land preparation is established if it will be replaced contemporaneously with a related depreciable asset. See Rev. Rul. 72-96, 1972-1 C.B. 66. Whether land preparation will be replaced contemporaneously with a related depreciable asset is necessarily a question of fact, but if the replacement of the asset will require the physical destruction of the land preparation, this test will be considered satisfied.

Accordingly, the landscaping consisting of the perennial shrubbery and ornamental trees immediately adjacent to the apartment buildings is depreciable property under section 167 of the Code since the replacement of the buildings will destroy this landscaping. The cost of this land preparation may therefore be recovered over the established useful life of the apartment buildings.

The balance of the landscaping, including the necessary clearing and general grading, top soil, seeding, finish grading, and planting of perennial shrubbery and ornamental trees around the perimeter of the tract of land, is general land improvement that will be unaffected by the replacement of the apartment buildings and, therefore, will not be replaced contemporaneously therewith. Accordingly, this land preparation is not depreciable property but rather is considered inextricably associated with the land. As such, the cost of this land preparation is added to taxpayer's basis in the land and is not depreciable.

***Eastwood Mall v. U.S.***, 95-1 USTC ¶50,236, 75 AFTR2d 2291 (DC-OH); aff'd 59 F3d 170 (6<sup>th</sup> Cir. 1995) (summary)

Taxpayer sought to depreciate the costs of leveling land so that a shopping center could be built. A jury found that the costs of earthmoving and blasting to reshape and level a 100 acre piece of mountainous land into a plateau were non-depreciable land costs, rather than depreciable costs of constructing the mall that was built on the plateau. The costs involved were almost \$10 million. Important to the holding that the costs were not depreciable were:

- The costs would not be incurred again if the mall were to be rebuilt;
- The earthen plateau was not part of the mall structure;
- Prior court cases had held that improvements inextricably associated with land, including costs to make land usable where it was not before, were not depreciable; such an asset is not wasting.

“The key test for determining whether land preparation costs are associated with nondepreciable land or the depreciable building thereon is whether these costs will be reincurred if the building were replaced or rebuilt. Land preparation costs for improvements that will continue to be useful when the existing building is replaced or rebuilt are considered inextricably associated with the land, and, as such, are to be added to the taxpayer’s cost basis in the land and are not depreciable. On the other hand, land preparation costs for improvements that are so closely associated with a particular building that they necessarily will be retired, abandoned, or replaced contemporaneously with the building are considered associated with the building, and, as such, added to the taxpayer’s cost basis in the building and are depreciable.”

### **Revenue Ruling 68-193** (excerpt)

“Costs attributable to general grading of the land are capital expenditures and are generally not subject to depreciation allowances. However, the costs of grading for roadways may be depreciable where it can be established that the grading is associated with a depreciable asset and that the grading will be retired, abandoned, or replaced contemporaneously with that asset.”

### **TAM 9110001** (summary)

Allocation of purchase price between land and building: The IRS ruled that taxpayer could not use the assessed values used for property tax purposes to allocate purchase price between land and buildings when better evidence existed to determine the value of the properties. Taxpayer pointed out that various cases have allowed for property tax values to be used for allocating basis between land and buildings, such as *Creston* (Tax Court 1963), and *Maloney* (TCM 1975). Also, IRS Pub 551 states that a taxpayer may allocate purchase price based on the assessed values of the property for real estate tax purposes. The IRS pointed out that case law also exists to support the position that the IRS is not bound by allocation in purchase contracts (*Palo Alto Town & Country Village*, 9<sup>th</sup> Cir. 1977 and Rev. Rul. 69-539. Apparently, the “better evidence” that existed was that of an IRS engineer.

## Revenue Ruling 67-349

Advice has been requested whether, under the circumstances described below, the carpeting installed by the taxpayer in his motel qualifies as "section 38 property" for purposes of the investment credit.

The taxpayer installed "wall-to-wall" carpeting in all guest rooms, office space, bar areas and dining rooms of his motel. The floor beneath the carpeting is concrete and is covered only by the padding and carpeting. The carpeting was installed by fastening it to wood strips with hooks attached to the strips. The strips are nailed along each wall. The carpeting in this case qualifies as property used by a hotel or motel and predominantly used by transients under the provisions of section 1.48-1(h)(2)(ii) of the Income Tax Regulations.

Section 38 of the Internal Revenue Code of 1954 allows a credit against Federal income tax for qualified investment in "section 38 property". The determination of what property qualifies as "section 38 property" is made in accordance with the rules provided in section 48 of the Code.

Section 48(a)(1) of the Code provides, in pertinent part, that the term "section 38 property" means tangible personal property or other tangible property (not including a building and its structural components). In order to qualify as "section 38 property", the property must also be depreciable property and have a useful life of four years or more.

Section 1.48-1(c) of the regulations 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). Local law shall not be controlling in determining whether property is or is not "tangible" or "personal". "Tangible personal property" includes all property (other than structural components) which is contained in or attached to a building, such as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs.

"Structural components" of a building do not qualify as "section 38 property". Section 1.48-1(e)(2) of the regulations defines "structural components" and provides, in part, that such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling, or tiling are "structural components".

The "wall-to-wall" carpeting installed in a building in the manner described above is not an integral part of the floor itself, and therefore, the carpeting is not a permanent covering for the floor. Thus, the "wall-to-wall" carpeting in the instant case is not a "structural component" within the meaning of the regulations.

In order for property to qualify as section 38 property, it must be depreciable property and have a useful life of four years or more. Useful life is a question of fact and depends upon the facts and circumstances of each particular case. Factors which have been found to have a significant bearing on the useful life of carpeting include such variables as use, wear, traffic, style, quality and maintenance standards.

Accordingly, the "wall-to-wall" carpeting, as installed in the motel building in this case, is tangible personal property within the meaning of section 1.48-1(c) of the regulations and will qualify as "section 38 property" for investment credit purposes provided it is depreciable property having a useful life of four years or more.

**Note:** While §48 providing for an investment tax credit was repealed in 1986, the numerous rulings under this provision are often still relevant in "cost segregation" studies in determining whether property is personal property or real property. The ability to classify something in a building as personal property rather than real property provides a significant depreciation advantage.

## **Additional Guidance on Classification of Property for Depreciation Purposes**

There have been a good number of rulings on distinguishing personal from real property, particularly in the context of personal property connected to a building. There have also been several cases and rulings on the class life of personal property. Rev. Proc. 87-56 lists personal property in two broad categories to help in determining their class life for MACRS purposes. The first broad class is property used generally in all business activities, such as vehicles and office furniture. The second broad class is for personal property used in a particular activity/industry, such as semiconductor manufacturing (Asset class 36.1). Rev. Proc. 87-56 can be found using CCH or RIA. You can also see the table in [IRS Publication 946, How to Depreciate Property](#) (near the end); there is a link to the publication on the Bus 225H website.

There are numerous cases on distinguishing personal from real property (such as Rev. Rul. 67-349 above). Following is a 2002 FSA that provides an overview to some of these important cases, such as *Whiteco*, and shows how personal property can be distinguished from real property. This type of work is typically called a cost segregation study and can be quite beneficial to purchasers of certain buildings so that the personal property can be identified and depreciated over a shorter life than is available for real property.

### **FSA 200203009**

#### **ISSUES**

1. Whether tangible personal property used in connection with a hotel/casino complex is includible in asset class 57.0, Distributive Trades and Services, of Rev. Proc. 87-56, 1987-2 C.B. 674, or asset class 79.0, Recreation?
2. Whether various facades, ceilings, wall coverings, millwork, decorative lighting fixtures, kitchen equipment hookups and guest room electrical outlets, emergency power generators, and door locks of the hotel/casino complex are section 1245 property or section 1250 property for depreciation purposes?
3. Whether site utilities at the hotel/casino complex are depreciated as part of the complex or as land improvements?
4. Whether an outdoor pylon sign is depreciated over 15 years as a land improvement?

#### **CONCLUSIONS**

1. Tangible personal property used in connection with a hotel/casino complex is includible in asset class 57.0 or asset class 79.0 in accordance with the activity in which it is primarily used.
2. The exterior facades, ceilings, guest room electrical outlets, and door locks of Taxpayer's hotel/casino complex are section 1250 property for depreciation purposes. The wall coverings, millwork, decorative lighting fixtures, kitchen equipment hookups, and emergency power generators at issue in the present case are section 1245 property for depreciation purposes. However, if it can be determined that a percentage of Taxpayer's emergency power generators' output is attributable to building operations, a functional allocation would be appropriate.
3. Site utilities at the hotel/casino complex relate to the overall operation and maintenance of the complex and are depreciated as part of the complex.
4. The outdoor pylon sign is a land improvement. A portion of the sign may qualify as section 1245 property.

#### **FACTS**

Taxpayer owns and operates an elaborate hotel/casino complex that it placed in service in b. The complex cost approximately \$d million to construct, exclusive of land and pre-opening costs. Of that amount, \$e

million is being recovered through depreciation over a 5-year recovery period. The taxable years at issue are b and c.

The complex is designed to evoke an extravagant, f ambiance and, in addition to gambling facilities, offers dining, live entertainment, a shopping promenade, swimming pools, a health spa, wedding and banquet facilities, a 1200-seat theater, and over 3000 hotel rooms. During the complex's first 18 months of operation, approximately half of its net operating revenues was derived from non-casino activities.

Several categories of construction costs are at issue in the present case. These categories are described briefly below.

1. Facades

Decorative facades provide the exterior wall covering of the hotel/casino complex.

2. Ceilings

This category includes dropped or lowered ceilings with decorative finishes.

3. Wall coverings

The wall coverings at issue consist of strippable wall paper and vinyl.

4. Millwork

This category includes molding, trim, paneling, and finish carpentry located throughout the hotel/casino complex.

5. Lighting

At issue are the costs of various types of lighting fixtures, including chandeliers, wall sconces, down lighting, neon lighting, column lights, theater lighting, and the costs of the wiring and electrical connections associated with these fixtures.

6. Kitchen equipment hookups and guest room electrical outlets

This category encompasses the electrical distribution system of the kitchen as well as electrical outlets located in guest rooms and guest bathrooms.

7. Generators

Two emergency power generators provide power for emergency/safety systems and casino operations.

8. Door locks

Each hotel guest room has a computerized door lock. Guests receive key cards with entry codes recorded on the magnetic stripes.

In addition to the categories of construction costs described above, costs attributable to Taxpayer's site utilities and a large outdoor pylon sign are at issue in the present case. Site utilities are the systems that are used to distribute city- furnished utility services from Taxpayer's property line to the hotel/casino complex (building) line. Water, sewer, and gas services are connected to the building by underground piping. Electric service is connected by overhead or underground lines. The outdoor pylon sign consists of a superstructure and a television-like message center.

## LAW AND ANALYSIS

### Issue 1

Section 167(a) of the Internal Revenue Code 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 section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in section 168(a); and (2) the alternative

depreciation system in section 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of either section 168(a) or 168(g), the applicable recovery period is determined by reference to class life or by statute. 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 section 167(m) as if it were in effect and the taxpayer were an elector. Prior to its revocation, section 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 of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations sets out the method for asset classification under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowances under section 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 (that is, asset classes 00.11 through 00.4) and an activity category (that is, asset classes 01.1 through 80.0), in which case the item is classified in the asset category. See *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). The business activity asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 57.0, Distributive Trades and Services, includes assets used in wholesale and retail trade, and personal and professional services. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 9 years for purposes of section 168(g).

Asset class 79.0, Recreation, includes assets used in the provision of entertainment services on payment of a fee or admission charge, as in the operation of bowling alleys, billiard and pool establishments, theaters, concert halls, and miniature golf courses. Assets in this class have a recovery period of 7 years for purposes of section 168(a) and 10 years for purposes of section 168(g).

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.

SIC category 7011 includes establishments furnishing lodging and meals for the general public, such as hotels and motels. Former asset class 70.2, Personal and Professional Services, included assets used in the provision of personal services, such as those offered by hotels and motels. Asset class 57.0 was established by Rev. Proc. 80-15, 1980-1 C.B. 818. The revenue procedure provides that asset class 57.0 includes assets formerly included in asset class 70.2. Assets used by taxpayers engaged in hotel operations are includible in asset class 57.0.

SIC categories 7993 and 7999 include establishments engaged in operating various gaming devices and casinos. The Tax Court has characterized legal gaming as entertainment. *Libutti v. Commissioner*, T.C. Memo. 1996-108. Assets used by taxpayers engaged in gaming activities are includible in asset class 79.0.

Under section 1.167(a)-11(b)(4)(iii)(b), assets are classified according to the activity they are primarily used in, regardless of whether the activity is insubstantial in relation to all the taxpayer's activities. Thus, a taxpayer, for depreciation purposes, may be engaged in more than one activity. If a taxpayer uses assets in more than one activity, the assets are classified according to the activity in which they are primarily used.

In the present case, Taxpayer is engaged in two business activities—casino operations and hotel operations. Taxpayer's section 1245 assets are classified, for depreciation purposes, in accordance with the activity in which they are used. Assets used by Taxpayer's in its casino operations are includible in asset class 79.0. Assets used by Taxpayer's in its hotel operations are includible in asset class 57.0. If a particular asset is used in both activities, 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. Section 1.167(a)-11(b)(4)(iii)(b). This determination may be made in any reasonable manner.

Rev. Proc. 62-21, 1962-2 C.B. 418, is a predecessor of Rev. Proc. 87-56. Rev. Proc. 62-21 states that the guideline lives set forth therein apply to broad classes of assets rather than to individual assets. Supplement II, 1963-2 C.B. 744, which consists of Questions and Answers, was published to assist taxpayers in applying Rev. Proc. 62-21. Answer 78 provides a primary use rule for the classification of assets used in more than one business activity similar to the rule found in section 1.167(a)-11(b)(4)(iii)(b). Answer 78 further provides that primary use may be determined in any reasonable manner. We note that in 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 is primarily used as a retail motor fuels outlet.

Issues 2, 3, and 4

The recovery period of nonresidential real property is established by statute. 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 section 168(a) and 40 years for purposes of section 168(g). Sections 168(c) and 168(g)(2)(c). Section 168(e)(2)(B) defines “nonresidential real property” as section 1250 property which is not residential rental property or property with a class life of less than 27.5 years.

Section 168(i)(12) provides that the term “section 1250 property” has the same meaning as given by section 1250(c). Section 1250(c) provides that section 1250 property is any real property, other than section 1245 property, which is or has been of a character subject to the allowance for depreciation provided in section 167. Section 1245(a)(3) provides that “section 1245 property” includes any property that is of a character subject to the allowance for depreciation under section 167 and is personal property. Section 1.1245-3(b) provides that “personal property” includes tangible personal property as defined in section 1.48-1(c) (relating to the definition of “section 38 property” for purposes of the investment tax credit). Section 1.48-1(c) provides that “tangible personal property” means 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). Tangible personal property includes all property (other than structural components) which is contained in or attached to a building.

Section 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.

Section 1.48-1(e)(2) provides that the term “structural components” includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components

relating to the operation or maintenance of a building. The section also provides that the term “structural components” does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs.

Senate Report 1881, 1962-3 C.B. 707, 722, which accompanied the Revenue Act of 1962, states that tangible personal property includes assets accessory to a business. Senate Report 95-1263, 1978-3 C.B. (Vol.1) 315, 415, which accompanied the Revenue Act of 1978, states that tangible personal property 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, the Senate Report stated that property eligible for the investment tax credit under prior law included 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 pictures 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.

The structural components provisions of the regulations, as well as the Senate Reports cited above, have been considered by the courts in a great number of cases, some of which are discussed below. *Morrison, Inc. v. Commissioner*, T.C. Memo. 1986-129, considered whether various items of property in the taxpayer's cafeterias were tangible personal property. Among the items considered were emergency lighting, decorative lighting, lattice millwork, and decor window treatments. The court held that the emergency lighting and decorative lighting fixtures were distinguishable from the lighting fixtures specifically mentioned in the regulations as structural components because they did not provide basic illumination in the cafeterias. Citing Senate Report 95-1263, the court found the decorative lighting, lattice millwork, and decor window treatments to be decorative components that related only incidentally to the operation or maintenance of the buildings.

In its consideration of whether various items in the taxpayer's buildings were tangible personal property, the court in *Metro National Corp. v. Commissioner*, T.C. Memo. 1987-38, found that the structural components listed in section 1.48-1(e)(2) share the common characteristic of reasonable permanency. The court stated that ordinarily a building is designed and constructed with the expectation that the components listed in the regulation will remain in place indefinitely, and that such components are usually integrated with the building during the construction phase. In determining whether a particular item was a structural component, the court looked to whether the item was incorporated in the original plan, design, and construction of the building.

In *Scott Paper Co.*, 74 T.C.137, 183, the Tax Court focused on the last sentence of section 1.48-1(e)(2) of the regulations and stated that:

the effect of the final element..., which reads “and other components relating to the operation or maintenance of a building, ” must be taken into account. That final element functions as a descriptive phrase intended to present the basic test used for identifying structural components. The preceding elements are examples of items which meet that test as a general rule. 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 section 1.48-1(e)(2), Income Tax Regs.

The Court of Claims takes a different view of these provisions. In *Boddie-Noell Enterprises, Inc. v. U.S.*, 36 Cl. Ct. 722, 739 (1996), the court stated that:

[b]ased on a reading of the clear language of the above statutory and regulatory scheme, to the extent any of the claimed items are expressly listed as a building or structural component in the regulations, they should be excluded from the definition of section 38 property and are not creditable.

The Claims Court, referring to *Scott Paper Co. v. Commissioner*, 74 T.C. 137 (1980), added that “[t]his court does not feel that a relaxed interpretation of the promulgated regulations is appropriate... .” *Boddie-Noell*, 36 Cl. Ct. at 740. In *Hospital Corp. of America v. Commissioner*, 109 T.C. 21 (1997) (“HCA”), the Tax Court concluded that tests developed under prior law for investment tax credit purposes could be used by taxpayers to distinguish section 1245 property from section 1250 property for depreciation purposes. In HCA the court considered whether various items in the taxpayer's buildings were structural components of the buildings or section 1245 property. In making this determination the court employed the factors set forth in *Whiteco Indus., Inc. v. Commissioner*, 65 T.C. 664, 672-673 (1975), to ascertain whether the items were inherently permanent and, accordingly, structural components. These 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 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 to the land?

Referring to its earlier decisions in *Scott Paper* and *Morrison*, the court in HCA also stated that an item constitutes a structural component of a building if the item relates to the operation and maintenance of the building. Property used to aid in the employment of a particular function or particular piece of property is not a structural component.

*L.L. Bean, Inc. v. Commissioner*, 73 TCM 2560 (1997), considered whether a storage facility, known as the “mezzanine system,” located within the taxpayer's shipping building was section 38 property. The mezzanine system, part of the original construction plan when the shipping building was designed, did not support the ceiling or walls of the shipping building. Various other elements were connected to, or suspended from the underside of, the mezzanine system, including cable, electricity and communications, lighting fixtures, and sprinkler piping. The court found that the building was planned and designed with the integration of the mezzanine system in mind and concluded that the substantial time and effort involved in both the construction and potential removal of the system, as well as the degree of its integration with the building, reflected the permanent nature of the system. The court also concluded that these factors indicated that the mezzanine system was related to the operation and maintenance of the shipping building.

In *L.L.Bean*, the court also considered whether a particular facility could be considered an improvement to land because it was movable. The court stated that proper application of the *Whiteco* factors rests on the premise that movability itself is not the key determinant of lack of permanence, and the mere fact that the facility could theoretically be moved did not establish that it was not inherently permanent. See also HCA, 109 T.C. at 57. In finding that the facility was inherently permanent, the court noted that the facility was specifically designed for the site as an addition to taxpayer's distribution center and that the time and effort involved to move the facility would be substantial.

In the Action On Decision (AOD) in HCA, 1999-008 (August 30, 1999), the Service acquiesced in the court's decision to the extent that it held that the tests developed under prior law for investment tax credit purposes could be used by taxpayers to distinguish section 1245 property from section 1250 property for depreciation purposes. However, the Service did not agree with the conclusions reached by the court with respect to the various items of property at issue in the case. The reference in the AOD to *Boddie-Noell*

and *La Petite Academy, Inc. v. United States*, 95-1 U.S.T.C. (CCH) 50,193 (W.D. Mo. 1995), cases in which items of property found by the HCA court to be section 1245 property were found to be section 1250 property, is an indication that the Service will carefully consider whether items of property specifically listed in the regulations as structural components are, because in the context of a particular case they appear in unusual circumstances and do not relate to the operation or maintenance of the building, section 1245 property.

The preceding discussion indicates that the determination of whether a particular item of property is a structural component of a building is highly factual. Of necessity the determination will involve an intense analysis of the facts and circumstances of the particular case. Unfortunately, no bright line test exists.

In the following discussion, we will apply the principles discussed above to the particular circumstances of the present case from the perspective of the national office. We will briefly consider each category of property at issue. The conclusions we reach regarding these categories are subject to change as warranted by continued factual development. As indicated above, items listed in the regulations are presumed to be structural components unless it can be shown that, because of unusual circumstances, they do not relate to the operation or maintenance of the building.

#### 1. Exterior facades

Taxpayer states that in designing its hotel/casino complex its intention was to create a theme with which its patrons could identify. To this end, Taxpayer incorporated a specific decor into the property as a compliment to its overall theme of extravagance.

The decorative exterior wall covering was placed on the entire exterior of Taxpayer's buildings to help create the theme for the hotel/casino complex. It 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. The synthetic plaster is not readily moveable. In order to comply with local building codes, the facade was designed to withstand an 85 mph wind load. The facades provide a barrier to the outside elements and their removal would expose other building elements to degradation.

Section 1.48-1(e)(2) provides that the term "structural components" includes such parts of buildings as walls, as well as any permanent coverings therefor. Because there is no indication that Taxpayer's exterior facades are easily removable, under the general rule, they would fall within the scope of this provision unless it can be shown that, because of unusual circumstances, they do not relate to the operation or maintenance of the buildings.

An essential element of Taxpayer's overall theme, the exterior facades were part of Taxpayer's original plan of construction. To support this theme, the exterior facades were designed and constructed with the expectation they would remain in place indefinitely. Further, they were integrated with the buildings during their construction. Under *Metro* and *L.L.Bean* these factors are indicative of structural components.

The decorative nature of the exterior facades does not, by itself, mean that the facades occur in unusual circumstances and are not related to the operation or maintenance of the buildings, the exception to the general rule discussed in *Scott Paper* and *HCA*. Among the items considered by the Claims Court in *Boddie-Noell* were decorative mansard roof panels. Rejecting the taxpayer's argument, based upon Senate Report 95-1263, that the panels were analogous to false balconies and only incidentally related to the operation or maintenance of the building, the court found that the roof panels performed the essential function of keeping out the elements.

Decorative mansard roofs were also at issue in *La Petite*. Noting that the mansard roof was part of the initial construction of the buildings, the court found that the mansard roof was integrated into the overall roof system and was intended to remain permanently in place. The court observed that removal of the mansard roof would result in the direct exposure of various building components to water, snow, wind, and moisture damage. The court concluded that the roof had a more than incidental relationship to the operation or maintenance of the building.

Taxpayer's exterior facades are similar to the mansard roofs discussed in the preceding paragraph. Like the roofs, they perform the essential function of protecting other building components from the elements. The facades were designed to withstand severe weather conditions and their removal would expose the buildings to significant damage and would necessitate major reconstruction. Thus, their relation to the operation or maintenance of the buildings is more than incidental. Because it cannot be argued that the facades do not relate to the operation or maintenance of the buildings, the exception to the general rule found by the court in *Scott Paper* and *HCA* is not applicable to Taxpayer's facades and, thus, they constitute section 1250 property.

We note that even if the facades were moveable this fact would not be dispositive. In *L.L.Bean* the court noted that an element of a building so integrated with the structure of the building that it is unlikely to be moved will be considered to be a structural component.

## 2. Decorative ceilings

The ceilings consist of 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 hide plumbing, wiring, sprinkler systems and air conditioning ducts. By serving as a channel for the return air, the ceilings also operate as a component of the heating and air conditioning system.

Section 1.48-1(e)(2) provides that the term "structural components" includes such parts of a building as ceilings, as well as any permanent coverings therefor. Taxpayer's decorative ceilings are capable of being moved, but movability itself is not the key determinant of lack of permanence. *L.L.Bean*. In *HCA*, the court concluded that suspended acoustical ceilings were structural components and stated that movability is only one factor to be considered in determining whether property is a structural component.

Many of our observations regarding Taxpayer's exterior facades are equally applicable to Taxpayer's decorative ceilings. Like the facades, the decorative ceilings were designed to enhance the overall theme of the hotel/casino complex and they were part of the original plan of construction. While removal of the ceilings would not place other elements of the building in jeopardy, it would require a major renovation of the interior of the building because the wiring, plumbing, and ventilation components located behind the ceilings would be exposed. Like the mezzanine system considered by the court in *L.L.Bean*, other building elements are connected to the ceilings. In addition, the ceilings complement the buildings' heating and air conditioning systems. Of course, removal of the ceilings would have an adverse effect on Taxpayer's overall theme. These factors suggest the likelihood of ceiling removal is very low. Accordingly, we conclude that Taxpayer's decorative ceilings are integrated into the overall design of the buildings sufficiently to be considered structural components of the buildings.

We note that suspended or "false" ceilings were found to be structural components by the courts in *Metro*, *Boddie-Noell*, and *HCA*.

## 3. Wall coverings

The wall coverings at issue are described as "strippable wall paper and vinyl wall coverings." The wall coverings are installed using strippable adhesive and can be removed easily for repair work and renovation projects. Such removal will not damage the walls.

Section 1.48-1(e)(2) provides that the term "structural components" includes such parts of buildings as walls, as well as any permanent coverings therefor. Application of the *Whiteco* factors to the wall coverings at issue does not support a structural component conclusion. Taxpayer's easily removable wall coverings are similar to the vinyl wall coverings considered by the court in *HCA*. In that case the court concluded that the vinyl wall coverings were not intended to be, and were not, a permanent covering for the hospital walls. The court contrasted the hospital's easily removable vinyl wall coverings with the tiles glued to the walls and floors of a fast food restaurant, which the court found to be structural components in *Duaine v. Commissioner*, T.C. Memo. 1985-39. The court's analysis in this context is consistent with

the Service's focus on manner of attachment as discussed in Rev. Rul. 67-349, 1967-2 C.B.48, which holds that carpeting put down on a floor with wooden carpet strips is not integral to the floor.

As noted by the court in *Metro*, the items listed in the regulations are generally installed with the expectation that they will remain in place indefinitely. The removal of Taxpayer's wall coverings would not require the degree of time and expense indicative of the structural integration discussed in *L.L.Bean* and *Metro*. Accordingly, we believe Taxpayer's wall coverings are not structural components and should be treated as section 1245 property.

We note that language in Senate Report 95-1263 indicates that adhesive attachment is recognized as non-permanent.

#### 4. Millwork

“Millwork” refers to the decorative finish carpentry located throughout Taxpayer's hotel/casino complex. These items were manufactured at millwork plants and brought to the building site for installation. Examples of Taxpayer's millwork include detailed crown moldings for the ceilings, ornate wall paneling systems, and lattice work for walls and ceilings. Obviously, the buildings were designed with the finished carpentry in mind, and the millwork serves to enhance Taxpayer's overall theme for the hotel/casino complex.

Section 1.48-1(e)(2) provides that the term “structural components” includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling. The question presented is whether Taxpayer's millwork constitutes a permanent covering for these structural components. Based upon the material submitted, we are unable to determine if, under a *Whiteco* analysis, the millwork would be considered inherently permanent. However, the agent has indicated that the millwork is easily removable.

In our discussion of Taxpayer's decorative ceilings, we indicated that movability is only one factor to be considered in determining whether property is a structural component. However, unlike the ceilings in the present case, there is no indication that the millwork performs any building functions or provides a platform for other building elements. Thus, while removal of the millwork would effect the appearance of the buildings, it would not effect the buildings' operation in any material way. Accordingly, the millwork is not integrated into the design and construction of the buildings in the sense discussed by the courts in *Metro* and *L.L.Bean*.

The agent is correct in observing that particular items of millwork, such as doors and windows, are integral parts of finished building components. However, these items perform essential building functions while the millwork at issue appears to be merely decorative and does not relate to the operation or maintenance of Taxpayer's buildings. See Senate Report 95-1263.

We note that in *Morrison* lattice millwork and decor window treatments were found to be tangible personal property. The court found that these items served merely decorative functions and could easily be removed at little cost without permanently damaging the underlying ceiling or walls. However, the court found that vanity cabinets and counters were structural components because they were permanently attached to the walls. The court found they could not be removed without damaging the underlying walls.

Based on the facts presented in the present case, we believe that Taxpayer's millwork should be treated as section 1245 property. Our consideration of Taxpayer's millwork assumes that, under *Whiteco*, it would not be considered to be permanently attached to other building elements. A different result would be obtained if the millwork is installed in such a way as to render it comparable to the cabinets and counters considered by the court in *Morrison*.

#### 6. Lighting

Taxpayer's hotel/casino complex makes use of a variety of lighting fixtures. Basic illumination is provided by recessed ceiling lights. These lights are classified as structural components and are not at issue. Additional illumination is provided by a variety of decorative lighting fixtures, including

chandeliers, wall sconces, track spot lighting, torch lighting, and wall wash fixtures. Again, these decorative lights serve to enhance Taxpayer's overall theme.

Section 1.48-1(e)(2) includes electric wiring and lighting fixtures as an example of structural components. However, under *Scott Paper* and *HCA*, these items must relate to the operation or maintenance of the building in order to be structural components.

Senate Report 95-1263 states that “special lighting” relates only incidentally to the operation or maintenance of a building and should be considered tangible personal property. In *Metro* the court concluded that decorative lighting was special lighting within the meaning of the Senate Report. In *Morrison* the court stated that lighting fixtures and electrical connections that do not provide basic illumination and are accessory to a business are not structural components. The court found the taxpayer's chandeliers and decor wall lights to be special lighting unrelated to the operation or maintenance of the building. In *Duaine* decorative lighting fixtures were found to be structural components because they provided the only lighting in the building.

In the present case, basic illumination is provided by recessed ceiling fixtures. Although admittedly on a much grander scale, we believe Taxpayer's decorative lighting is analogous to the circumstances addressed by the court in *Morrison*, and is special lighting only incidentally related to the buildings' operation or maintenance. Thus, we conclude that Taxpayer's decorative lighting at issue should be treated as section 1245 property.

#### 7. Kitchen equipment hookups and guest room electrical outlets

The kitchen equipment hookups comprise the electrical distribution system of the kitchen. The distribution system is designed to provide the right amount of electrical current to each utilization point.

While section 1.48-1(e)(2) specifically includes electric wiring as an example of a structural component, under the case law the test is whether the particular item relates to the operation or maintenance of the building. In *Scott Paper* and *Morrison* the court stated that even though the regulations specifically mention such items as “wiring and lighting fixtures” in describing structural components, the item must relate to the operation or maintenance of the building in order to be classified as a structural component. Accordingly, the court focused on the ultimate uses of power at the buildings and distinguished the power used in the buildings' overall operation or maintenance, such as lighting, heating, ventilation, and air conditioning, from the power used to operate equipment and machinery.

Components associated with equipment were considered tangible personal property. Similarly, in *Duaine*, the court concluded that electrical outlets and conduits providing localized power sources for specialized restaurant equipment constituted personal property.

We assume that the kitchen equipment hookups at issue in the present case are similar to the equipment considered by the court in *Morrison* and *Duaine*. We note that in *Morrison* the Service argued to no avail that the electrical kitchen components were of standard design rather than specially designed for the taxpayer's cafeterias. Accordingly, we conclude that Taxpayer's kitchen equipment hookups are not structural components and should be classified as section 1245 property.

The electrical outlets at issue are located in guest rooms and guest bathrooms. These outlets provide general access to electrical power and are not specifically associated with particular items of hotel equipment. Although some hotel equipment may be connected to these outlets, such as televisions, radios, and lighting fixtures, these items are easily disconnected and reconnected to other outlets. In *HCA*, the court classified electrical outlets in accordance with whose equipment (employee versus non-employee) could be connected to them. We share the agent's view that it is a simple matter to change the equipment at any wall outlet, especially in a hotel room. We conclude that electrical outlets of general applicability and accessibility perform an essential building function and are structural components.

#### 8. Emergency power generators

Taxpayer's emergency power system consists of two emergency standby generators with associated fuel tanks, feeder lines, alternator and controls, and battery powered lighting for critical operations. From the

material submitted, we are uncertain as to the precise systems supported by Taxpayer's two emergency power generators. It is stated that one of the generators is sufficient to operate the "emergency/safety" features of Taxpayer's buildings, but that both generators are tied to the buildings' emergency/safety features. Apparently, excess capacity is utilized by Taxpayer's other hotel/casino equipment.

In HCA the court considered whether taxpayer's hospitals' primary and secondary electrical distribution systems were structural components. With its focus on the ultimate uses of power at the hospital buildings, the court followed its decisions in Scott Paper and Morrison, discussed above, and concluded that the portion of the cost of the primary and secondary electrical distribution systems in the taxpayer's hospitals that is equal to the percentage of the electrical load carried to those systems allocable to the hospitals' equipment is depreciable as section 1245 property.

In a Revised Action on Decision in Illinois Cereal Mills, Inc. Commissioner, T.C. Memo 1983-469, the Service agreed that it would no longer challenge the functional allocation approach set forth in Scott Paper regarding the classification of electrical systems as section 38 property.

While it is true, as the agent says, that in HCA the parties agreed before trial that the emergency generators at issue in that case were tangible personal property, the court did state that, in its view, the generators were assets accessory to the conduct of the taxpayer's business within the meaning of Senate Report 1881 and, consequently, did not relate to the operation or maintenance of the buildings. Similar reasoning had been applied by the court in Morrison, where the court concluded that the taxpayer's emergency lighting fixtures were not structural components but were assets accessory to the cafeteria business that enabled the taxpayer to accomplish its business objectives. Accordingly, we believe Taxpayer's emergency power generators should not be classified as structural components. However, if it can be determined that a percentage of Taxpayer's emergency power generators' output is attributable to building operations, a functional allocation along the lines of Scott Paper would be appropriate.

#### 9. Door locks

Doors are specifically listed as structural components in section 1.48-1(e)(2). Under the case law, the listed items are structural components of a building as a general rule and will be considered as such unless they occur in unusual circumstances and do not relate to the operation and maintenance of the building. See Metro and HCA. Doors, especially in the context of a hotel building, are useless without a locking system. The locks are an integral part of the door. Further, the door locks are essential to the operation of the building as a hotel. We see no unusual circumstances surrounding Taxpayer's doors. Accordingly, the door locks, as an integral part of the doors, should be considered to be structural components of the building and should be classified as section 1250 property.

We note that the Tax Court applied both Scott Paper and Whiteco to interior doors in Morrison. The court stated that "doors constitute a structural component only if they are a permanent part of the cafeteria building, so that their removal would affect the essential structure of the building." However, the court also stated that the doors at issue did not function as an integral part of the taxpayer's cafeterias. As mentioned in the preceding paragraph, doors are essential to the operation of Taxpayer's building as a hotel. As such, they function as an integral part of Taxpayer's hotel.

#### Site Utilities

Taxpayer refers to the list of specific structural components in section 1.48-1(e)(2) in support of its contention that the site utilities at issue are land improvements rather than structural components. However, this section provides that structural components include, in addition to the specific items listed, "other components relating to the operation and maintenance of a building."

Rev. Rul. 70-160, 1970-1 C.B. 7, holds that an electrical distribution system transmitting energy from the power company to a building does not qualify as section 38 property because the system is a permanent building component servicing the overall electrical needs of the building and, as such, is a structural component relating generally to the overall operation of the building. The revenue ruling notes that the electrical distribution system is not directly associated with specific items of machinery or equipment.

The various site utilities at issue in the present case are analogous to the electrical distribution system addressed in Rev. Rul. 70-160. They distribute city furnished utility services to the building and are not directly associated with specific items of machinery and equipment. They will not be retired contemporaneously with the retirement of particular assets. Accordingly, the site utilities relate to the overall operation and maintenance of Taxpayer's building and are treated as structural components for depreciation purposes.

#### Outdoor Pylon Sign

The large outdoor pylon sign is used to draw attention to Taxpayer's hotel/casino complex and serves to enhance Taxpayer's f casino theme. The sign is not attached to a building. Taxpayer argues that the sign qualifies as personal property under the "sole justification test" of section 1.48-1(e)(2), and that the Whiteco factors are not applicable. We disagree with these contentions. The sole justification test is used to determine whether a particular item of property specifically listed in the regulations as an example of a structural component (for example, an air conditioning system) is, in the particular factual circumstances presented, a structural component of a building. Without considering whether Taxpayer's sign is the type of property to which the sole justification test is applicable, in the present case the issue presented is not whether the sign is a structural component of a building but whether the sign is an inherently permanent structure. Under section 1.48-1(c), tangible personal property does not include buildings or other inherently permanent structures. Accordingly, whether the sign is an inherently permanent structure is determined by application of the Whiteco factors.

We assume that under a Whiteco analysis the outdoor pylon sign would be determined to be an inherently permanent structure. Because this sign is not a building and asset class 79.0 does not include land improvements, Taxpayer's outdoor pylon sign is treated for depreciation purposes as a land improvement includible in asset class 00.3 of Rev. Proc. 87-56 and is depreciable over 15 years.

Rev. Rul. 69-170, 1969-1 C.B. 28, considered whether various items appurtenant to a sports stadium qualified as tangible personal property. Among the items considered were scoreboards and message boards mounted on large steel poles, attached to concrete foundations with steel bolts. The scoreboards and message boards were separate and apart from the stadium structure. The revenue ruling concluded that the score boards and message board were inherently permanent structures that housed equipment and circuitry. After noting that the equipment and circuitry can be replaced without having to replace the supporting and enclosing structure, the ruling held that the equipment and circuitry were tangible personal property but that the supporting and enclosing structures were inherently permanent structures.

Taxpayer's outdoor pylon sign is analogous to the score boards and message boards addressed in Rev. Rul. 69-170. If the sign houses electronic equipment, a portion of the sign should be treated as tangible personal property.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As stated previously in our memorandum, the determination of whether a particular item of property is a structural component involves an intense factual analysis with few easy answers. Using the Whiteco factors as a general guideline XXXXXXXXXXXX we recommend consideration including, but not limited to, the following points:

- the manner in which the various items are attached to the buildings or the land;
- the weight and size of the items;
- the time and costs required to move the components;
- amount of personnel required in planning and executing a move;
- the type and quantity of equipment required for a move;
- the history of these items or similar items being moved;

- the time, cost, manpower and equipment required to reconfigure the existing space if the items are removed;
- any intentions regarding removal or retention;
- is the item designed to be moved;
- is the item readily usable in another location;
- the amount of wiring, plumbing, duct work and other infrastructure housed by or hidden by the item;
- the costs incurred with respect to the infrastructure required if the item were to be moved.

### **Must property have a determinable useful life to be depreciable under MACRS?**

With the addition of specified lives at §168 (MACRS), an issue arose as to whether an asset with no determinable useful life, such as a valuable work of art, is depreciable. The IRS and courts have not taken consistent interpretations of the law. Following are two cases which also refer to other cases where either due to use or obsolescence, the courts held that property was a wasting asset depreciable under MACRS. The determination of an asset as depreciable or not also has a bearing on its treatment under §1221 (capital asset), §1231 and for charitable contribution treatment (§170).

#### **Bruce Selig, et ux., TC Memo 1995-519 (excerpt)**

After concessions, the issues remaining for decision are (1) whether petitioners are allowed depreciation deductions with regard to certain “exotic automobiles” owned and exhibited by petitioner husband, ...

#### **FINDINGS OF FACT**

Some of the facts have been stipulated and are so found. The stipulations of fact filed by the parties and attached exhibits are incorporated herein by this reference.

Petitioners resided in Cherry Hill, New Jersey, at the time the petition was filed.

Petitioners are husband and wife, who made joint returns of income for each of the years in question.

Petitioner husband (Petitioner) is a successful businessman. In 1983, petitioner opened a limousine leasing business under the name “Scott's Limo & Leasing” (Scott's Limo). Scott's Limo was conducted as a sole proprietorship. Exotic automobiles are state-of-the-art, high technology vehicles with unique design features or equipment. In 1987 and 1988, petitioner purchased the following exotic automobiles (the exotic automobiles) to be exhibited at car shows:

Year of Purchase	Type	Cost
1987	Lotus Pantera	\$ 63,000
1987	Lotus Espirit	\$ 48,000
1988	Gemballa Ferrari Testarossa	\$290,453

During the years in issue, Scott's Limo displayed the exotic automobiles at car shows and earned fees for doing so. For 1987 through 1990, Scott's Limo received gross income with respect to the exotic automobiles as follows:

Year	Gross Income
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1987	\$ 8,555
1988	38,120
1989	24,295
1990	25,760

The exotic automobiles did not have license plates and were not set up to be used on the street. They were not driven and were used exclusively for car shows or related promotional photography.

Petitioners claimed the following depreciation deductions with regard to the exotic automobiles:

Automobile	Depreciation Claimed In:			
	1987	1988	1989	1990
Lotus Pantera	\$12,600	\$20,160	\$12,096	\$ 7,258
Lotus Espirit	9,600	15,360	9,216	5,530
Gemballa Ferrari Testarossa		58,091	92,945	55,767

Exotic Bodies, Inc. (the corporation), is a New Jersey corporation. At all times here relevant, the corporation was wholly owned by petitioner. The corporation was organized in 1987. For 1988, 1989, and 1990, the corporation was an S corporation within the meaning of section 1361(a)(1). For those years, the corporation made its Federal income tax returns on the basis of a calendar year. The corporation was formed for the purpose of putting together exotic cars for shows as well as for cross-promoting different products (e.g., automobile-related paraphernalia, such as T-shirts and frames for license plates). The corporation was a marketing vehicle for the promotional aspects of the exotic cars owned by petitioner.

## OPINION

### I. Introduction

We must decide (1) whether certain automobiles owned by petitioner give rise to deductions for depreciation for tax purposes, (2) whether petitioner's S corporation was in a trade or business, so that petitioners may claim certain losses incurred by such corporation, and (3) whether petitioners are liable for certain additions to tax. Petitioners bear the burden of proof. Rule 142(a).

### II. Depreciation

Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction.<sup>1</sup>

Generally, section 168(a) provides that the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using certain applicable methods, periods, and conventions.<sup>2</sup>

Exotic automobiles are state-of-the-art, high technology vehicles with unique design features or equipment. Petitioner owned exotic automobiles that, during 1987 through 1990, he exhibited for a fee. The fees earned by petitioner for such exhibitions were substantially less than the depreciation deductions petitioner claimed with respect to such automobiles.

The parties do not dispute either that (1) the exotic automobiles are tangible property or (2) the exotic cars were used in petitioner's trade or business. Also, they do not dispute any aspect of applying section 168 to the exotic automobiles if we conclude that section 168 is applicable to the exotic automobiles. The dispute between the parties is whether a depreciation deduction is allowable under section 167(a) for automobiles held in a pristine condition and exhibited for a fee.

The long and the short of it is yes, provided the automobiles are subject to obsolescence. We have found that the exotic automobiles were state-of-the-art, high technology vehicles with unique design features or equipment. We have no doubt that, over time, the exotic automobiles would, because of just those factors, become obsolete in petitioner's business. The fact that petitioners have failed to show the useful lives of the exotic automobiles is irrelevant. Cf. *Liddle v. Commissioner*, 103 T.C. 285, 296-297 (1994), affd. 65

F.3d 329 (3d Cir. 1995); *Simon v. Commissioner*, 103 T.C. 247 (1994), *affd.* \_\_\_\_ F.3d \_\_\_\_ (2d Cir. 1995)

In the *Liddle* and *Simon* cases, we interpreted section 168, as added to the Code by section 201(a) of the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. 97- 34, 95 Stat. 172, 204 (sec. 168 (1981)). The operative term in section 168 (1981) is “recovery property”. The term “recovery property” is defined in relevant part to mean “tangible property of a character subject to the allowance for depreciation \*\*\* used in a trade or business”. Sec. 168(c)(1) (1981). In the *Simon* case, we dealt with two antique violin bows that the taxpayers, both professional musicians, used in that trade or business. In the *Liddle* case, we dealt with an antique viol, also used by a professional musician in his trade or business. In both cases, we rejected the Commissioner's argument that, for the instruments to be property of a character subject to the allowance for depreciation (i.e., recovery property within the meaning of section 168(c)(1) (1981)), the taxpayers had to show the useful life of the property. *Liddle v. Commissioner*, *supra* at 296; *Simon v. Commissioner*, *supra* at 264. We found it sufficient that the taxpayers had proven that the instruments were subject to exhaustion, wear and tear, or obsolescence. *Liddle v. Commissioner*, *supra* at 296-297; *Simon v. Commissioner*, *supra*.

In 1986, Congress extensively revised and restated section 168. Tax Reform Act of 1986 (TRA 86), Pub. L. 99-514, sec. 201(a), 100 Stat. 2121. As restated, section 168 is applicable to property placed in service after 1986. TRA 86, Pub. L. 99-514, sec. 203(a)(1), 100 Stat. 2143. The term “recovery property” does not appear in section 168, as restated. There is no indication, however, that Congress intended to reimpose the requirement, eliminated by ERTA, that a taxpayer must show the useful life of property if the taxpayer is to determine the section 167 depreciation deduction under section 168. Therefore, we shall follow *Liddle v. Commissioner*, *supra*, and *Simon v. Commissioner*, *supra*, in interpreting section 168, as restated. Accordingly, if petitioners can show that the exotic automobiles were subject to exhaustion, wear and tear, or obsolescence, they are entitled to the depreciation deductions that they claimed.

Petitioners do not seriously attempt to prove that the exotic automobiles were subject to wear and tear in the sense of physical deterioration. Indeed, they state that obsolescence is the principal basis for their claim of depreciation deductions. Respondent argues that petitioners have failed to prove that the exotic automobiles are subject to obsolescence.

From the beginning, it has been clear that a taxpayer could recover the cost of business property over a period shorter than the ordinary useful life of the property if the taxpayer could show that the assets would become obsolete in the business prior to the end of such ordinary useful life. See, e.g., *Columbia Malting Co. v. Commissioner*, 1 B.T.A. 999, 1001 (1925). Section 1.167(a)-9, Income Tax Regs., addresses obsolescence. In pertinent part, it states:

The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. \*\*\*

In *Columbia Malting Co. v. Commissioner*, *supra* at 1001, we said:

In order that the taxpayer may be entitled to the obsolescence deduction in the years involved, there must have been substantial reasons for believing that the assets would become obsolete prior to the end of their ordinary useful life, and second, it must have been known, or believed to have been known, to a reasonable degree of certainty, under all the facts and circumstances, when that event would likely occur. \*\*\*

Under section 168(a), we need not concern ourselves with the second part of that test (when obsolescence would occur), since we need not determine the actual useful life of the property. As to the first part of the test, we assume that the “ordinary” useful life of the exotic automobiles in petitioner's trade or business (as show cars) was indeterminable. Petitioners have introduced no evidence from which we could find that the exotic automobiles were subject to wear and tear or exhaustion. Nevertheless, we are convinced that the exotic automobiles had a limited useful life as show cars.

The exotic automobiles are state-of-the-art, high technology vehicles with unique design features or equipment. Petitioner testified that show cars such as the exotic automobiles:

are state of the art and within three years or four years, five years, there could be new cars that are more state of the art and cars change based on their technological opulence \*\*\*

A business associate of petitioner's, Leon Altemose, who had staged exotic car shows testified:

These highly customized, modified exotic cars have a limited life and I think it's about a year, typically, maybe two years and then they start to drop significantly in value because they are replaced by something better.

We do not need to determine the precise useful life of the exotic automobiles. Indeed, petitioner testified that some of the exotic automobiles might be shown for many years. Nevertheless, we are convinced that the exotic automobiles, precisely because of their nature as state-of-the-art, high technology vehicles, had a useful life as show cars shorter than their ordinary useful life and, thus, suffered obsolescence. We so find.

Explicit in our finding is a finding that the exotic automobiles were not museum pieces of indeterminable useful life. Respondent cites us the U.S. Court of Claims' decision in *Harrah's Club v. United States*, 228 Ct. Cl. 650, 661 F.2d 203 (1981). At issue there was the cost of restoring antique automobiles primarily held for display in connection with the taxpayer's trade or business. The taxpayer argued that the restoration costs were depreciable over the period in which the restoration could be estimated to be useful in the business of the taxpayer. The U.S. Court of Claims disallowed a depreciation deduction in part on the basis that: “The evidence establishes that there is no limit on the useful life of a restored car or other vehicle as a museum object.” *Id.*, 661 F.2d at 207. In *Simon v. Commissioner*, 103 T.C. at 264, we acknowledged that, to qualify as recovery property, in the case of a passive business asset that suffered no wear and tear, a taxpayer would have to prove a determinable useful life. An example of a passive business asset that normally would suffer no wear and tear is a painting displayed for business purposes. E.g., *Clinger v. Commissioner*, T.C. Memo. 1990-459 (painting purchased by a professional artist and displayed in part for marketing reasons not recovery property for failure to prove determinable useful life). Once a taxpayer establishes that an asset is subject to exhaustion, wear and tear, or obsolescence, however, we need not concern ourselves with the particular useful life of the asset. *Liddle v. Commissioner*, 103 T.C. at 296- 297; *Simon v. Commissioner*, *supra*. It is of course possible that the exotic automobiles might some day become museum pieces. Respondent suggests that they were museum pieces, but she offers no evidence to support that claim. We are satisfied that the exotic automobiles were show cars, which, because of obsolescence, had a limited useful life, not museum pieces with an indeterminable useful life. The facts of the *Harrah's Club* case are distinguishable.

Decision will be entered under Rule 155.

1

Sec. 167(a) provides as follows:

General Rule. — There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) —

(1) of property used in the trade or business, or (2) of property held for the production of income.

2

Sec. 168(a) provides as follows:

### Accelerated Cost Recovery System

General Rule. — Except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using —

the applicable depreciation method, (2) the applicable recovery period, (3) the applicable convention.

*O'Shaughnessy v. Comm'r.*, 89 AFTR 2d 2002-658 (DC MN), aff'd wrt depreciation issue, 91 AFTR 2d 2003-2559 (8<sup>th</sup> Cir.)

“To determine whether the original volume of tin “is property of a character subject to the allowance for depreciation,” I.R.C. § 168(c), the sole question the Court must answer is whether the property in question, that is, the original volume of tin, suffers exhaustion, wear and tear, or obsolescence within the meaning of § 167. *Liddle v. Commissioner*, 65 F.3d 329, 334–35 (3d Cir.1995) (to demonstrate that property is “recovery property” under 168(c)(1), “[plaintiffs] must only show that the [violin] bass was subject to exhaustion wear and tear”); *Simon v. Commissioner*, 68 F.3d 41, 47 (2d Cir.1995) (“The test is whether property will suffer exhaustion, wear and tear, or obsolescence in its use by a business.”).”

### **Extrusions Division, Inc., TC Memo 1995-370 (excerpt)**

A taxpayer whose investment in property is sufficient to give him or her a depreciable interest therein may deduct depreciation under section 168 if the property meets the four-prong test enunciated in *Simon v. Commissioner*, 103 T.C. 247, 259- 260 (1994); i.e., the property: (1) Is tangible personal property, (2) is placed in service after 1980, (3) is used in the taxpayer's trade or business, or held for the production of income, and (4) is of a character subject to the allowance for depreciation. Accordingly, petitioner may deduct depreciation on the subject automobiles if petitioner has a depreciable interest in the automobiles AND the automobiles meet the four-prong *Simon* test. *Simon v. Commissioner*, supra at 253, 259-260; see also *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 254 (1939); *Mayerson v. Commissioner*, 47 T.C. 340, 350 (1966); *Gladding Dry Goods Co. v. Commissioner*, 2 B.T.A. 336, 338 (1925). Although a taxpayer usually must have ownership of depreciable property in order to deduct depreciation thereon, a lack of ownership is not determinative. Depreciation may generally be deducted to the extent that the taxpayer proves that he or she actually expended capital in the acquisition or improvement of the property. *Helvering v. F. & R. Lazarus & Co.*, supra at 254; *Currier v. Commissioner*, 51 T.C. 488, 492 (1968); *Hunter v. Commissioner*, 46 T.C. 477, 490 (1966); *Blake v. Commissioner*, 20 T.C. 721, 732 (1953).

### **Action on Decision 1996-009**

*Richard L. and Fiona Simon v. Commissioner*, 68 F.3d 41 (2d Cir. 1995), aff'g 103 T.C. 247 (1994)

#### Issue

Whether professional musicians are entitled under I.R.C. section 168 to depreciate their antique musical instruments used in their trade or business, notwithstanding that the instruments have no determinable useful lives.

#### Discussion

The taxpayers claimed depreciation deductions for two nineteenth-century violin bows used in their careers as professional musicians. The instruments were purchased and placed in service during the taxable years governed by the accelerated cost recovery system (ACRS). The taxpayers claimed depreciation deductions as determined under I.R.C. section 168(b) with respect to 5-year recovery property. The Service disallowed taxpayers' depreciation deductions in full. See also *Liddle v. Commissioner*, 65 F.3d 329 (3d Cir. 1995), aff'g 103 T.C. 285 (1994) (depreciation deduction allowed for a seventeenth-century bass viol).

Section 167(a), which provided a “reasonable allowance” for depreciation, was amended to provide that the deduction allowable under section 168 shall be deemed to constitute such reasonable allowance. Section 203(a) of the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 1981-2 C.B. 283. Section 168 (added to the Code by section 201(a) of ERTA, 1981-2 C.B. 275) established the ACRS method of depreciation. Under section 168, the cost or other basis of eligible property was recovered using an accelerated method of depreciation over a predetermined recovery period. Eligible property, i.e., “recovery property”, was assigned to one of five classes of property each with its own designated recovery period. I.R.C. section 168(c). The term “recovery property” was defined as “tangible property of a character subject to the allowance for depreciation.” I.R.C. section 168(c)(1).

Prior to the enactment of ACRS, the concepts of useful life and salvage value were factors to be considered in determining the eligibility of an asset for a depreciation deduction. The amount of depreciation was limited to the cost or other basis of the property less a reasonable estimate for salvage value. The useful life was determined based on the facts and circumstances or under an asset depreciation range. See former I.R.C. section 167(m), section 109(a) of the Revenue Act of 1971, Pub. L. No. 92-178, 1972-1 C.B. 443, 450. Although ACRS statutorily eliminated the concept of salvage value by permitting the entire cost of an asset to be recovered, I.R.C. section 168(b), it did not diverge from the concept that to be entitled to depreciation, property had to have a determinable useful life.

The dispute is whether taxpayers' antique musical instruments constitute “recovery property” as defined in section 168(c)(1). Resolution of that question depends upon the meaning of the phrase “property of a character subject to the allowance for depreciation.” The government argued that antique musical instruments that do not have a determinable useful life are not “of a character subject to the allowance for depreciation.”

The Tax Court construed the phrase “property of a character subject to the allowance for depreciation” as including any property used in a trade or business that is subject to exhaustion, wear and tear or obsolescence, even if such property has an indeterminable useful life and concluded that the musical instruments were subject to wear and tear and thus depreciable. The Second Circuit (Simon) and the Third Circuit (Liddle) affirmed the Tax Court.

It is the Service's position that the enactment of ACRS merely shortened the recovery period over which an asset is depreciated to stimulate economic growth but did not convert assets that formerly were not depreciable into assets that are depreciable. The Senate Report, in discussing property that is depreciable under section 168, notes that “assets that do not have a determinable useful life and that do not decline in value predictably are not depreciable.” S. Rep. No. 144, 97th Cong., 1st Sess. 39 (1981), 1981- 2 C.B. at 421. See also H. Conf. Rep. No. 215, 97th Cong., 1st Sess. 196 (1981), 1981-2 C.B. 481.

Despite substantial statutory revisions that modify the accelerated cost recovery system (MACRS) and delete the term “recovery property,” section 201(a) of the 1986 Act, Pub. L. No. 99- 514, 1986-3 C.B. (Vol. 1) 38, the adverse decision in Simon impacts on property placed in service after 1986. See *Selig v. Commissioner*, T.C. Memo. 1995-519 (MACRS would not reinstate the determinable useful life requirement that the court previously had determined was eliminated with the enactment of ACRS).

Since there is no conflict among the circuits, no petition for certiorari was recommended. We believe that the Simon and Liddle cases are wrongly decided and the issue should be pursued in other circuits.

Recommendation

Nonacquiescence.

## **Character of Gain/Loss on Disposition of Property**

### **§1221 Capital asset defined**

- (a) In general. For purposes of this subtitle, the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
- (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
  - (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167 , or real property used in his trade or business;
  - (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—
    - (A) a taxpayer whose personal efforts created such property,
    - (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
    - (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B) ;
  - (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);
  - (5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—
    - (A) a taxpayer who so received such publication, or
    - (B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A) ;
  - (6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless—
    - (A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and
    - (B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);
  - (7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or
  - (8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.
- (b) Definitions and special rules.

- (1) Commodities derivative financial instruments. For purposes of subsection (a)(6) —
- (A) Commodities derivatives dealer. The term “commodities derivatives dealer” means a person which regularly offers to enter into, assume, offset, assign, or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.
  - (B) Commodities derivative financial instrument.
    - (i) In general. The term “commodities derivative financial instrument” means any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b)), the value or settlement price of which is calculated by or determined by reference to a specified index.
    - (ii) Specified index. The term “specified index” means any one or more or any combination of—
      - (I) a fixed rate, price, or amount, or
      - (II) a variable rate, price, or amount,
 which is based on any current, objectively determinable financial or economic information with respect to commodities which is not within the control of any of the parties to the contract or instrument and is not unique to any of the parties' circumstances.
- (2) Hedging transaction.
- (A) In general. For purposes of this section , the term “hedging transaction” means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily—
    - (i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,
    - (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or
    - (iii) to manage such other risks as the Secretary may prescribe in regulations.
  - (B) Treatment of nonidentification or improper identification of hedging transactions. Notwithstanding subsection (a)(7) , the Secretary shall prescribe regulations to properly characterize any income, gain, expense, or loss arising from a transaction—
    - (i) which is a hedging transaction but which was not identified as such in accordance with subsection (a)(7) , or
    - (ii) which was so identified but is not a hedging transaction.
- (3) Sale or exchange of self-created musical works. At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in subsection (a)(3) .

- (4) Regulations. The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of paragraph (6) and (7) of subsection (a) in the case of transactions involving related parties.

### **§1231 Property used in the trade or business and involuntary conversions**

(a) General rule.

(1) Gains exceed losses. If—

(A) the section 1231 gains for any taxable year, exceed

(B) the section 1231 losses for such taxable year,

such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be.

(2) Gains do not exceed losses. If—

(A) the section 1231 gains for any taxable year, do not exceed

(B) the section 1231 losses for such taxable year,

such gains and losses shall not be treated as gains and losses from sales or exchanges of capital assets.

(3) Section 1231 gains and losses. For purposes of this subsection —

(A) Section 1231 gain. The term “ section 1231 gain” means—

(i) any recognized gain on the sale or exchange of property used in the trade or business, and

(ii) any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of—

(I) property used in the trade or business, or

(II) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit.

(B) Section 1231 loss. The term “ section 1231 loss” means any recognized loss from a sale or exchange or conversion described in subparagraph (A) .

(4) Special rules. For purposes of this subsection —

(A) In determining under this subsection whether gains exceed losses—

(i) the section 1231 gains shall be included only if and to the extent taken into account in computing gross income, and

(ii) the section 1231 losses shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply.

(B) Losses (including losses not compensated for by insurance or otherwise) on the destruction, in whole or in part, theft or seizure, or requisition or condemnation of—

(i) property used in the trade or business, or

- (ii) capital assets which are held for more than 1 year and are held in connection with a trade or business or a transaction entered into for profit,

shall be treated as losses from a compulsory or involuntary conversion.

(C) In the case of any involuntary conversion (subject to the provisions of this subsection but for this sentence) arising from fire, storm, shipwreck, or other casualty, or from theft, of any—

- (i) property used in the trade or business, or
- (ii) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit,

this subsection shall not apply to such conversion (whether resulting in gain or loss) if during the taxable year the recognized losses from such conversions exceed the recognized gains from such conversions.

(b) Definition of property used in the trade or business. For purposes of this section —

(1) General rule. The term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year, which is not—

- (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,
- (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,
- (C) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221(a), or
- (D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section 1221(a).

(2) Timber, coal, or domestic iron ore. Such term includes timber, coal, and iron ore with respect to which section 631 applies.

(3) Livestock. Such term includes—

- (A) cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and
- (B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition.

Such term does not include poultry.

(4) Unharvested crop. In the case of an unharvested crop on land used in the trade or business and held for more than 1 year, if the crop and the land are sold or exchanged (or

compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as “property used in the trade or business.”

(c) Recapture of net ordinary losses.

- (1) In general. The net section 1231 gain for any taxable year shall be treated as ordinary income to the extent such gain does not exceed the non-recaptured net section 1231 losses.
- (2) Non-recaptured net section 1231 losses. For purposes of this subsection , the term “non-recaptured net section 1231 losses” means the excess of—
  - (A) the aggregate amount of the net section 1231 losses for the 5 most recent preceding taxable years beginning after December 31, 1981, over
  - (B) the portion of such losses taken into account under paragraph (1) for such preceding taxable years.
- (3) Net section 1231 gain. For purposes of this subsection , the term “net section 1231 gain” means the excess of—
  - (A) the section 1231 gains, over
  - (B) the section 1231 losses.
- (4) Net section 1231 loss. For purposes of this subsection , the term “net section 1231 loss” means the excess of—
  - (A) the section 1231 losses, over
  - (B) the section 1231 gains.
- (5) Special rules. For purposes of determining the amount of the net section 1231 gain or loss for any taxable year, the rules of paragraph (4) of subsection (a) shall apply.

**“Used in”**

“The Tax Court has considered business purpose in deciding that a taxpayer who purchases an asset for use in the taxpayer's trade or business may be allowed ordinary asset treatment under §1221(2) if the asset was "devoted to" the trade or business, even if post-acquisition events have prevented the taxpayer from actually using the asset in the manner intended. E.g., *Alamo Broadcasting Co. v. Commissioner*, 15 T.C. 534, 541 (1950); *Carter-Colton Cigar Co. v. Commissioner*, 9 T.C. 219, 221 (1947).” [*Azar Nut*, 931 F2d 314 (5<sup>th</sup> Cir. 1991) fn 2]

**§1231 and “trade or business”**

**PLR 8834004**

Issue

Is the loss sustained by the Taxpayer a capital loss or an ordinary loss?

Facts

The Taxpayer is a Real Estate Investment Trust (REIT) that annually engages in multiple transactions involving the purchase and leaseback of land on which improvements have been constructed and in many cases concurrently makes a loan to the seller/lessee secured by a mortgage on the leaseback and improvements.

Taxpayer's representatives expend substantial time and effort in negotiating Taxpayer's acquisitions and in monitoring its interests in the properties acquired. Typically, the method by which the Taxpayer

conducts its real estate activities, net leasing, does not require direct operational involvement in the underlying commercial and residential real estate.

At the close of the taxable year at issue, Taxpayer held interests in approximately 50 properties with an aggregate book value in excess of \$100,000,000. In the three-year period ending, with the taxable year at issue, Taxpayer's activities included its acquisition of 21 properties and its disposition of 11 properties.

In the transaction under consideration the Taxpayer purchased land underlying commercial complex X, subject to an existing mortgage held by Y, and leased the land back to the company that owned and managed X on a net lease basis. Five years after the execution of the lease, the owner and manager of X encountered financial difficulties that resulted in a cancellation of the lease and the conveyance to Taxpayer of all the owner's interests in the improvements on the land. Thus, the Taxpayer became the owner and operator of the commercial complex.

Taxpayer as owner of the commercial complex entered into a management contract with a company that acted as the Taxpayer's agent for managing the day-to-day operation of the commercial complex. Approximately one year after the execution of the management contract, Taxpayer conveyed the improvements and leased the land to another company. However, the operation of the commercial complex continued to experience financial difficulties and, eventually, the Taxpayer tendered a quitclaim deed for the land to the holder of first mortgage, Y, in lieu of foreclosure. The Taxpayer realized a loss of this transaction. The character of the loss is the issue presented in the instant case.

#### Applicable LAW AND RATIONALE:

Section 1221 of the Internal Revenue Code provides that the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include, among other things, real property used in his trade or business.

Section 1231 of the Code provides that if, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business exceed the recognized losses from such sales or exchanges, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than one year. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets held for more than one year.

Section 1231(b)(1) of the Code provides that the term "property used in the trade or business" means real property used in the trade or business held for more than one year, other than four specific categories of property, none of which are applicable in this case.

A mortgagor's voluntary conveyance of property to the mortgagee is a sale or exchange of the property. See Rev. Rul. 78-164, 1978-1 C.B. 264.

In *CURPHEY V. COMMISSIONER*, 73 T.C. 766 (1980), the Tax Court stated that the ownership and rental of real property does not, as a matter of law, constitute a trade or business. In the final analysis, the issue is ultimately one of fact in which the scope of the ownership and management activities may be an important consideration.

In *BAUER V. UNITED STATES*, 168 F. Supp. 539 (Ct. Cl. 1958), the Court of Claims stated that the question to be determined is whether the taxpayer's activities, personally or through agents, in connection with the property, are so extensive as to rise to the stature of his trade or business.

In the present, we are satisfied that the scope of Taxpayer's ownership and management activities constitute a trade or business and that the land was property used in its trade or business.

#### Conclusion

The loss sustained by the Taxpayer on the sale or exchange of the land underlying X will be considered an ordinary loss to the extent that the section 1231 gains do not exceed the section 1231 losses for the taxable year involved.

## §1245 Gain from dispositions of certain depreciable property

### (a) General rule.

(1) Ordinary income. Except as otherwise provided in this section, if section 1245 property is disposed of the amount by which the lower of—

(A) the recomputed basis of the property, or

(B)

(i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) in the case of any other disposition, the fair market value of such property,

exceeds the adjusted basis of such property shall be treated as ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(2) Recomputed basis. For purposes of this section —

(A) In general. The term “recomputed basis” means, with respect to any property, its adjusted basis recomputed by adding thereto all adjustments reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation or amortization.

(B) Taxpayer may establish amount allowed. For purposes of subparagraph (A) , if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation or amortization for any period was less than the amount allowable, the amount added for such period shall be the amount allowed.

(C) Certain deductions treated as amortization. Any deduction allowable under section 179 , 179A , 179B , 181 , 179C , 179D , 179E , 190 , 193 , or 194 shall be treated as if it were a deduction allowable for amortization.

(3) Section 1245 property. For purposes of this section , the term “ section 1245 property” means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either—

(A) personal property,

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,

(ii) constituted a research facility used in connection with any of the activities referred to in clause (i) , or

(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state),

(C) so much of any real property (other than any property described in subparagraph (B) ) which has an adjusted basis in which there are reflected

adjustments for amortization under section 169 , 179 , 179A , 179B , 179C , 179D , 179E , 185 , 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190 , 193 , or 194 [,]

(D) a single purpose agricultural or horticultural structure (as defined in section 168(i)(13)),

(E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum, or

(F) any railroad grading or tunnel bore (as defined in section 168(e)(4) ).

(b) Exceptions and limitations.

(1) Gifts. Subsection (a) shall not apply to a disposition by gift.

(2) Transfers at death. Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

(3) Certain tax-free transactions. If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332 , 351 , 361 , 721 , or 731 , then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section ). Except as provided in paragraph (6), this paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

(4) Like kind exchanges; involuntary conversions, etc. If property is disposed of and gain (determined without regard to this section ) is not recognized in whole or in part under section 1031 or 1033 , then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the sum of—

(A) the amount of gain recognized on such disposition (determined without regard to this section), plus

(B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

(5) Property distributed by a partnership to a partner.

(A) In general. For purposes of this section , the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(B) Adjustments added back. In the case of any property described in subparagraph (A) , for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be—

(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by

(ii) the amount of such gain to which section 751(b) applied.

(6) Transfers to tax-exempt organization where property will be used in unrelated business.

(A) In general. The second sentence of paragraph (3) shall not apply to a disposition of section 1245 property to an organization described in section

511(a)(2) or 511(b)(2) if, immediately after such disposition, such organization uses such property in an unrelated trade or business (as defined in section 513).

(B) Later change in use. If any property with respect to the disposition of which gain is not recognized by reason of subparagraph (A) ceases to be used in an unrelated trade or business of the organization acquiring such property, such organization shall be treated for purposes of this section as having disposed of such property on the date of such cessation.

(7) Timber property. In determining, under subsection (a)(2), the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, the taxpayer shall not take into account adjustments under section 194 to the extent such adjustments are attributable to the amortizable basis of the taxpayer acquired before the 10th taxable year preceding the taxable year in which gain with respect to the property is recognized.

(8) Disposition of amortizable section 197 intangibles.

(A) In general. If a taxpayer disposes of more than 1 amortizable section 197 intangible (as defined in section 197(c)) in a transaction or a series of related transactions, all such amortizable 197 intangibles shall be treated as 1 section 1245 property for purposes of this section .

(B) Exception. Subparagraph (A) shall not apply to any amortizable section 197 intangible (as so defined) with respect to which the adjusted basis exceeds the fair market value.

(c) Adjustments to basis. The Secretary shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under subsection (a).

(d) Application of section. This section shall apply notwithstanding any other provision of this subtitle.

### **§1250 Gain from dispositions of certain depreciable realty**

(a) General rule. Except as otherwise provided in this section—

(1) Additional depreciation after December 31, 1975.

(A) In general. If section 1250 property is disposed of after December 31, 1975, then the applicable percentage of the lower of—

(i) that portion of the additional depreciation (as defined in subsection (b)(1) or (4) ) attributable to periods after December 31, 1975, in respect of the property, or

(ii) the excess of the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of such property (in the case of any other disposition), over the adjusted basis of such property,

shall be treated as gain which is ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(B) Applicable percentage. For purposes of subparagraph (A) , the term “applicable percentage” means—

(i) in the case of section 1250 property with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws and with respect to which the

owner is subject to the restrictions described in section 1039(b)(1)(B) (as in effect on the day before the date of the enactment [11/5/90] of the Revenue Reconciliation Act of 1990), 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months;

- (ii) in the case of dwelling units which, on the average, were held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law authorizing similar levels of subsidy for lower-income families, 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months;
- (iii) in the case of section 1250 property with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k) , 100 percent minus 1 percentage point for each full month in excess of 100 full months after the date on which such property was placed in service;
- (iv) in the case of section 1250 property with respect to which a loan is made or insured under title V of the Housing Act of 1949, 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months; and
- (v) in the case of all other section 1250 property, 100 percent.

In the case of a building (or a portion of a building devoted to dwelling units), if, on the average, 85 percent or more of the dwelling units contained in such building (or portion thereof) are units described in clause (ii) , such building (or portion thereof) shall be treated as property described in clause (ii) . Clauses (i) , (ii) , and (iv) shall not apply with respect to the additional depreciation described in subsection (b)(4) which was allowed under section 167(k) .

(2) Additional depreciation after December 31, 1969, and before January 1, 1976.

(A) In general. If section 1250 property is disposed of after December 31, 1969, and the amount determined under paragraph (1)(A)(ii) exceeds the amount determined under paragraph (1)(A)(i) , then the applicable percentage of the lower of—

- (i) that portion of the additional depreciation attributable to periods after December 31, 1969, and before January 1, 1976, in respect of the property, or
- (ii) the excess of the amount determined under paragraph (1)(A)(ii) over the amount determined under paragraph (1)(A)(i) ,

shall also be treated as gain which is ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(B) Applicable percentage. For purposes of subparagraph (A) , the term “applicable percentage” means—

- (i) in the case of section 1250 property disposed of pursuant to a written contract which was, on July 24, 1969, and at all times thereafter, binding on the owner of the property, 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 20 full months;

(ii) in the case of section 1250 property with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws, and with respect to which the owner is subject to the restrictions described in section 1039(b)(1)(B) (as in effect on the day before the date of the enactment [11/5/90] of the Revenue Reconciliation Act of 1990), 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 20 full months;

(iii) in the case of residential rental property (as defined in section 167(j)(2)(B) ) other than that covered by clauses (i) and (ii) , 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months;

(iv) in the case of section 1250 property with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k) , 100 percent minus 1 percentage point for each full month in excess of 100 full months after the date on which such property was placed in service; and

(v) in the case of all other section 1250 property, 100 percent.

Clauses (i) , (ii) , and (iii) shall not apply with respect to the additional depreciation described in subsection (b)(4) .

(3) Additional depreciation before January 1, 1970.

(A) In general. If section 1250 property is disposed of after December 31, 1963, and the amount determined under paragraph (1)(A)(ii) exceeds the sum of the amounts determined under paragraphs (1)(A)(i) and (2)(A)(i) , then the applicable percentage of the lower of—

(i) that portion of the additional depreciation attributable to periods before January 1, 1970, in respect of the property, or

(ii) the excess of the amount determined under paragraph (1)(A)(ii) over the sum of the amounts determined under paragraphs (1)(A)(i) and (2)(A)(i) ,

shall also be treated as gain which is ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(B) Applicable percentage. For purposes of subparagraph (A) , the term “applicable percentage” means 100 percent minus 1 percentage point for each full month the property was held after the date on which the property was held for 20 full months.

(4) Special rule. For purposes of this subsection , any reference to section 167(k) or 167(j)(2)(B) shall be treated as a reference to such section as in effect on the day before the date of the enactment [11/5/90] of the Revenue Reconciliation Act of 1990.

(5) Cross reference. For reduction in the case of corporations on capital gain treatment under this section , see section 291(a)(1) .

(b) Additional depreciation defined. For purposes of this section —

(1) In general. The term “additional depreciation” means, in the case of any property, the depreciation adjustments in respect of such property; except that, in the case of property held more than one year, it means such adjustments only to the extent that they exceed

the amount of the depreciation adjustments which would have resulted if such adjustments had been determined for each taxable year under the straight line method of adjustment.

- (2) Property held by lessee. In the case of a lessee, in determining the depreciation adjustments which would have resulted in respect of any building erected (or other improvement made) on the leased property, or in respect of any cost of acquiring the lease, the lease period shall be treated as including all renewal periods. For purposes of the preceding sentence—
  - (A) the term “renewal period” means any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, but
  - (B) the inclusion of renewal periods shall not extend the period taken into account by more than  $\frac{2}{3}$  of the period on the basis of which the depreciation adjustments were allowed.
- (3) Depreciation adjustments. The term “depreciation adjustments” means, in respect of any property, all adjustments attributable to periods after December 31, 1963, reflected in the adjusted basis of such property on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for exhaustion, wear and tear, obsolescence, or amortization (other than amortization under section 168 (as in effect before its repeal by the Tax Reform Act of 1976), 169 , 185 (as in effect before its repeal by the Tax Reform Act of 1986), 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190 , or 193 ). For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed as a deduction for any period was less than the amount allowable, the amount taken into account for such period shall be the amount allowed.
- (4) Additional depreciation attributable to rehabilitation expenditures. The term “additional depreciation” also means, in the case of section 1250 property with respect to which a depreciation or amortization deduction for rehabilitation expenditures was allowed under section 167(k) (as in effect on the day before the date of the enactment [11/5/90] of the Revenue Reconciliation Act of 1990) or 191 (as in effect before its repeal by the Economic Recovery Tax Act of 1981), the depreciation or amortization adjustments allowed under such section to the extent attributable to such property, except that, in the case of such property held for more than one year after the rehabilitation expenditures so allowed were incurred, it means such adjustments only to the extent that they exceed the amount of the depreciation adjustments which would have resulted if such adjustments had been determined under the straight line method of adjustment without regard to the useful life permitted under section 167(k) (as in effect on the day before the date of the enactment [11/5/90] of the Revenue Reconciliation Act of 1990) or 191 (as in effect before its repeal by the Economic Recovery Tax Act of 1981).
- (5) Method of computing straight line adjustments. For purposes of paragraph (1) , the depreciation adjustments which would have resulted for any taxable year under the straight line method shall be determined—
  - (A) in the case of property to which section 168 applies, by determining the adjustments which would have resulted for such year if the taxpayer had elected the straight line method for such year using the recovery period applicable to such property, and
  - (B) in the case any property to which section 168 does not apply, if a useful life (or salvage value) was used in determining the amount allowable as a deduction for any taxable year, by using such life (or value).

(c) Section 1250 property. For purposes of this section , the term “ section 1250 property” means any real property (other than section 1245 property, as defined in section 1245(a)(3) ) which is or has been property of a character subject to the allowance for depreciation provided in section 167 .

(d) Exceptions and limitations.

- (1) Gifts. Subsection (a) shall not apply to a disposition by gift.
- (2) Transfers at death. Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.
- (3) Certain tax-free transactions. If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332 , 351 , 361 , 721 , or 731 , then the amount of gain taken into account by the transferor under subsection (a) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section ). Except as provided in paragraph (9) , this paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521 ) which is exempt from the tax imposed by this chapter.
- (4) Like kind exchanges; involuntary conversions, etc.
  - (A) Recognition limit. If property is disposed of and gain (determined without regard to this section ) is not recognized in whole or in part under section 1031 or 1033 , then the amount of gain taken into account by the transferor under subsection (a) shall not exceed the greater of the following:
    - (i) the amount of gain recognized on the disposition (determined without regard to this section ), increased as provided in subparagraph (B) , or
    - (ii) the amount determined under subparagraph (C) .
  - (B) Increase for certain stock. With respect to any transaction, the increase provided by this subparagraph is the amount equal to the fair market value of any stock purchased in a corporation which (but for this paragraph ) would result in nonrecognition of gain under section 1033(a)(2)(A) .
  - (C) Adjustment where insufficient section 1250 property is acquired. With respect to any transaction, the amount determined under this subparagraph shall be the excess of—
    - (i) the amount of gain which would (but for this paragraph ) be taken into account under subsection (a) , over
    - (ii) the fair market value (or cost in the case of a transaction described in section 1033(a)(2) ) of the section 1250 property acquired in the transaction.
  - (D) Basis of property acquired. In the case of property purchased by the taxpayer in a transaction described in section 1033(a)(2) , in applying section 1033(b)(2) , such sentence shall be applied—
    - (i) first solely to section 1250 properties and to the amount of gain not taken into account under subsection (a) by reason of this paragraph , and
    - (ii) then to all purchased properties to which such sentence applies and to the remaining gain not recognized on the transaction as if the cost of the section 1250 properties were the basis of such properties computed under clause (i) .

In the case of property acquired in any other transaction to which this paragraph applies, rules consistent with the preceding sentence shall be applied under regulations prescribed by the Secretary.

(E) Additional depreciation with respect to property disposed of. In the case of any transaction described in section 1031 or 1033, the additional depreciation in respect of the section 1250 property acquired which is attributable to the section 1250 property disposed of shall be an amount equal to the amount of the gain which was not taken into account under subsection (a) by reason of the application of this paragraph.

(5) Property distributed by a partnership to a partner.

(A) In general. For purposes of this section, the basis of section 1250 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(B) Additional depreciation. In respect of any property described in subparagraph (A), the additional depreciation attributable to periods before the distribution by the partnership shall be—

(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time and the applicable percentage for the property had been 100 percent, reduced by

(ii) if section 751(b) applied to any part of such gain, the amount of such gain to which section 751(b) would have applied if the applicable percentage for the property had been 100 percent.

(6) Transfers to tax-exempt organization where property will be used in unrelated business.

(A) In general. The second sentence of paragraph (3) shall not apply to a disposition of section 1250 property to an organization described in section 511(a)(2) or 511(b)(2) if, immediately after such disposition, such organization uses such property in an unrelated trade or business (as defined in section 513).

(B) Later change in use. If any property with respect to the disposition of which gain is not recognized by reason of subparagraph (A) ceases to be used in an unrelated trade or business of the organization acquiring such property, such organization shall be treated for purposes of this section as having disposed of such property on the date of such cessation.

(7) Foreclosure dispositions.

If any section 1250 property is disposed of by the taxpayer pursuant to a bid for such property at foreclosure or by operation of an agreement or of process of law after there was a default on indebtedness which such property secured, the applicable percentage referred to in paragraph (1)(B), (2)(B), or (3)(B) of subsection (a), as the case may be, shall be determined as if the taxpayer ceased to hold such property on the date of the beginning of the proceedings pursuant to which the disposition occurred, or, in the event there are no proceedings, such percentage shall be determined as if the taxpayer ceased to hold such property on the date, determined under regulations prescribed by the Secretary, on which such operation of an agreement or process of law, pursuant to which the disposition occurred, began.

(e) Holding period. For purposes of determining the applicable percentage under this section, the provisions of section 1223 shall not apply, and the holding period of section 1250 property shall be determined under the following rules:

## (1) Beginning of holding period.

The holding period of section 1250 property shall be deemed to begin—

(A) in the case of property acquired by the taxpayer, on the day after the date of acquisition, or

(B) in the case of property constructed, reconstructed, or erected by the taxpayer, on the first day of the month during which the property is placed in service.

## (2) Property with transferred basis.

If the basis of property acquired in a transaction described in paragraph (1), (2), or (3) of subsection (d) is determined by reference to its basis in the hands of the transferor, then the holding period of the property in the hands of the transferee shall include the holding period of the property in the hands of the transferor.

## (3) Repealed.

## (f) Special rules for property which is substantially improved.

(1) Amount treated as ordinary income. If, in the case of a disposition of section 1250 property, the property is treated as consisting of more than one element by reason of paragraph (3), then the amount taken into account under subsection (a) in respect of such section 1250 property as ordinary income shall be the sum of the amounts determined under paragraph (2).

(2) Ordinary income attributable to an element. For purposes of paragraph (1), the amount taken into account for any element shall be the sum of a series of amounts determined for the periods set forth in subsection (a), with the amount for any such period being determined by multiplying—

(A) the amount which bears the same ratio to the lower of the amounts specified in clause (i) or (ii) of subsection (a)(1)(A), in clause (i) or (ii) of subsection (a)(2)(A), or in clause (i) or (ii) of subsection (a)(3)(A), as the case may be, for the section 1250 property as the additional depreciation for such element attributable to such period bears to the sum of the additional depreciation for all elements attributable to such period, by

(B) the applicable percentage for such element for such period.

For purposes of this paragraph, determinations with respect to any element shall be made as if it were a separate property.

(3) Property consisting of more than one element. In applying this subsection in the case of any section 1250 property, there shall be treated as a separate element—

(A) each separate improvement,

(B) if, before completion of section 1250 property, units thereof (as distinguished from improvements) were placed in service, each such unit of section 1250 property, and

(C) the remaining property which is not taken into account under subparagraphs (A) and (B).

(4) Property which is substantially improved. For purposes of this subsection —

(A) In general. The term “separate improvement” means each improvement added during the 36-month period ending on the last day of any taxable year to the capital account for the property, but only if the sum of the amounts added to such account during such period exceeds the greatest of—

(i) 25 percent of the adjusted basis of the property,

- (ii) 10 percent of the adjusted basis of the property, determined without regard to the adjustments provided in paragraphs (2) and (3) of section 1016(a) , or
- (iii) \$5,000.

For purposes of clauses (i) and (ii) , the adjusted basis of the property shall be determined as of the beginning of the first day of such 36-month period, or of the holding period of the property (within the meaning of subsection (e) ), whichever is the later.

(B) Exception. Improvements in any taxable year shall be taken into account for purposes of subparagraph (A) only if the sum of the amounts added to the capital account for the property for such taxable year exceeds the greater of—

- (i) \$2,000, or
- (ii) one percent of the adjusted basis referred to in subparagraph (A)(ii) , determined, however, as of the beginning of such taxable year.

For purposes of this section , if the amount added to the capital account for any separate improvement does not exceed the greater of clause (i) or (ii) , such improvement shall be treated as placed in service on the first day, of a calendar month, which is closest to the middle of the taxable year.

(C) Improvement. The term “improvement” means, in the case of any section 1250 property, any addition to capital account for such property after the initial acquisition or after completion of the property.

- (g) Adjustments to basis. The Secretary shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under subsection (a).
- (h) Application of section. This section shall apply notwithstanding any other provision of this subtitle.

### **§291 Special rules relating to corporate preference items [excerpt]**

(a) Reduction in certain preference items, etc. For purposes of this subtitle, in the case of a corporation—

(1) Section 1250 capital gain treatment. In the case of section 1250 property which is disposed of during the taxable year, 20 percent of the excess (if any) of—

- (A) the amount which would be treated as ordinary income if such property was section 1245 property, over
- (B) the amount treated as ordinary income under section 1250 (determined without regard to this paragraph ) ,

shall be treated as gain which is ordinary income under section 1250 and shall be recognized notwithstanding any other provision of this title. Under regulations prescribed by the Secretary, the provisions of this paragraph shall not apply to the disposition of any property to the extent section 1250(a) does not apply to such disposition by reason of section 1250(d) .

...

## Inventory versus Real or Depreciable Property

Relevance:

- Inventory cannot be depreciated
- Installment sale method not available for inventory (it also is not available to the extent of depreciation recapture on depreciable property)
- §471 inventory rules apply to inventory

### Rev. Rul. 86-149

#### ISSUE

Whether a taxpayer engaged in the business of developing real estate may use the last-in, first-out (LIFO) inventory identification method in accounting for the costs of its completed homes and homes under construction, exclusive of land costs?

#### FACTS

The taxpayer is a real estate developer that keeps its books and records and files its federal income tax returns on an accrual method of accounting. Its principal business activity is developing real estate upon which it constructs residential homes.

The taxpayer uses an accumulated “job cost” method to account for its construction and development costs. Under this method, each home is treated as a separate costing unit to which all direct identifiable costs are charged and all overhead costs, including the variable overhead as well as the construction and architectural costs, are allocated. All costs that have been accumulated for a particular home under the job cost method are charged to cost of sales at the time of settlement with the purchaser of the home.

With its federal income tax return filed for the year ended 1984, the taxpayer filed a timely Form 970, Application to Use LIFO Inventory Method, for its “inventory” of completed new homes and jobs in progress. The cost of its building lots, including the various development costs of improving the lots such as streets, curbs and gutters, were not included in the application to use the LIFO method.

#### LAW AND ANALYSIS

Section 263(a)(1) of the Internal Revenue Code and section 1.263(a)-1(1) of the Income Tax Regulations provides that no deductions shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)-2 of the regulations sets forth examples of capital expenditures, including the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the tax year.

Section 446(a) of the Code states the general rule that taxable income shall be computed by a taxpayer under the method of accounting it regularly uses in keeping its books. Section 446(b), however, provides that where a taxpayer's accounting method does not clearly reflect income, the computation of taxable income shall be made under such method as, in the Secretary's opinion, does clearly reflect income.

Section 471 of the Code provides that whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Section 472(a) of the Code allows a taxpayer to use the LIFO method in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary may prescribe.

Section 1.471-1 of the regulations provides that inventories at the beginning and end of each tax year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor.

Section 1.472-1(a) of the regulations provides that any taxpayer permitted or required to take inventories pursuant to the provisions of section 471 of the Code may elect with respect to those goods specified in its application and properly subject to inventory to compute its opening and closing inventories in accordance with the method provided by section 472.

Whether a real estate developer may use the LIFO method to account for the costs of its completed homes and jobs in progress is dependent upon whether the taxpayer is required or permitted to maintain inventories with respect to these costs. Historically, taxpayers engaged in the real estate business have not been permitted to inventory real estate held for sale to customers. *Atlantic Coast Realty Co. v. Commissioner*, 11 B.T.A. 416 (1928); Rev. Rul. 69-536, 1969-2 C.B. 109. In *Atlantic Coast Realty Co.*, the United States Board of Tax Appeals concluded that, based on the purpose and legislative intent of the inventory provisions, the use of inventories is inappropriate for a taxpayer engaged in buying and selling lands. As stated by the Board of Tax Appeals on page 419:

The use of inventories must be reasonably necessary to the determination of income. The basis of their use must be prescribed by the Commissioner, not arbitrarily, but in conformity to the best accounting practice in the trade or business and as most clearly reflecting income. The language indicates no intention to recognize in any trade a new method of determining income or a new limitation upon income, but only a recognition of the use of inventories in such trades or businesses, like "manufacturing and merchandise concerns" as had been found to require such accounting practice.

Unlike a manufacturing or merchandise concern, the use of inventories for the valuation of either unimproved land or developed real estate is unnecessary for the determination of income and generally impractical as a method to value real estate. See *Atlantic Coast Realty Co.* Real estate is unique and is particularly subject to specific accounting of costs including the tracing of costs to individual parcels and the separate computations of gains or losses on sales. See for example, Rev. Rul. 66-247, 1966-2 C.B. 198, which states that capitalized costs incurred in the construction of a house for speculative sale should be applied against the amount realized upon the sale of the house for purposes of determining gain or loss.

Instead of being a more convenient method of accounting, as it is with large stocks of merchandise, an inventory method for real estate could be so cumbersome and uncertain as to be generally impractical. *Atlantic Coast Realty Co.* For this reason, neither the land nor the materials and supplies used to construct the houses on the lots are considered merchandise or goods within the meaning of section 471 of the Code and its regulations. See *Homes by Ayres v. Commissioner*, 795 F. 2d 832 (9th Cir. 1986), aff'g T.C.M. 1984-475; *W. C. & A. N. Miller Development Co. v. Commissioner*, 81 T.C. 619 (1983); see also *Francisco Sugar Co. v. Commissioner*, 47 F. 2d 555 (2nd Cir. 1931), aff'g in part 14 B.T.A. 1062 (1929). Instead, the property and its improvements constitute real estate held for sale by the taxpayer. See section 263(a)(1).

In the instant situation, therefore, the taxpayer is neither permitted nor required to maintain inventories. Its job order cost method for accumulating the costs of its completed but unsold homes and construction in progress is not an inventory method but a capitalization method even though it may approximate the results of a specific identification inventory method. *W.C. & A.N. Miller Development Co.* As stated by the United States Tax Court in *W.C. & A.N. Miller Development Co.* on pages 632 and 633:

There is a fundamental difference between capitalization and an inventory method. Under capitalization, gain will be determined pursuant to section 1001 on each individual home when it is sold, and such gain is to be determined based generally on the taxpayer's actual cost for that particular home. Since the specific identification method of inventory valuation is only one of several permissible inventory methods, there is not necessarily the requirement under this method that actual cost be used in arriving at cost of goods sold.

Thus, the Tax Court held that a seller of homes cannot maintain inventories.

A taxpayer engaged in the real estate business capitalizes its costs in accordance with section 263 of the Code. Under section 263(a)(1), costs incurred in the construction of homes and other permanent improvements to real property are not currently deductible. Instead the cost of unsold homes and construction in progress is capital expenditure that becomes part of the cost of the real estate, which, in turn, is recovered either through a depreciation allowance if the property is used in a trade or business, or as an offset against the price received in the subsequent sale or disposition of such property.

By utilizing the LIFO method of inventory accounting for its completed but unsold houses and costs of construction in progress, the taxpayer may be, in effect, deducting a portion of its construction costs before it has actually disposed of the real property. For example, as construction costs increase, the LIFO method will produce a cost of goods sold deduction in excess of the cost specifically attributable to the particular real property actually disposed of during the year and in effect the taxpayer will be currently deducting the cost of improving other real property prior to its sale. Thus, as a consequence of utilizing the LIFO inventory method in conjunction with its job order cost method, the taxpayer is selectively combining attributes of both an inventory method and a capitalization method with a resulting distortion of income within the meaning of section 446(b) of the Code.

#### HOLDING

A taxpayer engaged in the business of developing real estate may not use the LIFO inventory identification method to account for its completed homes and homes under construction, exclusive of land costs.

Any change from the taxpayer's present method of accounting for its construction costs to the method described in this revenue ruling is a change in method of accounting to which sections 446 and 481 of the Code and the regulations thereunder apply.

#### **Rev. Rul. 97-54**

##### Facts

“Line pack gas” is the minimum volume of natural gas necessary to provide the pressure to facilitate the flow of gas through a pipeline. “Cushion gas” is the minimum volume of natural gas necessary to provide the pressure to facilitate the flow of gas from a storage reservoir to a pipeline. Recoverable line pack gas and recoverable cushion gas will be available for sale or other use upon the abandonment of the pipeline or storage reservoir, respectively. Unrecoverable line pack gas and unrecoverable cushion gas will not be available for sale or other use upon the abandonment of the pipeline or storage reservoir, but will become obsolete with that abandonment.

##### Law and Analysis

Section 263(a) provides that no deduction shall be allowed for amounts paid out for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)-2 of the Income Tax Regulations provides that a “capital expenditure” includes the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the tax year.

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business or held for the production of income.

Generally, for tangible property, the depreciation deduction under section 167(a) is determined under section 168 by using the applicable depreciation method, the applicable recovery period, and the applicable convention.

Section 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by that taxpayer, on the

basis the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Section 1.471-1 provides that in order to reflect income correctly, inventories at the beginning and end of each tax year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. Inventories should include all finished and partly finished goods and, in the case of raw materials and supplies, only those that have been acquired for sale or that will physically become a part of merchandise intended for sale.

Rev. Rul. 68-620, 1968-2 C.B. 199, amplified by Rev. Rul. 78-352, 1978-2 C.B. 168, holds that line pack gas is merchandise in transit that is intended to be sold to customers and therefore must be included in the inventory of the taxpayer.

Rev. Rul. 75-233, 1975-1 C.B. 95, holds that the cost of unrecoverable cushion gas is a capital expenditure under section 263, which is recoverable through an annual depreciation deduction under section 167.

With respect to both line pack gas and cushion gas, several court decisions have considered the capital expenditure versus-inventory issue, as well as the depreciation issue. In *Pacific Enterprises v. Commissioner*, 101 T.C. 1 (1993), the United States Tax Court held that the costs of line pack gas and cushion gas are capital expenditures. Accord *Transwestern Pipeline Co. v. United States*, 639 F.2d 679 (Ct.Cl. 1980), regarding line pack gas; *Arkla, Inc. v. United States*, 765 F.2d 487 (5th Cir. 1985), regarding cushion gas. The United States Court of Appeals for the Fifth Circuit in *Arkla* further held that recoverable cushion gas was not subject to depreciation because it was not subject to exhaustion, wear, tear, or obsolescence. Accord *Washington Energy Co. v. United States*, 94 F.3d 1557 (Fed. Cir. 1996). The Fifth Circuit in *Arkla* distinguished unrecoverable cushion gas as being subject to depreciation because that gas will become obsolete along with the storage facility. Accord Rev. Rul. 75-233. Finally, in *Arkla, Inc. v. United States*, 37 F.3d 621 (Fed. Cir. 1994), the United States Court of Appeals for the Federal Circuit held that line pack gas and cushion gas are treated the same for purposes of depreciation. Accord *Washington Energy Co. v. United States*, 94 F.3d 1557.

Line pack gas or cushion gas is recoverable if it will be available for sale or other use upon abandonment of a pipeline or storage reservoir. See *Arkla, Inc. v. United States*, 765 F.2d at 490. The Service will treat line pack gas or cushion gas as being available for sale or other use to the extent that such gas will be recovered from an abandoned pipeline or storage reservoir pursuant to a plan, a requirement of law, or economic feasibility, whichever method projects the greatest actual recovery of such gas.

The Service will follow the court decisions cited in this revenue ruling to the extent they hold that the cost of line pack gas or cushion gas is a capital expenditure, the cost of recoverable line pack gas or recoverable cushion gas is not depreciable, and the cost of unrecoverable line pack gas or unrecoverable cushion gas is depreciable.

#### HOLDINGS

- (1) The cost of line pack gas or cushion gas is a capital expenditure under section 263.
- (2) The cost of recoverable line pack gas or recoverable cushion gas is not depreciable, but the cost of unrecoverable line pack gas or unrecoverable cushion gas is depreciable under sections 167 and 168. The Service will treat line pack gas or cushion gas as recoverable to the extent that such gas will be recovered from an abandoned pipeline or storage reservoir pursuant to a plan, a requirement of law, or economic feasibility, whichever method projects the greatest actual recovered of such gas.

Also recall the rotatable spare parts cases covered in BUS 223F (Accounting Methods).

## Disposition Terminology

Amount realized - §1001(b) and Reg. §1.1001-2(a)

Adjusted Basis - §1011 and §1016

Gain or Loss Realized - §1001(a) and Reg. §1.1001-1(a)

Gain or Loss Recognized - §1001(c)



In later weeks, we'll also discuss abandonment, "other disposition," exchange, contributions, bargain sales, depreciation recapture and more.

### §1001 Determination of amount of and recognition of gain or loss [excerpt]

- (a) Computation of gain or loss. The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
- (b) Amount realized. The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—
- (1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and
  - (2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.
- (c) Recognition of gain or loss. Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

### Realization Event

*Lakewood Associates v. Commissioner*, 109 TC 450 (1997), aff'd 173 F3d 851 (4<sup>th</sup> Cir. 1998)

The issue for our consideration is whether Lakewood Associates is entitled to a loss deduction under section 165 in 1989 for a decrease in the value of real property alleged to have been caused by restrictions imposed on its ability to develop the property by Federal wetland regulations that were issued in that year.

### FINDINGS OF FACT

Lakewood Associates (Lakewood) is a Virginia general partnership with its principal place of business in Virginia Beach, Virginia, at the time the petition was filed. In 1987, Lakewood purchased approximately 632 acres of unimproved real estate located on Elbow Road in Chesapeake, Virginia, to construct single-family homes in a residential development to be called Elbow Lake Estates (Elbow Lake property). Lakewood purchased the property from R.G. Moore Building Corp. (Moore Corp.) for a purchase price of \$8,860,000 and granted Moore Corp. a 55-percent general partnership interest in the Lakewood partnership. Lakewood intended to develop the property in conjunction with an adjacent 59.7-acre

property, the Boy Scout Tract, owned by Lakewood's tax matters partner, Robert G. Moore. Mr. Moore has been a real estate developer and contractor for over 40 years.

At the time Lakewood acquired the property, it was zoned for agricultural use. On February 8, 1988, Lakewood applied for rezoning of the Elbow Lake property from an agricultural district to a single-family residential district. Following a public hearing, a staff report to the Chesapeake Planning Commission recommended that the Commission deny Lakewood's proposed rezoning because the proposed residential development would create traffic and education demands that could not be met by Lakewood's or the city's budget. In addition, the staff report cited problems with the planned sewer system on the property, which did not meet city requirements, and the local government's inability to serve the residents of the proposed development. Based on the staff's recommendation, in September 1988, the Planning Commission recommended to the Chesapeake City Council (City Council) that Lakewood's rezoning application be denied. In October 1988, however, the City Council approved Lakewood's rezoning application contingent on certain proffers.

...

Lakewood's adjusted basis in the Elbow Lake property was \$13,268,320. On its 1989 income tax return, Lakewood treated the issuance of the 1989 Manual as a regulatory taking, or condemnation, of the Elbow Lake property and claimed an ordinary loss deduction under sections 165 and 1231(a) with respect to the property in the amount of \$9,849,682. The amount of the claimed loss deduction represents approximately 74 percent of Lakewood's adjusted basis in the property, which is the portion of the Elbow Lake property determined to be protected wetlands under the 1989 Manual. Lakewood's tax matters partner Robert G. Moore who owned the Boy Scout Tract adjacent to the Elbow Lake property also claimed a section 165 loss deduction in 1989 with regard to the Boy Scout Tract due to the issuance of 1989 Manual.

#### OPINION

The issue for our consideration is whether Lakewood is entitled to a loss deduction in 1989 because of the issuance of the 1989 Wetlands Manual and MOA. Petitioner argues that Lakewood is entitled to a deduction in the amount of the decrease in value of the Elbow Lake property as a result of being prevented from developing the property for residential use under the Federal wetland regulations. Petitioner contends that Lakewood's inability to use its property for the purpose Lakewood intended when it purchased the property constitutes an involuntary conversion of property. Accordingly, petitioner contends that Lakewood is entitled to a loss deduction under section 165. On its 1989 tax return, Lakewood characterized the loss as a governmental taking of property upon the issuance of the 1989 Manual and the execution of the MOA. On brief, however, petitioner contends that a constitutional taking of the property is not required in this case to establish a deductible loss under section 165.

Section 165(a) permits a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 1231(a) governs the characterization of gains and losses from sales, exchanges, and involuntary conversions of real and depreciable property used in a trade or business and permits a taxpayer, in certain circumstances, to characterize recognized losses incurred from such transactions or occurrences as an ordinary loss rather than a capital loss subject to the limitations on deductibility under section 165(f).

For purposes of section 165(a), a loss must be evidenced by a closed and completed transaction and fixed by an identifiable event. Sec. 1.165-1(b), Income Tax Regs. The mere diminution in value of property is not sufficient to establish a loss for purposes of section 165(a). *United States v. White Dental Manufacturing Co.*, 274 U.S. 398 (1927). To deduct a decrease in value of property, there must be some event that fixes the fact of the loss and the amount thereof. Petitioner contends that an involuntary conversion of property is an identifiable event that gives rise to a section 165 loss deduction. Petitioner contends that an involuntary conversion of property occurs when a "taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his [purposes]" quoting *C.G. Willis, Inc. v. Commissioner*, 41 T.C. 468, 476 (1964), *affd.* 342 F.2d 996 (3d Cir. 1965), which involved nonrecognition of gain upon an involuntary conversion under section 1033. Petitioner

also quotes a similar definition of an involuntary conversion in *Grant Oil Tool Co. v. United States*, 180 Ct. Cl. 620, 381 F.2d 389, 395 (1967), which provides that an involuntary conversion of property occurs for purposes of the section 1231(a) gain and loss characterization rules when property is “[rendered] \*\*\* useless for the purpose[s] for which it was intended” regardless of whether the property is in fact physically destroyed.

Petitioner argues that an involuntary conversion occurred upon the issuance of the 1989 Manual and the execution of the MOA for purposes of section 165 because Lakewood could no longer use the Elbow Lake property for residential development as it had intended. Respondent does not dispute that under the 1989 Manual the amount of protected wetlands on the Elbow Lake property increased or that the 1989 Manual and MOA made it more difficult to obtain a section 404 permit. Respondent argues that the advent of the 1989 Manual and MOA are not identifiable events that establish a closed and completed transaction for loss recognition purposes under section 165.

Respondent presents a series of independent arguments against Lakewood's claimed loss deduction for the decrease in value alleged in this case. Respondent's principal position is that the agricultural zoning of the Elbow Lake property prevented Lakewood's intended residential use of the property. Accordingly, respondent maintains that Lakewood would not have been able to build single-family residences on the Elbow Lake property even in the absence of the stricter Federal wetlands regulations contained in the 1989 Manual and MOA. We agree with respondent's first argument to the extent that, in substantial part, it was the zoning limitation that restricted the intended use of the property. In that regard, the 1989 Manual and the MOA would have had a relatively small effect, if any, on the property when used for agricultural purposes. In any event, petitioner has not advanced an alternative theory or provided us with a factual predicate for a finding that the 1989 Manual and the MOA caused a reduction in value for agricultural purposes.

Lakewood faced two obstacles to its residential development project: (1) Local zoning law, and (2) Federal wetland regulations. The Elbow Lakes property was zoned as an agricultural district at the time Lakewood acquired it. In 1988, Lakewood applied for rezoning of the property from agricultural to residential. After the City Council initially approved the rezoning, the rezoning was overwhelmingly defeated in a voter referendum in 1989, the year that Lakewood claimed the loss deduction on the property. Lakewood has not applied for rezoning of the property to residential since this unsuccessful attempt, and the Elbow Lake property had retained its agricultural zoning up to the time of trial.

Petitioner presented the expert testimony of a real estate appraiser, Bruce Hatfield, to the effect that the value of the property decreased in 1989 from about \$11 million to \$1 million as a result of the 1989 Manual and MOA. Mr. Hatfield's valuation is based on his conclusion that the highest and best use of the Elbow Lake property is residential development and that the property could be rezoned from agricultural to residential. The fair market value of property is a question of fact for which the burden of proof is on petitioner. *Symington v. Commissioner*, 87 T.C. 892, 896 (1986). The fair market value of property is based on the highest and best use for the property on the date of valuation regardless of whether the property is actually being used for that purpose or the land owner intended to put the property to that use. *Frazer v. Commissioner*, 98 T.C. 554, 563 (1992); *Stanley Works v. Commissioner*, 87 T.C. 389, 400 (1986). Rather, “The realistic, objective potential uses” of the property control. *Stanley Works v. Commissioner*, supra at 400. The highest and best use is a reasonable and probable use of the property in the near future. *Frazer v. Commissioner*, supra. Restrictions on a land owner's right to use the property are relevant in determining whether the identified highest and best use of the property is reasonable. *Stanley Works v. Commissioner*, supra at 402. Accordingly, petitioner must prove that it was reasonable and probable that the Elbow Lake property could be rezoned for residential development within reasonable proximity to the year in issue.

Mr. Hatfield examined the growth patterns and population shifts in the Chesapeake, Virginia, area and determined that the Elbow Lake property could be part of the ongoing residential development in that area. He believed that the property could be rezoned for residential purposes because property located in close vicinity to the Elbow Lake property had been rezoned from agricultural to residential shortly after Lakewood's application for rezoning was defeated. Petitioner's expert attributed the ability of the

Chesapeake, Virginia, citizens to defeat the residential rezoning of the Elbow Lake property to luck, testifying that opponents of the rezoning were able to obtain the required 15 percent of voters' signatures for the petition because they collected the signatures of voters at polling sites during a general election. The expert did not assert any special expertise in zoning issues and merely concluded that since other property had been rezoned, the chances for rezoning the Elbow Lake property were good. Mr. Hatfield did not discount the value of the property prior to the 1989 Manual and MOA for the possibility that the property could not be rezoned for residential use.

Despite the expert's opinion, we cannot ignore the agricultural zoning of the Elbow Lake property and Lakewood's failed attempt to rezone the property for residential purposes during the year in issue. The Planning Commission and staff opposed residential zoning of the property, recommending to the City Council to deny the rezoning request. In 1989, Lakewood's proposed rezoning of the Elbow Lake property was overwhelmingly defeated by 95 percent of the voters in the referendum. Petitioner has not presented a persuasive reason to believe that the City Council would ignore this near-unanimous, clear public objection to residential zoning of the Elbow Lake property and approve a subsequent rezoning application for the property. Moreover, at the time of trial, the Elbow Lake property was still zoned for agricultural use. We conclude that a change in the zoning of the Elbow Lake property was not probable at the time of the claimed deduction or within a reasonable period of time thereafter. Lakewood's proposed development of the Elbow Lake property was prohibited in 1989 because of the local zoning ordinance, which predates the 1989 Manual, regardless of the 1989 Manual and MOA. Accordingly, the 1989 Manual and MOA did not cause the \$9 million reduction in the value of the Elbow Lake property claimed by Lakewood.

We find that the continued agricultural zoning of the Elbow property resulted in a \$1 million value of the property in 1989. In that regard, we must determine whether Lakewood is entitled to deduct either the difference between the basis and \$1 million or any reduction in value caused by Government land use regulations.

The mere diminution in value of property does not create a deductible loss. An economic loss in value of property must be determined by the permanent closing of a transaction with respect to the property. A decrease in value must be accompanied by some affirmative step that fixes the amount of the loss, such as an abandonment, sale, or exchange. The barrier to Lakewood's intended use for the property because of zoning regulations is the lack of a closed and completed transaction for purposes of section 165. When Lakewood purchased the Elbow Lake property, it acquired certain rights with respect to the property. Lakewood's right to use the property was limited because the Elbow Lake property was then zoned for agricultural use. After the zoning application was defeated, Lakewood had not been denied a right that it previously possessed. Lakewood paid an amount for the Elbow Lake property in excess of the \$1 million agricultural use value under the belief that the property could be rezoned for residential development. Such an assumption, whether reasonable or not, is not grounds for a loss deduction under section 165 when the assumption is proved to be in error. Land use regulations are akin to market conditions that are constantly subject to change. If we treated an adverse zoning decision or land use regulation as a loss realization event, it would then be necessary to treat increases from these sources as a taxable gain to the property owner. Rather, we hold that until the Elbow Lake property is sold, abandoned, or otherwise disposed of in a completed transaction, Lakewood is not entitled to a loss deduction. Until such a time, it is impossible to determine accurately whether in fact Lakewood suffered a loss on the property or the amount of the loss. Because Lakewood continued to own the property, there was not a closed and completed transaction with regard to the Elbow Lake property in 1989 that triggered loss recognition for the \$9 million decline in value.

Moreover, allowing Lakewood to deduct the diminution in value caused by land use regulations would be inconsistent with the other grounds for a loss deduction that exist under section 165; i.e., abandonment and obsolescence. Section 165 provides for a loss deduction for obsolescence of nondepreciable property used in a trade or business where the property is permanently discarded from use by the taxpayer. Sec. 1.165-2, Income Tax Regs. In addition, a deduction is permitted for an abandonment loss where the taxpayer intends to abandon the property and has taken an affirmative act of abandonment. *Citron v.*

Commissioner, 97 T.C. 200, 208 (1991). Lakewood has not permanently discarded or abandoned the Elbow Lake property. Rather, Lakewood filed a permit application in January 1991, after the year in issue. In 1992, Lakewood renewed discussions with the Corps regarding the determination of wetlands on its property. In 1993, Lakewood provided a delineation of wetlands to the Corps as required for the permit, and the Corps confirmed the delineation. These actions show that Lakewood has not abandoned the property. The property has continued to be held by Lakewood for future use or sale. We hold that there was not a loss realization event with respect to the zoning laws.

To characterize the loss as ordinary under section 1231, petitioner at very least, would have to show that land use regulations constitute an involuntary conversion. Section 1.1231-1(e), Income Tax Regs., defines involuntary conversion of property as follows:

the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition, or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money \*\*\*

Government land use regulations, such as local zoning law or Federal wetland regulations, rarely constitute a condemnation of property under eminent domain powers. See *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003 (1992); *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121 (1985); *Agins v. City of Tiburon*, 447 U.S. 255 (1980). Condemnation requires property to be taken against the taxpayer's will by a public or quasi-public entity exercising the power of eminent domain. *Koziara v. Commissioner*, 86 T.C. 999, 1006-1007 (1986) affd. 841 F.2d 1126 (6th Cir. 1988). A condemnation or involuntary conversion of property as defined under section 1231 has not occurred in this case.

Considering the question of the effect of the 1989 Manual and the MOA, it was possible that they adversely affected the value of the Elbow Lake property for agricultural use, causing a reduction in value of the property below the \$1 million determined by petitioner's expert. Petitioner, however, only argues that the newly issued Federal wetland regulations prevented Lakewood's use of the Elbow Lake property for residential development and contends that the value of the land is \$1 million based on agriculture as the highest and best use of the property.

At trial, petitioner presented four wetlands experts who provided credible and convincing testimony that it was highly unlikely that Lakewood would be granted a section 404 permit by the Corps to develop single-family residences on the Elbow Lake property. One expert, Bernard Goode, who was employed as an engineer by the Corps for 34 years, believed that there was a "very low likelihood" that under the 1989 Manual, the Corps would grant a section 404 permit to Lakewood for the proposed residential development or that Lakewood's residential project could have been developed in an economically feasible manner. Mr. Goode's testimony was corroborated by the other expert witnesses who testified that it would be "virtually impossible" to obtain a section 404 permit or to develop the Elbow Lake property after the 1989 Manual. Conversely, petitioner's experts also believed that Lakewood could have obtained a section 404 permit under the terms of the 1987 Manual and could have developed the Elbow Lake property for residential purposes in an economically feasible manner. Petitioner has not argued that Lakewood could not use the Elbow Lake property for agricultural use because of the terms of the 1989 Manual and the MOA or that the Federal regulations affected Lakewood's use in any way other than preventing real estate development. Petitioner has chosen not to argue that there was a partial regulatory taking of the Elbow Lake property that would constitute a realization event for the loss in value of the property. Moreover, petitioner's own expert witness testified that the property was not worthless as agricultural property after 1989. Accordingly, we find that Lakewood is not entitled to the loss deduction claimed.<sup>5</sup>

On July 10, 1997, after the briefs were filed in this case, respondent filed a motion to reopen the record to permit the introduction of a certified copy of a petition filed by Lakewood Associates on April 28, 1997, in the U.S. Court of Federal Claims. The petition seeks compensation in the amount of \$10 million under

the Fifth Amendment takings clause for the regulatory taking of the Elbow Lake property as a result of the issuance of the 1989 Manual. On brief, petitioner had maintained that Lakewood had abandoned any claim for reimbursement under the Fifth Amendment for the loss in value of the Elbow Lake property caused by a regulatory taking. The petition that respondent seeks to enter into evidence [pg. 463]relates to the issue of whether Lakewood would have a reasonable prospect to recovery for any loss that it sustained due to the 1989 Manual and the MOA. Due to our holding in this case, we need not address the merits of respondent's motion to reopen the record and deny it as moot.

To reflect the foregoing,

Decision will be entered for respondent.

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<sup>2</sup>

In an earlier opinion, respondent's motion for summary judgment was denied. See *Lakewood Associates v. Commissioner*, T.C. Memo. 1995-552.

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<sup>5</sup>

Although we are not factually compelled to address the question of whether the Federal wetland regulations cause a tax recognizable event, it appears that the result would be no different from that of a zoning limitation.

## **Forms of Ownership**

Individually (sole owner)

Tenants in common – each tenant owns an undivided interest in the property and each may transfer his interest at death. Unlike joint tenancy, an owner's share does not automatically go to the other owner(s) at death.

Joint tenancy – each tenants owns an undivided interest in the property with right of survivorship. That is, upon death of one joint tenant, the property interest automatically goes to the surviving owner.

Community property – a special form of property ownership allowed in some states, such as California. Both husband and wife have an undivided one-half interest in the property.

Corporation

Partnership

Limited liability company (LLC)

Trust

Special entity such as a REIT

### **PLR 200303023**

This letter responds to your submission of May 24, 2002, and supplemental correspondence, dated August 7, 2002, and August 15, 2002, regarding the income tax consequences under §1001 of the Internal Revenue Code of the proposed partition of the Jointly-Owned Property (JOP) into separate parcels. You have requested a ruling that the partition does not constitute a sale, exchange, or other disposition that would cause any of the taxpayers, A, B, C, or T, to recognize any gain or loss under §1001.

FACTS:

Ownership of Jointly-Owned Property

The JOP is a contiguous tract of real estate owned as tenants-in-common by A and B, C, and T. A and B are parents of C, and T is a trust for the benefit of D, another child of A and B. A and B, as joint tenants,

own an undivided fee interest in three-sixths of the JOP and a life estate for the life of the survivor of A and B in one-sixth of the JOP. C owns an undivided fee interest in two-sixths of the JOP. T owns a remainder interest in the one-sixth interest in which A and B own a life estate.

A and B hold a mortgage on a portion of the JOP. The obligors on the mortgage are C, as to approximately \$31x, and another child (who formerly owned an interest in the JOP) of A and B, as to approximately \$32x.

#### Partition of Jointly-Owned Property

The JOP will be partitioned into separate parcels of property that will not be owned jointly by A and B, C, and T, but will be owned separately, as follows:

- (1) A and B will own a parcel as joint tenants in fee simple;
- (2) A and B will also own a life estate for the life of the survivor in a parcel;
- (3) T will own the remainder interest in the parcel in which A and B own a life estate; and
- (4) C will own two parcels in fee simple.

You have made the following representations:

- (1) Based on appraisals obtained, each parcel of property will be approximately equal in value to the value of the taxpayers' respective undivided interests in the JOP immediately prior to the partition.
- (2) None of the taxpayers will benefit disproportionately as a result of the partition, and no gift will be made or received as a result of the partition.
- (3) No interest in the JOP property that is subject to a mortgage will be transferred or assumed by any of the taxpayers as a result of the partition. The mortgage obligors will remain indebted to A and B in the same amounts.

You have asked us to rule that the partition of the JOP as described above will not constitute a sale, exchange, or other disposition that would cause any of the taxpayers to recognize any gain or loss under §1001.

#### LAW AND ANALYSIS:

Section 61(a)(3) provides that gross income includes gains derived from dealings in property. Under §1001(a) the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in §1011 for determining gain, and the loss is the excess of the adjusted basis over the amount realized. Section 1001(c) provides that, except as otherwise provided in Subtitle A of the Code, the entire amount of the gain or loss, determined under §1001, on the sale or exchange of property, must be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides generally that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

For purposes of §1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange of property is a disposition under §1001(a). See section 1.1001-1. In a partition, the parties do not acquire a new or additional interest. See *Noble v. Beach*, 130 P.2d 426, 430 (Cal. 1942). The partition of jointly-owned property is not a sale or other disposition, but merely the severance of joint ownership.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that the conversion of a joint tenancy in corporate stock into a tenancy in common for the purpose of eliminating a survivorship feature, is a nontaxable transaction for federal income tax purposes. Similarly, the severance of a joint tenancy in stock, pursuant to an action under state law to compel partition, and the issuance of two separate stock certificates in the names of

each joint tenant, is a nontaxable transaction. Rev. Rul. 56-437 concludes that in both cases there was no sale or exchange, and the taxpayers neither realized a taxable gain nor sustained a deductible loss.

Rev. Rul. 73-476, 1973-2 C.B. 301, holds that if three unrelated tenants-in-common of three separate parcels rearrange their interests so that each party becomes the sole owner of one of the parcels, an exchange occurs so that gain or loss is realized. Rev. Rul. 79-44, 1979-2 C.B. 265, reaches the same conclusion on similar facts.

**CONCLUSION:**

The JOP is contiguous and is owned as tenants-in-common by A and B, C, and T. Because the JOP will be partitioned and no exchange of separate parcels of property will occur, the result in Rev. Rul. 56-437, rather than in Rev. Rul. 73-476, applies. Based on the facts presented, including the representations made, we conclude that the partition of the JOP will not be treated as a sale or exchange by the taxpayers. Accordingly, no gain will be realized the taxpayers under § 1001 as a result of the partition.

## **In-Class Questions**

1. What is the difference between:
  - a. Real and personal property?
  - b. Tangible and intangible property?
  - c. Capital assets and non-capital assets?
2. Your client recently purchased an office building including the land. The purchase agreement does not break out the price between the land, building, fixtures, etc. What should you recommend to your client and why? Be specific.
3. ABC Hotels is constructing a ski resort on a very large piece of property it owns near Lake Tahoe. The work includes grading the land to make it suitable for a ski slope and lift. It must also construct some roads so visitors can get in and out of the resort. ABC's controller knows that these costs must be capitalized and is wondering if any of the capitalized amounts are depreciable for tax purposes and if so, what is the recovery period and method.<sup>1</sup>
4. Hartford Corporation is modifying one of the floors of its 10-story office building to house more computer equipment. It will raise the floor so that wiring can be installed below it. For depreciation purposes, is the cost of the raised floor considered part of the building or the computer equipment or neither?<sup>2</sup>

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<sup>1</sup> Consider FSA 200021013 (not in Reader) and Eastwood Mall (6<sup>th</sup> 1995; summary in Reader).

<sup>2</sup> Consider FSA 200044002 (not in Reader) and Rev. Rul. 67-349 and FAS 200203009 (both in Reader).

5. Create four questions suitable for a cost segregation study. Consider FSA 200203009 and the cases mentioned in it and Rev. Rul. 67-349.
  
  
  
  
  
  
  
  
  
  
  
  
  
  
6. Per Rev. Proc. 87-56, what asset classes, descriptions and MACRS lives might be used by a
  - a. Semiconductor manufacturer?
  
  
  
  
  
  
  
  - b. Retail department store?
  
  
  
  
  
  
  
  
  
  
  
  
  
7. Calculate depreciation for this year and next for the following assets placed in service by a calendar year company. Assume no §179 election was made.
  - a. Computer \$13,000 placed in service on 5/2/0X1

b. Car \$38,000 placed in service on 9/1/X1 (also see Rev. Proc. 2008-22 attached)

c. Warehouse (excluding land) \$800,000 placed in service on 7/5/X1

8. Would any of the property in the above question be eligible for:

a. A §179 election?

b. 50% bonus depreciation under §168(k)?

9. How is the property in Question #7 depreciated for AMT purposes? (§56)

10. List three §1231 assets that a computer manufacturer might have:

11. List two assets that a computer manufacturer might have that are neither §1231 assets nor capital assets:

12. Calculate recognized gain and its character on the sale of equipment owned by sole proprietor Sam:

- |                         |           |
|-------------------------|-----------|
| a. Sales price          | \$80,000  |
| b. Purchase price       | \$110,000 |
| c. Depreciation claimed | \$45,000  |

13. How would your answer change to Question #12 if

a. The sales price was \$20,000?

b. Instead of selling the equipment, Sam gave it to his son? (§1245(b) and §1.1245-2(a)(4))?

14. Calculate recognized gain and its character on the sale of a building owned by ABC Corporation:

- |                         |             |
|-------------------------|-------------|
| a. Sales price          | \$2,500,000 |
| b. Purchase price       | \$1,100,000 |
| c. Depreciation claimed | \$600,000   |

15. Calculate the character of the following gains and losses from sales of §1231 assets:

Tax Year	Net §1231 loss	Net §1231 gain
20X1	-0-	
20X2	\$11,000	
20X3	\$23,000	
20X4		\$9,000
20X5		\$19,000
20X6		\$13,000

16. Why was there no tax effect in the *Lakewood* case?

17. What does “sale or other disposition” as used in §1001 mean?

18. Convert §1001(a), (b) and (c) into a formula and set of questions that can be used to compute gain or loss on sale of any asset.

19. Should used assets have a shorter recovery period or more rapid depreciation method than new assets? Explain.
20. A dispute remains as to whether an appreciating asset “used” in a trade or business, such as an antique musical instrument used by a professional musician, is depreciable under §168. The *Selig* case in the Reader includes a summary of the *Simon* and *Liddle* cases. The IRS issued the following AOD (NA) for the *Simon* case.

**Action on Decision 1996-009**

*Richard L. and Fiona Simon v. Commissioner*, 68 F.3d 41 (2d Cir. 1995), aff’g 103 T.C. 247 (1994)

Issue

Whether professional musicians are entitled under I.R.C. section 168 to depreciate their antique musical instruments used in their trade or business, notwithstanding that the instruments have no determinable useful lives.

Discussion

The taxpayers claimed depreciation deductions for two nineteenth-century violin bows used in their careers as professional musicians. The instruments were purchased and placed in service during the taxable years governed by the accelerated cost recovery system (ACRS). The taxpayers claimed depreciation deductions as determined under I.R.C. section 168(b) with respect to 5-year recovery property. The Service disallowed taxpayers' depreciation deductions in full. See also *Liddle v. Commissioner*, 65 F.3d 329 (3d Cir. 1995), aff’g 103 T.C. 285 (1994) (depreciation deduction allowed for a seventeenth-century bass viol).

Section 167(a), which provided a “reasonable allowance” for depreciation, was amended to provide that the deduction allowable under section 168 shall be deemed to constitute such reasonable allowance. Section 203(a) of the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 1981-2 C.B. 283. Section 168 (added to the Code by section 201(a) of ERTA, 1981-2 C.B. 275) established the ACRS method of depreciation. Under section 168, the cost or other basis of eligible property was recovered using an accelerated method of depreciation over a predetermined recovery period. Eligible property, i.e., “recovery property”, was assigned to one of five classes of property each with its own designated recovery period. I.R.C. section 168(c). The term “recovery property” was defined as “tangible property of a character subject to the allowance for depreciation.” I.R.C. section 168(c)(1).

Prior to the enactment of ACRS, the concepts of useful life and salvage value were factors to be considered in determining the eligibility of an asset for a depreciation deduction. The amount of depreciation was limited to the cost or other basis of the property less a reasonable estimate for salvage value. The useful life was determined based on the facts and circumstances or under an asset depreciation range. See former I.R.C. section 167(m), section 109(a) of the Revenue Act of 1971, Pub. L. No. 92-178, 1972-1 C.B. 443, 450. Although ACRS statutorily eliminated the concept of salvage value by permitting the entire cost of an asset to be recovered, I.R.C. section 168(b), it did not diverge from the concept that to be entitled to depreciation, property had to have a determinable useful life.

The dispute is whether taxpayers' antique musical instruments constitute "recovery property" as defined in section 168(c)(1). Resolution of that question depends upon the meaning of the phrase "property of a character subject to the allowance for depreciation." The government argued that antique musical instruments that do not have a determinable useful life are not "of a character subject to the allowance for depreciation."

The Tax Court construed the phrase "property of a character subject to the allowance for depreciation" as including any property used in a trade or business that is subject to exhaustion, wear and tear or obsolescence, even if such property has an indeterminable useful life and concluded that the musical instruments were subject to wear and tear and thus depreciable. The Second Circuit (Simon) and the Third Circuit (Liddle) affirmed the Tax Court.

It is the Service's position that the enactment of ACRS merely shortened the recovery period over which an asset is depreciated to stimulate economic growth but did not convert assets that formerly were not depreciable into assets that are depreciable. The Senate Report, in discussing property that is depreciable under section 168, notes that "assets that do not have a determinable useful life and that do not decline in value predictably are not depreciable." S. Rep. No. 144, 97th Cong., 1st Sess. 39 (1981), 1981- 2 C.B. at 421. See also H. Conf. Rep. No. 215, 97th Cong., 1st Sess. 196 (1981), 1981- 2 C.B. 481.

Despite substantial statutory revisions that modify the accelerated cost recovery system (MACRS) and delete the term "recovery property," section 201(a) of the 1986 Act, Pub. L. No. 99- 514, 1986-3 C.B. (Vol. 1) 38, the adverse decision in Simon impacts on property placed in service after 1986. See *Selig v. Commissioner*, T.C. Memo. 1995-519 (MACRS would not reinstate the determinable useful life requirement that the court previously had determined was eliminated with the enactment of ACRS).

Since there is no conflict among the circuits, no petition for certiorari was recommended. We believe that the Simon and Liddle cases are wrongly decided and the issue should be pursued in other circuits.

Recommendation - Nonacquiescence.

A dissenting judge (Hamblen) in the Tax Court opinion of *Simon* (103 TC 247, 268 (1994)) noted that the holding of the majority would create a "tax shelter for musicians." This judge also noted that whether an asset is subject to wear and tear is just one determinant of whether it is depreciable, but is not the "final determinant." This judge also referred to the legislative history to the 1981 Act which created ACRS (although the meaning of the statements is likely ambiguous). Another dissenting judge (Gerber) suggested that perhaps there were divisible parts of the property with some depreciable and others not (such as the collector's value of the instrument). Another dissenting judge (Halpern) argued against such a division noting that all of the elements of real property are not segregated and separately depreciated (or found not depreciable). Per Halpern: "We do not, in general, allow the fee owner of land to fragment the varied utilities inherent in her ownership in order separately to depreciate those with a determinable useful life. I do not see why we should do so with respect to otherwise nondepreciable property, such as the bows." (103 TC 247, 285)

Recall that in FSA 200203009 (Reader p. 8) that if an asset is used in more than one activity, for depreciation purposes, its use is not split for depreciation, but is depreciated based on its primary use. Perhaps that is another justification for not splitting the musical instrument into depreciable and non-depreciable pieces.

Per IRS Publication 946, *How to Depreciate Property*: “To be depreciable, the property must meet all the following requirements.

- It must be property you own.
- It must be used in your business or income-producing activity.
- It must have a determinable useful life.
- It must be expected to last more than one year.”

“To be depreciable, your property must have a determinable useful life. This means that it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.”

There is no specific mention in Pub 946 that antiques or other appreciating property is not depreciable.

What do you think is the correct interpretation of §168 regarding whether appreciating assets are depreciable? Explain.

21. The Tax Relief Act of 1995 (H.R. 1215, §6321) proposed a new depreciation system called Neutral Cost Recovery System (NCRS). NCRS factors inflation and rate of return into depreciation calculations. The purpose was to have depreciation reflect the benefit a taxpayer would have received if it were able to deduct the entire basis of the asset in the year of acquisition. Under NCRS, aggregate depreciation deductions for an asset will exceed the asset's basis. For tangible personal property, NCRS requires 150% DB rather than 200%DB. For real property, only the inflation factor is used (not also the 3.5% interest factor).

For tangible personal property with a life less than 15 years, depreciation is computed using 150% DB multiplied by the “applicable neutral cost recovery ratio” each year except for the year the asset is placed in service.

“applicable neutral cost recover ratio” =

$$\frac{\text{GDP deflator for calendar quarter which includes the midpoint of the tax year}}{\text{GDP deflator for calendar quarter which includes the mid-point of the tax year in which the property was placed in service}}$$

x 1.035<sup>n</sup> [rounded to the nearest 1/1000; shall never be less than 1]

Taxpayers could irrevocably elect not to use NCRS.

The additional depreciation allowed by NCRS is not to affect the adjusted basis or any interest in a pass-through entity, and shall not be treated as depreciation for recapture purposes under IRC §1245 and §1250.

Example:

- \$100,000 equipment with 7-year life
- Half-year convention
- Placed in service on first day of tax year (therefore, in year 2, n = 1)
- Applicable neutral cost recovery ratio used below assumes 3% inflation

Year	200% DB	150% DB	NCRS
1	\$14,290	\$10,710	\$10,710
2	\$24,490	\$19,130	\$20,394
3	\$17,490	\$15,030	\$17,082
4	\$12,490	\$12,250	\$14,841
5	\$8,930	\$12,250	\$15,821
6	\$8,920	\$12,250	\$16,866
7	\$8,920	\$12,250	\$17,980
8	\$4,460	\$6,130	\$9,592
Total	\$100,000	\$100,000	\$123,286

- What are the advantages of NCRS?

b. What are the disadvantages of NCRS?

c. What alternatives exist that would provide similar results?

22. Excerpt from the Treasury Department's Report to The Congress on Depreciation Recovery Periods and Methods, 7/00, pgs. 2 – 3 (link to full report - <http://www.treasury.gov/resource-center/tax-policy/Documents/depreci8.pdf>) :

**“Principal Issues and Findings Related to the Current Depreciation System**

...

The current depreciation system is dated. The asset class lives that serve as the primary basis for the assignment of recovery periods have remained largely unchanged since 1981, and most class lives date back at least to 1962. Entirely new industries have developed in the interim, and manufacturing processes in traditional industries have changed. These developments are not reflected in the current cost recovery system, which does not provide for updating depreciation rules to reflect new assets, new activities, and new production technologies. As a consequence, income may be mismeasured for these assets, relative to the measurement of the income generated by properly classified existing assets. Data requirements for keeping the system up-to-date, however, are significant.

The current depreciation system has been constructed using an ambiguous classification criterion. Most assets receive depreciation allowances that are determined by the length of their “class lives.” However, current class lives have been assigned to property over a period of decades, under a number of different depreciation regimes serving dissimilar purposes, and with changed definitions of class lives. The ambiguous meaning of current class lives contributes to administrative problems and taxpayer controversies. It also makes difficult the rational inclusion of new assets and activities into the system, and inhibits rational changes in class lives for existing categories of investments.

The current system creates cliffs and plateaus in the values of depreciation deductions that may favor some assets while penalizing others. These problems arise because of the way class lives are mapped into Modified Accelerated Cost Recovery System (MACRS) recovery classes. Cliffs, in which assets with similar class lives receive very different depreciation allowances, occur because the length of the MACRS cost recovery period (and sometimes the depreciation method) changes abruptly at the endpoints of recovery classes. Plateaus, on which assets with very different class lives receive the same depreciation allowances, occur because MACRS

