



IRS

# Cost Segregation at Auto Dealerships

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## Introduction:

On February 25, 2008, The Heavy Manufacturing and Transportation Industry Director signed industry directive # LMSB-4-0208-006 which provides technical guidance to field agents. This directive is intended to serve as a tool to reduce audit cycle time and taxpayer burden. It should be noted that while this document has been drafted following current guidance, it is not an official pronouncement of law and is not intended to be relied on as such.

This directive and the attached asset matrix represent a new Chapter in the Cost Segregation Audit Technique Guide. The Guide was written by the Capitalization Technical Advisor with the assistance of IRS engineers, IRS counsel attorneys and input from internal and external stakeholders. This new Chapter for Auto Dealerships is not a stand alone product and the content of the Audit Technique Guide should be considered as a whole.

## Background:

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

The determination of real or personal property treatment for MACRS purposes are to be based on the **facts and circumstances** surrounding each individual item claimed as personal property. These facts and circumstances must be viewed in the light of the criterion set forth not only by the courts, but the historical statutes set by Congress, the Internal Revenue Code and Regulations, Revenue Rulings, Revenue Procedures and other directives from the Commissioner of the IRS. The Tax Court and other Courts' findings and determinations as to specific items should also be considered.

## History of Cost Segregation:

### **Definition of Building and Structural Components in general:**

Reg. 1-48 (e) states that the term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores.

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 therefore 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.

**Definition of Personal Property in general:**

Section 1.48-1 (c) defines tangible personal property as including all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property

**Class Life Asset Depreciation Range:**

Revenue Procedure 87-56 provides the most current version of the Class Life Asset Depreciation Range (CLADR). This CLADR sets forth the lives of property that are necessary to compute the depreciation allowances under Section 168. Activity Class 57.0 – DISTRIBUTIVE TRADES AND SERVICES applies to assets used in wholesale and retail trade, and personal and professional services, and includes section 1245 assets used in marketing petroleum and petroleum products. These assets qualify for a MACRS life of 5 years.

**Hospital Corporation of America v. Commissioner:**

In a landmark decision, Hospital Corporation of America v. Commissioner, 109 T.C. 21 (1997), provided the legal support to use cost segregation studies for computing depreciation. In effect, this decision has reinstated a form of component depreciation for certain building support systems, such as electrical and plumbing systems that directly serve tangible personal property. This decision changed the way in which allocations between tangible personal property and real property are viewed by the courts.

**Chief Counsel Guidance:**

Chief Counsel issued further guidance to the field in the form of an advice memorandum dated May 28, 1999. It made the following observations and recommendations for field agents examining cost segregation studies:

- The determination of whether an asset is a structural component or tangible personal property is a facts-and-circumstances assessment.
- The use of cost segregation studies must be specifically applied by the taxpayer.
- Allocations must be based on a "logical and objective measure" of the portion of the equipment that constitutes § 1245 property.
- An accurate cost segregation study may not be based on non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records.
- Cost segregation studies should be closely scrutinized by the field.
- A change in depreciation method is a change in method of accounting, requiring the consent of the Secretary or his delegate.

**Whiteco Factors:**

Revenue Ruling 75-178, 1975-1 C.B. 9 outlined several criteria to determine § 1245 property classification. These criteria included:

- whether the asset is movable or removable;
- how the asset is attached to real property;
- the design of the asset; and
- whether the asset bears a load.

The classic pronouncement addressing inherent permanency was *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664, 672-673 (1975). The Tax Court, based on an analysis of judicial precedent, developed six questions designed to ascertain whether a particular asset qualifies as tangible personal property. These questions, referred to as the "Whiteco Factors," are:

1. Can the property be moved and has it been moved?
2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances that show that the property may or will have to be moved?
4. Is the property readily movable?
5. How much damage will the property sustain when it is removed?
6. How is the property affixed to land?

It should also be noted, however, that moveability is not the only determinative factor in measuring inherent permanency. In *L.L. Bean, Inc. v. Comm.*, T.C. Memo. 1997-175, aff'd, 145 F.3d 53 (1st Cir. 1998), it was determined that, even though the structure could be moved, it was designed to remain permanently in place. Thus, it was determined to be an inherently permanent structure.

Other factors that should be considered when addressing the Whiteco factors include:

- The manner in which an item is attached to a building or to the land,
- The weight and size of the item,
- The time and costs required to move the components,
- The number of personnel required in planning and executing a move,
- The type and quantity of equipment required for a move,  
The history of the item or similar items being moved,
- The time, cost, manpower and equipment required to reconfigure the existing space if the item is removed,
- Any intentions regarding the removal,
- Whether the item is designed to be moved, and
- Whether the item is readily usable in another location.

**Summary:**

To determine an asset that is constructed with and is integral to a building facility as personal property eligible for the MACRS recovery period and bonus depreciation is a complicated task.

The historical guidance set by the Code, Regulations and Revenue Procedures through the CLADR show that an asset that is a structural component of a building should be depreciated with the building. However, the Courts over the years, have found that in certain instances items that are a part of a building can still qualify as personal property if they meet certain tests, or their use is integral to the taxpayer business activity.

The IRS assumes an item built as an integral part of a building structure is a structural component of the building placed for the operation and maintenance of the building and should be allowed depreciation with the underlying building - unless substantially proven otherwise.

The Cost Segregation Audit Technique Guide, and the specific chapter of Auto Dealerships, is based on current published guidance. Any questions can be directed to the Motor Vehicle Technical Advisor - Retail Terri Harris (616) 235-1655.