Bloomberg BNA

Daily Tax Report®

Depreciation

David Burton examines a recent private letter ruling where the Internal Revenue Service held that ''zip'' drywall partition systems are depreci-ated faster than conventional drywall partitions. He compares the Service's ruling in the PLR with consistent federal appeals court decisions that preceded it—but were omitted from the ruling's discussion—and considers opportunities for real estate developers and im-plications for certain nontraditional real estate investment trusts.

All Drywall Systems Aren't Created Equal Under MACRS

BY DAVID BURTON

Private Letter Ruling 201404001[1] highlights that assets with a similar purpose and a similar cost can have starkly different tax treatments.

In the ruling, the taxpayer intended to purchase, install and place into service two different types of ''interior non-load bearing drywall partition systems''—zip and conventional. The taxpayer requested a ruling from the Internal Revenue Service as to the appropriate depreciation classification of each type of drywall system.

A zip drywall system is described having the following feature:

> a person can zip the zip tape up without it breaking even after the joint compound has significantly cured. When zipped up, the zip tape removes the joint compound that covers it and then exposes the screws under the tape in a manner that allows screw removal and then disassembly of the zip type partition for removal and reuse. . . . It can be readily removed and can remain in substantially the same condition after removal as before.

In contrast, a conventional drywall system is described as:

> gypsum board partitions, studs, joint tape, and covering joint compound. The joint tape cannot be removed without breaking after the joint compound has had time to significantly cure. The removal of the joint tape and a conventional drywall partition can be easily accomplished only by demolition of the partitions. Disassembly or deconstruction of a conventional drywall partition in a manner that provides for easy reuse isn't practical because the screws are beneath the non-removable joint tape and the covering joint compound.

The ruling further notes that conventional drywall ''cannot be easily removed and cannot remain in substantially the same condition after removal as before.''

Analysis

The ruling provides that the ''depreciation classification of . . . zip type partitions and conventional drywall partitions depends on whether the partitions are inherently permanent structures. This determination is made by applying the *Whiteco* factors,'' referring to *Whiteco Indus. Inc. v. Commissioner*, 65 T.C. 664 (1975).

There are six *Whiteco* factors:

- Is the property capable of being moved, and has it in fact been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that tend to show that the property may or will have to be moved?
- How substantial and time-consuming is removal of the property?

[1] Jan. 24, 2014 (17 DTR K-3, 1/27/14).

 ISSN 0092-6884

■ How much damage will removal cause?

■ What is the manner of affixation of the property to the land?[2]

No one factor is decisive.[3]

In the ruling, the Service dodges applying the six factors to zip and conventional drywall systems because the taxpayer represents that the ''zip type partitions . . . are not inherently permanent structures'' and the ''conventional drywall partitions . . . are inherently permanent structures under the factors described in *Whiteco*.''

Holding

Based on the representation, the Service rules that the zip drywall system is included in asset class 57.0 of Revenue Procedure 87-56. Assets in that class, so long as they avoid the foreign and tax-exempt use property rules,[4] are eligible for five-year double declining balance depreciation. Further based on the representations, the Service rules that conventional drywall systems are nonresidential real property, which results in a 39-year recovery period and straight-line depreciation.

Omitted Precedents

This ruling is actually consistent with two cases from the U.S. Court of Appeals for the Eighth Circuit and one case from the Tenth Circuit.

The first case, *Minot Fed. Sav. & Loan Ass'n v. United States*, 435 F.2d 1368 (8th Cir. 1970), involved movable partitions. The partitions in question were installed by a landlord in an empty building because the landlord wanted to be able to configure the building however the future tenant desired. It was possible to store the partitions.

The Eighth Circuit described the installation process as ''simple'' and requiring attaching ''channels'' to the ceiling and floor and inserting the partitions into the channels. The channels were attached to the ceiling and floor with ''No. 8 sheet metal screws and a small masonry nail in approximately three-feet intervals.'' Once the partitions are removed, the ''small nail and screw holes are virtually invisible.'' Not surprisingly, the court held that the partitions weren't ''structural components'' and thus were eligible for a general investment tax credit that was effective for the year in question.

The Tenth Circuit opted to follow the Eighth Circuit when a radio station owner litigated the status of movable partitions used to divide office and other work space. The Tenth Circuit, in *King Radio Corp., Inc. v. United States*, 486 F.2d 1091 (10th Cir. 1973), wrote: ''We find ourselves with this problem adrift in the murky sea of tax law with only one buoy to guide us in reaching a decision. That buoy is the Eighth Circuit's decision in *Minot*.''

Planning Considerations

■ A rough estimate is that the more favorable depreciation permitted for zip drywall systems could justify paying 20 percent or more to upgrade from a conventional system.

■ The PLR doesn't provide full audit protection, but Eighth and Tenth Circuit court rulings provide significant comfort.

■ A different branch of IRS will address similar issues in pending PLRs regarding REIT investments in file storage shelving systems and computer server farms.

The IRS acquiesced to these holdings when it decided to not request that the Supreme Court grant certiorari in the Tenth Circuit case.[5]

In 1985, a taxpayer decided to try to test the generosity of the Eighth Circuit's holding in *Minot* by asserting to that court that the ''movable partition'' precedent should be extended to conventional drywall. The Eighth Circuit described the items in question as ''non-load bearing gypsum drywall partitions, extending from the floor to the height of a false ceiling.'' The court in *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985), concluded:

> the walls or partitions in question are not easily removed, and, if they are removed at all, a portion of them is normally destroyed in the process. There is no evidence that the taxpayer, when it installed these walls or partitions, ever intended that they be removed or reused. They were permanent parts of the building in a sense that the walls or partitions in *Minot* were not. Taxpayer contends that it was an error of law for the Tax Court to rely upon the lack of reusability as one factor in reaching the conclusion that these walls were permanent parts of the structure. We disagree. The fact that an item is not readily reusable in another location certainly is evidence supporting the conclusion that it is to be treated as permanent in its present location.

Thus, the Eighth Circuit concluded that conventional drywall constituted a ''structural component'' ineligible for the then-applicable investment tax credit that only applies to certain personal property.

Oddly, despite an appellate opinion directly on point with respect to the Service's conclusion in the private letter ruling regarding conventional drywall, the PLR didn't cite *Mallinckrodt*. Similarly, the Service didn't opt to include the movable partition analysis from the *Minot* or *King Radio* cases, or the *King Radio* action on the decision as support for its conclusion that zip drywall is personal property eligible for accelerated depreciation. Was the author of the private letter ruling unaware of these cases and the action on the decision? Or did the author conclude that the Eighth and Tenth Circuit precedents didn't merit citation in the private letter ruling?

[2] *Whiteco Indus. Inc. v. Commissioner*, 65 T.C. 664, 672-73 (1975), *acq.* 1980-1 C.B. 1.

[3] See *JFM Inc. v. Commissioner*, T.C. Memo. 1994-239.

[4] See I.R.C. Section 168(g).

[5] *In Re: King Radio Corp., Inc. v. United States*, AOD 1975-580.

  DTR ISSN 0092-6884

Tax Planning Opportunity For Real Estate Developers

The ruling raises the question as to whether real estate developers will incur the incremental cost of zip drywall systems, in circumstances in which conventional drywall systems would suffice, in order to improve their cost recovery from 39-year straight-line to five-year double declining balance depreciation. A rough estimate is that the more favorable tax treatment could justify paying 20 percent or more to upgrade from a conventional to a zip drywall system, assuming the owner of the building has the tax appetite for the accelerated depreciation.

The private letter ruling provides such real estate developers with less than full audit protection. First, the Service is only bound to follow the ruling with respect to the taxpayer to whom it issued the ruling. Second, the ruling is based on the *Whiteco* representation that the taxpayer provided; if that representation is inaccurate, the ruling is invalid even for the taxpayer who requested it.

Nonetheless, as zip system drywall seems to be akin to a movable partition, the Eighth and Tenth Circuit's opinions in *Minot* and *King Radio*, respectively, appear to provide all taxpayers with significant comfort.

Harbinger of Proposed REIT Regulations

This ruling turned out to be a harbinger of proposed regulations defining ''real estate assets.'' Treasury released the proposed regulations (REG-150760-13) on May 9, 2014, and the regulations addressed drywall, as well as solar projects and other nontraditional real estate investment trust (REIT) assets.[6]

The proposed regulations refer to a ''modular partition system'' (rather than the more colloquial ''zip drywall'' terminology from the private letter ruling) and ''conventional partition system.'' A modular partition system is described as ''can be easily removed, remains in substantially the same condition as before, and can be reused.'' In contrast, the conventional partition system ''can be removed only by demolition, and once removed, neither the conventional partition system nor its components can be reused.''[7]

The proposed regulations apply a nine-factor test in determining whether the modular partitions are ''structural components'' (i.e., real estate assets):

- the time and expense to install and remove the asset;
- whether the item is designed to be moved;
- the damage that removal would cause to the asset or the building to which it is affixed;
- whether the asset serves a utility-like function with respect to the building it is associated with;
- whether the asset services the building in its passive function;
- whether the asset produces income from consideration for the use of the building;
- whether the asset is installed during construction of the building;
- whether the asset will remain if the tenant vacates the building; and
- whether the asset is owned by the same party that owns the building.[8]

The proposed regulations conclude that the modular partition system ''is not a structural component . . . and, therefore, is not real property'' based on the application of the nine-factor test. In contrast, the conventional partition system ''is a wall, and walls are listed as structural components'' and therefore, real property.[9]

The nine-factor test is similar to the six-factor *Whiteco* test discussed above. The preamble to the proposed regulations offers no explanation as to the relationship between the nine-factor test and the six-factor *Whiteco* test. Further, there is no explanation as to why the nine-factor test is a better determinant of real property status than the six-factor *Whiteco* test.

Although the outcome is similar in both the private letter ruling and the proposed regulations, the preamble to the proposed regulations provides that it defines ''real property only for purposes of sections 856 through 859'' (i.e., the REIT statutory provisions). Rather than making it clear that there is a clear demarcation between the REIT and the depreciation rules, the preamble requests comments ''on the extent to which various meanings of real property . . . should be reconciled, whether through modifications to these proposed regulations or through modifications to the regulations under other Code provisions.'' Such a reconciliation would mean little for drywall but could have ramifications for solar projects, data centers and cold storage warehouses, all of which the proposed regulations determine in certain circumstances to be real estate but are generally not ''nonresidential real property'' for depreciation purposes.[10]

Leasing Drywall

In years past, some financiers have asserted it is possible to own and lease out under a true lease conventional drywall installed in a building (while not owning the building itself) and depreciate the drywall. This ruling references the fact that the ''taxpayer is contemplating leasing a portion of, or all of, the . . . space'' containing the drywall ''to the general public.''

It would be inappropriate to read this ruling as the Service blessing a taxpayer purporting to purchase and lease conventional drywall and treating the arrangement as a true lease. First, the ruling provides that the taxpayer will lease the ''space'' (i.e., a customary lease of real estate (not an ''equipment'' style lease of standalone drywall)). Second, the ruling provides that ''no opinion is expressed or implied concerning . . . whether Taxpayer has a depreciable interest in the zip type partitions or the conventional drywall partitions.''

---

[6] https://s3.amazonaws.com/public-inspection.federalregister.gov/2014-11115.pdf. The proposed regulations are prospectively effective following publication in their final form.

[7] Prop. Regs. Section 1.856-10(g), Ex. 7.

[8] Prop. Regs. Section 1.856-10(d)(3)(iii).

[9] Prop. Regs. Section 1.856-10(g), Ex. 7.

[10] See I.R.C. Section 168(c).

Conclusion

Few real estate investors would think that they needed to consult a tax adviser about the drywall installed in their investment properties, but this ruling demonstrates that they do. Depending upon one's perspective, the drywall private letter ruling highlights either the elegant technical precision of our tax system, with its ability to distinguish between the zip and conventional drywall systems, or its counterintuitive complexity.

  DTR ISSN 0092-6884