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**COORDINATED ISSUE
RETAIL INDUSTRY
ACRS & ITC - SUSPENDED ACOUSTICAL CEILINGS**

Facts

Company A is a retailer engaged in the business of selling a wide variety of goods directly to the consuming public through its operation of department, discount and specialty stores. The company's new store facilities are located in regional shopping centers, malls, or separate buildings.

Company A treats the suspended acoustical ceilings of the new store facilities as either three or five year ACRS property and also takes investment credit on these ceilings.

Question

Does the suspended acoustical ceiling installed in the selling area of the new store facilities qualify as either three or five year ACRS property?

Would this property also qualify for the investment tax credit?

Law

(Prior to enactment of the 1986 Tax Reform Act which extended the lives of the ACRS property and eliminated the investment tax credit.)

Proposed Regulation 1.168-1 states that "Section 168 of the Internal Revenue Code of 1954 provides a system for determining cost recovery deductions for recovery property, the Accelerated Cost Recovery System (ACRS)." The definition of recovery property and the classification of recovery property into recovery categories of 3, 5, 10 and 15 years is provided in Regulation 1.168-3.

Internal Revenue Code Section 168(f)(1)(A)(i) states "the deduction allowable under subsection (a) with respect to any component (which is Section 1250 class property) of a building shall be computed in the same manner as the deduction allowable with respect to such building...."

Section 38 of the Internal Revenue Code allows a credit against Federal Income Tax for qualified investments in "section 38 property". The determination of what 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 Internal Revenue Code defines Section 38 property as (a) tangible personal property or (b) other tangible property, but only if such property "is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communication, electrical energy, gas, water or sewage disposal services...."

Regulation 1.48-1(c) states the term "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). Thus, buildings, swimming pools, paved parking areas, wharves or docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which are contained in or attached to a building, constitutes tangible property for purposes of the credit allowed by Section 38."

Regulation 1.48-1(d)(2) defines manufacturing, production and extraction. "For purposes of the credit allowed by Section 38, the terms "manufacturing", "production" and "extraction", include the construction, reconstruction or making of property out of scrap, salvage or junk material, as well as from new or raw material, by processing, manipulating, refining or changing the form of an article, or by combining or assembling two or more articles, and include the cultivation of the soil, the raising of livestock, and the mining of materials...."

Revenue Ruling 81-66, 1981 C.B. 19 states that activities involving the sale of merchandise, food and other items to the general public for personal or household consumption, and the rendering of services incidental to the sale of goods are considered to be retail activities rather than manufacturing within the commonly accepted meaning of the term. The retail activities are not listed in Code Section 48(a)(1) and therefore the retailer is not eligible for investment tax credit for other tangible property.

Regulation 1.48-1(e)(2) states the "structural components" includes such parts of a building as walls, partitions, floors and ceilings, as well as any permanent coverings, 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; electrical wiring and lighting fixtures; chimneys; stairs, escalators and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation and maintenance of a building.

Revenue Ruling 75-178, 1975-1 C.B. 9 states that the use of a functional or equivalency test (1) to classify property as inherently permanent where it is not itself physically attached to the land, or (2) to classify property as a structural component where it is not an integral part of (and therefore, a permanent part of) a building, is no longer the criteria to be used to classify property. Rather, the problem of classification of property as "personal" or "inherently permanent" should be made on the basis of the manner of attachment to the land or the structure and how permanent the property is designed to remain in place.

Revenue Ruling 77-362, 1977-2 C.B. 8, provides that a fire protection system that is designed to remain in place permanently but has a variety of component parts, each of which may be mechanically removed, is a structural component of the building and does not qualify as Section 38 property. In the rationale, the Revenue Ruling states that the system must be viewed as including all component parts that function to perform the task of providing automatic fire protection for the building. For example, the computer, even though detachable and transportable, is necessary for the system to provide the automatic fire protection for which it is designed.

In Dixie Manor, Inc. vs. U.S. (W.D. Ky 1979), 79-2 USTC, p. 9469, 44 AFTR F.2d 79-5442 the courts determined that room partitions installed in a shopping center where it is customary to install interior walls to meet the design requirements of the tenants and to remove, change or replace such walls when new tenants are substituted for old tenants, could not be categorized as tangible personal property for which the taxpayer could obtain investment credit.

In Kramertown Co., Inc. vs. Commissioner, 488 F2d 728, (5th. Cir. 1974), aff'g TCM 1972-239 the court held that shopping center roof top heating and air conditioning units designed and installed so that they would be removed from the building for service and replacement were structural components which did not qualify as Section 38 property. In its opinion, the court stated that removability is not the sole determinate for classifying an asset as tangible personal property.

Discussion

The retailer contends that the suspended ceilings are tangible personal property, readily removable, and used as accessories to their retail operation.

The government contends that suspended ceilings are structural building components as defined by Section 1.48-1(e)(2) of the Regulations. The Government also stresses that the removability of the suspended ceiling is not the controlling factor in determining the ACRS recovery property classification and investment tax credit eligibility, as many of the structural components listed in the regulations can be readily removed from the

building.

To be considered an accessory to the retail trade, a suspended acoustical ceiling would have to be essential to the operation of the retail activity. Suspended acoustical ceilings are not essential for retail activities since not all retail facilities have this type of ceiling. When installed in a building, a suspended acoustical ceiling becomes a structural component of the building.

Suspended ceilings serve to finish the usable space below them. The ceilings are designed and installed in manner to be aesthetically pleasing and at the same time conceal the above mechanical, electrical and plumbing systems. When a suspended acoustical ceiling is installed in a building it becomes a boundary for use in design of the buildings HVAC system.

The suspended ceiling is not viewed as a temporary covering for the ceiling; it is the ceiling. The regulations, revenue rulings and court cases previously cited, all point to the fact that suspended acoustical ceilings are structural components ineligible for classification as Section 1245 property, and do not qualify for the ACRS deduction as 3 or 5-year property or for the investment tax credit.