Section 1245 & 1250 Property

The benefits of the ITC were somewhat offset by the provisions of IRC §§ 1245 and 1250, also enacted in 1962. These Code sections result in the conversion of capital gain to ordinary income on the disposition of a property, to the extent its basis has been reduced by an accelerated depreciation method. The definitions of property for purposes of §§ 1245 and 1250 are very similar to that for ITC and make reference to the regulations under § 48 and the definitions under § 38 property. These interrelated Code sections and the regulations (38, 48, 1245 and 1250) provide the pertinent authority for determining eligibility for ITC. They also determine eligibility for the immediate write-offs under section 179, the appropriate recovery periods for depreciation (§§ 167 and 168) and for depreciation recapture upon a disposition.

The primary issue in cost segregation studies is the proper classification of assets as either § 1245 or § 1250 property. Accordingly, the ITC rules are critical in determining whether a taxpayer has classified property into the appropriate asset class.

Section 1245(a)(3) provides that "section 1245 property" is any property which is or has been subject to depreciation under § 167 and which is either personal property or other tangible property used as an integral part of certain activities. Such activities include manufacturing, production or extraction; furnishing transportation, communication, electrical energy, gas, water, or sewage disposal services. Certain other "special use" property also qualifies as § 1245 property, but is not of a primary concern for purposes of this discussion. It is important to note that § 1245(a)(3) specifically excludes a building or its structural components from the definition of § 1245 property.

Treas. Reg. § 1.1245-3 defines "personal property," "other tangible property," "building," and "structural component" by reference to Treas. Reg. § 1.48-1. As previously discussed, those regulations (§ 1.48-1) provide definitions of tangible personal property that qualifies as § 38 property for ITC.

Section 1250(c) defines "section 1250 property" as any real property, other than section 1245 property, which is or has been subject to an allowance for depreciation. In other words, § 1250 property encompasses all depreciable property that is not § 1245 property.

Land improvements (i.e., depreciable improvements made directly to or added to land), as defined in Asset Class 00.3 of Rev. Proc. 87-56, may be either § 1245 or § 1250 property and are depreciated over a 15-year recovery period. Buildings and structural components are specifically excluded from 15-year property. Examples of land improvements include sidewalks, roads, canals, waterways, drainage facilities, sewers, wharves and docks, bridges, fences, landscaping, shrubbery, and radio and television towers. Note that some activity asset classes also include land improvements such as asset class 57.1 of Rev. Proc. 87-56.

From a statutory standpoint, the primary test for determining whether an asset is § 1245 property eligible for ITC is to determine whether or not it is a structural component of a building. In other words, if an asset is not a structural component of a building, then it can be considered to be § 1245 property. The structural component determination hinges on what constitutes an inherently permanent structure and how permanently the asset is attached to such a structure. Clearly, this is a factually intensive determination and explains the lack of bright-line tests for segregating property into § 1245 and § 1250 classifications.