Office of Chief Counsel
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from: Branch Chief, Branch 7, CC:ITA:7
(Income Tax & Accounting)

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subject: Qualified leasehold improvement property under § 168(e)(6)

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ISSUE

Whether the installation of an HVAC unit, either located on the roof of a building or located on a concrete pad adjacent to the building, constitutes qualified leasehold improvement property ("QLIP") pursuant to § 168(e)(6) of the Internal Revenue Code?

CONCLUSION

The installation of an HVAC unit on the roof of a building or on a concrete pad adjacent to the building is not QLIP under § 168(e)(6) because the installation of such exterior HVAC unit is not an improvement to an interior portion of a building.

FACTS

Pursuant to a lease agreement with an independent third-party lessor, a lessee bears responsibility for improvements to the leased space. The leased premises are a large, stand-alone commercial building used for retail sales. The lessee has replaced several of the HVAC units: some are located on the roof of the building, and some are located on concrete slabs adjacent to the building. The replacement HVAC units serve the leased space which is exclusively occupied by the lessee. The HVAC unit

replacements do not benefit a common area, are not part of the internal structural framework of the building, and do not enlarge the building. The HVAC unit replacements were placed in service by the lessee after October 22, 2004, and before January 1, 2012, and were placed in service more than three years after the building on which they are located or with which they are associated was first placed in service.

The building that is the subject of the lease agreement between the lessee and the lessor is nonresidential real property under § 168(e)(2). Moreover, the lessee claims that the replacement HVAC units are nonresidential real property and are QLIP.

LAW AND ANALYSIS

Section 167(a) provides 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 taxpayer's trade or business. The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168.

Under the general depreciation system (GDS) of § 168(a), the depreciation method, recovery period, and convention are prescribed in, respectively, § 168(b), (c), and (d). For nonresidential real property, the depreciation method is the straight-line method of depreciation. Section 168(b)(3)(A). Section 168(c) prescribes the applicable recovery period of 39 years to nonresidential real property. The applicable convention for nonresidential real property is the mid-month convention. Section 168(d)(2). Section 168(e)(2)(B) defines nonresidential real property as § 1250 property that is not residential rental property or property with a class life of less than 27.5 years.

However, § 168(e)(3)(E)(iv) provides that 15-year property includes QLIP. This classification is effective for property placed in service after October 22, 2004, and before January 1, 2012. For QLIP described in § 168(e)(6), the depreciation method is the straight-line method of depreciation. Section 168(b)(3)(G). Pursuant to § 168(c), 15-year property has a recovery period of 15 years. The applicable convention for QLIP is the half-year convention or the mid-quarter convention, as applicable. Section 168(d)(1) and (3).

Under § 168(e)(6), QLIP has the meaning given such term under § 168(k)(3), except that (A) in the case of an improvement made by the person who was the lessor of such improvement when such improvement was placed in service, such improvement shall be QLIP (if at all) only so long as such improvement is held by such person. Section 168(e)(6)(B) provides an exception to the rule under § 168(e)(6)(A) in the case of death and the transactions listed in § 168(e)(6)(B)(ii)-(v).

Section 168(k)(3)(A) provides that the term “QLIP” means any improvement to an interior portion of a building which is nonresidential real property if: (i) such improvement is made under or pursuant to a lease (as defined in § 168(h)(7)) by the lessee (or

sublessee), or by the lessor, of that portion; (ii) that portion is to be occupied exclusively by the lessee (or any sublessee) of the portion; and (iii) the improvement is placed in service more than three years after the date the building was first placed in service. Section 168(k)(3)(B) provides that QLIP does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

Section 1.168(k)-1(c) of the Income Tax Regulations provides the rules relating to § 168(k)(3). For purposes of § 168(k), § 1.168(k)-1(c)(1) provides that qualified leasehold improvement property means any improvement, which is § 1250 property, to an interior portion of a building that is nonresidential real property if: (i) the improvement is made under or pursuant to a lease (as defined in § 1.168(k)-1(c)(3)(vi)) by the lessee (or a sublessee) of that interior portion, or by the lessor of that interior portion; (ii) the interior portion of the building is to be occupied exclusively by the lessee (or any sublessee) of that interior portion; and (iii) the improvement is placed in service more than 3 years after the date the building was first placed in service by any person. Section 1.168(k)-1(c)(2) provides that qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building. For purposes of § 1.168(k)-1(c), § 1.168(k)-1(c)(3) defines the following terms: building, common area, elevator, escalator, enlargement, internal structural component, lease, nonresidential real property, and structural component.

The term “structural component,” defined in § 1.48-1(e)(2), 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.

The following analysis assumes that the replacement HVAC units are improvements that are required to be capitalized under § 263(a).

The facts presented show that most of the requirements of §§ 168(e)(6) and (k)(3) are otherwise satisfied, and none of the exceptions described in § 168(k)(3)(B) are present. The central issue is whether replacement HVAC units installed by the lessee on the outside of the building can satisfy the requirement in §§ 168(e)(6) that the improvement be “to an interior portion of the building which is nonresidential real property.”

There is no guidance in the statute, the legislative history, or in the regulations under § 1.168(k)-1(c) on the meaning of the language "to an interior portion" of a building. However, a plain reading of the statute provides guidance on what is meant by the term "interior portion" of a building. See Connecticut National Bank v. Germain, 503 U.S. 249, 254 (1992) (providing that Congress "says in a statute what it means and means in a statute what it says there" such that the interpretative analysis begins with the statute); Hatfried, Inc. v. Commissioner, 162 F.2d 628, 631 (3d Cir. 1947) (providing that if the meaning of the statute is clear and unambiguous, then it must be interpreted as Congress has written it, unless it leads to an absurd result).

In particular, the dictionary definition of the word "interior" provides guidance on the meaning of this word. See Crane v. Commissioner, 331 U.S. 1, 6 (1947) (stating that "words of statutes . . . should be interpreted where possible in their ordinary everyday senses"); United States v. Edward Rose & Sons, 384 F.3d 258, 263 (6th Cir. 2004) (using dictionary definition to determine the definition of a "common" area in a statute when use of the term was unambiguous). In this case, "interior," as an adjective, means "1: being within the limiting surface or boundary <~ communication>: INSIDE, INNER – opposed to *exterior*". Webster's Third New International Dictionary (1986).

Section 168(e)(6) requires that a qualifying improvement be made to an interior portion of a building which is nonresidential real property. The use of the word "interior" in § 168(e)(6) is clear and unambiguous. Based on the plain reading of the word "interior," § 168(e)(6) requires that a qualifying improvement be made to the inside or inner portion of the building.

Sections 168(e)(6) and (k)(3) are explicit as to the type of nonresidential real property (as defined in § 168(e)(2)(B)) that qualifies as QLIP, and narrowly provide that the improvement must be made to an interior portion of a building which is nonresidential real property, to qualify for a 15-year recovery period. While the replacement HVAC units installed on the roof of the building and on concrete slabs adjacent to the building are structural components of the building, these improvements are to the exterior of the building and not to the interior portion of the building.

In conclusion, HVAC units installed on the roof or on concrete pads adjacent to the building will not qualify as QLIP under §§ 168(e)(6) and (k)(3) because the improvements are not to an interior portion of a building.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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