New York Law Journal
Volume 230
Copyright 2003 ALM Properties, Inc. All rights reserved

Monday, November 24, 2003

News

USING COST SEGREGATION STUDIES TO TAX ADVANTAGE

Todd R. **Pajonas**

THE NOTED English economist John Maynard Keynes once stated that "[t]he avoidance of taxes is the only intellectual pursuit that carries any reward." While the absolute truth of that statement may be debatable, legally avoiding the payment of taxes is a national pastime that rivals baseball.

A cost segregation study is perhaps the newest service in the real estate investor's tax arsenal. Recent legislation has clarified both the process and what property qualifies for a cost segregation study, giving taxpayers the guidance they need to rely on when filing their tax returns.

A cost segregation study allows investors who own residential or commercial investment property to increase the profitability of their investment by accelerating their depreciation deductions for personal property that is improperly classified as IRC § 1250 real property. When purchasing or improving real estate used for business or investment purposes, real estate investors must depreciate these properties over 27.5 years for residential rental property and 39 years for non-residential property. However, not all of the property acquired or improved is necessarily real property. Accordingly, instead of depreciating all of the property over one of the aforementioned longer periods, the taxpayer may reclassify certain portions as IRC § 1245 personal property with a shorter life span.

To analogize the benefit: If someone owed you $100, would you rather be paid back over the course of 39 years or five years? Given the time value of money, it is always better to receive the same benefit over a shorter period of time.

Cost Segregation History

A cost segregation study is available for property or improvements placed in service after 1986. However, it was not until 1997, with the decision in Hospital Corp. of America v. Commissioner of Internal Revenue, 109 T.C. 21 (July 24, 1997), that something akin to component depreciation was allowed under the Modified Accelerated Cost Recovery System (MACRS) that was introduced by the Tax Reform Act of 1986.

In Hospital Corp. of America (HCA), the Tax Court ruled that items in a building that qualify as tangible personal property under the former investment tax credit rules, as defined in Treas. Reg. § 1.48-1(c), may be depreciated under MACRS more rapidly as personal property. If a building component is not personal property under the former investment tax credit rules, then it is considered a structural component.

Subsequent to the HCA ruling, the IRS issued a ruling providing further guidance on this issue: "the determination of whether an asset is a structural component or tangible personal property is a facts and circumstances assessment ... no bright line test exists." IRS Letter Ruling 199921045, April 1, 1999.

In addition to IRS and Tax Court decisions, a review of the cost segregation process is in order to provide an understanding as to whether there might, in a particular case, be a basis for property reclassification.

Depreciation: the Rules

In order to more fully understand the benefits of a cost segregation study, it is necessary to first understand the rules governing real and personal property depreciation.

Depreciation is a reasonable allowance for the exhaustion, wear and tear, and obsolescence of certain types of property used in a trade or business or for the production of income. IRC § 167(a). Depreciation is an accounting concept that treats an allocable part of the cost of certain limited-life assets as an expense in determining taxable income. This expense is also deducted over the number of years that the asset is expected to be used, or a specified recovery period, rather than deducted all in one year. 2003 US Master Depreciation Guide ¶ 3, 2003 (CCH).

Real estate, improvements to real estate, and personal property placed in service after 1986, are depreciated pursuant to MACRS. Property is depreciable if it is: used for business or held for the production of income; has a determinable useful life exceeding one year; and wears out, decays, becomes obsolete, or loses value from natural causes. In addition to the 27.5 year recoverable period for residential property and 39 years for non-residential property, there is a whole host of depreciable periods for personal property. A cost segregation study concerns itself primarily with reclassifying these 27.5- or 39- year properties as personal property with a five, seven or 15 year depreciable life.

It is important to note that the Tax Reform Act of 1986 provides that the applicable period of recovery for improvements begins on the later of the date on which the addition or improvement is placed in service, or the date on which the property with respect to which the addition or improvement is made is placed in service. 26 U.S.C.A. § 168(I)(6)(B).

Thus it is not necessarily the date upon which real property is acquired, or improvements to real property are completed, which governs the start of the property's depreciable life, but the date that the property or improvements are put into service. Furthermore, the depreciable life for improvements to real property is to be computed in the same manner as the underlying property if such property was placed in service at the same time as such improvements. Thus, the nature of the underlying property may control whether it is residential or non-residential. Fass, Peter M., 1 Tax Adv. Sec. Handbook § 2:7 (West Group 2003).

Prior to the Tax Reform Act of 1986, lessees could depreciate improvements to real property over the artificial period of the lease term. In many cases the lease term bore little or no resemblance to the actual depreciable life of the improvements. Since the Act, leasehold improvements are subject to the same depreciation deduction rules that would apply for regular improvements to real property. However, in the case of leasehold improvements the lessee will recognize gain or loss, if any, at the time the lease terminates. 26 U.S.C.A. § 168(i)(8). Once the lease terminates, a lessor must deduct the unrecovered adjusted basis of leasehold improvements that are abandoned or destroyed due to the termination of the lease agreement, if such abandonment or destruction occurred after June 12, 1996.

What Property Qualifies?

Identifying the types of properties that qualify to be reclassified with a shorter depreciable life is the goal of the cost segregation study. In order to accomplish this, the personal property components must be segregated from the real property

with which they were improperly classified.

Tangible personal property is defined by Treas. Reg. § 1.48-1(c) as any tangible property except land and improvements to land, such as buildings or other inherently permanent structures, and their structural components. Further, the IRS has ruled that the determination as to what is tangible personal property "should be made on the basis of the manner of attachment to the land or structure and how permanently the property is designed to remain in place." Rev. Rul. 75-178.

The test for inherent permanency set forth in Munford, Inc. v. Commissioner of Internal Revenue, 849 F.2d 1398, 1405 (11th Cir. 1988), citing Whiteco Industries, Inc. v. Commissioner of Internal Revenue, 75 T.C. 664, 672-73 (Dec. 31, 1975), calls for examination of the property in question in light of the following six 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 the expected or intended length of affixation, i.e., are there circumstances that show that the property may or will have to be moved?

- How substantial a job is removal of the property and how time-consuming is it?

- How much damage will the property sustain upon its removal?

- What is the manner of affixation of the property to the land?

As can be seen from the above test, it is much more than the four walls and roof of a property that will be classified as IRC § 1250 real property. Additional items that one may not necessarily consider "necessary" to the operation of a property, but that are classified as real property nonetheless, include: acoustical ceiling tiles, water softeners, fire detection systems, and security protection systems. On the other hand, examples of items that are routinely classified as IRC § 1245 personal property include signs and lettering, carpeting, security lighting, landscape lighting, incidental "scene" or "mood" lighting, and certain exterior ornamentations such as false balconies. 2003 US Master Depreciation Guide ¶ 127, 2003.

The Process

CSS (cost segregation study) companies are generally composed of several different types of professionals, including, but not limited to, construction engineers, appraisers, architects, accountants and attorneys. Their function is to review the building and construction plans and identify items, such as supplemental air conditioning units, floor and wall coverings, security lighting, etc., that may be depreciated over a period of five, seven or 15 years. To supplement the document review it is also necessary to make a physical review of the property to identify items, such as fire extinguishers or window treatments that may not be contained on the building or construction plans.

A partial list of items that may be useful in preparing a cost segregation study follows:

- closing statement for the property;

- any available construction drawings, including site survey; plumbing/HVAC/electrical; fire/security protection; architectural; structural;

- property rent roll as of the acquisition date;

• recent appraisal of the property (if available);

• recent property tax bill;

• historical cost information, including: final general contractor's payment application; fixed asset schedule/tax depreciation schedules; inventories of furniture, fixtures and equipment;

• property manager contact person.

Utilizing these records and the physical review of the property, a cost segregation company will make a determination as to what should be considered real property depreciable over 27.5 or 39 years, or personal property depreciable over five, seven or 15 years. A report is generated using either actual construction costs from the document review, or historical costing data to establish values for the personal property contained in the building.

The IRS has stated that 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." IRS Letter Ruling 199921045. It is important that a cost segregation study be performed utilizing actual data from the subject property, and not in a "cookie cutter" fashion where data from similar-type properties, such as chain restaurants, are aggregated to establish a cost segregation report. The IRS has made it clear that it is the taxpayer's burden to prepare an accurate and well documented cost segregation study.

Application of the Study

Once the cost segregation study is prepared, it is utilized by the taxpayer's accountant to prepare a tax return using the new classifications. However, a cost segregation study's benefits can be both prospective and retrospective.

If a property is newly acquired and placed into service, or if new improvements are completed and placed into service, the benefits of a cost segregation study will be for the current and future tax returns. However, for property or improvements already in service where IRC § 1245 property has not been segregated from IRC § 1250 property, there is the additional opportunity to "catch up" on this missed depreciation.

The benefit of restating past depreciation is the opportunity to recoup the benefit of the missed depreciation all at one time. Often this results in the added benefit of recouping an amount that is multiples of any cost of performing a study. However, in most cases it will be necessary to file a request for change in accounting method with the Internal Revenue Service pursuant to Rev. Prov. 2002-9, which provides for an automatic consent procedure for taxpayers who have claimed, among other things, less depreciation than allowable.

Recent Additional Benefits

The Job Creation and Worker Assistance Act of 2002 (2002 Job Act) provides for an additional 30 percent first-year depreciation deduction for certain qualifying property acquired after Sept. 10, 2001 and before Sept. 11, 2004, under the newly added IRC § 168(k). For real estate investors, the 2002 Job Act provides a tremendous opportunity to realize much greater present day saving by more rapidly depreciating items such as qualified leasehold improvements (IRC § 168(k)(3)), and property that has a depreciable life of 20 years or less under MACRS.

In addition, the Jobs and Growth Tax Relief Reconciliation Act of 2003 expands and modifies the bonus depreciation provisions of the 2002 Job Act. The 2003 Act allows

taxpayers to elect additional first-year depreciation of 50 percent for qualified property, as defined under the 2002 Job Act. The original use of the property must commence with the taxpayer after May 5, 2003, and the property must be acquired by the taxpayer after May 5, 2003, and before Jan. 1, 2005, and be placed in service before the latter date. The 2003 Act also provides a clarification that provides that the adjusted basis of qualified property acquired in an IRC § 1031 tax deferred exchange or an involuntary conversation is eligible for the additional first-year depreciation benefits.

A cost segregation study takes on additional importance as it can segregate property that would qualify for the benefits of the 2002 Job Act from the specifically excluded 27.5 year residential rental property and 39 year nonresidential property. Furthermore, a taxpayer qualified for the benefits of the 2002 Job Act but who has already filed a tax return without claiming the benefit can revise the previous year's returns.

The Bottom Line

Too often, investors in real estate fail to take into consideration the tax consequences and benefits of their investments. Many times the combination of real estate property taxes, depreciation deductions, and capital gains taxes due upon the sale of the property can have a significant effect on the profitability of an investment. In some cases, the failure to recognize the role that taxes play in the investment can even result in a loss to the investor.

A cost segregation study is another tool at the disposal of real estate investors to help make sure that their investments remain profitable. As always, however, it is important to consult a tax professional to discuss options available before an acquisition, during the period of ownership, and upon a contemplated disposition of the property.

Todd R. **Pajonas** is the President of Legal 1031 Exchange Services, Inc., a national qualified intermediary for IRC §1031 tax deferred exchanges.

END OF DOCUMENT