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The Best of Both Worlds

A combination of cost segregation and like-kind exchanges can save on real estate taxes.

BY WILLIAM EDWARD III ALLEN AND MARY B. FOSTER

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Tax-deferral strategies are a great way to minimize taxes, and cost segregation and IRC section 1031 exchanges are two of the most valuable tax-deferral strategies available to commercial real estate owners today. This article examines the interaction of these two strategies, the increased benefits that result from using them in combination, and the recapture issues that CPAs may encounter after the fact and how to plan for them.

THE DETAILS

Section 1031 exchanges of real estate have long been a favorite tax-deferral tool for owners. In these exchanges, business or investment property is disposed of through a qualified intermediary, and the proceeds are used to purchase a replacement property of like kind. This results in a deferral of all or most of the gain that otherwise would be subject to income tax on the disposed property. The replacement property has a carryover tax basis that is generally the value of the replacement property less the gain deferred in the exchange.

Value of Cost Segregation

The average cost segregation study identifies 25% to 30% of a property's basis that is eligible for faster depreciation.

Source: DASI Cost Segregation Group LP.

New guidance from the IRS and some of the most taxpayer-friendly legislation since the Tax Act of 1986 also have made a second form of income tax deferral—cost segregation—increasingly popular. The primary goal of cost segregation is to identify building components that can be reclassified from real property to personal property. This results in a substantially shorter depreciable tax life and accelerated depreciation methods. Ordinarily, the cost of real, or section 1250, property is recovered over lengthy periods (27.5 and 39 years for residential and nonresidential property, respectively), using the straight-line method of depreciation. Personal, or section 1245, property is recovered over considerably shorter periods (5, 7 or 15 years), and employs accelerated or “front-end loaded” methods of depreciation, such as 200% or 150% declining balance.

When section 1250 property is reallocated to section 1245, the differences can be great. For example, installed carpet purchased with a facility is considered personal property for depreciation purposes and recovered in a 5- or 7-year period using the 200% declining balance method of depreciation. Otherwise the carpet generally would be included in the value of the real property and the cost would be capitalized and recovered on a straight-line basis over 39 years. It takes a unique combination of engineering and tax expertise to properly analyze construction information, compute industry-standard estimates and identify and segregate the subcomponent costs needed for cost segregation, however. CPAs without that expertise might consider hiring a consultant.

REAL VS. PERSONAL PROPERTY

In a section 1031 exchange, real property must be replaced with real property in order to defer the gain. In general, the definition of real property under section 1031 is determined by state law. In contrast, the definition of real and

personal property for tax-depreciation purposes is determined under federal law. State law tends to classify fixtures in a building as real property. Therefore, property such as wall coverings, carpeting, special purpose wiring or other installations affixed to the building can be considered real property under state law and like kind for section 1031 purposes, but personal property in cost segregation studies. Thus, real estate owners can benefit from both the gain deferral under section 1031 for real estate exchanges and the enhanced cost recovery deductions of the cost segregation study.

COMBINING 1031 WITH COST SEGREGATION

While it's good news that real estate owners can take advantage of both cost segregation and section 1031 exchanges to defer the maximum amount of income taxes, the interaction of the two must be carefully examined. First, CPAs must determine whether a cost segregation study will be beneficial for a replacement property acquired in a section 1031 exchange with the carryover tax basis. Second, CPAs must consider depreciation recapture resulting from the cost segregation study if the property is later disposed of in a section 1031 exchange.

The taxpayer receives a carryover tax basis for the replacement property in a 1031 exchange, rather than a fair-market-value tax basis. Nevertheless, it is entirely feasible for taxpayers to benefit from a cost segregation study on the replacement property.

Let's say, for example, that a taxpayer disposes of land and building property he has owned for six years with a value of \$3 million and an adjusted basis of \$1 million. He treated the entire building as section 1250 property for depreciation purposes. He then buys land and a building with a total value of \$3 million, 85% of which is allocated to the building. Therefore, the basis in the building is \$850,000 (85% x \$1 million). A cost segregation study identifies the portions of the building that qualify as personal property and land improvements for depreciation purposes (but are still like kind for 1031 purposes). The result of a typical study on an office building might identify 10%, or \$85,000, as land improvements, and another 15%, or \$127,500, as personal property qualifying for a 7-year recovery period and the 200% declining balance method of depreciation. This leaves \$637,500 as real, or 39-year, property.

The results of combining the two tax-deferral methods are a gain deferral from the section 1031 exchange of \$2 million and an increase of \$50,000 in depreciation deductions in the current year, resulting in reduced taxes of nearly \$20,000, assuming a 40% ordinary income tax rate.

Note that section 168(k) includes regulations relating to the depreciation of the basis of the replacement property in an exchange under section 1031 for modified accelerated cost recovery system (MACRS) property. The carryover or "exchanged" basis of the replacement MACRS property is depreciated over the remaining recovery period of, and using the depreciation method and convention of, the relinquished MACRS property. Thus, in our example, the taxpayer could depreciate the exchanged basis for the building over the remaining 33 years on the straight-line method. The regulations also allow taxpayers to opt to treat the replacement MACRS property as MACRS property placed in service at the time of replacement if this results in a shorter recovery period. Using the cost segregation study results should yield more gain deferral.

Planning tip. Consider having your clients elect out of the section 168(k) rules if this results in a shorter recovery period and faster depreciation.

Also, taxpayers often exchange up in value and, under the 168(k) regulations, the taxpayer treats the "excess basis" in the replacement MACRS property as property that is placed in service in that taxable year. The depreciation allowances for the excess basis are determined using the applicable recovery period, depreciation method and convention prescribed under section 168 for the replacement MACRS property at the time of replacement. Therefore, the taxpayer can accelerate the depreciation deductions on the excess basis through the cost segregation study.

For example, John Smith disposes of land and building with a value of \$4 million. The building has an adjusted basis of \$1 million. He acquires land and building with a value of \$6

	TIPS
PRACTICAL	▶ Advise taxpayers to consider electing out of the section 168(k) rules if replacement property can be depreciated faster.
	▶ Alert taxpayers to the possibility of future recapture so they can anticipate paying some tax in the later exchange or acquiring replacement property with sufficient amounts of section 1245 property to avoid recapture. Taxpayers should look for replacement properties that have significant potential for section 1245 property.

million. The excess basis is \$2 million; 85%, or \$1.7 million, is allocated to the building. The “exchanged” basis in the building, \$1 million, is depreciated under the prior method unless Smith elects out. The \$1.7 million excess basis may be depreciated under an accelerated method as determined through the cost segregation study.

Planning tip. Cost segregation studies are most useful when the taxpayer is exchanging up in value significantly, or exchanging from nondepreciable property, such as land, to depreciable property.

Cost Segregation Reaffirmed

Engineering-based cost segregation studies take assets that have been classified as real property for federal income tax purposes and, using engineering-based analysis techniques, segregate the property that should have been classified as personal property into the shorter, appropriate class lives. The engineering-based cost segregation study provides tax preparers with the information and supporting documentation needed to depreciate assets over the appropriate, shorter tax lives.

Real property recovery periods range from 27.5 to 39 years and employ the straight-line method of depreciation. Personal property can be depreciated in as few as five years and employ a 200% or 150% declining balance method of depreciation. The result is an increase in current year depreciation expense due to a significantly shorter depreciable tax life and a front-end-loaded method of calculating the depreciation expense. The resulting increase in depreciation expense typically yields a significant decrease in income tax liability.

The legislation and procedures used in an engineering-based cost segregation study have been around since the enactment of the Investment Tax Credit (ITC) in 1962. With the repeal of the ITC and the enactment of the rules limiting passive losses in 1986, most companies assumed that engineering-based cost segregation provided no further benefit under the new tax law. However, in a 1997 tax court case, *Hospital Corporation of America*, the taxpayer successfully defended the application of engineering-based cost segregation as a method to differentiate real and personal property. The IRS now has acquiesced to the viability of engineering-based cost segregation as a legitimate method to differentiate real and personal property under current tax law.

RECAPTURE PITFALLS

Cost segregation generally reclassifies section 1250 property as section 1245 property for depreciation purposes. Land improvements, however, remain section 1250 property. Section 1245 property has significant depreciation recapture rules in a section 1031 exchange; generally the replacement property must contain the same value of section 1245 property as the relinquished property, or the taxpayer will recapture the difference (up to the realized amount) at ordinary income tax rates.

As an illustration, let’s say Joan Brown, the owner of a manufacturing facility, had a cost segregation study performed in 2000 that reclassified \$1 million of real property as section 1245 property. By 2004, after realizing the benefits from \$430,000 of depreciation deductions, Brown exchanged the facility for an office building of equal value and equity. Since the section 1245 property in the relinquished property still is valued at \$1 million, Brown typically would pay no tax on the exchange.

However, the office building has only \$700,000 of section 1245 property; the remaining \$300,000 of value is section 1250 property. Therefore, Brown will recapture and pay ordinary income tax on \$300,000 of the prior depreciation deductions due to the difference between the \$1 million of section 1245 property in the relinquished property and the \$700,000 of section 1245 property in the replacement property.

Despite the potential of future tax in a section 1031 exchange, cost segregation still can be justified due to the tremendous present value of the accelerated depreciation deductions. Based on the fundamental principle of the time value of money, a dollar saved today through reduced taxes always is worth more than a dollar in later years. Furthermore, Brown can exchange into other real property with similar amounts of personal section 1245 property and avoid the recapture tax altogether.

Planning tip. Tax advisers should alert taxpayers to the possibility of future depreciation recapture so they can anticipate paying some tax in the later exchange or acquiring replacement property with sufficient amounts of section 1245 property to avoid recapture. Taxpayers should look for replacement properties that have significant potential for section 1245 property.

RESOURCES

AICPA Resources

JofA article

“[Cost Segregation Applied](#),” (*JofA* , Aug.04, page 28).

Conference

AICPA National Construction Industry Conference

December 8–10

Wynn Hotel, Las Vegas

For more information or to register, go to www.cpa2biz.com or call the Institute at 888-777-7077.

Other Resources

■ *Cost Segregation Audit Techniques Guide* , <http://www.irs.gov/businesses/article/0,,id=134180,00.html>.

■ “Cost Segregation, Code Section 1031 Exchanges & Depreciation Recapture” by Mary B. Foster and Martin E. Verdick, *Journal of Passthrough Entities* , Jan–Feb 2004 issue.

There also are recapture rules for section 1250 property in an exchange, but they are less onerous. Only the excess depreciation over straight-line depreciation (the additional depreciation) is subject to recapture. Land improvements such as sidewalks, fences and landscaping are depreciated on an accelerated basis and can give rise to additional depreciation or recapture if the taxpayer does not acquire replacement property with an amount of section 1250 property equal to the additional depreciation.

For example, Jim Black has \$20,000 of additional depreciation from relinquished property disposition. He needs to acquire only \$20,000 of section 1250 property, including the building, to avoid recapture. Section 1250 recapture would be a problem, however, if he had additional depreciation and exchanges into raw land.

AN UPSIDE AND A DOWNSIDE

When combining tax-deferred exchanges under section 1031 and cost segregation, tax professionals must understand both the significant upside and the potential issues that are involved. With proper planning, using the two methods can provide a tremendous opportunity for taxpayers to defer income taxes into future periods and maximize cash flow in the current one through accelerated depreciation deductions.

Who Should Perform a Cost Segregation Study?

In Chapter 4 of the IRS *Cost Segregation Audit Techniques Guide* , the first element of a “quality cost segregation study” is “preparation by an individual with expertise and experience.” The *Audit Techniques Guide* goes on to say: “Preparation of cost segregation studies requires knowledge of both the construction process and the tax law involving property classifications for depreciation purposes. In general, a study by a construction engineer is more reliable than one conducted by someone with no engineering or construction background. Experience in cost estimating and allocation, as well as knowledge of the applicable law, are other important criteria.”

A good cost segregation firm brings engineering, accounting and tax expertise together in a unique marriage to ensure maximum benefit for the property owner. This expertise also ensures that the engineering study will be delivered in an understandable, supportable and technically sound format.

Cost segregation methods employed nationally vary greatly in their detail and scope. Cost segregation professionals need to spend several hours, even days in some cases, at the site verifying the accuracy of blueprints and specifications or taking necessary measurements to calculate an asset's costs and segregate them. Selecting a firm that uses qualified professionals with years of significant, relevant experience can be an important differentiator in the quality of a cost segregation study.