

Finding Tax Savings in Commercial Realty Through Cost Segregation

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As a tax professional, how can you legally save a client tens of thousands of dollars on his tax bill? Fortunately, there may be such tax savings hiding in your clients' real estate. A cost segregation study can uncover those hidden tax savings by helping the building owner maximize depreciation expense.

The cost of commercial realty must generally be depreciated over 39 years using straight-line depreciation. However, a substantial portion of the cost of a building may actually be depreciated over a much shorter period resulting in enormous tax savings for the building owner. In fact, thanks to the Job Creation and Worker Assistance Act of 2002, a building owner may be able to take advantage of a 30% "bonus depreciation" on certain portions of his investment. The key to taking advantage of these faster write-offs is a clear and objective definition of three broad categories of construction costs: building, land improvements, and tangible personal property. Unfortunately, detailed IRS guidance on the tangible personal property versus commercial realty issue does not exist. However, the answers to such questions can be found through a complex linkage to a considerable body of cases and rulings dating back to the Investment Tax Credit, which was repealed by the 1986 Tax Reform Act.

History

Court cases such as Scott Paper Company v. Commissioner, Whiteco Industries, Inc. v. Commissioner, L. L. Bean, Inc. v. Commissioner, and a multitude of others established the definition of tangible personal property for federal tax purposes. Prior to Hospital Corporation of America, the IRS held that such definitions were no longer valid under the Modified Accelerated Cost Recovery System (MACRS). In simple terms, the IRS worked under the premise that all costs incurred in a construction contract were real property costs and should be depreciated as such. In Hospital Corporation of America, the Tax Court ruled that tangible personal property is defined by the same pre-1981 case law that determined definitions for Investment Tax Credit purposes. Legal Advice Memorandum 199921045, issued by the IRS in 1999, further validated the Tax Court's conclusion that pre-1981 case law is still relevant in determining the proper treatment of costs for depreciation purposes.

Practical Implications

In practical terms, what does this mean to the taxpayer? As much as 40% of the cost of a building, and sometimes more, may be classified as tangible personal property, depreciated over 5 years, or land improvements, depreciated over 15 years. To illustrate the tax effect of this, let's assume a taxpayer acquires a building in 2002 and is able to classify \$500,000 of the total cost as tangible personal property, eligible for the 30%

bonus depreciation prescribed by the Job Creation and Worker Assistance Act of 2002. We will also assume the taxpayer is in the top federal tax bracket and we will ignore state taxes for this illustration. Under this scenario, the taxpayer will save over \$80,000 in federal income taxes in 2002! Over the first four years he owns the building, the tax savings are over \$150,000. Of course, these taxes are deferred until later years. The present value of the tax deferrals over the 39-year life of the property, assuming a discount rate of 8%, is still over \$100,000!

If a taxpayer already owns a building that was placed in service in a previous year, he can also reap the benefits of properly re-classifying the cost of the building. A series of Revenue Rulings from the IRS, beginning in 1996, have set forth the procedures for making a "Change in Accounting Method" to implement such a change. Essentially, the taxpayer will recalculate the depreciation he should have taken in previous years and will take any excess depreciation as an adjustment on the current tax return. In other words, it is not necessary to amend prior tax returns.

Cost Segregation Studies

In Legal Advice Memorandum 199921045, the IRS indicated that a "cost segregation study" is necessary to define assets that constitute Section 1245 property, or tangible personal property. The memorandum continues by defining a cost segregation study as an engineering or architectural report that cannot be based upon noncontemporaneous data or taxpayer estimates with no supporting documentation. In other words, you cannot take advantage of accelerated depreciation without consulting the appropriate experts, such as construction engineers or real estate appraisers.

Conclusion

Any taxpayer with a substantial investment in commercial realty may be able to greatly reduce his tax bill by having a cost segregation study performed on his buildings. Cost segregation studies provide accountants with a tremendous opportunity to introduce their clients to a high-value service that will pay for itself many times over. Accountants should take the lead role in finding competent firms to perform these studies for their clients before clients are approached by outside parties for the same service.

Citations:

- Scott Paper Co. v. Commissioner, 74 T.C. 137
- Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664
- L. L. Bean, Inc. v. Commissioner, KTC 1998-174
- Hospital Corp. of America, et al. v. Commissioner, 109 T.C. 21
- IRS Chief Counsel Memorandum 199921045 (April 1, 1999)

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