Cost Segregation Studies: Accelerating Tax Depreciation

BY RICHARD R. SHAVELL

It's hard to get excited about depreciation until you consider this: *How depreciation is calculated can have a significant impact on a company's bottom line.* Accelerating depreciation through cost segregation can defer income taxes and improve cash flow.

Cost segregation is a viable tax planning strategy – and one that CFMs should understand for reasons beyond the obvious, as you will soon see.

A Familiar Story

Let's look at the following hypothetical example involving Mr. Jones, who purchased a $4 million industrial rental property during 2001. At issue was how the property was to be depreciated.

Mr. Jones' accountant followed standard depreciation procedures and reduced the purchase price by $400,000 for the value of the land; he then depreciated the remaining $3.6 million as 39-year commercial property. Without more detailed information, this appeared to be reasonable.

However, a colleague advised Mr. Jones to undertake a cost segregation study (CSS) to determine what portion of the $3.6 million might be depreciated as 15-year, 7-year, or 5-year property. Why? Because the tax implications could be significant over the life of the property.

The Cost Segregation Approach

Assume first that the property is placed into service in June of Year 1. Assume also that the CSS shows that 5% of the total costs (exclusive of land) can be moved to 7-year property and 15% to 15-year property.

The total depreciation in years 1-7 would then be increased by $320,000 and the corresponding tax reduction would be $119,000.[1] Over 40 years, the present value increase in after-tax cash was computed at $96,000.[2]

In this example, the assumed percentages that can be reclassified (5% and 15%) are not particularly aggressive; however, the resulting tax impact of the CSS yields a significant present value savings.

Of course, reclassifying the property in this manner merely creates a timing difference: *Over the life of the project, the total depreciation is identical.* However, lowering the depreciable lives of a portion of the asset purchase cost significantly increases present value cash flow.

As this simple example shows, a CSS can yield significant tax benefits. With that in mind, let's take a closer look at some of the nuts and bolts of a CSS, starting with why you, as your company's CFM, should be familiar with this underused procedure.

A Double-Sided Strategy

The first reason to consider a CSS is obvious: The facilities purchased by your company or built for its use should be analyzed to see if cost segregation could accelerate depreciation and yield tax benefits.

The second reason is not so obvious: The ability to offer potential clients assistance with their own CSS is a marketing strategy that can increase a contractor's competitive edge by differentiating it from competitors.

Here's how this works. Say a contractor is bidding a job and the competition is fierce. The contractor can suggest to the property owner(s) that they may be able to save money on the project by investigating CSS tax savings opportunities that will mitigate the carrying cost of the property. Of course,

the contractor would be integrally involved in computing and providing the cost data required to complete the CSS.

If this approach is taken, procedures can be implemented at the outset to track certain costs more easily, so that your project management team is not burdened after project completion.

Imagine being able to offer this type of service the next time your company is bidding a job – one that potentially maximizes the acceleration of the owner's tax deductions for depreciation, saving thousands of dollars after the project is completed!

The basis of a CSS is the identification of those assets for which depreciation can be accelerated. In order to do that, let's review how the IRS differentiates between types of assets.

How the IRS Defines Assets

Explaining the IRS' rationale for considering certain assets tangible personal property (TPP), as opposed to nonresidential realty, is complicated because there is no specific detailed IRS guidance on this issue.

Instead, we must look at definitions derived from numerous cases and rulings, many of which deal with the issue of TPP vs. real property in the context of the old investment tax credit (ITC). (*Note:* The 1986 Tax Reform Act re-pealed the ITC.)

This complex chain of rules includes a number of IRC and regulation citings:

Section 168(e)(2)(B) defines nonresidential real property as §1250 property that is not residential property with a class life of less than 27½ years;

Section 1250(c) states that §1250 property is any real property (other than §1245 property) that is depreciable property;

Section 1245(a)(3)(A) states that §1245 property is property that is both subject to a charge for depreciation and falls into one of six specified categories, the first and broadest of which is personal property;

Reg. 1.1245-3(b) defines personal property for §1245 (a)(3) as merely tangible personal property defined in the same way it is defined under Reg. 1.48-1(c) for ITC purposes; and intangible personal property; and

Reg. 1.48-1(c) defines TPP to include any tangible property. The regulation indicates that local law does not control on the issue of whether or not property is "tangible" or "personal." It also states that buildings and "other inherently permanent structures" including "structural components" of such buildings are presumed to fit within the definition of "improvements" and, therefore, are generally considered "real property."

These "definitions" lead us to certain issues that are addressed by the Tax Court decision in *Hospital Corp. of America and Subsidiaries, (1997) 109 TC 21 (HCA)*.

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In HCA, the IRS took the position that the judicially developed tests under the old ITC were not applicable to depreciation under either the ACRS (Accelerated Cost Recovery System, effective 1981-1986) or the MACRS (Modified ACRS, in effect since 1987). The IRS reasoned that the cases were decided at a time when the fundamental depreciation rules were very different than the rules under MACRS.

Further, the IRS contended that, under pre-ACRS law, component depreciation (such as treating a building's components and its shell as separate depreciable assets) was permissible, but was no longer applicable to ACRS or MACRS.

The Tax Court rejected this position. The IRS subsequently acquiesced to the Court's decision, holding that the tests judicially developed under the old ITC are applicable in determining whether an asset is a structural component for ACRS and MACRS purposes.

The Court's decision in this case represents a significant victory for taxpayers searching out accelerated tax depreciation deductions.

Coming to Terms

So, if the IRS permits us to look at older cases, how can we determine if an item of property is a building or a structural component?

What the Regs Do (and Don't) Say

Under Reg. 1.48-1 (e)(1) a structure is not a "building" if it:

- Is essentially an item of machinery or equipment; or
- Houses property used as an integral part of an activity specified in §48 (a)(1)(B)(i); but only if the use of the structure is so closely related to the use of the property

that the structure clearly can be expected to be replaced when the property it initially houses is replaced.

Activities specified in the regulation include:

- manufacturing, production, or extraction; and
- furnishing transportation, communications, electrical energy, gas, water, or sewage services.

Conversely, the regulation states that a "building or other inherently permanent structure" is not TPP. Basic examples of inherently permanent structures (such as swimming pools, wharves, docks, bridges, and fences) are included in the regulation; however, it does not define the term "inherently permanent structure" or explain when an asset is not included in this category.

The regulation also does not provide a clear definition of what constitutes a structural component. Rather, it amplifies by example, stating in Reg. 1.48-1 (e)(2) that the term "structural component" includes such parts of a building as:

- walls, partitions, floors, and ceilings;
- any permanent coverings 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; and
- sprinkler systems, fire escapes, and other components relating to the operation or maintenance of a building.

So, now that you have an overview of how the IRS will construe assets and property that may or may not be eligible for quicker depreciation, the next question is, "Why do a CSS?"

The Value of Performing a CSS

There are a number of financial benefits that can be derived from performing a CSS. However, one of the primary benefits is that the CSS can fully document the taxpayer's position in the event of an audit.

For instance, in the HCA opinion, the IRS was successful in defeating certain specific "allocated" equipment because the taxpayer did not provide any "logical and objective measure" of how the §1245 portion of assets was determined.

In Chief Counsel Memorandum 199921045, the IRS tells its examiners 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 record."

It also advises IRS examiners that the CSS should be closely scrutinized in the field. Because of this, industry analysts and commentators highlight the need to have a CSS performed at or near the time property is acquired or built, noting that "third-party" professionals can provide more credible cost determinations than the taxpayer's own estimates.

The CSS Process

The Feasibility Study

Before undertaking a CSS, the feasibility of conducting it must be considered. Is it worth completing the study and incurring the professional fees and administrative burdens to appropriately document those items of property that can be segregated? Here's how to make that determination.

> As an estimate, assume 25% of the total hard costs of a newly constructed manufacturing facility will be items that can be segregated as land improvements (15-year lives) or §1245 property (5- or 7-year lives); the balance can be depreciated over a 39-year life. The present value of the tax savings can be computed by comparing the deductions available under the standard 39-year depreciation schedule without cost segregated items.

The Review Process

Once it is determined that there is value in conducting a CSS, a review of the building project should be undertaken. A qualified cost segregation specialist can determine which assets may be segregated. Experience and knowledge of construction methods can be invaluable for these analyses.

The Final Report

Once costs are accumulated for the items to be segregated, the assets are grouped under their accelerated de-preciation rate (ADR) classification (5, 7, 15, and 39 years) for the final recommendation in the report.

This should provide sufficient support if an IRS examiner later decides to review the company's detailed depreciation schedules.

Catch-Up Depreciation

If depreciation has already been de-ducted for the new facility, the IRS permits taxpayers to make changes on a "catch-up" basis.

Generally, if only one tax return has been filed, an amended return can be submitted to correct the "error" in classification. If more than one return has been filed, an automatic-consent procedure can be followed. Currently, Rev. Proc. 2002-9 contains the latest guidance on these filings.

Bonus Depreciation

On March 11, 2002, President Bush signed the "Job Creation and Worker Assistance Act," which included a retroactive, special depreciation bonus on the purchase of new equipment.

The depreciation bonus is 30% of qualified assets placed into service after 9/10/01 and before 9/11/03. The impact of this on a CSS can be significant.

Under §168(k), bonus depreciation specifically applies to property with a recovery period of 20 years or less, certain computer software, water utility property, and qualified leasehold improvements.

In order to take the bonus depreciation, a binding contract for the purchase of the new property cannot have been in effect before 9/11/01. For a CSS, this rule may preclude some recently completed projects from qualifying for the bonus depreciation.

Over the next few years, bonus depreciation will have a significant impact on the present value benefits of CSS for newly constructed property. A look back to Mr. Jones' example shows why.

The $720,000 segregated by Mr. Jones would yield $216,000 (30%) in immediate bonus depreciation if the project otherwise qualifies. The residual $504,000 would be depreciated as permitted by the respective recovery periods.

The present value calculation with the bonus depreciation reflects $126,000 of tax savings in today's dollars – a $30,000 increase (30.8%) over the original present value savings – along with the huge increment in first-year tax savings.

Conclusion

Although complex to perform, taxpayers can secure significant tax benefits by accelerating depreciation deductions to defer income taxes and improve cash flow.

These tax advantages can be secured in two ways:

1) prospectively for new projects and
2) retroactively for older projects already placed in service and being depreciated.

Also, additional bonus depreciation may be applicable under recently passed legislation.

There's one final thought I would like to leave with you: Although we all recognize the importance of depreciation calculations, depreciation methodology is something we usually take for granted. However, because of both their financial and marketing benefits, CFMs should seriously consider using cost segregation studies to gain every advantage in today's competitive marketplace. BP

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Endnotes

1. Assume it is a pass -through to Mr. Jones, who is taxed at the highest individual rates beginning in 2001.
2. The calculation of the total projected cash savings in this example is based on various assumptions including, but not limited to, marginal U.S. tax, zero state tax, time value of money, and present value factors (8% discount rate assumed). The computations also assume that the company retains the assets for their full depreciable lives and that the AMT and passive loss limitation rules do not apply.

   The calculation is intended to be a general estimate only and is not intended to specifically calculate an exact amount due to the multitude of assumptions, future law changes, and other unknown factors that alter and change the present value of cash flow savings over time.