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Oregon Cost Segregation Decision Could Vindicate Consultants

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The decision by the Oregon Tax Court in the case of [Ronald and Daryl Pearce](#) is a Happy Halloween gift to cost segregation consultants. Cost recovery deductions for commercial real estate are very slow. A commercial building is deemed to have a 39 year life. This has led to a small army of consultants who engage in a practice called “cost segregation”. The purpose of cost segregation is to identify all the things that are attached to the building – such as cabinets – that are not really part of the building. Those items can be

assigned to a different class and have their costs recovered much more rapidly. The question I have been asked sometimes is whether you really need a consultant to do this. Real estate guys like paying consultants about as much as they like paying taxes. [Ronald and Daryl Pearce](#) decided that they did not need to pay no stinking consultants:

Although Plaintiffs had no special experience in applying the cost-segregation methodology, they believed that their analysis was proper because it followed the “rule of thumb” approach,” which is based upon “a preparer’s ‘experience’ in a particular industry.” Plaintiffs used the results of their cost-segregation analysis as the grounds for including accelerated depreciation deductions in their 2004 return. Plaintiffs carried forward some of those accelerated depreciation deductions to the tax years at issue in this case, 2006 and 2007.

When a client asked me about whether they needed a consultant I threw the question at a consultant and they came back at me with what constitutes a quality study. The source for their quality study definition was an [IRS Audit](#)

[manual](#). An audit manual, while good stuff and well worth attending to, is not authority. If the consultants are paying attention, thanks to Ronald and Daryl Pearce's frugality, they now have some case law that recognizes the audit manual:

Plaintiffs failed to satisfy their burden of proof in regards to accelerated depreciation through cost segregation. The IRS issued an Audit Technique Guide (ATG) to help guide their examiners when they encounter a return that uses cost segregated items for depreciation. The ATG instructs examiners to view the "rule of thumb" approach used by Plaintiffs with caution because the results are "based on a preparer's 'experience' in a particular industry" and "[lack] sufficient documentation to support its allocation of project costs." Chapter three of the ATG states in part:

"Despite the lack of specific requirements for preparing cost segregation studies, taxpayers still must substantiate their depreciation deductions and classifications of property. Substantiation using actual costs is generally preferable to the use of estimates. However, in situations where estimation is the only option, the methodology and the source of any cost data should be clearly documented. In addition, estimated costs should be reconciled back to actual costs or purchase price."

The thirteen principal elements of a quality study include:

- 1. Preparation By An Individual With Expertise And Experience*
- 2. Detailed Description Of The Methodology*
- 3. Use Of Appropriate Documentation*
- 4. Interviews Conducted With Appropriate Parties*
- 5. Use Of A Common Nomenclature*
- 6. Use Of A Standard Numbering System*
- 7. Explanation Of The Legal Analysis*
- 8. Determination Of Unit Costs And Engineering (Take-Offs)*
- 9. Organization Of Assets Into [Lists](#) Or Groups*
- 10. Reconciliation Of Total Allocated Costs To Total Actual Costs*
- 11. Explanation Of The Treatment Of Indirect Costs*
- 12. Identification And Listing Of Section 1245 Property*
- 13. Consideration Of Related Aspects (e.g., IRC § 263A , Change In*

Accounting Method And Sampling Techniques)

The other issue in the case was the statute of limitations. Oregon was challenging depreciation deductions that had carried over into 2006 and 2007 based on a cost segregation study that had been done for the tax year 2004.

In the instant case, Plaintiffs' 2004 cost segregation established the basis for their continued reporting of depreciation in 2006 and 2007. Defendant is not attempting to go back and adjust Plaintiffs' 2004 return, but simply trying to adjust their returns for 2006 and 2007 by denying Plaintiffs' accelerated depreciation.

The Court went along with the state on this, so you can continue to lose sleep over a crappy cost seg study even after the statute is closed on the year that the study was done. If cost seg consultants are paying attention they will use this case as a caution to overly frugal commercial real estate owners.

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