Side Effects of Cost Segregation

Tax advisers need to tally the pros and cons.

by Larry Maples, CPA, DBA, and Robert D. Hayes, CPA, Ph.D.

Increased current cash flows and net-present-value savings from accelerated tax depreciation resulting from cost-segregation studies have been discussed in the JofA and other professional literature. But the initial cost-segregation decision can determine later tax side effects, both positive and negative. This article explores some of the tax benefits and drawbacks linked to the use of cost segregation that can materialize in subsequent periods.

Before 1981, taxpayers could break real estate into components, which allowed part of the cost to qualify for the investment credit. The identified personal property also qualified for a much shorter life for depreciation. The Economic Recovery Tax Act of 1981, P.L. 97-34, repealed component depreciation, but the accompanying 15-year life for buildings only temporarily removed some of the sting, because the modified accelerated cost recovery system provisions of the Tax Reform Act of 1986, P.L. 99-514, increased the cost-recovery period to 27.5 years for residential and 39 years for nonresidential buildings.

Taxpayers, however, found refuge in the definition of personal property left over from the repealed investment credit. In the watershed case of Hospital Corp. of America (109 T.C. 21 (1997)), the Tax Court relied on the Sec. 38 definition of personal property, which allowed the taxpayer to use a cost technique that resulted in the classification of many parts of its hospitals as personal property. The IRS eventually agreed that cost segregation does not constitute component depreciation. Current IRS revenue procedures and audit manuals outline what is required to produce a cost-segregation report that passes IRS scrutiny.

SEgregATING THE BUILDING

Cost segregation, or allocating costs or values of a building's components into appropriate classes of personal property to shorten their depreciation recovery period, can be applied to buildings used in a business that were recently constructed, purchased, expanded or remodeled by the taxpayer. In addition, cost segregation can be used for buildings that have been in service for some time, as well as some buildings that have been sold. For buildings already in service, depreciation deductions for prior years can be recomputed, and a one-time catch-up provision (a Sec. 481(a) adjustment) allows a current-period deduction for the difference between depreciation deducted to date and that which could have been deducted using cost segregation (Rev. Proc. 2002-9), instead of having to amend prior-year returns. The IRS has taken the position that a change in recovery period is a change in accounting method. Hence, to implement the catch-up provision, the taxpayer must complete and timely file Form 3115, Application for Change in Accounting Method. For buildings that have been sold in a prior tax period, the taxpayer must also be eligible to file an amended return for the tax year of the sale.

Although the most significant benefit of cost segregation is the acceleration of depreciation due to maximizing the costs allocated to personal property and land improvements, segregating the building may have other tax advantages if the separated component is eventually replaced. For example, the unrecovered cost of an old roof could be written off when replaced rather than continuing to be spread over the remaining portion of the original 27.5- or 39-year period, as would be the case if there had been no cost segregation. If not written off, the replaced roof continues to be depreciated (along with the new roof) for the remainder of its "life" even though it has been replaced.

The timing of a cost-segregation study may be crucial. In Peco Foods, Inc. (T.C. Memo. 2012-18), the Tax Court denied the benefits of a change in accounting method to a taxpayer that had acquired the assets in a Sec. 1060 transaction (one in which the assets constitute a trade or business and the...
basis is determined by the consideration paid). In Peco, the purchase agreement for two poultry processing plants included a schedule allocating the purchase price among various assets "for all purposes (including financial accounting and tax purposes)." After the transaction, the taxpayer hired a company to perform a cost-segregation study and filed for a change in accounting method to claim a Sec. 481(a) adjustment and increased depreciation deductions going forward. The IRS refused to allow the change. The Tax Court ruled that the Service had not abused its discretion because Sec. 1060(a) requires an allocation agreement to be binding on both the transferee and transferor. Therefore, a taxpayer desiring the benefits of faster depreciation of the assets of a business acquired in a Sec. 1060 transaction should perform a cost-segregation study to determine the proper allocation of the purchase price of the business before the purchase agreement is finalized.

INTERPLAY WITH TAXABLE EXCHANGES

For property in service, implementing a cost-segregation study essentially allows a taxpayer to look back and accelerate ordinary income deductions via the Sec. 481(a) catch-up adjustment. But if the property is subsequently sold in a taxable transaction, the basis reduction accompanying the catch-up could result in the taxpayer’s being taxed on the gain at ordinary income tax rates due to the depreciation recapture rules. With a 35% ordinary income rate, the taxpayer would realize a catch-up benefit and subsequent tax on the gain, both at 35%—a wash, except for present-value considerations.

In the end, the effect of cost segregation is to reclassify Sec. 1250 real property as Sec. 1245 personal property. The recapture rate on Sec. 1250 property is 25%; therefore, there could be a rate differential of as much as 10 percentage points. This potential tax cost would be mitigated in present-value terms as more time elapses between the catch-up application and the sale of the property. Another possible mitigating factor is that Sec. 1245 property often does not maintain its value compared with real property, and property components with a value less than their adjusted basis will not be subject to recapture.

INTERPLAY WITH LIKE-KIND EXCHANGES

Cost segregation complicates a subsequent like-kind exchange, because Regs. Sec. 1.1031(j)-1 requires the taxpayer to group multiple properties in exchange groups of like kind or like class. The gain and basis are then calculated by reference to the fair market value of each exchange group. This grouping can result in recognition of a substantial gain that would have been deferred without cost segregation. Gain must be recognized to the extent there is a surplus fair market value of property received over unrecovered cost of the property relinquished in each exchange group. This "splitting of the boot rule" makes the tax on the deferred gain more difficult to avoid. But applying cost-segregation principles to the replacement property would lessen the impact somewhat.

Depreciation recapture can also surface in a like-kind exchange. Although avoiding recapture (along with any taxable gain) is normally a benefit of like-kind exchanges, Sec. 1245(b)(4) has the effect of requiring recapture on a portion of what would normally be deferred gain. If the taxpayer receives non-Sec. 1245 property that is qualifying property under the like-kind exchange rules, recapture is required in the amount of any boot gain plus the value of the non-Sec. 1245 property acquired.

The assumption thus far has been that a like-kind exchange is effected using cost-segregated property. But suppose the tax adviser encounters a like-kind exchange in which the depreciable basis of the relinquished property has not been segregated. Rev. Proc. 2011-14 now provides that automatic consent using Form 3115 is available to change the accounting method for the year of property disposition. Thus a lookback calculation can be done to see if taxes can be reduced. For example, suppose the like-kind exchange generated

EXECUTIVE SUMMARY

- Cost segregation of building components can shorten recovery periods of the affected parts of a taxpayer’s building and therefore accelerate deductions for depreciation. However, taxpayers must be wary of potentially unfavorable side effects of cost segregation.
- These side effects include, in taxable exchanges of cost-segregated property, possible recapture of depreciation under Sec. 1245, subjecting it to an ordinary income tax rate potentially higher than the 25% recapture rate for real property under Sec. 1250. This recapture can be a particular hazard for boot gain realized in like-kind exchanges. An additional complication for cost-segregated property in a like-kind exchange is the requirement that components be grouped according to kind or class.
- However, the interplay of cost segregation with bonus depreciation rules is often taxpayer-friendly, particularly given a recent liberal IRS definition of “components” of self-constructed property qualifying for bonus depreciation.
- Cost segregation can complicate allocating costs to deductible repairs rather than capitalizing them, since the IRS is scrutinizing accounting method change requests where the taxpayer’s definition of “unit of property” may have changed.
- Other possible considerations for taxpayers using cost segregation include alternative minimum tax liability and cost segregation’s effect on the domestic production activities deduction.

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some boot gain. A cost-segregation study could generate a Sec. 481(a) catch-up adjustment to offset some of the boot gain. The benefit of this maneuver may depend on the degree to which it is possible to avoid the boot problem of mismatched groups discussed above.

**Components and Bonus Depreciation**


The new bonus depreciation rules contain a liberal definition of "component" of self-constructed property. In fact, judging from one Treasury attorney's remarks concerning the definition contained in Rev. Proc. 2011-26 as "any part used in the manufacture, construction, or production of the larger self-constructed property," it appears that the taxpayer may deduct bonus depreciation on every component of self-constructed property "down to the screw" (see "Bonus Depreciation Guidance Is Intended to Favor Taxpayers, Says Treasury Official," by Joseph DiSciullo, 2011 TNT 89-21 (May 9, 2011)). This taxpayer-friendly rule is intended to maximize the economic effect of the bonus depreciation rules. The only limit to componentization is the taxpayer's willingness to provide documentation.

**Exhibit 1 Positive and Negative Side Effects of Cost Segregation**

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<tr>
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**Repairs**

In 2010, the IRS designated as a Tier I issue taxpayer requests for a change in accounting method to currently deduct previously capitalized expenditures. A few months later, a new audit technique guide (LB&I-1-4-0910-023) revealed some of the rationale behind this increased scrutiny. The IRS believes some taxpayers are taking inconsistent positions when they segregate costs for depreciation purposes versus when they deduct some costs as repairs or maintenance.

The audit technique guide advises IRS examiners to determine whether the taxpayer is using the same definition of "unit of property" when the taxpayer makes a request to change accounting methods. If the taxpayer is using different definitions, the examiner should verify whether the new method of determining repairs is consistent with claimed dispositions in prior years. An
underlying message in the audit technique guide is that taxpayers who avail themselves of the benefits of cost-segregation studies will have to live with their unit-of-property choices. In effect, the smaller the unit of property, the more likely that subsequent expenditures related to it will add to the value or appreciably extend the useful life of the property and the taxpayer will have to capitalize the expenditures instead of expensing them as a repair.

The audit technique guide gives an illustration of a taxpayer’s placing a building and structural components in service in year 1, replacing the roof and windows in year 5, treating the original roof and windows as a disposition/retirement and capitalizing the cost of the new roof and windows. If the taxpayer subsequently files a Form 3115 to treat the cost of the new roof and windows as repairs and maintenance, the taxpayer will have changed the definition of “unit of property” from a smaller separate asset to the entire building. Stated another way, there will be no roof or windows to “repair,” since they will have been treated as a disposition earlier.

**AMT Considerations**

The immediate cash infusion from the Sec. 481(a) catch-up adjustment may be significantly reduced if the taxpayer is subject to the alternative minimum tax (AMT) during the catch-up period. In a corporate situation, the refund for AMT years will be only 20% (the corporate AMT rate) of the adjustment. The adjustment amount also will be decreased for AMT years to the extent that the 200% declining balance method has been used on tangible personal property. Taxpayers subject to the AMT must choose between 150% declining balance or straight-line depreciation. However, depreciation of real property and the recovery periods and conventions on all property are the same under both regular tax and AMT depreciation systems.

**Domestic Production Activities Deduction**

Sec. 199 allows a domestic production activities deduction (DPAD) of 9% of the lesser of qualified production activities income (QPAI) or the business’s taxable income before the deduction. The final deduction cannot exceed 50% of the wages paid to employees working in qualifying production activities. The taxable income limit is determined after deducting any net operating loss (NOL) for the year (Regs. Sec. 1.199-1(b)(1)). Thus, the DPAD cannot be added to an NOL, and the DPAD can be reduced in carryback or carryforward years. Since the desired result of cost segregation is to defer income tax payments by accelerating depreciation, the effect of these increased deductions may be to permanently reduce or eliminate DPAD benefits.

For example, a taxpayer who leases a self-constructed building to a tenant cannot allocate leasing revenue from real estate to domestic production gross receipts (DPGR) (Regs. Sec. 1.199-3(m)(6)(iii)). But, based on a cost-segregation study, the taxpayer may be able to allocate some of its revenue to DPGR as a producer of tangible personal property installed in the building, thus increasing QPAI. On the other hand, if the self-constructed property is sold rather than leased, the real estate sale is DPGR, and the portion of sales proceeds allocable to tangible personal property not constructed by the taxpayer is not DPGR.

**Analyze Future Benefits and Drawbacks**

Cost segregation is a legitimate tax planning strategy that can result in increased current cash inflows and generate net-present-value savings for owners of depreciable real property. These benefits can often be magnified if the taxpayer can also take advantage of the Sec. 481(a) catch-up adjustment. A cost-segregation tax strategy, however, is not without potential positive and negative tax side effects that arise as subsequent events unfold (see Exhibit 1). As a part of value-added services provided to clients, CPAs advising businesses should factor in potential future benefits and drawbacks when advising about the suitability of implementing any cost-segregation strategy. Also, the expense of a cost-segregation study may be a significant nontax impact.

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