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San Francisco Apartment Magazine

FEATURE

Cost-Segregation and Purchase-Price Allocation

by Cal Fugitt

For owners of apartment buildings, maximizing the depreciation deduction is one of the most significant, but often overlooked, opportunities to reduce income-tax liability. Just a commercial property owners use tax specialists, both real-estate specialists and 1031-exchange specialists need cost segregation specialists to achieve this goal. Without this service, money is frequently left on the table. Achieving the most from a property's income-tax deductions by optimizing depreciation makes sense whether a business is buying, building or improving a property. For a viable cost-segregation study, an apartment must have net profit (taxable income) and have been constructed, acquired or remodeled since January 1, 1987.

Under the Modified Accelerated Cost Recovery System (MACRS), residential real property assigned a 27.5-year straight-line depreciation period; land improvements, a 15-year life and apartment-related personal property, a 5-year life. Without a cost segregation study, the cost basis of the shorter-lived assets is typically unknown and, thus, included and recovered over the long real-property recovery period. Assets identified by an engineerin approach that can receive a 5-year life include equipment-related electrical, selected mechanical systems and finishes. (Personal property used in rental real estate is included under the Internal Revenue Service's (IRS) Asset Class 57.0 and, therefore, has a five-ye recovery period. In 1999, the Internal Revenue Service issued IRS Announcement 99-82, which corrected instructions in Form 4562 that incorrectly stated personal property had a seven-year life.) An analysis can produce a substantial classification into shorter-lived property, which means there can be a current and future tax benefit.

Assets Typically Classified in a Cost-Segregation Study

5-year life: carpeting, washer/dryer electrical and plumbing, ceiling fans, window treatment, phone system, shelving, etc. 15-year life: asphalt paving, concrete walks, site lighting, wiring and conduit, landscaping, swimming pool, built-in spa, fencing, site drainage, etc. 27.5-year life: apartment buildings, clubhouse and garages.

When to Have a Cost-Segregation Study Performed

Apartment owners can achieve improved cash flow by enhancing the income-tax depreciation deductions from the following three scenarios: (1) construction or renovation—cost segregation; (2) purchase of apartment building—allocation of purchase price; and (3) under-depreciated fixed assets—catch-up depreciation under IRS Revenue Procedure 2002-09.

Cost Segregation

The process begins with construction cost data, such as contractors' costs and change orders. Next is analyzing the construction plans to identify shorter-lived property and tyir the report to project-capitalized costs, allocating indirect costs such as general conditions architect fees, permits and capitalized interest.

Allocation of Purchase Price

When an existing apartment is purchased, the lump sum purchase price needs to be categorized into correct lives for optimal income-tax reporting. This scenario includes: land; buildings (27.5-year tax life); shorter-lived components (5-year tax life); and land improvements (15-year tax life).

Catch-up Depreciation with Rev. Proc. 2002-09

Utilizing an Internal Revenue Service automatic consent procedure, under-depreciated assets from both open and closed tax years can be corrected without the need of filing ar amended tax return.

This scenario allows a catch-up of under-claimed depreciation for past years. It applies tc open and closed tax years and permits catch-up depreciation to be taken in one year (I.R.S. Section 481 Adjustment). This allows automatic consent procedure, using I.R.S. Form 3115 (does not require amended returns) and applies to federal tax only uses. Review of the depreciation schedule is the starting point for determining potential reclassification opportunities. Building owners with substantial under-claimed deprecation may have potential for a significant tax benefit.

Combination of Tax and Engineering Knowledge

The key to maximizing the depreciation benefit is to apply a combination of in-depth tax-depreciation knowledge with a detailed engineering approach. This involves a familiarity with pertinent court cases, revenue rulings and other pronouncements, and a detailed blueprint analysis in order to identify, quantify and establish an income-tax basis for the shorter-lived property in residential buildings.

The opinions expressed in this article are those of the author and do not necessarily refle the viewpoint of SFAA or the San Francisco Apartment Magazine. Cal Fugitt has practiced appraisal and valuation, construction consulting and property taxes since the early 1970s and is currently president of Cost Tech Consulting, a cost-segregation firm. He can be reached at 866-267-8734, www.costtech.com.

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