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What is cost segregation study and how does it work?

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Real property has, since MACRS days, been depreciable over 39 years for non-residential properties and 27.5 for residential real estate. However, since 1997, there has been an alternative method for allocating costs for depreciation purposes. A cost segregation study using architectural and engineering analyses makes it possible to classify and depreciate certain costs as personal property and use shorter MACRS lives. The result is a faster write off and improved cash flow due to lower income taxes.

In Hospital Corporation of America (HCA) v. Commissioner, 109 TC 21 (1997), HCA was allowed by the Tax Court to use cost segregation to classify certain building improvements as 5 year property rather than using a 39 year life. The court allowed HCA to distinguish between components that were section 1250 property (real property), and section 1245 property (tangible personal property). The advantage of this distinction is apparent. Increased deductions mean lower income and therefore lower income taxes.

The advantages are not automatic, however. A thorough study of architectural and engineering drawings and reports must be performed to provide support for the classification of assets as personal rather than real property. IRS requires that the study be performed by a "qualified" individual, who has the proper knowledge of both tax law and the design and construction process. The taxpayer should engage the services of an expert to perform such a study and compile the required supporting data.

The goal of a study is to segregate the assets into four categories: personal property, land improvements, buildings, and land. Personal property such as furniture and fixtures, carpeting, and window treatments is depreciated over a 5 or 7 year life. Land improvements such as sidewalks, paving, or landscaping, are subject to a 15 year life. Buildings are depreciated over 39 or 27.5 years. The last category, land is almost never depreciated. With proper documentation, a lower allocation than normal will assist the taxpayer to withstand an IRS challenge.

How do you differentiate between the four categories? Tangible personal property is described as all property other than the structural components that are part of or attached to a building. This includes office equipment, cabinetry, and floor coverings. Structural components of a building are described as property that relates to the operation or maintenance of a building, such as some types of lighting, central air conditioning systems, or plumbing and wiring.

In Whiteco Industries, Inc. v. Commissioner 65 TC 664 (1975), the Tax Court listed six factors that can be considered when determining if property is a structural component or whether it can be classified as personal property:

Can the property be moved, and has it been moved?

Is the property designed or constructed to remain permanently in place?

Are there circumstances, which tend to show the expected or intended length of affixation, that is,

are there circumstances, which show that the property may or will have to be moved?
How substantial of a job is removal of the property and how time-consuming is it?
Is it readily removable?
How much damage will the property sustain upon its removal?
What is the manner of affixation of the property to the land?
Whiteco was concerned with outdoor advertising signs placed along major highways, but the Court cited items such as movable partition systems, mobile homes, and floating docks. This is not a complete list of criteria, but it does give the taxpayer an idea of what support would be needed if the asset classification were to be challenged by the IRS.
Are there disadvantages to a cost segregation study? The process will entail some cost and time. A study could cost as much as $20,000 or more, depending on the location, age of the property, and whether the building is residential or nonresidential. The study could take a month or more to complete. If personal property is disposed of, there could be depreciation recapture income subject to ordinary rates as high as 35%, plus any state taxes, and possible unrecaptured section 1250 gain, taxed at 25%, again, in addition to state taxes. If a cost segregation study is too aggressive or contains erroneous information, the IRS could assess penalties on the additional tax due to a "substantial valuation overstatement".
It is always good policy to consult one's tax advisor as each situation is different. If you do your homework, the benefits of cost segregation can be substantial.

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