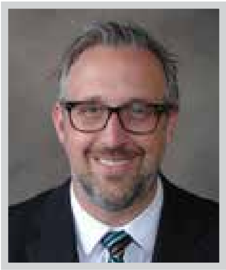
Cost Segregation Industry Update



By Mark Vorkapich, ASA

An engineering-based cost segregation study traditionally has been used to reclassify federal tax depreciation rates of real property from one lump-sum asset listed in a fixed asset system as a "building," with a recovery period of 39 years, to multiple detailed entries that identify separate assets with shorter recovery periods, such as five, seven or 15 years. A study not only results in correctly identifying both the 1250 and 1245 components of a structure but also establishes a starting point for federal tax depreciation assets.

Over the last several years, there have been many tax law changes that affect how and why a competent study should be performed. Tax law changes over the last few years are numerous. This article addresses some significant modifications that have impacted the cost segregation industry.

At the time of this writing, there is pending legislation to bring back 100% bonus depreciation, effective 2023 going forward. However, its future will depend on the new Congress.

The Internal Revenue Service issued an updated Cost Segregation Audit Techniques Guide in June 2022. The guide includes detailed descriptions of the different types of studies, what should be included in a competent study, and all of the previously issued specific industry directives that show what assets might typically be considered as 1250 or 1245 property. It is important to note that these documents are not considered to be law — they are to be used only as a guide.

H.R. 1 – Tax Cuts and Jobs Act (TCJA) of 2017

Bonus depreciation was increased to 100% through Dec. 31, 2022, and then reduced to 80% for 2023. It is currently 60% for 2024 and will go down to 40% for 2025. There is proposed legislation that would bring bonus depreciation back to 100%, but at the time of writing it has not yet passed.

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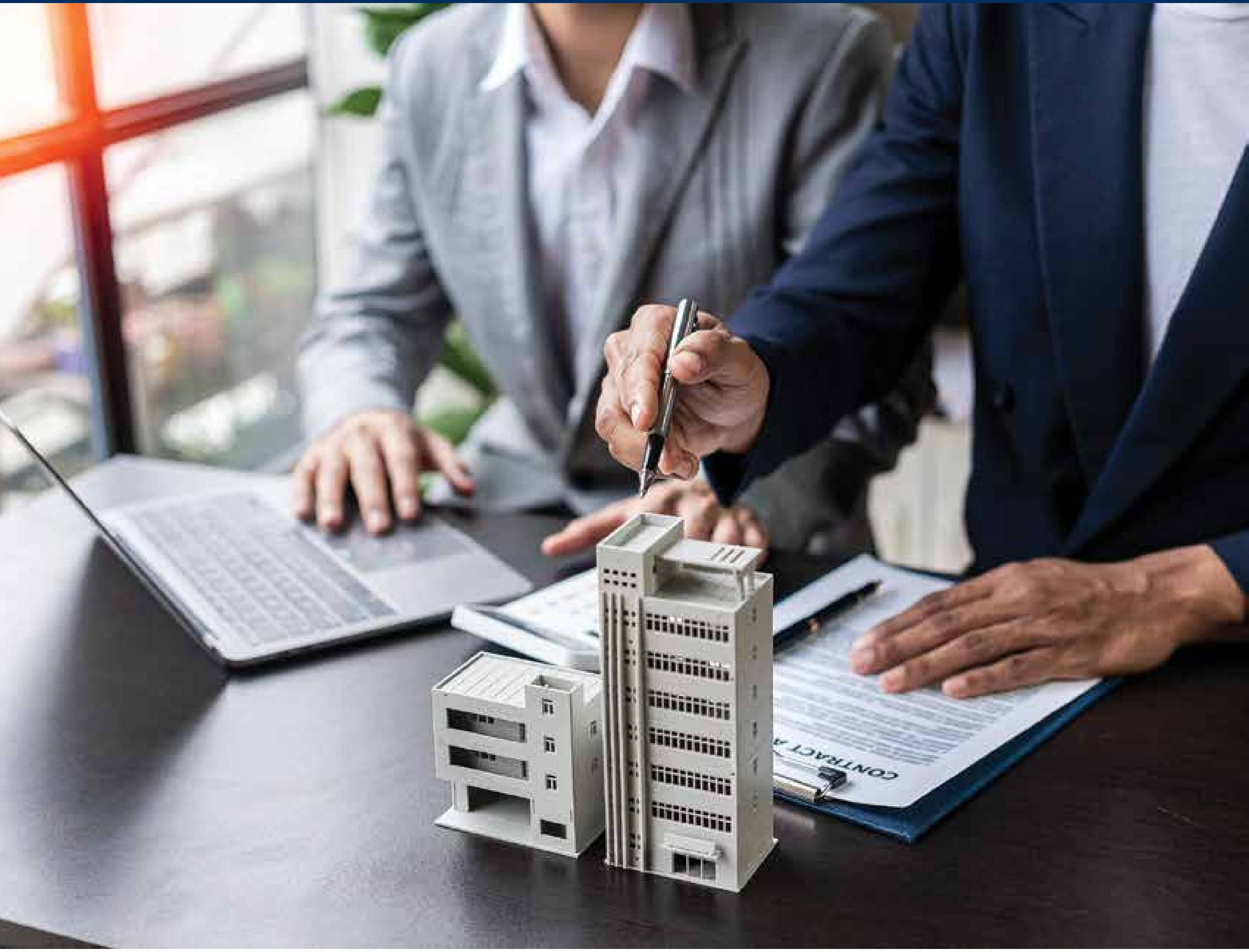
In regard to modified accelerated cost recovery periods (MACRS), real property will continue to be depreciated over 39 years and 27.5 years (for residential rental property).

The previous requirement for property to be "original use" has been eliminated. Now, in order to qualify for bonus depreciation, the original use does not begin only with the initial property owner but instead when the building is placed into service with the current property owner (including acquired property). This means bonus depreciation now applies to both newly constructed buildings and used property acquired after Sept. 27, 2017. For example, a retail strip mall is acquired, and a cost segregation study is performed to identify all of the appropriate 1250 and 1245 improvements. All those assets with less than a 20-year life will (as of Sept. 27, 2017) be able to qualify for the applicable bonus depreciation and thus be deducted in the current year. Land improvements are considered 15-year property under MACRS (Asset Class 00.3) and, thus, will be able to be deducted at the applicable bonus depreciation rate in the current year. However, they need to be correctly identified and classified — and a proper cost segregation study accomplishes this.

The Protecting Americans from Tax Hikes Act of 2015 introduced the category of qualified improvement property (QIP) as any improvement to an interior portion of a



building that is nonresidential real property as long as that improvement is placed in service after the building was first placed in service by any taxpayer (Section 168(k)(3)). It specifically excludes expenditures for the following:

1. the enlargement of a building
2. elevators or escalators
3. the internal structural framework of a building

The QIP provisions are effective for property placed in service after Dec. 31, 2015.

The TCJA eliminated the separate definitions of qualified leasehold improvements, qualified restaurant improvements and qualified retail improvements. These have all been replaced with the general grouping of QIP. The depreciable life of QIP was to be reduced from 39 to 15 years, with 100% bonus depreciation (in the applicable year) being available for all assets with a life of 20 years or less. Unfortunately, Congress forgot to give QIP a 15-year life, and it remained 39 years; so it was not eligible for 100% bonus depreciation (in the applicable year). As a result, the taxpayer who spent $2 million on qualified interior improvements to their property did not receive a $2 million deduction in that current year but had to depreciate the entire amount straight-line over 39 years.

The QIP technical correction

The Coronavirus Aid, Relief, and Economic Security Act provides a technical correction for QIP property, allowing bonus depreciation or special straight-line MACRS depreciation over 15 years instead of 39 years, while making the change retroactive to Jan. 1, 2018. Net operating loss generated by the additional depreciation may be carried back for up to five years to recover taxes previously paid. Going forward, all QIP property is eligible to be deducted at a rate of 100% (2022), 80% (2023), 60% (2024) and 40% (2025).

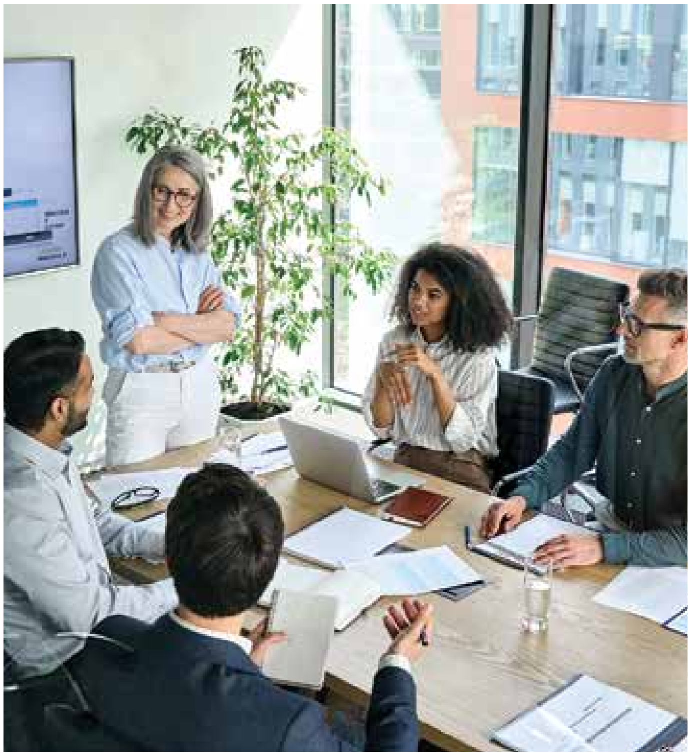
Final regulations 263a

Under the final regulations 263a (effective Jan. 1, 2014 — T.D. 9636), a building and its structural components are considered a single unit of property. The "unit of property" for buildings consists of the building structure and building systems, which include the heating, ventilation and air conditioning (HVAC) systems; plumbing systems; electrical system; all escalators and elevators; fire protection and alarm systems; security systems; gas distribution systems; and other structural components identified in published guidance.

In addition to defining the "unit of property" for tracking expenditures, the IRS has separately issued regulations (IRC Section 168) detailing the rules for dispositions and partial dispositions of depreciable assets that include building structural components. Prior to Jan. 1, 2012, losses were not allowed for retired building components, and consequently, the replacement of building components resulted in the continued depreciation of both the property that was replaced and the property that replaced it. Section 168 has established a facts-based approach to determining whether work performed on a building or leasehold improvements should be considered a deductible repair or a capital expense.

Under these rules, the taxpayer can end depreciation of building components upon removal and recognize a loss. A proper cost segregation study includes costs by building system and will facilitate a taxpayer's accurate reporting of losses when the component is disposed. In the case of existing property, the study should take into consideration the taxpayer's fixed-asset accounting of the building's original cost and aid in the identification of disposals that will occur as a result of the new capital improvements.

The numerous tax law changes have impacted both how a cost segregation study is performed and the methodology used. Taking into account all of the different modifying rules has made cost segregation studies very complex. An engineering-based study that takes all of these rules into consideration is an essential part of the process in order to not only correctly identify the significant depreciation deduction, which will offset taxable income, but also correctly set up the starting point for federal tax depreciation.



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