

Cost Segregation FAQ's

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Q) I received a call from a client of mine that wants to know what the consequences are of having a cost segregation study on a building and then selling it within a year or two.

A) It appears that you are asking what the consequences would be with respect to the property reclassified from residential (27.5 year) or non-residential (39 year) real estate to 5, 7 and 15 year property. If so, the consequences would be recapturing of accelerated depreciation as ordinary income on the 5 & 7 year property (aka section 1245 recapture). There would be recapture on the 15 year property to the extent that accelerated depreciation exceeds straight line (aka section 1250 recapture).

Q) If you don't mind, can I run a question by you regarding your experience with LIHC properties? We have a client who is in the beginning stages of construction of a LIHC property, and they had a question whether or not a "cost segregation study" would affect the tax credit eligible cost basis of the property. Have you had any of your LIHC properties go through a "cost segregation study", and what affects either good or bad did the study have?

A) The LIHC can be claimed with respect to both personal and real property, so a taxpayer has an incentive to allocate basis to personal property in order to obtain faster write off of basis. The key benefit of a cost segregation study is accelerated depreciation deductions. Accelerated depreciation deductions improve a project's internal rate of return which is an important consideration for investors in LIHC projects.

Q) A partnership purchased an office building about 5 years ago. The total purchase price was \$19M allocated as follows:

7 year property \$1.9M
39 year property \$15.3M
remainder as land

The client purchased about 90% of the partnership. The 'step up' is about \$5M.

Therefore, we have potential additional depreciation from the original purchase and interplay with the step up from the acquisition. I would be interested if E&M has seen this interplay between the partnership rules upon an acquisition and the cost segregation rules.

A) When a change in partnership interest occurs, as in your case for example, from admission of a new partner, the partnership can do a section 754 election to step up the basis to fair market value ,i.e., the new partner's basis in partnership assets is adjusted to fair market value. E&M will allocate 5, 7, 15 year property out of the total original cost of the office building (less land and maybe adjust the 7 year they are already using if necessary) and then do an allocation of fair

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market value to 5, 7, 15, 39 year property. The new partner would get additional 5, 7, 15 and 39 year depreciation on 90% of the difference between fair market value and original cost, which should be the \$5 million step up.

Q) I am working with two clients that are 50/50 owners in a commercial property. Their scenario is, the two owners purchased this building in 2003. One of the owners sold his 50% ownership to another person in Jan. 1st. Of 2007. So one has ownership since 2003 and the other a year ago. How do we provide feasibility reports?

A) This is a 754 step up issue. They would have to allocate 50% of the original cost to the original partner and 50% of the fair market value to the new one.

Q) I spoke w/ a CPA yesterday who has doctors that have set up LLC's for their medical office buildings. Can you explain to me how the passive and active rules impact the opportunity to do a CS study?

A) It sounds like the Docs are passive investors in the real estate project. If that is the case then the additional depreciation expense resulting from a cost segregation study could generate passive losses. Those passive losses may have to be suspended unless the Docs have passive income from other sources that can offset the passive losses. Also, it is possible that rents for the cost seg project buildings could be increased to reduce passive losses generated by the additional depreciation deductions. That could create additional tax deductions in another entity – maybe an operating company- that can use the additional deductions. Essentially they would be transferring the deductions by picking up additional income in the cost seg property and creating additional expense in the entity that rents the property. However, they have to be careful to be sure that the rents are reasonable.

Q) Have situation where two people owned building under a legal LLC they formed in 2005. In 2007 the 1 owner sold her shares to the other owner and he dissolved the legal entity and formed another. Does the Cost seg study get moved thru the new legal entity? Does it flow thru the old owner at all? How does an entity shift affect things?

A) The cost seg study will affect only the new entity. The new owner's basis in the assets should be adjusted.

Q) If owner just purchased property last year and thus don't have depreciation schedule made up yet, does the actual 3115 form get completed? Their intention is to start off with correct depreciation and thus wouldn't be "changing" anything per se. Is the automatic change in accounting needed?

A) Form 3115 is not applicable because an accounting method would not have been adopted. An accounting method is adopted by default with the filing of the second year's tax return.

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Q) Leaseholder improvements: Tenant pays to have improvements made so cost is theirs but asset is owners. When cost seg is done, does this area get put under the owners cost seg study?

A) Depends on the terms of the lease. Generally the lessee claims depreciation for improvements made by the lessee. This holds even though the lease terms may provide for transfer of ownership of the improvements to the landlord. However, a lessee takes rent deductions if the lessee makes improvements to the property in lieu of rent. The landlord will recognize rent income in the amount of the cost of the improvements and is deemed to have used the rent to make a depreciable leasehold improvement. In this situation, the landlord will claim depreciation deductions for the improvements. Whoever gets the depreciation deduction will include the improvements in a cost seg study. Keep in mind that the engineers don't review lease agreements or rental agreements to determine who owns the leasehold improvements. That determination should have already been done by the client and his advisors.

Q) Does IRS review cost seg submittal of 3115 or does automatically go through?

A) The commissioner's consent is automatic if properly filed. The service may review the form.

Q) Are commercial farms/ horse farms eligible for cost seg?

A) Yes. Losses could be limited.

Q) Does cost segregation affect property taxes?

A) Accelerated property components of real estate identified by a cost segregation study are generally not the same as personal property at the state level for property tax purposes. Problems sometimes arise when state property tax assessors pick up allocations of building cost to personal property on depreciation reports. This can be avoided by keeping the various components identified through a cost segregation study classified as real property. Confirm this treatment by looking to the law and regulations in your state.

Q) Does cost segregation affect sales taxes?

A) Accelerated property components of real property identified by a cost segregation study are generally not considered tangible personal property subject to sales tax. Confirm this treatment by looking to the law and regulations in your state.