The IRS View on Cost Segregation

BACKGROUND

Cost segregation is an established technique for deferring income taxes. Because the benefit of cost segregation can be significant in amount, most knowledgeable real property owners utilize cost segregation as a routine step in the process of preparing their income tax returns.

In spite of the popularity of cost segregation, many real property owners are unclear about how it fits into tax law. Because cost segregation evolved from years of litigation and rulings rather than from a Code section or succinct ruling, the legal basis underlying cost segregation can be confusing.

A common perception is that cost segregation is a method that is an elective provision that the IRS considers to be an aggressive filing position. This perception frequently causes real property owners to avoid cost segregation and, in turn, miss out on benefits that can be substantial.

ISSUE

How does the IRS view cost segregation?

CONCLUSION

Cost segregation is neither aggressive nor elective. In fact, according to the IRS, cost segregation is "required" when allocating "lump sum" costs to specific asset classifications. In other words, a real property owner that does not utilize cost segregation is not properly classifying costs.

The IRS is primarily concerned with the methodologies and procedures used to perform a study. As long as the study is performed by a qualified professional using methodologies and procedures as described in the IRS *Cost Segregation Audit Techniques Guide*, the risk of being challenged in an IRS audit is virtually nil.

ANALYSIS

To understand the current position of the IRS on cost segregation, it is helpful to review the historical development of the technique. Prior to 1981, real property owners utilized a similar technique, component depreciation studies, to achieve the same result of accelerating depreciation deductions. In 1981, Congress enacted legislation that expressly precludes taxpayers from utilizing component depreciation. However, from 1981 through 1987 taxpayers benefitted from Investment Tax Credit (ITC) studies. Cost segregation studies and ITC studies are virtually identical with respect to reclassifications from real property classifications to tangible personal property classifications. In fact, most of the law that supports cost segregation is based on court decisions and IRS rulings and pronouncements that arose from ITC studies.

Before 1987 the only significant benefit to reclassifying costs from real property to tangible personal property classifications was from tax credits. The benefit from accelerating depreciation deductions was minimal because real property was depreciated over recovery periods that were much shorter than under the current system. Buildings placed in service from 1981 through 1986 were assigned recovery periods of from 15 to 19 years. The benefit from reclassifying costs from 15 to 19 year recovery periods to 5, 7 or 15 year recovery periods is relatively small in amount. However, beginning in 1987 the recovery period for buildings was changed to 27.5 years for residential real property and 31.5 years for commercial real property. The 31.5 recovery period for commercial property was changed to 39 years for buildings placed in service after March 1993. With the longer recovery periods, the benefit of reclassifying costs to 5, 7 and 15 years is substantial.

In effect, after 1986 the objective switched from maximizing ITC to maximizing depreciation deductions. However, the IRS initially challenged most of the basic concepts utilized in cost segregations. arguing that cost segregation is basically a variation of component depreciation and is therefore not allowed. As a result, most taxpayers, wanting to avoid IRS scrutiny, did not utilize cost segregation for many years.

Many large companies chose to challenge the IRS. The IRS was successful at challenging many of the specific types of property that taxpayers attempted to reclassify to shorter lives. The IRS was also successful at challenging many of the methodologies that taxpayers used to measure and allocate the cost of the shorter lived assets. However, the companies prevailed on the most important issues. The courts consistently ruled that the basic concepts of cost segregation were legitimate, and that if a taxpayer utilizes detailed, comprehensive methodologies based on construction cost engineering methods, the results would be allowed.

In a 1997 Tax Court case, *HCA vs. Commissioner*, the court issued an opinion that, on the substantive issues, overwhelmingly favored the real property owner. The IRS chose not to appeal the *HCA* case, and in 1999 acquiesced. Effective with the 1999 acquiescence, the legitimacy of cost segregation became clear. However, the court made it clear that cost segregation studies would be accepted only if stringent methodologies are followed and if the professionals performing the study are qualified to carry out the study.

For the first few years after the IRS acquiesced to the *HCA* case, taxpayers were in a difficult position. Cost segregation studies were clearly legitimate, but there were no clear guidelines for proper methodologies. Finally, in 2004 the IRS published a *Cost Segregation Audit Techniques Guide.* The purpose of the *Guide* is to direct IRS auditors on how to handle cost segregation studies when clients are being audited. It does not have the effect of law. However, the *Guide* provides real property owners with clear guidelines for methodologies that the IRS will accept in an audit.

In the introduction, the *Guide* describes cost segregation as the analysis used to properly "…'segregate' or 'allocate' costs to individual components of property…."

> In order to calculate depreciation for Federal income tax purposes, taxpayers must use the correct method and proper recovery period for each asset or property owned. Property, whether acquired or constructed, often consists of numerous

> asset types with different recovery periods. Thus, property must be separated into individual components or asset groups having the same recovery periods and placed-in-service dates in order to properly compute depreciation.
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> When the actual cost of each individual component is available, this is a rather simple procedure. However, when only lump-sum costs are available, cost estimating techniques may be required to "segregate" or "allocate" costs to individual components of property (e.g., land, land improvements, buildings, equipment, furniture and fixtures, etc.). This type of analysis is generally called a "cost segregation study," "cost segregation analysis," or "cost allocation study."

Cost segregation is neither elective nor aggressive. In fact, it is described by the IRS as the “required” method for accurately measuring and classifying “lump sum” costs for depreciation purposes. In fact, in most situations, if a cost segregation study is not performed, the real property owner is not properly classifying real property costs. The IRS does not require taxpayers to utilize cost segregation primarily, because the IRS doesn’t require taxpayers to follow the law in situations where taxpayers are overpaying their taxes.

The IRS focus is on which assets are assigned shorter lives, and the methodologies used to determine the cost of those assets. Fortunately, by following the methodologies and classifications that the Guide advocates, real property owner will not be challenged on any aspect of a cost segregation study. As long as the real property owner engages qualified professionals who follow the methodologies described in the Cost Segregation Audit Techniques Guide, the IRS will have no basis for challenging the results.