Chances Are, You're Paying Too Much Tax … and You're Not Alone!

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Wednesday, September 03, 2003

Thousands of commercial property owners overpay federal income taxes every year. Why? Because they are missing out on allowable depreciation expense deductions.

Ironically, these accelerated depreciation expense deductions are available to all federal taxpayers under existing IRS tax laws. But don't blame your tax preparer. Without an engineering-based cost segregation study, your tax preparer cannot maximize your benefit under the current tax law. That's where engineers who are familiar with tax law come in—by providing engineering-based cost segregation studies.

For income tax depreciation purposes, there are two major types of assets—§1250, real property, and §1245, personal property. Properly classifying your business assets between these two categories is of paramount importance to the cash-conscious real estate owner. Tax law allows personal property to be depreciated significantly faster than real property—over shorter lives and using accelerated depreciation methods.

Engineering-based cost segregation studies take assets that have been classified as real property for federal income tax purposes and, using engineering-based analysis techniques, segregate the property that should have been classified as personal property into the shorter, appropriate class lives. The engineering-based cost segregation study provides your tax preparer with the information and supporting documentation needed to depreciate your assets over the appropriate, shorter tax lives.

Real property recovery periods range from 27.5 to 39 years and employ the straight line method of depreciation. Personal property can be depreciated in as few as five years and employ a 200 percent or 150 percent declining balance method of depreciation. The result is an increase in current year depreciation expense on your income tax return due to (1) a significantly shorter depreciable tax life and (2) a front-end-loaded method of calculating the depreciation expense. The resulting increase in depreciation expense typically yields a significant decrease in income tax liability.

Several new law changes make it beneficial to perform a cost segregation study immediately. The first beneficial law change was released in the form of a Revenue Procedure, Rev. Proc 2002–19. Prior to this issuance, the beneficial adjustment resulting from a cost segregation study had to be spread over four years. Revenue Procedure 2002–19 allows for the adjustment resulting from a cost segregation study to be expensed entirely in the year of the change.

An engineering-based cost segregation study is a change in depreciation method. This change in method is reported on Form 3115, being filed with the taxpayer's return in the year the change is elected. The adjustment that results from the change in method is the difference between the depreciation expense reported on prior returns and the depreciation that would have been reported had the assets been depreciated under the new method all along. The adjustment is then entirely expensed in the current year. No amended returns need to be filed. No amended K-1s need be issued. The adjustment, a §481(a) adjustment, is simply reported on your income tax return as a reduction to your current year taxable income. All of the depreciation you could have reported, had you performed an engineering-based cost segregation study initially, but did not, is simply expensed against the current year's income. For assets that have been placed in service for three or more years the §481(a) adjustment can often be substantial!

Example
An office building with capitalized costs of $10 million was placed in service 10 years ago. The election was made to place the building into a 39-year straight line method of depreciation. The building undergoes an engineering-based cost segregation study resulting in $1 million being reclassified to five-year property and $1.5 million being reclassified to 15-year property.

The §481(a) adjustment and resulting tax benefit would then be calculated as:

Depreciation Reported Previously	$ 2,564,100
Cost Seg. Study Depreciation	3,923,070
Section 481(a) Adjustment	$ (1,358,970)
Tax Rate	40%
Tax Benefit in year of study	$ 543,588

"What if the §481(a) adjustment wipes out your current year taxable income?"
That question brings us to the second beneficial tax law change. As part of the "Economic Stimulus Package" Congress put in place following the tragic events of September 11, 2001, taxpayers creating NOLs in 2001 and 2002 can now carry those losses back an additional three years. This means that NOLs, for a short time, can be carried back five years instead of the two years that were allowed. However, the window for this opportunity is quickly closing. Only losses generated in 2001 and 2002 can be carried back five years. (It is important to note that in 2003 the two-year carry-back rules resume.)

Additionally, 30 percent bonus depreciation is not allowed on real property. However, by properly reclassifying some real property to personal property, 30 percent bonus depreciation can be accessed. As a result of legislation that has just been passed into law, the amount of property purchased that can be expensed in the current year (i.e., the §179 deduction) has been increased from $24,000 to $100,000. The §179 deduction is not available on real property. All of these recent new laws make cost segregation studies more beneficial than ever before.

"If this is such a great tax planning strategy, why haven't I heard about it before now?"
The legislation and procedures used in an engineering-based cost segregation study have been around since the enactment of the Investment Tax Credit (ITC) in 1962. With the repeal of the ITC and the enactment of the rules limiting passive losses in 1986, most companies assumed that engineering-based cost segregation provided no further benefit under the new tax law. However, in a 1997 tax court case, Hospital Corporation of America successfully defended the application of engineering-based cost segregation as a method to differentiate real and personal property. Subsequent to the court's ruling, the IRS acquiesced to the viability of engineering-based cost segregation as a legitimate method to differentiate real and personal property under current tax law.

The benefit from performing an engineering-based cost segregation study on commercial real property can be significant. The benefits have never been greater due to recent legislation. However, you should consult your tax preparer to determine whether this tax planning strategy can benefit you.

For more information, visit DASI's Website at www.DASIconsulting.com.

Ed Allen began his career in the tax compliance division of Ernst & Young. He was a partner in Mid American Capital Resource Group, Inc., a national factoring company based in Dallas, where he served as vice president and chief financial officer. He also served as a tax analyst at Lacerte Software Corp., a division of Intuit, where he led the development of various tax modules achieving seamless integration between federal and state returns. His credentials include a B.B.A. in accounting from Abilene Christian University.

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