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Property Owners Profit From Change in Tax Law

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Landlords of commercial buildings who have been struggling with the weak economy are finding consolation from an unusual source: the Internal Revenue Service. Recent rulings by the IRS on depreciation rules have major implications for owners of fast-food restaurants, stores, apartment buildings, manufacturing property and other types of specialized real estate. The rule changes are especially significant when combined with the 30% bonus depreciation provision of the economic-stimulus package approved in Washington earlier this spring.

"For many property owners, this is a windfall," says Carl de Stefanis, vice president of Construction Cost Recovery Inc., a White Plains, N.Y., tax-consulting firm.

The new rules all affect how fast property can be depreciated. Generally, the IRS allows owners to depreciate commercial property over 39 years and income-producing residential property over 27.5 years. But under the new rules, a wide range of building improvements -- from wall coverings to supplemental air conditioning to certain land improvements like swimming pools and tennis courts -- can be reclassified and depreciated as personal property and land improvements rather than structural components of a building. Depending upon what it is, personal property can be depreciated over five or seven years and land improvements can be written off over 15 years.

According to some accountants, in some cases as much as 40% of a property's construction costs could be reclassified as personal property and land improvements and depreciated much faster, greatly reducing an owner's tax bill. Take, for example, the case of a recently developed manufacturing building in Southern California that cost $4.6 million to develop.

In its first full year of operation, the owner could have depreciated his property by $120,000 if he had used the simple 39-year IRS formula. But by segregating the costs of the development that weren't part of the building's structure -- a process known as "cost segregation" -- he was able to depreciate the facility by $397,000 in the first year, according to Lori St. Marie, a senior tax manager of the Spokane, Wash., office of Moss Adam LLP, an accounting firm that worked on the project.

While most major corporations and property owners have begun to use cost-segregation methods to depreciate their property, accountants and other experts say there are thousands of smaller landlords who continue to depreciate their property the old way. The method can be used both for old and new property. "There are quite a few people out there who are not doing it," Ms. St. Marie says.

Peter O'Connor, an accountant with accounting firm CSEG Inc., of Williamsville, N.Y., says that many accountants are unfamiliar with cost-segregation methods because they don't have engineering backgrounds and the IRS prohibited their use for years. "Anyone who came into the profession in the last 12 years hasn't spent any time looking at it," he says.

Cost-segregation accounting methods have a long history. They were used extensively in the 1980s when developers of new property could get special investment tax credits for the personal property in the buildings. The IRS even had special rules for determining what was personal property and what made up the building and its structural components. But the overhaul of the tax law in 1986 eliminated the investment tax credits and, as far as the IRS was concerned, the

cost-segregation rules no longer applied.
But not all taxpayers agreed. The Hospital Corporation of America argued that even after 1986 the old tax credit rules could be used for determining the difference between a building and personal property for depreciation purposes. The dispute eventually wound up in U.S. Tax Court, and in 1997 the court ruled in HCA's favor. According to the court, a wide range of improvements weren't related to the operation or maintenance of the building, including carpeting, kitchen-plumbing connections, exhaust hoods, television wiring and secondary electrical-distribution systems. All of these items could be depreciated faster, saving HCA millions of dollars in tax expenses. Two years later, the IRS issued a memorandum in which it acquiesced to the Tax Court ruling. A new era of cost-segregation accounting had begun.
Accountants caution that there are no clear definitions for exactly what constitutes personal property and land improvements. Indeed, in its 1999 memorandum, the IRS stated that it disagreed with the Tax Court's classification of some of the items as personal property, but stopped short of saying what those items were. Property owners who want to use a cost-segregation method for figuring out depreciation must hire firms to do much of the work, for fees that range from $10,000 to $100,000, depending on the property's size and complexity. Professionals at these firms, however, say that their fees are more than paid for in tax savings.
The advantages of using cost-segregation accounting became even greater this year, accountants say. For one thing, the IRS changed its rule for how it treats taxpayers who want to redo their taxes from earlier years using cost segregation. In the past, the IRS said the benefits from the accelerated depreciation must be spread out over four years. Under the new rule, all the benefits can all be taken in one year.
Also, earlier this year President Bush signed the economic-stimulus bill that included a provision that allows taxpayers to depreciate 30% of any investment in one year as long as that investment would normally be depreciated in 20 years or less. That means that if a portion of a property's costs can be classified as personal property or land improvements, they would qualify for the 30% bonus.

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