Tax court ruling recommends cost segregation studies be done by professionals

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Jon Smith owns multiple commercial buildings. All have been either purchased or constructed over the last two years. Smith's accountants recommend a cost segregation study on these buildings as this will create additional cash flow and reduce his overall tax liability - allowing for what Smith does best - the purchasing of additional properties.

Who should prepare these studies for Mr. Smith? Should he hire a cost segregation expert? Can his accountant segregate the costs for him? Or perhaps Mr. Smith can do it himself. He knows all the costs associated with the buildings. Can he just use the "rule of thumb" approach and segregate the costs himself? My advice to Smith is to save himself a headache (and possible problems with the Department of Revenue) and hire an expert. He is better served hiring a qualified cost segregation firm to prepare the studies.

It appears even the Department of Revenue agrees with this advice. It reached the same conclusion in the case of Ronald Pearce and Daryl Pearce, Plaintiffs, v. Department of Revenue, State of Oregon, Defendant (Oregon State Tax Reporter). In Pearce vs. the Dept. of Revenue, the Plaintiffs owned properties that qualified for depreciation deductions under Federal and Oregon law. These properties are ordinarily depreciable on the 39-year schedule applicable to buildings. In order to distinguish the buildings from their related "tangible personal property," such as equipment, furniture, and fixtures, which qualify for depreciation deductions on an accelerated schedule of between five to seven years, the plaintiffs prepared their own cost-segregation analysis of their properties. Although plaintiffs had no special experience in applying the cost-segregation methodology, they believed that their analysis was proper because it followed the "'rule of thumb' approach," which is based upon "a preparer's 'experience' in a particular industry." Plaintiffs used the results of their cost segregation analysis including accelerated depreciation deductions, in their 2004 return.

On August 4, 2009, and August 6, 2009, defendant sent plaintiffs Notices of Tax Deficiency. The tax deficiencies arose from defendant's denial of plaintiffs 2004 cost segregation analysis and defendant's consequent disallowance of plaintiffs' accelerated depreciation deductions. In a letter dated March 2, 2010 the defendant upheld its denial of plaintiffs cost-segregation analysis explaining that the "rule of thumb" approach that plaintiffs used "should [be] viewed by the Department of Revenue with caution, since it lacks sufficient documentation to support its allocation of costs" and that plaintiffs failed to substantiate their costs or prepare a timely analysis.

Plaintiffs failed to satisfy their burden of proof in regards to accelerated depreciation through cost segregation. The IRS issued an Audit Technique Guide (ATG) to help guide their examiners when they encounter a return that uses cost segregated items for depreciation. The ATG instructs examiners to view the "rule of thumb" approach used by plaintiffs with caution because the results are "based on a preparer's 'experience' in a particular industry" and "[lack] of sufficient documentation to support its allocation of project costs."

Chapter three of the ATG states in part: "Despite the lack of specific requirements for preparing cost segregation studies, taxpayers still must substantiate their depreciation deductions and classifications of property. Substantiation using actual costs is generally preferable to the use of estimates. However, in situations where estimation is the only option, the methodology and the source of any cost data should be clearly documented. In addition, estimated costs should be reconciled back to actual costs or purchase price."

A "quality" cost segregation study is "both accurate and well documented." A taxpayer's estimated assumptions, based on guesses without supporting records, could not form the basis for acknowledgement of a plaintiff's claim.

In the Pearce case, plaintiffs used a "written inventory" to allocate values to fixtures and cabinets. Plaintiffs did not substantiate their cost allocation using actual costs. Instead, they merely used their own estimations or assumptions with no supporting records. In doing so, the Ronald and Daryl Pearce failed to clearly document the methodology and the source of any cost data. As such, they did not prove by the preponderance of the evidence that their cost segregation was appropriate.

This case showed that while a property owner can prepare his own cost segregation study, he probably shouldn't since the rules of a cost segregation study are many and cumbersome. While a do-it-yourself approach may work for retiling a bathroom or refinishing cabinets, when it comes to tax benefits, some things are best left to the experts. That's why even most CPA firms refer their clients to cost segregation specialists.

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