Cost seg of the IRS' final regs: A combo one-two punch maximizing tax deductions/write-off benefits

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It's hard to believe that once again, April 15th is just around the corner, and people are scrambling to try and figure out how they can lower their income tax liability. It's not too late for owners of investment real estate and property used for business to offset their 2013 tax bill through a cost segregation analysis, regardless of the size or complexity of the property. This valuable, yet often overlooked, strategy enables owners to reduce their tax liability and increase cash flow with the use of accelerated depreciations on eligible assets. For many owners, the likelihood of significant tax benefits from a cost segregation study - commonly referred to as "cost seg" - warrants filing for an extension until September 2014 or October 2014. This will allow ample time to complete the analysis.

Adding to the benefits of cost segregation is the release of the IRS' final regulations dealing with the capitalization of fixed assets. It has been a tumultuous process for the IRS to finalize its capitalization regulations. A key issue of the final regulations is the classification of tangible property expenses, commonly referred to as "repair regs." The turmoil has come from multiple IRS attempts to resolve the confusion between business expenses versus the capitalized costs of building. Original regulations were proposed by the IRS in 2006, withdrawn in 2008, reissued in 2011, and then postponed until 2014. The final regulations were finally published in September, 2013 and will apply to tax years beginning on or after Jan 1, 2014. These new regulations will affect all taxpayers that acquire, produce or improve tangible property.

Here is a brief summary of the key points of the final regs, and their impact on cost segregation studies.

The regulations determine eight designated building systems as Units of Property (UOP).

1. HVAC system
2. Plumbing system
3. Electrical System
4. All Escalators
5. All Elevators
6. Fire Protection and Alarm systems
7. Security Systems
8. Gas Distribution systems

The new requirements for capitalization can be categorized into three areas: 1) Betterment, 2) Restoration, and 3) Adaptation.

Betterment is defined as amounts paid to improve any of the eight designated UOPs. For example, if a retailer decides to refresh his store with sheet rock repairs, or new cabinetry and mill work, the taxpayer is not required to capitalize the amounts paid for this work. However, if the retailer

upgrades the bathroom fixtures, the taxpayer is required to capitalize those costs, since they directly improve the plumbing system, which is one of the UOPs.

Restoration is defined as the amounts paid to restore any of the designated UOPs and must be capitalized. For example, roof replacement, replacement of toilets, sinks or plumbing fixtures qualify as restoration.

Adaptation is defined as amounts paid that result in new or different use of the designated UOPs. An example would be modifying a UOP for a different use than the intended ordinary use of the UOP. These must be capitalized. This is a common occurrence in multi-use buildings, such as hotels and casinos, where a conversion from a standard room to a suite or a coffee shop to a high-end steakhouse happens frequently.

Taxpayers will now be required to track the activities performed in each UOP to determine if the results of the improvement to that building system must be capitalized. This will require increased scrutiny of expenses in order to ensure tax compliance. Any changes in UOP which require capitalization will need to be filed in order to capitalize those costs and claim the proper depreciation on the improvements.

An area that will cause many taxpayers to breathe a sigh of relief is the ability to be able to write-off assets that are in fact UOP, that were replaced with newer units or systems. The regulations allow for taxpayers to be able to identify various assets within the building systems that, when replaced, can be written off in its entirety (net of depreciation) when the assets are taken out of service. This will give taxpayers immediate deductions rather than leaving the replaced assets sitting on the existing books and continuing to depreciate over its remaining useful life.

Generally speaking, buildings can be depreciated over a 27.5-year or 39-year period. However, according to the Internal Revenue Code, certain categories of assets that exist within a building, or surrounding a building, can be depreciated more quickly, over 5, 7, or 15 years. Reclassifying these eligible assets often serve to accelerate part of the building's tax depreciation, creating a reduced tax liability.

That is what cost segregation does. A cost segregation study is the tax and engineering analysis that scrutinizes an entire property, and then identifies and segregates eligible assets, assesses their value and determines the resulting asset classes as well as its corresponding depreciation deduction. It takes a team of qualified engineering, accounting and tax experts to conduct a proper analysis because the end results depend on accurate tax, accounting and engineering valuations. Eligible assets include systems, fixtures and other related elements that are either unnecessary for the operation of the building itself, are decorative or ornamental in nature, or are temporary structures. Some examples include ornamental lighting or moldings, certain flooring, wall coverings, and redundant HVAC systems. The end result of a cost segregation study breaks out the entire building, from sub grade all the way up to the roof including all of the building systems, and sets up the owner's depreciation system to include the structural (i.e. building) assets, land improvements, and the tangible personal property.

Due to the new regulations, owners of investment property and property used for business will benefit even more from having a cost segregation study performed. An expert cost segregation analysis will segregate the building into the eight designated UOPs, and the residual building structure, then analyze subsequent renovation work to determine which building systems must be capitalized, and which systems have been replaced, thus triggering the ability to write-off the remaining basis of the replaced systems no longer in service. A rigorous analysis will determine the

adjusted basis for loss recognition purposes. This will help the taxpayer to properly assign the total costs for the building into the correct building system category.

So there you have it; the perfect match between cost segregation and the final regs; a combination one-two punch that will maximize tax deductions and write-off benefits for real estate owners that will hopefully achieve an owner's goal of trying to manage their tax liability in the most efficient manner possible.

Eli Loebenberg, CPA, is the chief executive officer of Madison SPECS, LLC, Lakewood, N.J.