Vol 21 | No 2 | Jan. 29-Feb. 11, 2007 www.webcpa.com

accountingtoday

THE BUSINESS NEWSPAPER FOR THE TAX & ACCOUNTING COMMUNITY

The interaction between cost segregation and like-kind exchanges

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Cost segregation and 1031 like-kind exchanges are two of the most valuable tax planning strategies available to commercial real estate investors. Through proper planning, both tax-deferral techniques can be used on the same properties in order to obtain the maximum benefit.

However, the combination of the two can present challenges. In order to use cost segregation and 1031 exchanges together successfully, the property owner's tax advisor must be well versed in both techniques, and understand how they apply to the individual investment strategy of the client.

A 1031 exchange is almost always valuable when a taxpayer intends to hold real property, even for a relatively short period of time. This is because the cost of entering into an exchange is relatively low compared to the benefits of deferring gain on the relinquished property. This issue is more complicated when evaluating a cost-segregation study. However, a study will allow a taxpayer to substantially accelerate ordinary income deductions, the present-value benefit of which can be dramatic.

This benefit may be "given back" when the property is sold in a taxable transaction, but at what cost? Since the concept of cost segregation is essentially a reclassification of depreciable Section 1250 real property to depreciable Section 1245 property, the rate differential (all other things being equal) is 10 percent. This is as a result of a change in the character of future income from 25 percent (the tax rate of depreciation recapture on 1250 property) to 35 percent (the rate of depreciation recapture on 1245 property).

The impact of this increased tax cost is mitigated in at least two ways. First, rarely does 1245 property retain its value consistent with the value of real property. This is certainly the case with furniture and equipment, and to a lesser extent with fixtures attached to real property. Second, the longer a property is held, the less impact the reclassification has (through the time value of money).

Assuming that the relinquished property was acquired in 1998 and was never segregated, what opportunities are available? A study can be performed on a property acquired in a prior year through a process known as a look-back study.

In a look-back study, a cost-segregation specialist determines the cost allocation to the various proper asset categories as of the time the property was acquired. This requires reviewing historical acquisition documents (i.e. escrow statements, appraisals, blueprints, etc.). It also involves inquiry of the taxpayer to determine what changes have been made to the property from the time it was acquired.

Once the study is completed, the taxpayer computes the "missed" depreciation. The result is deducted as a Section 481 adjustment by the taxpayer in the year the study is implemented (in our example below, 2006).

The 481 adjustment from a study performed on a property that is to be traded in a 1031 exchange can potentially serve two purposes: sheltering income from other sources and offsetting taxable boot on an exchange.

Performing a cost-segregation study on the relinquished property adds a layer of complexity. In our example, the study resulted in an allocation of cost basis to five-year personal property (i.e. furniture, machinery and equipment), five-year real property (i.e. fixtures) and 15-year land improvements. Even when trading similar properties, these allocations will not match up exactly. For example, our case study involves the sale of a strip mall. Let's assume that the taxpayer is trading this strip mall for another strip mall in a different location but of equal value. The initial reaction would be that there is no boot and no step-up in basis on this transaction. However, this may not be the case, as shown in Figure 1.

In this example, $4.93 million of real property was exchanged for $4.835 million of real property, resulting in taxable boot of $95,000. In addition, as a separate exchange group, $70,000 of Sec. 1245 personal property plus $95,000 of real property was

exchanged for $165,000 of 1245 personal property. The $70,000 exchange piece would transfer tax-free via the 1031 exchange, and the additional $95,000 in personal property would be treated as newly acquired assets, depreciable under MACRS.

ALIKE, BUT NOT EXACTLY

The taxpayer has two issues to consider if the replacement property is different than the relinquished property. First, a more dramatic version of the "boot issue" illustrated above results when a taxpayer is exchanging two properties that are in similar industries but are of different grades. For example, if a taxpayer is exchanging a high-end strip mall (with a high allocation of 1245 property) for a low-end strip mall (with a lower allocation of 1245 property), it will be difficult covering each exchange group unless there is sufficient step-up in value.

The second area of concern is meeting the like-kind requirement with respect to the non-1250 real property. Many real property exchanges (involving a structure) are typically a multiple property exchange. It is widely accepted that most such exchanges qualify as like-kind. However, the personal property portion of a real property transaction is more problematic.

In our example, we exchanged personal property from one strip mall to another in a qualified 1031 exchange, since both groups of property were deemed to be either of a like kind or a like class. Had the replacement property been a recreation facility, the likely result would be a taxable transaction.

Cost-segregation studies have been around for quite some time. However, it was not until the *Hospital Corp. of America* case was decided in 1997 that the concept began to be more widely accepted. As a result, tax professionals continue to be confronted with clients and relinquished

FIGURE 1

A sample of the interaction between cost segregation and like-kind exchanges

	Total	Land	Sec. 1250 39-year real property	Sec. 1250 15-year land improv	Sec. 1245 5-year real property	Sec. 1245 5-year personal property	Total A/D
Original property – acquired 6/98							
Cost	$2,600,000	$800,000	$1,800,000				
Accumulated depreciation			$(323,064)				$(323,064)
Allocation per cost segregation			***78%***	***15%***	***5%***	***2%***	
Cost after study – revised		$800,000	$1,404,000	$270,000	$90,000	$36,000	
Accumulated depreciation – revised			$(251,990)	$(142,456)	$(90,000)	$(36,000)	$(520,446)
C/Y 481(a) adjustment							**$(197,382)**
FMV of relinquished property	$5,000,000	$1,500,000	$2,730,000	$525,000	$175,000	$70,000	
				Total real property:	**$4,930,000**		
Date of exchange – 6/06							
Allocation per cost segregation			***78%***	***12%***	***5.15%***	***4.85%***	
FMV of replacement property	$5,000,000	$1,600,000	$2,652,000	$408,000	$175,000	$165,000	
				Total real property:	**$4,835,000**		
Step-up						**$95,000**	
Boot					**$95,000**		$95,000
Taxable income (loss)							**$(102,382)**

properties whose depreciable basis has not been segregated.

Will the IRS look at the relinquished property and claim that a portion was 1245 property that either creates boot on the 1031 transaction or creates 1245 recapture? This issue is certainly something that should be considered. However, this approach on the part of the IRS may be mitigated by Rev. Proc. 2004-11, which effectively eliminates the "allowed or allowable" issue.

DEPRECIATION RECAPTURE

An additional issue that confronts tax professionals is the question of depreciation recapture. Most tax professionals focus on ordinary income recapture under Sec. 1245(a) and 25 percent tax recapture for Sec. 1250 gain. These forms of recapture should not be confused with 1245(b)(4) and 1250(d)(4).

We will limit our discussion to 1245(b)(4), since it is far more common and dramatic. Earlier we discussed how most real property transactions include both real and personal property. We also illustrated the need to match both exchange groups in order to avoid boot. In order to accomplish this match, tax practitioners need to address the definition of real property in a 1031 exchange context.

» A 1031 EXCHANGE **IS ALMOST ALWAYS VALUABLE** WHEN A TAXPAYER INTENDS TO HOLD REAL PROPERTY.

While some debate exists, common practice with respect to a real property exchange is to include land, building, land improvements and fixtures as real property in one exchange group, and personal property in another. Sec. 1245(b)(4) has the effect of creating a third sub-exchange group, since it requires depreciation recapture on a portion of what would otherwise be a non-recognition piece of the 1031 exchange.

DEPRECIATION ON PROPERTY ACQUIRED

Temp. Reg. 1.168(i)-6T was issued to provide guidance on depreciating assets acquired in a 1031 exchange. Under the regulations, the taxpayer has two choices: implement the provisions of the regulations, or elect out and treat the entire basis of the replacement property as a newly acquired asset.

Regulations require that replacement property be divided into two categories — exchange basis (carry-over) and excess basis (step-up). The rules with respect to depreciating the exchange basis are outside the scope of this article.

CONCLUSION

Despite the complexities and unanswered questions, cost segregation in conjunction with a 1031 exchange is a powerful tool, as long as the taxpayer and their advisor are familiar with the interaction of the tax laws. **AT**

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