

TAX ALERT

April 9, 2012

Tax Court: Cost Segregation - Is Your Documentation Sufficient?

Synopsis:

In March 2012, the United States Tax Court issued a decision that will have an impact on taxpayers who have used cost segregation studies to determine depreciation deductions for multifamily housing projects. The Tax Court decision will especially impact those who have used a cost segregation study to support accelerated tax depreciation deductions on purchased as opposed to newly constructed properties.

Suggested Action:

- Determine if you have used a cost segregation study in the past in establishing tax depreciation deductions.
- While Reznick Group is confident in its cost segregation processes and procedures and this Tax Court decision is related to another service provider, in light of this recent Tax Court decision, it is prudent to read this Tax Alert and the [AmeriSouth XXXII, Ltd. v. Commissioner, T.C. Memo. 2012-67](#) and contact [Joseph Mudd](#), Director of National Tax, at 301-280-1920 or [Chris Thomas](#), Principal and Cost Segregation Services Leader, at 512-499-1408 to establish your risk position with respect to the documentation supporting your cost segregation study.

Issue:

The taxpayer, AmeriSouth XXXII (AmeriSouth), purchased an apartment property in 2003. The property, built in the 1970s, had nine buildings containing apartments and several buildings with common space. After purchasing the building, AmeriSouth spent an additional \$2 million to renovate the apartments and subsequently engaged an engineering firm to perform a cost segregation study related to the building and the new renovations. The study entailed separating the buildings into individual asset classes and depreciation deductions were taken on the assets based upon costs estimated by the engineering firm. Upon examination, the Internal Revenue Service (IRS) rejected much of the study, claiming first, the building and all of its components were depreciable over 27.5 years and later that the estimates used by the engineering firm lacked adequate support.

AmeriSouth filed a petition in the United States Tax Court to challenge the Commissioner's findings. However, AmeriSouth also sold the building during the Tax Court proceedings. Once the building was sold, AmeriSouth stopped responding to the Tax Court and the IRS. AmeriSouth also fired its attorneys, who formally withdrew their representation of AmeriSouth. In the Tax Court opinion, the judge stated that AmeriSouth's lack of response could have resulted in dismissal of the case, but decided against dismissal and instead continued with Tax Court proceedings. Despite AmeriSouth's highly unusual lack of responsiveness, the Tax Court ruled on the merits of the case in AmeriSouth's absence.



The Tax Court's ruling examined each of the assets in the buildings detailed in AmeriSouth's cost segregation study. If the Tax Court determined that an asset was related to the operation or maintenance of an apartment building, that type of property was ruled to be property that is depreciable over 27.5 years (the depreciation period for a multifamily housing building). If not, the asset was allowed to be depreciated as described in the cost segregation study. Because AmeriSouth stopped participating in the trial before presentation of the evidence, the Tax Court based its decision almost entirely on the determination of the IRS and one taxpayer expert witness (who did not perform the study).

The Tax Court states throughout the opinion that its determinations were made because AmeriSouth did not provide evidence to support its position. The Tax Court's decision cannot be dismissed as a faulty study and is a significant concern for cost segregation studies where substantive documentation such as blue prints, architect's cost reports with project modifications and/or contractor invoices, are not available. This is especially relevant where studies have been performed on older buildings without such documentation.

Contact:

To learn more, please contact [Joseph Mudd](#), Director of National Tax, at 301-280-1920 or [Chris Thomas](#), Principal and Cost Segregation Services Leader, at 512-499-1408.

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