A Novel Tool

Cost Segregation Studies Can Produce Extra Benefits

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Owners and developers of low-income housing tax credit projects (LIHTC) looking to generate larger tax deductions to offset current taxable income, negotiate investor yield issues, or resolve certain Year 15 LIHTC issues may wish to explore getting a cost segregation study for their property. The additional benefits can outweigh the costs of a study, which can be utilized by those constructing, purchasing, renovating, or expanding any kind of real estate.

Cost segregation is the process of analyzing all of the physical components of a real estate property (e.g., a building) and reclassifying many of the components, for federal tax purposes, as assets with shorter tax lives. The end result is to accelerate (i.e. frontload) annual depreciation tax deductions, increase cash flow, and consequently defer federal and state income taxes. This contrasts with the standard approach of depreciating the entire building and its components over 27½ years (residential real estate) or 39 years (non-residential real estate). The trade-off is smaller annual depreciation deductions and greater taxable income in the out years.

Accordingly, the primary goals of a cost segregation study for a LIHTC project are:

- Identifying the parts of the property (assets) that can be depreciated over shorter lives than 27½ years, such as decorative or business-related costs depreciable over 5, 7, or 15 years; and,
- Leveraging the results as a tool to help general partners solve problems with capital accounts in Year 15 LIHTC dispositions.

In many LIHTC projects, assets are improperly categorized as property depreciable over 27½ years. A cost segregation study dissects construction costs usually depreciated over 27½ or 39 years and splits them into separate assets that have shorter depreciation periods. For instance, 30% to 50% of the cost of a building's electrical system can usually qualify as personal property depreciable over 5 or 7 years, thereby increasing the annual depreciation deductions for this equipment over this period.

To understand the tax benefit of a cost segregation study, the following illustration may be helpful:

> A taxpayer (a limited partnership) builds a LIHTC property for $25 million and places it in service in 2007. The taxpayer has a cost segregation study performed for the 2011 tax year. Prior to the study, only $4 million of the $25 million cost was identified as furniture and equipment (e.g., refrigerators, ovens, etc.) to be depreciated over 5 years. The remaining $21 million of project costs was classified as 27½-year property.
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> Prior to the cost segregation study, the taxpayer claimed approximately $763,000 in depreciation deductions for the property in the first year. However, after performance of the cost segregation study, $6,060,000 of the $21 million in component assets originally treated as 27½-year property are reclassified as assets with 5- or 15-year lives.
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> As a result of the cost segregation study, and after a Section 481(a) adjustment (change in accounting method), the depreciation deductions are increased by $3,420,472 ($423,360 for tax year 2011 and $2,997,112 for previous years) over the old classification. Assuming the taxpayer is at a 40% tax rate, this means deferring approximately $1,368,189 in federal taxes in the current year. While the specific benefit amount for a particular taxpayer will depend on their tax rate and tax position, this example is representative of the positive tax impact for LIHTC projects from cost segregation studies.

Cost segregation studies have been used and are used for LIHTC projects. While corporate investors gen-

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erally prefer more of their return from LIHTC investments to be from tax credits and less from tax losses, and often will not pay extra for extra losses, there are ways to structure transactions using cost segregation studies in order to help GPs at risk of financial penalties due to the underdelivery of projected tax benefits to provide the expected return to investors.

While it may appear simple to re-categorize a property's components into shorter-life assets, the process and documentation required to properly support shorter tax asset lives is complex. Project owners and developers should obtain a cost segregation study from a firm with the expertise and experience in performing these studies. These companies will provide thorough documentation to substantiate their positions reclassifying various components of the property, to minimize the risk to the taxpayer of a challenge by the IRS. The importance of this was underscored by a recent U.S. Tax Court decision *(see sidebar article.)*.

In performing a cost segregation study, Reznick Group conducts an engineering-based analysis of a property and its components and obtains proper substantiation of costs by evaluating construction invoices (G702 & G703), change orders, depreciation schedules, and other available records. Ultimately, site inspections, interviews and engineering analysis of the data are essential in order to present findings that will withstand scrutiny. TCA

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Tax Court Backs IRS in Case Involving Cost Segregation Study

In a March 12 decision, the U.S. Tax Court ruled in favor of the IRS in its efforts to adjust the tax returns of a taxpayer that claimed larger depreciation deductions for an apartment complex based on the results of a cost segregation study. *(U.S. Tax Court Memo 2012-67)*

The opinion was only somewhat useful. The opinion provides detail about why the IRS – in challenges supported by the court – contended that various specific components of the complex were not eligible for shorter depreciation lives than 27½ years. But the IRS victory was due in large part to some aggressive positions taken in the cost segregation study, poor documentation, and the taxpayer's nonresponsive to court communications.

The taxpayer, a limited liability company called AmeriSouth XXXII, Ltd., acquired the apartment complex (over 40 buildings, 366 units) in 2003 for $10.25 million and began a $2 million renovation. The cost segregation study reclassified about 33% of the property as 5- or 15-year assets (e.g., utility lines, wiring, special HVAC and plumbing), and the taxpayer took larger depreciation deductions on its tax returns for 2003-2005. The IRS argued that with minor exceptions the apartment complex was one asset depreciable over 27½ years. The IRS made adjustments to the taxpayers' 2003-2005 returns, denying about $1.8 million in depreciation deductions. The taxpayer appealed to the U.S. Tax Court.

The taxpayer did not file a post-trial brief, as the court had ordered. The Court did not dismiss the taxpayer's position, though, but did rule that any factual matters not otherwise contested to be conceded.

(T.C. Memo 2012-67: http://tinyurl.com/7lfgwbk) TCA