Are You Missing Tax Breaks When You Depreciate Your Property?
by Megan Heintzkill and William Truax

After over forty years of IRS regulations, rulings, and court decisions, taxpayers are understandably confused by depreciation rules as they apply to their real estate assets. But many owners may be missing a substantial tax advantage by not fully understanding the opportunities to fully depreciate some of the component parts of their properties.

The IRS requires property owners to clearly identify and distinguish on their tax returns those costs which are considered repairs (which can be expensed) from those which are improvements and need to be depreciated.

Most owners are aware of the basic depreciation rules: residential rental property is depreciated over 27.5 years and nonresidential real property is depreciated over 39 years. Land value must be subtracted from improvements before arriving at the depreciable value of the property. The IRS requires property owners to clearly identify and distinguish on their tax returns those costs which are considered repairs (which can be expensed) from those which are improvements and need to be depreciated. Most real estate owners are also aware that the type of improvement they make to the property determines whether they must include the improvement as part of the building, or whether the improvement can be assigned to a class of assets which depreciate much faster than the 27.5 or 39 years mentioned above. Buildings, land and improvements thereon are called real property, and all other types of assets are typically called personal property.

This distinction is also critical to the recapture rules when you sell. Improvements which were considered part of the real property are Section 1250 property and generally are not subjected to recapture rules (depending on the year of acquisition and holding period). Depreciation on personal property, also known as Section 1245 property, must generally be recaptured as ordinary income upon sale.

In recent years, more sophisticated taxpayers have hired firms to conduct what are called “cost segregation” studies. These studies make detailed inventories of individual assets that make up the real estate property in order to distinguish items of Section 1245 property from items of Section 1250 property. Why would taxpayers do this? Following a selection of recent court decisions, these studies have been aggressive in designating property as Section 1245 property, allowing for substantially greater depreciation to be taken by the taxpayer. When you purchase a building, are you buying just the “structural components” of that building (walls, floors, roof, and the like) or are you also purchasing some items of tangible personal property such as phone systems, computer systems, carpeting, wall covering, partitions, lighting fixtures? If you were to go out and purchase a phone system for your office building, it would be considered a personal property asset with a seven-year life, and you would depreciate the cost of that phone system over seven years, not over thirty-nine years as you do the office building itself. This accelerates depreciation, making your tax write-offs five times greater during these seven years. But if the building *had* a phone system in it when you bought it, did you separate out the elements of tangible personal property from the rest of the purchase price when you started depreciating the building? It’s possible you didn’t. This separation of component costs within the building itself is what cost segregation studies focus on in order to increase the depreciation deductions that the taxpayer is entitled to.

In a recent landmark decision (*Hospital Corporation of America*, 109 T.C.21, 1997) the Tax Court ruled that to the extent tangible personal property is included in a acquisition or in overall costs, it should be treated as such for depreciation purposes. The Court also decided that the rules for determining whether property qualifies as tangible personal property for purposes of the Investment Tax Credit (ITC) are also applicable to determining depreciation under current law. The IRS agreed to the use of ITC rules for distinguishing Section 1245 property from Section 1250 property as a result of this decision and so cleared the way for cost segregation studies to prevail when challenged by the IRS.

There are some drawbacks to using cost segregation studies, primarily the lack of any consistent standard for their preparation. The laws in this area are quite complex and the rules for distinguishing property type by Section are not always consistent. The same piece of equipment could be considered a

structural component of one building and not of another. There may be some ambiguity in determining which components of your building are considered part of the building itself and which aren't. However, the expense of having a cost segregation study done on the next building you purchase may well be worth it in additional accelerated depreciation.

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