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# Tax Court Addresses Real Estate Cost Segregation

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The popularity of cost segregation for real estate has been rapidly increasing over recent years. Many accounting firms now have whole divisions devoted to performing cost segregation studies and are enthusiastically marketing these services. The potential tax benefits of cost segregation are clear—tangible personal property and land improvements can be depreciated significantly faster than the rate at which a building can be depreciated. Therefore, since cost segregation allocates to tangible personal property and land improvements whatever portion of the costs is allocable to them, cost segregation enables a taxpayer to increase the rate at which it depreciates the cost of real estate.

However, the IRS seems to be increasingly giving cost segregation a close look on audit, and we may be seeing the beginnings of increased litigation in situations where the IRS considers cost segregation to be abused. In a recent case involving cost segregation, the Tax Court began by noting the tax benefits of accelerated depreciation through cost segregation and asserted that it was "tempted to say this is why [the taxpayer] throws in everything but the kitchen sink to support its argument—except it actually throws in a few hundred kitchen sinks, urging us to classify them as 'special plumbing.'" Unfortunately, notwithstanding the Tax Court's wit, real estate owners may not find this case humorous.

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Internal Revenue Code section 167(a) authorizes taxpayers to deduct "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property used in a trade or business or held for the production of income. Land in general does not constitute depreciable property, although improvements to land (e.g., paving for parking lots and grading) generally are depreciable.

For tangible property placed in service after 1986, depreciation deductions generally must be taken in accordance with the Modified Accelerated Cost Recovery System set forth in Internal Revenue Code section 168. Under this system, items of tangible property are depreciated over a "recovery period" that depends on the "class life" of the property as set forth by IRS guidance. In general, tangible personal property is depreciable over a five-year or seven-year period, land improvements are depreciable over a 15-year period, and buildings are depreciable over a 27.5-year period (for residential rental property) or a 39-year period (for commercial property). In addition to the different class lives, the Code assigns different "recovery methods" to different categories of tangible property. More specifically, (1) tangible personal property generally may be depreciated using the "200 percent declining balance method," (2) land improvements generally may be depreciated using the "150 percent declining balance method," and (3) buildings generally must be depreciated using straight-line depreciation. (The declining balance method has the effect of front-loading depreciation.)

The unfavorable depreciation rules with respect to buildings include "structural components" of buildings. Regulations define a "building" to generally mean "any structure or edifice enclosing a space within its walls, and usually covered by a roof," and provide that the term "building" does not include a structure that is "essentially an item of machinery or equipment." Regulations provide that "structural components" of a building include items such as walls, partitions, floors, ceilings, windows and doors, central air conditioning or heating systems, plumbing and plumbing fixtures including sinks, electric wiring and lighting fixtures, and "other components relating to the operation or maintenance of a building."

Cost segregation takes a building and subdivides it into hundreds of items of property, some of which will be structural components of the building and some of which will be tangible personal property. The overall cost for the real estate is allocated between each of these components of the building and to land improvements such as landscaping or sidewalks. Having this cost breakdown performed enables a real estate owner to recover his costs through depreciation at a faster rate than he could have had all of his costs been allocated to either building or land.

### *AmeriSouth XXXII, Ltd. v. Commissioner*

The recent tax court case of *AmeriSouth XXXII, Ltd. V. Commissioner*[1] considered the cost segregation of a rental real estate complex (Garden House) that consisted of 366 units in 40 buildings over 16 acres of land. The owner of Garden House (AmeriSouth) had commissioned a company (MS Consultants) to do a cost-segregation study which MS Consultants had "boasted" would defer taxes of almost $730,000 over a five-year period. The IRS challenged the cost segregation, asserting that it resulted in numerous assets being depreciated over a five-year or 15-year period which should be treated as part of the residential real estate building and be depreciated over 27.5 years.

The Tax Court began its analysis by explaining factors that the courts have used in categorizing property. In general, components related to the operation or maintenance of a building are treated as structural components. However, property that is an accessory to a business (such as grocery store counters, printing presses, and drains or water lines that serve a restaurant owner's equipment) is not treated as a structural component of a building. Permanence is an important factor toward determining whether an item is a structural component of a building, although not by itself always an overriding factor. In addition, decorative items such as special lighting, false balconies, and other exterior ornamentation are not treated as structural components of a building since they "have no more than an incidental relationship to the operation or maintenance of the building."

The Tax Court then moved on to address specific categories of property which were in dispute between the IRS and the taxpayer, finding in favor of the IRS in most (though not all) of the cases. The following are items which the Tax Court found to be depreciable over a 27.5-year period as structural components of the buildings:

- Sinks (which by definition are structural components regardless of how easy they are to move)
- Shelving, clothing rods, cabinets, and counter-tops (which, although movable, appeared to have been designed to remain in place, and no evidence was presented to indicate that there was any intention that they would ever be moved)
- Interior window and mirrors (which the Tax Court would have considered to be personal property had they been for primarily intended for decorative purposes, as opposed to functional purposes, but no evidence to this effect was presented)
- Paneling, molding, and chair rails
- Multi-use electrical outlets

The following are among the items which the Tax Court found to be depreciable over a 27.5-year period by virtue of being integral to the operation or maintenance of the buildings or to structural components thereof:

- Water distribution systems (which were an integral part of the plumbing and air conditioning systems, i.e., structural components of the buildings)
- Sink drain pipes (which were an integral part of the sinks, i.e., structural components of the buildings)
- Gas lines (an integral part of the operation or maintenance of the buildings in general)
- Vent hoods above stoves (although stoves are tangible property, these vents were treated as structural components since they were intended to remove heat and odors from the apartments generally and were not just there to serve the stoves specifically)
- Drains and waste lines connected to the dryers (which were intended for the well-being of the buildings in general and not just for the dryers specifically)

The following are a few categories of property about which the Tax Court sided with the taxpayer and held to be personal property as a result of being integral to non-structural components:

- Clothes dryer vents (since their sole function was to the serve dryers, i.e., personal property)
- Gas lines which only provided gas to dryers
- Special outlets which were specifically designed to be used only for refrigerators

Finally, an unusual twist in this case was the fact that, as the Tax Court explained, "AmeriSouth sold Garden House about the time the case was tried, and stopped responding to communications from the Court, the Commissioner, and even its own counsel." As a result, AmeriSouth's attorneys withdrew from the case, and AmeriSouth failed to file a post-trial brief that the Tax Court had ordered. Could AmeriSouth's actions have stemmed from the realization that, upon sale of the property, it would be subject to 35% ordinary recapture for the depreciation that was taken with respect to its personal property (i.e., section 1245 property)? (In contrast, it would face only a 25% recapture rate for depreciation that was taken on the building itself.) Would the case have come out differently with a more diligent taxpayer?

**Conclusion**

Cost segregation has become very popular with real estate owners, enabling them to accelerate depreciation deductions. While the benefits of cost segregation are clear, it is important that taxpayers understand the drawbacks. For example, cost segregation can lead to increased depreciation recapture at ordinary income rates down the road when the property is sold. Also, as *AmeriSouth* will remind real estate owners, there are limits to how far cost segregation can go. Items such as removable sinks and shelves, for example, which might seem like personal property, were found to be structural components of the buildings in *AmeriSouth*. While *AmeriSouth* affirms the ability of a taxpayer to take depreciation on real estate based on cost segregation, it provides a note of caution to real estate owners as to the perils of being over-aggressive in a cost segregation and the importance of having detailed documentation to back it up.

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**1** T.C. Memo 2012-67.