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Now or Never? Appellate Court Addresses Post-Closing Cost Segregation

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Cost segregation can offer huge tax benefits to real estate owners willing to commission what may be a complex and expensive study. Instead of viewing real estate as being comprised of just land and building, cost segregation generally aims to segment a real estate owner's cost basis into hundreds of separate items, some of which constitute tangible personal property and land improvements. This method of cost allocation generally enables a real estate owner to increase the rate at which it depreciates its property, taking advantage of the fact that personal property and land improvements can be depreciated significantly faster than the 39-year straight-line depreciation for a commercial building. It is no surprise that the popularity of cost segregation has surged over recent years.

In 2012, the Tax Court in *Peco Foods, Inc. v. Commissioner*[1] took some by surprise in disregarding a real estate purchaser's post-closing cost segregation study. The Court of Appeals for the Eleventh Circuit recently upheld the Tax Court's decision. What does this case mean for cost segregation?

Background

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, (i) tangible personal property generally may be depreciated using the "200 percent declining balance method," (ii) land improvements generally may be depreciated using the "150 percent declining balance method," and (iii) buildings generally must be depreciated using straight-line depreciation. The declining balance method has the effect of front-loading depreciation.

Under Internal Revenue Code section 1060 and the Treasury Regulations thereunder, the seller and the purchaser in an "applicable asset acquisition" each must report on Form 8594 certain information concerning the amount of consideration in the transaction and its allocation among the assets transferred. The term "applicable asset acquisition" generally includes the taxable sale of a group of assets which constitute a trade or business. Section 1060(a) provides that "[i]f in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate."

In *Danielson v. Commissioner*,[2] the Court of Appeals for the Third Circuit held that a taxpayer can challenge the tax consequences of a written agreement as construed by the IRS "only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."

Peco Foods, Inc. v. Commissioner

Peco Foods, Inc. ("Peco") was the common parent of an affiliated group of corporations engaged in the business of poultry processing. Peco entered into an agreement to purchase one poultry plant in 1995 (the "Sebastopol Plant") and then entered into an agreement to purchase another poultry plant in 1998 (the "Canton Plant"). In each case, the purchase agreement included a schedule which allocated the purchase price between different assets and specified that the allocation was being made "for all purposes (including financial accounting and tax purposes)." Among other assets, the

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schedule on the Sebastopol operating agreement allocated $3,802,550 to "Processing Plant Building," and the schedule on the Canton operating agreement allocated $5,100,000 to "Real Property: Improvements." In 1999, after Peco's acquisition of these two poultry processing plants, it commissioned a cost segregation study of them. The resulting report subdivided the costs that had been allocated in the purchase agreements to the Sebastopol "Processing Plant Building" and the Canton "Real property: Improvements" into numerous component parts. Starting with its 1998 tax return, Peco began separately depreciating the different components set forth by the cost segregation studies. It also began depreciating certain property with a double declining balance method or 150-percent declining balance method.

The IRS determined that, since the purchase agreements had provided that the poultry processing plants would be treated as real property (i.e., depreciable over a 39-year period), Peco was precluded from subsequently subdividing the plants into separate components including tangible personal property. The Tax Court in *Peco Foods v. Commissioner* agreed with the IRS's position, and Peco appealed.

In upholding the Tax Court's decision, the Court of Appeals for the Eleventh Circuit agreed with the Tax Court that the purchase price allocations in the purchase agreement would be binding unless either (i) the IRS determines that they are not appropriate or (ii) the agreements are unenforceable under traditional contract formation defenses. Since the IRS had not challenged the allocations included in the purchase agreements and there was nothing to invalidate the agreements under local law, it followed that the allocations in the purchase agreements were binding on both Peco and the sellers. The Eleventh Circuit then concurred with the Tax Court in rejecting Peco's contention that the terms "Processing Plant Building" and "Real Property: Improvements" are broad and ambiguous terms which can be understood to include both the buildings and their interior components.

As a result, the Eleventh Circuit held that, under both section 1060(a) and *Danielson*, Peco was bound by the original allocation schedules attached to the purchase agreements that it signed. This meant that Peco had to treat the two poultry processing plants as 39-year property with straight-line depreciation and was unable to segment them in accordance with the cost segregation studies.

Analysis

Two identical buildings could stand side by side with one of them treated as just a building and depreciated over 39 years and the other treated as including separate components of tangible personal property which are depreciated much more quickly. The fact that the IRS considers both of these approaches to be acceptable would seem to indicate that the IRS recognizes the validity of depreciation based on cost segregation, but is also ok with a taxpayer preferring the simplicity of depreciating an entire building and everything inside it over 39 years. Based on this approach, it would seem that a property owner generally should be able to decide at some point after its purchase that it wants to segment its property into the various components at the expense of simplicity; Peco's problem was that it had agreed to a purchase price allocation at the time of the sale.

A real estate buyer and seller will often, although not always, have conflicting incentives regarding the characterization of the property that is being sold. From the buyer's perspective, it is generally preferable for the property to include as much tangible personal property and land improvements as possible in order to accelerate depreciation. In contrast, a seller will often prefer for as much of the purchase price as possible to be allocated to land and building, since depreciation recapture on tangible personal property (i.e., section 1245 property) is taxed at ordinary income rates. However, there are circumstances in which the purchase price allocation will not matter to the purchaser (e.g., the purchaser is a C corporation, or has ordinary losses or NOL carryovers to offset its gain).

In cases where the buyer and seller have conflicting preferences regarding the allocation of the purchase price, the potential for the IRS to get "whip-sawed" is eliminated if they agree on a purchase price allocation. While the IRS could still challenge the allocation, its incentive for doing so in such a case would generally be significantly reduced. Then, if one side subsequently makes an allocation that is incompatible with its signed agreement, that taxpayer would be going against the form of a transaction to which it had previously consented. The decision of the Tax Court and the Eleventh Circuit in *Peco Foods* appears to stand for the proposition that section 1060(a) (if applicable) and *Danielson* preclude a taxpayer from doing so.

What should a real estate purchaser do in order to be able to depreciate its property based on a cost segregation study? One option is to have a cost segregation study done before closing and to have the seller agree to allocate the purchase price in accordance therewith. However, a pre-closing cost segregation study may not be practical given time constraints and, regardless, the seller may not agree to it. A more practical option may be for the buyer and seller to avoid agreeing to any purchase price allocation. If Form 8594 must be filed as a result of there being a transfer of a group of assets that makes up a trade or business under section 1060, there generally should be no need to allocate the purchase price between a building structure and the tangible personal property inside it, since they would both generally be included in the same asset class (i.e., Class V). Moreover, many transfers of real property may not require Form 8594 to be filed.

In sum, while it appears that *Peco Foods* generally should not inhibit real estate owners from depreciating their property in accordance with a cost segregation study, the case highlights the imperative not to take any action that is explicitly inconsistent with cost segregation. Real estate buyers—including those who are not contemplating doing a cost segregation study—should learn from Peco's mistake and keep their options open by not agreeing to an allocation that would prevent future cost segregation. More generally, *Peco Foods* provides both real estate buyers and sellers with a reminder of the importance of carefully drafting their documents and the unfortunate consequences that can result from failing to do so.

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1 T.C. Memo 2012-18, *aff'd*, 112 AFTR 2d 2013-5137 (11th Cir. 2013).

2 19 AFTR 2d 1356 (3d Cir. 1967).