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TAX-DEFERRED EXCHANGES AND COST SEGREGATION:

BENEFITS AND PITFALLS

by

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I. INTRODUCTION: The essence of this article is to focus on the concepts of tax-deferred exchanges integrated with cost segregation. Those terms are defined below, and the interplay of these two (2) areas becomes very important for those involved in either a straight cost segregation issue or a tax-deferred exchange issue.

II. COST SEGREGATION: The concept of "cost segregation" was examined by us in a more detailed article entitled: "Cash Flow Produces Benefits By Accelerating Deductions Via Cost Segregation." 1/ That article focused on the basic idea that cost segregation recognizes that, although one might generally divide the type of property being purchased as being real estate improvements or land, there is much more to be divided or allocated as to the purchase price. This allocation of the purchase price is extremely important, since such allocation determines, in many instances, whether a property is or is not depreciable -- such as land not being depreciable and a building being depreciable, if it is otherwise used in a trade or business or for investment. Further, a "building" is generally structural in nature, but there might be a great deal of personalty involved in what one might generally label as the "building."

The ability to break out these parts, i.e., building and the personalty, are important because these will be separately depreciated, with the personalty having a shorter life and with a more rapid depreciation method. 2/

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Assuming that a building is qualified to claim depreciation under the Internal Revenue Code, 3/ a residential building is depreciated on the basis of 27.5 years. But the basis of 39 years 4/ is used for almost all other types of real property (such as office buildings, shopping centers and other non-residential property).

The "personalty" portion (the non-real estate portion of property), sometimes labeled as Code §1245 property, 5/ will have a shorter life (as opposed to "real estate property," as under Code §1250). 6/ The shorter "life" depends on the type of asset involved. For example, beverage equipment, automobiles, computers and floor carpeting each might be depreciated over 5 years. 7/

In addition to a shorter life, as noted, the depreciation method is faster when personalty is involved, as opposed to realty. 8/

Thus, if straight-line depreciation for a 5-year property would be 20%, the accelerated method would be double this, or 40%.

One does not gain more "depreciation" than the qualified basis to depreciate. However, the ability to take the deduction sooner, thus generating more current deductions, and, therefore, less current taxes to be paid, all other things being equal, makes the accelerated positions of deductions that much more attractive. 9/

Thus, “cost segregation” attempts to break apart a property into the property types or segments that are present. (This is not "component depreciation," which was outlawed many years ago by the government.) 10/

This is an attempt to "break out" the actual properties that are being acquired. Those actual properties often consist of land, land improvements, structure of the building and many pieces of personalty within the building.

III. TAX-DEFERRED EXCHANGES: Tax-deferred exchanges have existed in one form or another since approximately 1921 in what is now known as the Internal Revenue Code. 11/ The tax-deferred exchange under Code §1031 allows the taxpayer to undertake a tax-deferred exchange and postpone the payment of tax on the exchange of qualified property under Code §1031(a).

Assuming all conditions are met 12/ for a Code §1031, one of the qualifications is to exchange like-kind property. Generally speaking, the like-kind property would be "real estate" for real estate, or "personalty" for personalty, although there are many refinements from this general statement. 13/

One can quickly see that the interplay of these rules, cost segregation and Code §1031, apply to determine if the property being exchanged is classified, for cost segregation purposes, as "personalty" or "realty" and how it will be treated for exchange purposes under Code §1031. That is, one cannot undertake a valid tax-deferral under Code §1031 if the exchange is realty for personalty!

IV. INTERPLAY OF CODE §1031 AND COST SEGREGATION FOR DEPRECIATION PURPOSES: As mentioned, there is interplay between the two (2) areas: Cost segregation to accelerate depreciation deductions, and the use of a Code §1031 exchange.

The danger is that if taxpayers do not realize the type of property on the acquisition of replacement property in a Code §1031 exchange, to properly "complete" an exchange, then taxpayers will find that they have not qualified for the deferral under Code §1031. 14/

A simple example illustrates this point: If Taxpayer X exchanged X-1 property, labeled as "real estate land and building" to Taxpayer Y for the Y-1 "building," which also consisted of "real estate land and building," assuming that all other elements of a Code §1031 exchange were met, it would “probably” qualify as a Code §1031 tax deferral. (There are many requirements to meet Code §1031 requirements. 15/

The key at this point is to recognize that if Taxpayer X had undertaken a cost segregation of the X Property, breaking out the part that is, arguably, personalty under local law, as opposed to "realty" (real estate "land"), trying to gain

the benefits of a faster write-off for depreciation purposes, this would be potentially beneficial at the time of the depreciation deductions. However, when undertaking the exchange and "relinquishing" the property that Taxpayer X owned (the X-1 Property), Taxpayer X must recognize that to be consistent, the replacement property that X-1 acquires from Taxpayer Y, the Y-2 property, should consist of the proper proportion of real estate and personalty, making sure that the qualified like-kind property is involved to complete the exchange requirements. 16/

For example, if Taxpayer X transfers X-1 property for $1 million of "realty" and $200,000 of "personalty," and Taxpayer X acquires Y-1 property (replacement property), which consists of only "realty" and no "personalty," then Taxpayer X would not be able to support a 100% tax deferral, since Taxpayer X did not receive realty and personalty, but instead only received realty.

V. CONCLUSION: Although cost segregation has wonderful advantages, 17/ and it is a legitimate tool to use, if properly applied as illustrated in the case of Hospital Corporation of America. 4/ Taxpayers must be consistent in taking the position that specific property is "personalty" or "realty."

For example, where Taxpayer X transfers his X-1 "relinquished property," consisting of part "personalty" and part "realty," for Y-1 "replacement property," consisting of only "realty," there will be a partial disqualification of the exchange because the X-1 property (part "personalty" and part "realty") was different from the Y-1 property (only "realty"). 19/

With proper recognition of this issue, taxpayers, with their representatives, can often adequately prepare to match the qualified real estate and personalty from the" relinquished property" to the "replacement property."

If representatives fail to focus on this issue on an exchange, where there was cost segregation to identify the personalty acquired, representatives of taxpayers can expect to see lawsuits and other confrontations, arguing that the representative should have been aware of this issue.

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FOOTNOTES

1. See Levine, Mark Lee, and Segev, Libbi Levine, Scott Zarret and Ed Allen, "Cash Flow Produces Benefits By Accelerating Deductions Via Cost Segregation," PP&E, Englewood, Colorado (2004).

2. Id.

3. See Code §167 and §168 of the Internal Revenue Code of 1986, as amended. This is herein referenced as the "Code."

4. See Code §167 and §168.

5. See Code §1245. This Section generally covers personalty and its treatment, tax-wise, on a sale of the personalty.

6. See Code §1250. This Section addresses the tax treatement when realty is sold at a gain.

7. See Code §168.

8. See supra, Note 1.

9. See Levine, Mark Lee, Real Estate Transactions, Tax Planning, Chapter 14, published by Thomson-West, St. Paul, Minnesota (2005).

10. See this topic discussed in Chapter 14 in the Authority noted supra, Note 9.

11. For more details on the idiosycrancies of Code §1031, see Levine, Mark Lee, Real Estate Transactions, Tax Planning, Thomson-West, St. Paul, Minnesota (2004). See also Levine, Mark Lee, Exchanging Real Estate, PP&E, Englewood, Colorado (2004).

12. There are many conditions. These are discussed in the two Works noted supra, Note 11. See also Code §1031(a).

13. See Note 11, supra.

14. See Code §1031(a).

15. See the Levine texts, cited supra, in Note 11.

16. For the details of these requirements, see Code §11031 and Footnote 11, supra.

17. The advantage is the time value of money in large part. See this issue discussed in the article noted in Footnote 1, supra.

18. Hospital Corporation of America, 109 T.C. 21 (1997). This case supported the concept of cost segregation. See this issue and case discussed in the article noted supra, Note 1.

19. See Code §11031(a). See also the discussion of this issue in the authorities noted in Footnote 11, supra.

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