COST SEGREGATION TAX INTRO

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Topics To Cover

- Depreciation & MACRS
- Bonus Depreciation
- Important Court Cases
- Capitalization under TARs

Depreciation & MACRS

Topics

- What is depreciation?
  - MACRS & Rev. Proc. 87-56
- What is the purpose?
- What is depreciable?
- How is depreciation calculated?
- Why important for cost segregation?

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Depreciation & MACRS

What is Depreciation?

- A reasonable allowance for exhaustion, wear and tear and obsolescence for property used in a trade or business or for production of income

What is the Purpose?

- Recognize a portion of the cost as expense over the number of years expected to be used or specified recovery period
- Matches expense to revenue

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Depreciation & MACRS

What Property is Depreciable?

- Property is depreciable if it:
  - Is used in business or held for production of income
  - Has a useful life > 1 year
  - Wears out, decays, become obsolete or loses value from natural causes
  - Is not inventory, stocks in trade or land

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Depreciation & MACRS

- How is Depreciation Calculated?
  - Determined in Section 168 of the IRC
  - Modified Accelerated Cost Recovery System (MACRS) for property in service after 12/31/1986
  - MACRS consists of two systems
    - General Depreciation System (GDS) – based on applicable method, recovery period and convention
    - Alternative Depreciation System (ADS) – mandatory straight line method and longer class lives
      - Property used outside US
      - Tax-exempt use property
      - Property financed with tax-exempt bonds
      - Special Rules: trade or business with floor plan financing indebtedness

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Depreciation & MACRS

Steps To Calculate Depreciation

1) Identify the asset class and the associated recovery period for the property as prescribed in Rev. Proc. 87-56

- Rev. Proc. 87-56 has two tables to use
  - B-1: Depreciable Assets Used in all Business Activities
  - B-2: Depreciable Assets Used in Specific Activities

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Depreciation & MACRS

Proper Use of the Tables

1. Check Table B-1 for property description
2. If described in B-1, next check B-2 to determine if the property is specifically included or excluded from a specified asset class activity.
3. If in B-2, then that is the recovery period to be used for that asset class; if not included or is specifically excluded in B-2, then use recovery period for asset class in Table B-1
4. If activity or property is not described in Tables B-1 or B-2, then look at end of Table B-2 under *Certain Property For Which Recovery Periods Assigned*
    - Generally 7 years for GDS and 12 years for ADS

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Depreciation & MACRS

Example Asset Classes Include:

- Table B-1
  - Asset Class 00.11 – Office FFE
  - Asset Class 00.12 – Information Systems
  - Asset Class 00.3 – Land Improvements
- Table B-2
  - Asset Class 20.4 – Manufacture of Other Food & Kindred Products
  - Asset Class 34.0 – Manufacture of Fabricated Metal Products
  - Asset Class 57.0 – Distributive Trades & Services

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Depreciation & MACRS

2) Calculate MACRS depreciation deduction using applicable method & convention

- Determine Recovery Method

Recovery Period			Recovery Method
3	year		200% declining balance
5	year		200% declining balance
7	year		200% declining balance
10	year		200% declining balance
15	year		150% declining balance
20	year		150% declining balance
27.5	year		Straight-line
39	year		Straight-line

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Depreciation & MACRS

- Determine Proper Convention
  - Period of time depreciation to be claimed in the year placed in service under MACRS
    - Half-Year
      - Excludes residential and non-residential property
      - Deemed to be placed in service or disposed of in middle of the year
    - Mid-Quarter
      - Excludes residential and non-residential property
      - When the aggregate basis of property placed in service during last three months is > 40% of all property placed in service during that year
      - Treated as placed in service at mid-point of that quarter

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Depreciation & MACRS

- Mid-Month
  - Residential rental property and nonresidential property
  - Deemed to be placed in service or disposed of during middle of the month
  - Based on number of months property was in service

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Depreciation & MACRS

Depreciation and Cost Segregation

- Benefit
  - ➢ Accelerated depreciation = reduced taxable income = less tax due = more cash for taxpayer

- Tax vs Book Depreciation
  - Book governed by GAAP and useful asset lives
  - Tax asset lives prescribed by IRC
  - Tax accelerated depreciation deductions don’t impact book bottom line but creates book to tax differences
    - So no influence on bank covenants, bonus calculations, etc.

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Depreciation & MACRS

- Consideration if more depreciation beneficial
  - Substantial NOLs
  - Passive Loss Rules
  - Planned Holding Period (Recapture)
  - Sufficient Benefit
  - Consider Like-Kind Exchanges

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Bonus Depreciation

Purpose

- Provides accelerated depreciation in first year

Qualifying Property

- MACRS new or used property with recovery period of 20 years or less
- Certain computer software
- Water utility property
- Qualified improvement Property (QIP)
  - ➢ Still 39 year life – need technical correction to get bonus
- Qualified film or television production or
- Qualified live theatrical production

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Bonus Depreciation

Other Considerations:

- Special rules for Acquisition, In-Service Date, Original Use, Safe Harbors, etc.
- Specific Property Excluded from Bonus
  - Includes property required to be depreciated under ADS
- Bonus is mandatory but have option to opt out fully or by class life

Important Court Cases

- Hospital Corp of America v. Commissioner
- Whiteco Industries Inc. v. Commissioner
- AmeriSouth XXXII Ltd et al v. Commissioner
- Peco Foods, Inc., et al v. Commissioner
- Scott Paper Company v. Commissioner
- Morrison Incorporation, et al v. Commissioner
- Piggly-Wiggly Southern Inc. vs. Commissioner
- Boddie-Noelle Enterprises Inc. vs. US

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Hospital Corp of America

- Landmark case for cost segregation in 1997
- Provided the legal support to use cost segregation studies for computing depreciation
  - Critical to the Tax Court's analysis was that Congress intended to distinguish between components that constitute §1250 property (real property) and those that constitute §1245 property (tangible personal property).
- Tax Court held the Investment Tax Credit (ITC) tests used to determine personal property, although repealed, are still applicable for MACRS or same purpose. to determine personal property
- It was also concluded that items that constitute as accessory to the conduct of the business and not related to the operation or maintenance of the building are tangible personal property, depreciable over a 5-year recovery period.

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Whiteco Industries

- Outdoor advertising vendor manufacturing & maintaining highway billboard signs
- Tax Court held signs were tangible personal property and not inherently permanent
- Court developed six qualification questions:
  - (1) Can property be moved? Has it been moved?
  - (2) How difficult is removal? How time consuming?
  - (3) Is property designed or constructed to be permanent?
  - (4) Any circumstances that show the expected or intended length of affixation or that property may or will have to be moved?
  - (5) How much damage will property sustain upon its removal?
  - (6) How is property affixed to building and/or land?

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AmeriSouth

- Overly aggressive cost segregation study prepared for rental apartment complex
- Court disallowed most of the deductions taken but mainly because taxpayer stopped responding to the action
- Tax Court rules any issue not already resolved or settled was conceded

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Peco Foods

- Asset purchase agreement for poultry processing plants
- Agreement specifically stated the parties agreed to allocate the purchase price “for all purposes (including financial and tax purposes)” per a set allocation schedule
- Court held purchaser could not modify those allocations when attempting to perform a cost segregation study

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Scott Paper Company

- Taxpayer expanded its pulp mill and paper processing plant to increase paper output per day
  - Primarily included two new electrical systems
    - (1) Primary electrical system: reduced raw power/voltage to suitable level and channeled it where needed; and
    - (2) Secondary electrical distribution system: delivered power to devices for energy consumption; requires primary system to function

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Scott Paper Company

- Both systems used for general building purposes but mostly for machinery and processes
- Court concluded could break down the electrical load used for production based on consumption and reference to circuit diagrams.
- Percentage allocations were determined to be an acceptable method for both systems

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Morrison Incorporated

- Operates cafeteria style restaurants
- Constructed several new restaurants and claimed ITC for "equipment"
- Favorable Tax Court Conclusions
  - Items meeting sole justification test
    - Kitchen: heat recovery, make-up air unit, hot water heater
  - Kitchen equipment related
    - Kitchen water piping and drainage; kitchen portion of electrical distribution system (percentage allocation)
  - Decorative wallcoverings, millwork, lattice, chandeliers
  - Special purpose/removable
    - Eliason doors
    - Customer line partitions
    - Emergency lighting to allow customer to finish meal and pay

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Morrison Incorporated

- Unfavorable Tax Court Conclusions
  - Considered permanent structural components:
    - Garbage rooms;
    - Service line concrete curbs to protect customers from spills behind serving lines;
    - Cooler, freezer and garbage room floors (double insulation)
    - Kitchen floor quarry tiles and sanitary walls permanently attached and requirement of building code for easy cleaning
    - Restroom accessories and vanities – not an integral part of the business but related to operation of the building
    - Kitchen hand sinks required by building code and of permanent nature
    - Electrical water coolers for employees

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Piggly Wiggly Southern

- HVAC installed in supermarket chains to meet temp and humidity requirements essential to operate open front refrigerated display cases
- Court held the HVAC met the “sole justification” test

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Boddie=Noelle Enterprises

- Operated several hundred restaurant franchises
- Failed to prove some improvements were personal property under ITC rules
- Denied application of 12 year old study percentage allocations to new restaurants instead of having new studies performed
- Failed to show the HVAC met the sole justification exception

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Another Consideration

- Tangible Asset Regulations (TARs) – Capitalization Perspective
  - Process to determine if must capitalize a cost or can be recognized as repair/maintenance expense
  - First consider the safe harbor elections

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Capitalization Under TARs

Safe Harbor Elections to Consider:

- De Minimis
- Small Taxpayers
- Routine Maintenance

Capitalization Under TARs

Applying Improvement Standards

- If meet standard criteria, must capitalize
- If not, then repair and maintenance expense

- Two Step Process
  1. Identify the Unit of Property (UoP)
  2. Apply the Three Improvement Standards
     - ❖ Betterment
     - ❖ Restoration
     - ❖ Adaptation

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Step One: Identify UoP

UoP Definition

- A single UoP consists of all components that are functionally interdependent
- One component is dependent upon another component to function

Examples:

- Functionally Interdependence
  - Automobile: Frame, chassis, engine, axle, etc.
- Single Independent UoP
  - Table and a chair

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Special UoP Rules

There are special UoP Rules for:

- Buildings
- Leased Property
- Network Assets and
- Plant Property

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Building UoP Special Rules

- Each building and its structural components are functionally interdependent and considered a single UoP; and
- There are eight subsystems identified as part of the Building UoP

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Building Subsystems

The 8 Identified Building Subsystems:

1. HVAC
2. Electrical
3. Plumbing
4. Gas Distribution
5. Security
6. Fire Suppression
7. Elevator
8. Escalator

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Step 2: Apply The Improvement Standards

There are three improvement standards:

1. Betterment
2. Restoration
3. Adaptation

If the criteria is met for any three of these standards, then the improvement cost must be capitalized. If not, then it is considered repair and maintenance expense.

Betterment Standard

1. Betterment

- ❑ Corrects material condition or defect that existed (whether known or not)

- ❑ Material addition (of the footprint)

- ❑ Increases productivity, efficiency, strength, quality or output

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Restoration Standard

Restoration

- Replaces component deducted as a loss or after casualty if basis adjusted
- Returns to operating condition if in non-functional disrepair
- Rebuilds to like-kind condition after class life
- Replace major or significant portion of a component or UoP

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Adaptation Standard

Adaptation

- Adapts the UoP to a different or new use

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THE END

QUESTIONS?

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