A PRIMER ON COST SEGREGATION

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Written
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INTRODUCTION

First of all, what is cost segregation? To put the definition in simple terms, in this article cost segregation is reclassifying assets originally classified as real estate into another asset category for the purpose of tax savings. The situation commonly comes about when a taxpayer buys a building with fixtures included. Ordinarily, fixtures in, on, or around the land or building are considered real property. The consequence of this classification is that the depreciation period is up to nearly forty years long for real estate. However, not all fixtures attached in, on, or around the building are part of the building asset for tax purposes. This article provides guidance on how to determine which fixtures should be included in the cost of the building, which ones should not, and when a specialist should be employed to make the determination as to the asset classification.

Not all commercial buildings are created equal when it comes to tax savings. For example, a warehouse purchased for $1,000,000 typically has $100,000 to $200,000 of property contained in the building that can be cost segregated as personal property. This reclassification provides the taxpayer with higher deductions on some of the building costs up front resulting in an overall tax benefit. Another example would be a taxpayer buying a restaurant building for $1,000,000. Restaurant buildings purchased for this amount typically involve segregated costs of up to $600,000 dollars. This result of the reclassification is a huge tax benefit for the taxpayer. Therefore, it is imperative that the taxpayer achieves the appropriate amount of cost segregation when purchasing a building to minimize their tax liability.

WHEN IS A STRUCTURE A BUILDING?

The IRS Regulations on this point state that a building “generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space.” This definition is important. If the structure is not a building, the depreciation period is much shorter and advantageous to the taxpayer. If it is a building, cost segregation should be used to give the taxpayer an optimal and appropriate tax position.
The Courts have developed two tests to determine if a structure is a building. The first is the permanency test and the second is the appearance and function test. There are many specific factors arising from case law and rulings on these two tests that go into determining when a structure is a building and when it is not. Even though there may be many specific factors, the process is actually quite simple and conclusions are usually easy to reach. Let's look at each test.

**The Permanency Test:** The courts have ruled that a structure cannot be a building unless the structure is “inherently permanent”. To establish if a structure is permanent, the Tax Court has developed a six-factor test from the Whiteco Industries case. The six factors are: 1) Can the building be moved? 2) Is the property designed to stay in place permanently? 3) How long is the structure intended to stay in place? 4) Is the structure easy to remove, not requiring much time? 5) How much will the property be damaged by removal? 6) How is the property affixed to the land? Some structures are easy to classify, while others like self-storage units are more difficult. From the cases, generally the bigger the structure is, the more likely it is that it will be classified as permanent.

**The Appearance and Function Test:** The big question to be answered in this analysis is whether the structure looks like a building or not. This may seem overly simplistic, but it is contained in the respective research materials on the subject. Generally, if the structure looks like a building, it is a building for tax purposes. If the structure has a roof and walls, this nearly establishes a prima facie case that the structure is a building, although this presumption is rebuttable. In applying the function test, the courts have looked to the factor of whether or not the space is being used as an employee workspace as opposed to whether employee involvement in the building is incidental to the building. The more employees that use the structure, the more likely it is considered a building.

The more favorable tax position is to classify the structure as personal property as opposed to a building for tax purposes. Once it is determined that a structure is a

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building, cost segregation can then be used to reclassify assets located within the structure as personal property.

GENERALLY HOW MUCH CAN BE COST SEGREGATED?

There is no rule stating how much property in the building can be segregated from the cost of the building. However, general guidelines have been established for amounts that can be segregated. They are as follows:

- Apartments: 10%-20%
- Hotels: 20%-30%
- Office Buildings: 10%-20%
- Retail Stores: 15%-25%
- Grocery Stores: 20%-30%
- Manufacturing Facilities: 20%-60%
- Facilities Restaurants: 25%-35%
- Warehouse: 10%-20%

What is significant to note about the above amounts is that they are not the last word in segregation determination. It may be appropriate to go above these amounts, while at other times it may be appropriate to be within the ranges stated. The segregation amount is determined by specific items, not a general rule. The key is to look at the individual assets contained in the building to determine whether or not they are a component part of the building or a separate asset.

WHAT PARTS OF THE BUILDING ARE PART OF THE STRUCTURE?

To exist and stand, logically some parts of the building purchased must be included in the structure. The test for this has come to be known as the “maintenance and operation” test. Fixtures limited to the maintenance and operation of the building are included as part of the structure. This is substantially different from the general principals of property law that state a building is anything attached to it or the land.

Though the fixture may be attached, it is not automatically included in the building account. The fixture must be needed for the maintenance and operation of the
building itself. Fixtures that are an integral part of the building are, to be sure, included in this equation. This includes walls, roofs, ceilings, plumbing, wiring, etc.. These fixtures are usually easy to tell from other fixtures.

Fixtures beyond embedded or fully integrated items like those described above then go through the maintenance and operation analysis. Ask yourself “Is this item necessary for the maintenance and operation of the BUILDING or solely for the operation of the BUSINESS?” Operation and maintenance items of a building often include items separate from operations of the business.

Operation and maintenance items at this level include heating, cooling, lighting, plumbing, bathroom facilities, and locking mechanisms. Examples of items at this level are doors, light fixtures, sinks, bathtubs, toilets, paper towel dispensers, lights on the outside of the building that are attached, etc. The distinguishing factor here is whether the object plays an important part in the operation and maintenance of the building.

Some items of the structure have specific rules on them and can be irregular in analyzing. Carpet is one of these examples. Logically it should be a structure item. It is similar in nature to a door which is an item included in the structure. Carpeting is attached to the building usually by tacks or small nails. It would seem as though it is necessary to the operation or maintenance of the building, because it is a floor surface and floor surfaces are necessary. The IRS ruled that carpeting may or may not be a part of the structure. The determining factor is whether the carpet is glued down using a permanent adhesive or is held in place by a less permanent method. If it is permanently installed, it is part of the structure. If not, it is personal property depreciable under a shorter life.

It is important to note in these determinations that specific tax cases have been argued and resolved. Since this has been done over a period of time, the cases, as can be expected, have become precedent and can be used as guides in determining the proper classification for specific assets. It is important that on some items, the taxpayer or their agent needs to look up the specific case or ruling on the matter to be sure of its status as either personal property or structure.
WHAT PARTS OF THE BUILDING ARE PERSONAL PROPERTY?

The analysis to determine if property is structure or personal property should also be performed from the opposite end of the spectrum of logic. It is not necessary to think of an item through the lens of structure / not structure, when it is clearly not the structure of the building.

Most definitely items purchased with the building that are not attached are nearly always personal property. An example of this may be an air conditioner unit, an air compressor, stoves, refrigerators, washers, etc. These items are nearly always personal property and can be distinguished from the cost of the building itself.

Items attached to the building itself can certainly be personal property if they are not necessary to the operation and maintenance of the building. Items in this category will usually be more relevant to the operation of the business as opposed to operation of the building. These tend to be a bit more building type specific. What is important here is the logic involved. In a restaurant building, items such as booths, soda machines, walk in refrigerators, etc are included in the personal property category. This is because the items don’t operate the building. They are more relevant to the business. In warehouses, items such as shelves can be segregated as personal. Office buildings can segregate servers, shelves, wall safes, and the like. What is important to ask in these situations is whether it is more business oriented or more building oriented.

SHOULD I GET AN EXPERT OPINION?

An opinion of a specialist is not required by the Internal Revenue Code, but is probably a good idea for audit purposes. Depending on an accountant’s level of expertise and the amount of money involved, an accountant can do the study. The expert is usually not cost feasible until the building the taxpayer has purchased goes above $500,000 in value. Even though an expert may not generally be feasible until the building costs $500,000, a cost segregation study may still be done in extreme circumstances,

Generally a specialist known as a cost segregation specialist is employed by the taxpayer or his agent to determine the appropriate cost segregation amount.
Specialists in this area should be knowledgeable in building components, structure, auditing, and estimating. The run of the mill accountant or attorney probably does not possess this level of knowledge. Usually the taxpayer or accountant will employ an individual to make the assessment.

On the initial assessment, the specialist will determine if a cost segregation study is feasible. The specialist will roughly calculate the items of personal property versus structural and then make a decision on feasibility from there. This means that if the cost of the study outweighs the benefits, the study is not feasible.

After determining if the study is feasible, the specialist then begins his or her study and issues a report of the findings. The specialist will typically work with an architect, look at blueprints, look at the building and its materials, do research, and other activities to determine what is in the building and how it should be classified for tax purposes.

Once the assessment is made, the findings must be reported. Tax Court decisions have held that the reporting requirements are very stringent, so the specialist must enter a detailed and potentially lengthy report. A dollar figure circled on a napkin is simply not enough. The report optimally should include pictures, writings, and other real and demonstrative evidence to support conclusions.

WHEN SHOULD COST SEGREGATION BE DONE?

Optimally, a cost segregation should be done when the asset is purchased or before the close of the tax year. This way any confusion can be cleared up and tax savings can be optimized. If the taxpayer goes beyond this time to segregate costs, cost segregation can still be done but some problems may be encountered. Even though more hassles may be the result of a later segregation date, they can still be dealt with and can make the segregation study still financially feasible.

CONCLUSION

The process of cost segregation may seem long and difficult, but it is worth the effort in many circumstances. Not all real property in the lay legal sense is real property in the tax sense. Since segregating costs into faster asset depreciation categories can
limit the amount of taxes you pay, it is often beneficial for the taxpayer to segregate property into its component parts and obtain a faster tax write-off.

Don't settle for the conventional property law definition of real property when segregating costs. Have your tax advisor or an expert follow the standards described above. Many costs in a building can be segregated from the cost of the real estate. Use an expert when necessary, and save money on taxes. For more on cost segregation, contact the professionals at The Center for Financial, Legal and Tax Planning, Inc. for assistance when considering purchasing or constructing a building.