COST SEGREGATION UPDATE

Tax Cuts and Jobs Act … now what?

By Mark Vorkapich, ASA

An engineering-based cost segregation study traditionally has been used to reclassify federal tax depreciation rates of real property from one lump-sum asset listed in a fixed asset system as a "building" with a recovery period of 39 years to multiple detailed entries that identify separate assets with shorter recovery periods, such as 5, 7 or 15 years. A study not only results in correctly identifying both the 1250 and 1245 components of a structure, but it also establishes a starting point for federal tax depreciation assets.

Over the last several years, there have been many tax law changes that affect how and why a competent study should be performed. Under the final regulations of section 263a of the Internal Revenue Code (IRC), effective Jan. 1, 2014 (TD 9636), a building and its structural components are considered a single unit of property. The "unit of property" for buildings consists of the building structure and building systems, which include heating, ventilation and air conditioning; plumbing; electrical; all escalators and elevators; fire protection and alarms; security; gas distribution systems; and other structural components identified in published guidance. The qualitative and quantitative information already contained in an engineering-based study is used to readily identify all these assets.

In addition to defining the "unit of property" for tracking expenditures, the IRS has separately issued regulations (IRC section 168) detailing the rules for dispositions and partial dispositions of depreciable assets that include building structural components. Prior to Jan. 1, 2012, losses were not allowed for retired building components; and, consequently, the replacement of building components resulted in the continued depreciation of both the replaced and replacement property. The IRS has established a fact-based approach to determining whether work performed on a building or leasehold improvements should be considered a deductible repair or a capital expense.

Under these rules, the taxpayer can end depreciation of building components upon removal and recognize a loss. A proper cost segregation study includes costs by building system as well as additional information to identify costs and qualitative information of building components. This will facilitate a taxpayer's accurate reporting of losses when the component is disposed. In the case of existing property, the study should take into consideration the taxpayer's fixed asset accounting of the building historical cost and aid in the identification of disposals that will occur as a result of the new capital improvements.

Tax Cuts and Jobs Act (TCJA) creates changes

With the passage of TCJA in late December 2017, there are several key areas that affect cost segregation:

Bonus depreciation has increased to 100 percent through Dec. 31, 2022. It has generally been available since Sept. 11, 2001, and has ranged from 30 percent to 100 percent over the years:

Sept. 11, 2001–May 5, 2003: 30 percent

May 6, 2003–Dec. 31, 2004: 50 percent

Jan. 1, 2008–Sept. 8, 2010: 50 percent

Sept. 9, 2010–Dec. 31, 2011: 100 percent

Jan. 1, 2012–Sept. 26, 2017: 50 percent

For property acquired after Sept. 27, 2017, the following schedule applies:

Sept. 27, 2017–Dec. 31, 2022: 100 percent

Jan. 1, 2023–Dec. 31, 2023: 80 percent

Jan. 1, 2024–Dec. 31, 2024: 60 percent

Jan. 1, 2025–Dec. 31, 2025: 40 percent

Jan. 1, 2026–Dec. 31, 2026: 20 percent

In regard to modified accelerated cost recovery system (MACRS) periods, real property will continue to be depreciated over 39 years and 27.5 years (residential rental property).

The previous requirement for property to be "original use" has been eliminated. Now, in order to qualify for bonus

depreciation, the original use does not begin with the initial property owner, but instead when the building is placed into service with the current property owner (including acquired property). This means bonus depreciation now applies to both newly constructed buildings and used property acquired after Sept. 27, 2017.

Prior to TCJA, an acquired property (commercial building) was simply classified into a 39-, 15-, 7- or 5-year life with the appropriate accelerated depreciation rates for MACRS property. Post-TCJA, owners of property acquired after Sept. 27, 2017, can now claim bonus depreciation on real property with a class life less than 20 years.

For example, a retail strip mall is acquired and a cost segregation study is performed to identify all of the appropriate 1250 and 1245 improvements. All those assets with a less than 20-year life will (after Sept. 27, 2017) be able to qualify for 100 percent bonus depreciation and, thus, be entirely deducted in the current year. Land improvements are considered 15-year property under MACRS (Asset Class 00.3) and, thus, will be able to be fully deducted in the current year. However, they need to be correctly identified and classified, and a proper cost segregation study accomplishes this.

There are no longer separate definitions of the following: qualified leasehold improvements, qualified restaurant improvements, or qualified retail improvements; they have all been replaced with the general grouping of qualified improvement property (QIP). Prior to the TCJA, this qualification was eligible for 50 percent bonus depreciation, even though it was 39-year property. However, beginning with 2018, QIP retains its 39-year recovery period and does not qualify for bonus depreciation. The original intent of Congress was to change that classification to a 15-year recovery period and 100 percent bonus depreciation for QIP placed in service after 2017 (bonus depreciation is applicable for property with a recovery period of 20 years or less). Unfortunately, an oversight did not specify that QIP should be changed to a 15-year recovery period, so it remained classified as 39-year property. A technical correction is expected to come out on this point, and it should adjust the life of QIP to 15 years and make it eligible for bonus depreciation. But, currently, QIP is 39-year property not eligible for bonus depreciation.

Section 179 expense limitations beginning in 2018 will double from $500,000 to $1 million, while the phase-out limitation will be increased from $2 million to $2.5 million. Qualifying property eligible for 179 expensing will include the following: section 1245 property or roofs, HVAC, fire protection and alarms, and security systems, as long as the improvements are made to nonresidential real property and placed in service after the building was first placed in service. Section 179 also expanded to include tangible personal property used in connection with furnishing lodging, such as furniture and appliances in hotels, apartment buildings and student housing.

As 2019 begins, we recognize there have been many tax law changes that have not only affected the way a cost segregation study is performed for depreciation system purposes—and the reason why—but also how those assets are identified within the exhibits themselves and how they are correctly classified. The resulting benefit of the accelerated shorter-life asset classification and bonus depreciation treatment should be a principal driver for utilizing a cost segregation study for any newly constructed or acquired property.

Mark Vorkapich, ASA, is the director of cost segregation services at Gladstone Strategies & Solutions, Milwaukee. He has been performing cost segregation studies for more than 20 years in all industries for newly constructed and acquired property, purchase price allocations, 1031 exchanges and look-back studies.

memorials

Dean R. Goetter, CPA
(1952–2018)

Dean R. Goetter, CPA, a retired partner of Ritz Holman CPAs, passed away Friday, Dec. 14, 2018, at the age of 66. He was a lifelong resident of Cedarburg/Grafton and an active member of First Immanuel Lutheran Church, where he served on various committees and organizations. Goetter is survived by his wife of 39 years, Sue; two children; three grandchildren and other relatives and friends.

Robert H. Eldridge, CPA
(1938–2018)

Robert H. "Bob" Eldridge, CPA, passed away Monday, Dec. 17, 2018, at 80 years of age. Eldridge graduated from Marquette University High School in1956 and went on to earn his bachelor's degree in accounting from Marquette University, graduating with honors in 1960. His career as a CPA began at Arthur Andersen, where he worked as an accountant until he was recruited by one of his clients, Briggs & Stratton, in 1966. Eldridge held various positions there, including chief financial officer. He retired after 34 years with the company. Eldridge is survived by his wife, Mary; four children; nine grandchildren and other relatives and friends.

If you are aware of a member obituary and believe it should be included in Memorials, please send a copy of the obituary or contact Marcia Tillett-Zinzow at mtzinzow@icloud.com.