Best of Both Worlds: 1031 Exchanges and Cost Segregation

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Kelly Pearl

Combining 1031 and Cost Segregation?

If this is your first thought ... then this is the seminar for you!
Topics

• Cost Segregation Basics – Joan
• 1031 Exchange Basics – Kelly
• Case Studies

History

Hospital Corp. of America (HCA)
109 TC 21 (1997)

What did the Tax Court say?
The Tax Court determined that if an asset qualified as personal property for purposes of the former investment tax credit under IRC Section 38, then the asset qualified as personal property (IRC Section 1245 property) for depreciation purposes.
The IRS Response

In 1999, the IRS issued Chief Counsel Advice (CCA) # 199921045 –

Taxpayer must have a contemporaneous, independent analysis to substantiate any reclassification –

a COST SEGREGATION STUDY.

IRS Audit Techniques Guide
Cost Segregation - 2004

- A review of architectural drawings / engineering drawings to separate structural versus non-structural elements of the property
- An on-site inspection
- By discussion and inspection, learning about any specific elements of the property
- Review of any supporting documentation
The Final Report

Costs are classified into four basic categories:

- Personal property
- Land improvements
- Building
- Land

A quality cost segregation report, as defined by the IRS, includes

- Executive summary
- Asset schedules
- Costing data
- Certification
- Legal citations
- Exhibits.

What are assets are reclassified?

EXAMPLES INCLUDE -

Personal Property – 5 Year property
- Fixtures, specialty lighting
- Wiring for specialty equipment
- Carpeting, floor coverings
- Specialty plumbing
- Non-permanent, moveable walls and partitions
  
  200% Double Declining Depreciation

Land Improvements – 15 Year property
- Driveways, sidewalks
- Landscaping, gardens
  
  150% Declining Depreciation
Average savings 7-10% of building cost in the first five years

Impact of Cost Segregation on Depreciation Expense

“Catch up” depreciation means $$’s in your client’s pocket

$2.0 Million Building Impact of Cost Segregation on Depreciation & Taxes

3 Yr Tax Savings - $116K
5 Yr Tax Savings - $140K
15 Yr Tax Savings - $131K
Cumulative Avg Income Tax Savings vs Cost of Study

<table>
<thead>
<tr>
<th>Dollars</th>
<th>Yr 1</th>
<th>Yr 1 &amp; 2</th>
<th>Yr 1 - 5</th>
<th>Study Cost</th>
</tr>
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<tbody>
<tr>
<td>Debbie's $1M Apartment</td>
<td>$2M Lawyers R Us Bldg</td>
<td></td>
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<tr>
<td>Debbie's $3M Apartment</td>
<td>Jody's $500K Residential</td>
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</table>

Works for all types of commercial and investment properties ...

- Airports, Apartment buildings, Assisted living facilities, Automobile dealerships
- Bank branches
- Casinos, Cinemas
- Day care facilities, Department stores
- Fitness centers, Food processing facilities, Funeral homes
- Gas stations, Golf courses, Grocery stores
- Hospitals/medical centers/physician practices, Hotels/motels
- Industrial facilities
- Laboratories
- Manufacturing facilities, Marinas, Medical facilities, Mixed-use facilities
- Nursing homes
- Office buildings
- Parking lots, Pharmaceutical, Public utilities
- Research facilities, Retail centers, Resorts, Restaurants
- Shopping centers, Sports facilities, Storage facilities
- Warehouses and distribution centers
Taking it to the next level ...

- 2008 Economic Stimulus Package
  - 1st Yr 50% Bonus Depreciation for Qualifying Sec. 1245 Property

- Recapture depreciation needs to be factored in with a sale. Rule of thumb: need to keep the property at least three years

- Who ever owns the tenant improvements gets the benefits of cost segregation

- Cost segregation is great for estate planning because of the step up in basis

- Alternative Minimum Tax? No problem, use 150% depreciation vs. 200%

Will cost segregation work for your client?

- What is their marginal tax rate?

- Is the building cost greater than $300K?

- Building purchased in last 15 years?

- Can they take advantage of the increased deductions?
  - Active business or real estate professional
  - Are they limited by passive loss rules

You can use online software to quantify payback
Will cost segregation work for your client?

- Do they plan on keeping their building at least 3 more years?
  - If not, do they plan on doing a 1031 Exchange?

IRC Section 1031 Tax-Deferred Exchanges

General Statutory Requirements
General Rule

Taxpayer who sells

must be

Taxpayer who acquires

---

General Rule

Equal or Up in Equity

and

Equal or Up in Value
1 - Business/Investment

Property must be held for investment or used in a trade or business in which taxpayer is engaged.

No minimum holding period time guidelines available.

Intent is key to this inquiry.

2 - Like-Kind

Property classified as realty under state law is “Like-Kind”.

“Like-Kind” refers to the nature or the character of the property, not its grade or quality.

Improved or unimproved is immaterial.

Income production is immaterial.
Real or Personal Property?


Therefore, practitioners feel that cost segregating a property for depreciation purposes does not affect its classification as real property for 1031 exchange purposes.

1031 Exchange - Classification

State Law Defines Property Rights

Real Property: Land
Building
Land Improve.

Tangible 1245 Prop (except F,F&E)

Real Property: Land
Building
Land Improve.

Tangible 1245 Prop (except F, F &E)

1245 Property - F,F&E

1245 Property - F,F&E
1031 Exchange Tax Computation

Federal Law Determines Tax Consequences

Real Property: Land
Building
Land Improve.

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Building
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Tangible 1245 Prop (except F,F&E)

Tangible 1245 Prop (except F,F&E)

1245 Property -F,F&E

1245 Property -F,F&E

3 – Exchange Requirement

The Exchange must be a reciprocal transfer of properties as distinguished from a sale followed by a re-investment.
Excluded Property

IRC SECTION 1031 DOES NOT APPLY TO ANY EXCHANGE OF:

Stock in trade or any other property held primarily for sale.

Stocks, bonds, notes and other securities or evidences of indebtedness or Interest.

Interests in a partnership.

Definition of a Delayed Exchange

Taxpayer Transfers Relinquished Property

Taxpayer SUBSEQUENTLY Receives Replacement Property
Timing Requirements

45 Days From Close of Sale Escrow: Identify Replacement Property(ies) (the “Identification Period”).

180 Days From Close of Sale Escrow: Close on Purchase of Replacement Property(ies) (the “Exchange Period”).

Identification Rules

Three properties of any fair market value; or

Any number of properties as long as their aggregate FMV as of the end of the Identification Period does not exceed 200% of the aggregate FMV of all relinquished properties.

If, as of the end of the Identification Period, the Taxpayer has identified more replacement properties than is permitted, the Taxpayer will be treated as if NO replacement property had been identified.
Qualified Intermediary

Must not be the taxpayer or a disqualified person.

Acts to facilitate a deferred exchange by entering into a written agreement with the taxpayer which obligates the Intermediary to:

1. Acquire relinquished property from Taxpayer,
2. Transfer relinquished property,
3. Acquire replacement property, and
4. Transfer replacement property to Taxpayer;

Acquisition and transfer obligations routinely satisfied by assignment of rights in contract and escrow, and notice thereof to all parties, on or before the closing date of the relevant transfer.

Disqualified Person

• Is the agent of the taxpayer at the time of the transaction.
• Has acted as taxpayer’s employee, attorney, accountant, investment banker, real estate agent, or broker within the 2 year period ending on the date of the transfer of relinquished property.
• Is “related” to the taxpayer as described in section 267(B) or section 707(B), using a 10% ownership threshold (e.g., immediate family member or entity in which the taxpayer has more than a 10% interest).
**Additional Restrictions on Safe Harbors - 1.103 (k)-1(g)(6)**

The Taxpayer must not have the right to receive, pledge, borrow, or otherwise obtain the benefit of the money or other property until:

1. The end of the Exchange Period, or

2. After the end of the Identification Period if no replacement property is identified, or

3. After the taxpayer has received all of the identified replacement property which he has identified (i.e., to which he is entitled).

**General Rule**

Equal or Up in Equity

and

Equal or Up in Value
### Scenario I

**Trade up in Equity & Value**

**Entire Gain Deferred**

<table>
<thead>
<tr>
<th></th>
<th>Original Basis</th>
<th>NBV</th>
<th>FMV</th>
<th>+ Cash</th>
<th>New Bldg</th>
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<tbody>
<tr>
<td><strong>1245 Property</strong></td>
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<tr>
<td>5 Yr Property</td>
<td>2,000</td>
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<td>2,400</td>
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<tr>
<td><strong>1250 Property</strong></td>
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</tr>
<tr>
<td>15 Yr Property</td>
<td>1,000</td>
<td>650</td>
<td>1,100</td>
<td>100</td>
<td>1,200</td>
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<tr>
<td>39 Yr Property</td>
<td>7,000</td>
<td>6,300</td>
<td>7,700</td>
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<td>8,400</td>
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<td>6,950</td>
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<td><strong>Total Property</strong></td>
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<td>7,450</td>
<td>11,000</td>
<td>1,000</td>
<td>12,000</td>
</tr>
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**Total Realized Gain** 3,550

**Total Deferred Gain** 3,550

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**Boot & Gain Recognition**
BOOT: Property Received in the Exchange That is Not Like-Kind

MORTGAGE BOOT: Liabilities assumed or given up by the Taxpayer.

CASH BOOT: Cash or any other property that is not like-kind.

Relief of debt is a taxable event.

Realized gain is recognized to the extent of net boot received.

Boot Netting Rules

Different types of boot may be netted against one another to reduce recognized gain:

Cash boot paid on acquisition offsets cash boot received at end of exchange.

Cash boot paid offsets mortgage boot received (debt relief) on disposition.

Mortgage boot paid (debt assumed) on acquisition offsets mortgage boot received on disposition.

Mortgage boot paid will not offset cash boot received.
**Tax on Trade Down**

Taxed on the GREATER of

the trade down in value

or

cash boot received,

but only to the extent of the realized gain.

**BOOT & Cost Segregation**

- Cost Segregation creates two categories of depreciable real property in a like-kind exchange:
  - Section 1245
  - Section 1250

- If a cost segregation study was performed on the relinquished property, in order to be consistent with Chief Counsel Advice, a cost segregation study should be performed on the replacement property in order to avoid “not like-kind” boot for Section 1245 property.
### Scenario II

**Trade down in Equity & Value**

**$1 Million Gain Recognized**

<table>
<thead>
<tr>
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<td>-1,000</td>
<td>10,000</td>
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**Total Realized Gain** 3,550

**Recognized Gain** 1,000

### 1031 Exchange & Depreciation Recapture

Non-recognition possible only if like-kind §1245/§1250 property received in exchange.

**§1245 - depreciable real property:**
Replacement property must contain §1245 real property equal or greater in value to the relinquished §1245 real property or the difference will be recaptured (up to the realized gain amount).

**§1250 - depreciable building and land improvements:**
Replacement property must contain §1250 property equal or greater in value to the relinquished §1250 property or gain will be recognized on the difference. Also any additional depreciation will be recaptured in the amount of the greater of (1) any taxable boot or (2) the excess of the additional depreciation over the FMV of the replacement property.
Scenario II
Trade down in Equity & Value
$1 Million Gain Recognized

Taxed on the GREATER of the trade down in value ($1,000) OR cash boot received ($1,000), but only to the extent of realized gain.

Section 1245 and Section 1250 analyzed separately

<table>
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<tr>
<th>Original</th>
<th>FMV</th>
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<tbody>
<tr>
<td>(in 000’s)</td>
<td>Basis</td>
</tr>
<tr>
<td>Sec 1245 Prop</td>
<td>2,000</td>
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</table>

$200 recognized gain is recapture depreciation, taxed at ordinary income rates.

| Sec 1250 Prop | 8,000 | 6,950 | 8,800 | -800 | 8,000 |

Assume additional depreciation is $100, remainder of $1,050 depreciation is straight-line.

Recapture $100 additional depreciation at ordinary income rates [recapture of additional depreciation cannot exceed the greater of taxable boot ($800) or the excess of the additional depreciation less the FMV of property acquired ($0); $100 does not exceed that threshold].

Remaining $700 Section 1250 gain is recognized at 25% rate.

New Rules for “MACRS” Depreciation

In March, 2007, the IRS finalized regulations on how to depreciate MACRS property acquired in a like-kind exchange or involuntary conversion.

Basis of replacement property is split into “exchanged basis” and “excess basis”.

Treas. Reg. §1.168(i)-6
**Basis: Exchanged v. Excess**

**EXCESS BASIS**

Basis Acquired With New Money
Depreciated As Property Newly Placed in Service

**EXCHANGED BASIS**

Carried Over from Relinquished Property
Depreciated Over the Remaining Recovery Period of Relinquished Property, Using the Same Depreciation Method

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**Scenario I**
Trade up in Equity & Value Replacement Property - Basis

<table>
<thead>
<tr>
<th>(in 000's)</th>
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<th>Excess Basis</th>
<th>New Basis</th>
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<td>1,000</td>
<td>8,450</td>
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</table>

(a) Depreciated over the remaining recovery period of Relinquished Property, using the same depreciation method.
Election Out

• New rules apply when the replacement property has the same (or shorter) recovery period, or the same (or more accelerated) depreciation method than the relinquished property.
• Taxpayers can elect not to apply this method and treat the entire basis as newly placed in service property.
• Some experts feel that an election out is not advantageous, since it slows down depreciation.
• But, the election eliminates the need to maintain and compute multiple depreciation schedules

Quoting the Experts

“The enormous benefit of the accelerated cost recovery deductions would appear always to outweigh costs of the later depreciation recapture at the time of the exchange. The only downside to the cost segregation would be the cost of the study.”

» Mary B. Foster & Martin Verdick
The Interaction of Cost Segregation, Code Sec. 1031 Exchanges and Depreciation Recapture
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