

2004 TRENDS Seminar -- Tax Trends

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Cost Segregation

Of the current developments in tax law effecting real estate, the development of cost segregation of real property might be the most significant. Cost segregation allows owners of residential and nonresidential property to treat certain cost as personal property under the former investment tax credit rules. The benefit of this treatment is increased depreciation expense through reclassifying assets to shorter recovery periods. The concept of cost segregation is the outgrowth of a court case settled in 1997. The IRS has since accepted the concept and provided rulings to enable taxpayers to implement cost segregation to real estate properties.

Cost segregation is based on a study performed by a qualified outside consultant who applies the methodology approved by the IRS. The study will determine which cost relates to the building structure and operation of the building, land improvements and personal property. The depreciation recovery periods are as follows:

Nonresidential building structure and operation	39 years
Residential building structure and operations	27.5 years
Land improvements	15 years
Personal property	5 to 7 years

The benefit of moving cost from 39-year recovery period to 5, 7 and 15-year recovery periods is to reduce taxable income during the early years of ownership. An additional benefit is new land improvements and personal property may qualify for MACRS bonus depreciation for the first year placed in service. Personal property cost qualifies for Section 179 expensing in the first year subject to limitations set out in that code section.

Cost segregation is not limited to new acquisitions and construction. Studies can be performed on older buildings to provide a larger depreciation deduction in the current year.

Leasehold Improvements

Leasehold improvements made by a lessor or lessee to the interior portion of nonresidential real property may qualify for bonus depreciation equal to 50% of the cost. The property must be original use property placed in service after May 5, 2003 and before January 1, 2005. The improvements must be pursuant to a lease which the lessor and lessee are not related persons as defined by the IRS. Certain expenditures that do not qualify are enlargement of the building, internal structural framework, structural work benefiting common areas, and any elevator or escalator cost. Additionally, the building must have been placed in service more than three years before the improvements are placed in service.

Tax Rates on Sales of Real Estate

On sales of rental real estate property after May 5, 2003, the gain is generally taxed at 15% for federal income purposes. Depreciation taken in prior periods is recaptured and taxed at a federal rate of 25% in most cases. Louisiana taxes all gains as ordinary income.