Cost Segregation and a 1031 Property Exchange

Scenario

A property sold as part of a 1031 exchange never had a cost-segregation study and was on the books as all 39-year real property and land. The new buildings purchased did have a cost-segregation study and were broken into 5, 7 and 15-year property.

Issue

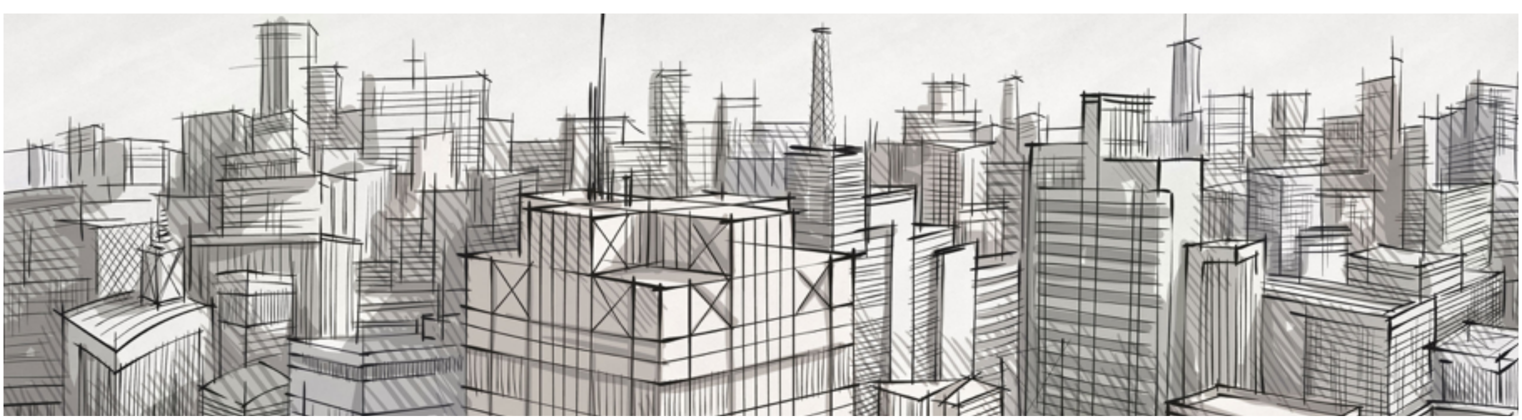
Would the 5 and 7-year property qualify as real property and be included in the 1031, or would this be personal property for 1031 purposes and should not be part of 1031?

Scarpello Consulting's Position

An exchange of real property for personal property is not an exchange of property for property of like kind. See *Oregon Lumber v. Comm.*, 20 TC 192 (1953). Unfortunately, there seems to be confusion in the ranks concerning whether the reclassified property from a cost segregation study continues to qualify as real property, or becomes personal property.

The authors of the article from the Journal of Accountancy are of the opinion that the definition of real property is control by state law for purposes of §1031, and therefore, many of the assets that we reclassify as personal property for purposes of §168 (MACRS depreciation) remain real property under the like-kind analysis of §1031 because they remain real property as state law fixtures. However, they have not cited to any relevant authority. However, in the *Oregon Lumber* case, the taxpayer exchanged a fee simple interest in real property for a limited right to cut and remove standing timber. The court found that the cutting rights were personal property under Oregon law and held that "an exchange or realty [real property] for personalty [personal property] is not an exchange of property for property of like kind."

(http://www.journalofaccountancy.com/issues/2005/aug/thebestofbothworlds.html)



Furthermore, TAM 200424001 (6/11/2004) indicates that state law controls for purposes of determining real vs. personal property. Here, components of railroad track that were assembled and attached to the land and considered real property for state law purposes were not of like-kind to unassembled railroad track components considered personal property for state law purposes.

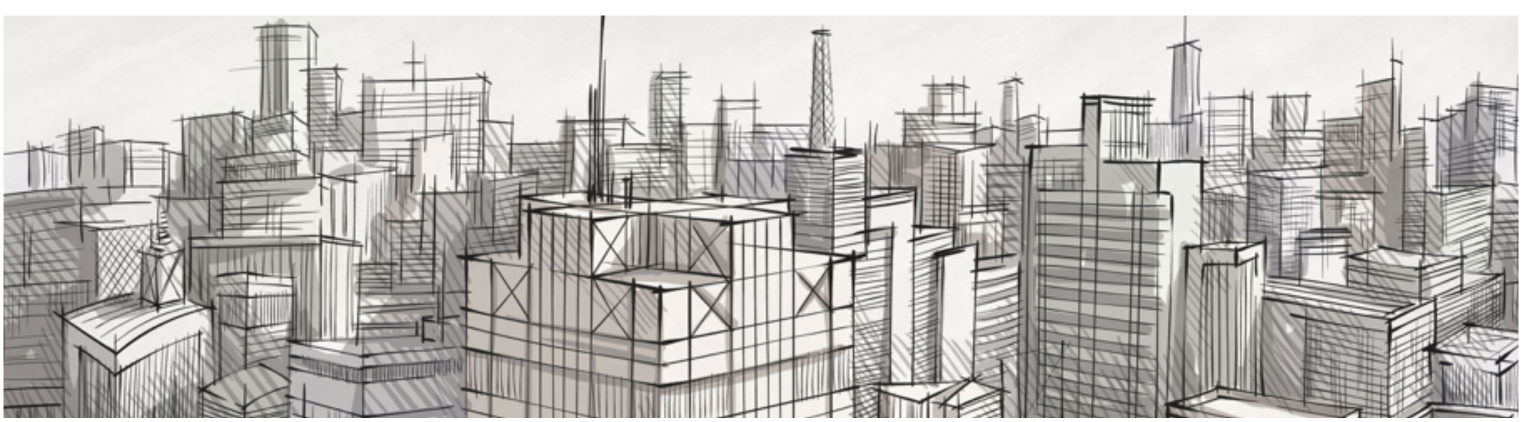
However, the authors of the article from The Tax Adviser take the opposite stance. If you look under the section titled "Splintering an Asset," you'll see that the authors believe that the reclassifications result in the creation of non-real estate (presumably, real property) assets that cannot be offset against the real property in a §1031 exchange.

http://www.thetaxadviser.com/issues/2009/aug/whencostsegregationcostsextra.html

Like-kind property is not defined under §1031. Treas. Reg. §1.1031(a)-1(b) tells us that "like kind" references the nature or character of the property, and not it's grade or quality. There are some examples given that provide the basis for the understanding that real estate is like kind to other real estate, no matter its use or level of improvement. Outside of that, no further explanation or definition is provided for real property.

§1.1031(a)-2(a), which provides additional rules for exchanges of personal property, tells us that properties that are of a like class are considered to be of a "like kind" for purposes of §1031. Tangible personal properties are of a like class if they are within the same General Asset Class or Product Class. The General Asset Classes are asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87.56. These are the asset classes we use to reclassify a lot of the assets in our studies. The Product Class refers to an asset's 6-digit product class under Sections 31-33 of the NAICS.

§1.48-1(c) defines tangible personal property as "any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures." Tangible personal property "includes all property (other than structural components) which is contained in or attached to a building." Furthermore, "[l]ocal law shall not be controlling for purposes of determining whether property is not 'tangible' or 'personal...' Property may be personal property for purposes of the investment credit [and therefore, cost segregation] even though under local law the property is considered to be a fixture and therefore real property."



The §1.48-1(c) definition of tangible personal property is very important for cost segregation purposes because it is the tangible personal property (§1245 property) that would have once qualified for the repealed investment tax credit that can now be reclassified for depreciation purposes. See *Hospital Corp. of America, et. al.*, 109 TC 21 (1997). If you read the *Hospital Corp.* case, you will read that the Court characterized the properly reclassified property as "§1245 tangible personal property."

Furthermore, Internal Legal Memorandum 2012238027 from the Office of Chief Counsel, dated 9/21/2012, responding to the question "How do state law characterizations of property as real or personal affect whether the property is of like kind for purposes of §1031 of the IRC?," concluded that federal income tax law, rather than state law, controls whether exchanged properties are of like kind for purposes of §1031. State law property classifications, while relevant for determining if property is real or personal property, are not determinative of whether properties are of the same nature and character as required to be like kind under §1031. Rather, all facts and circumstances should be considered in determining whether properties are of the same nature and character and thus are of like kind.

Given the IRS's position that state law does not control, my conservative opinion is that the cost segregation study does create separate classes of property that will require the taxpayer to analyze the §1031 exchange under §1.1031(j)-1, Exchanges of multiple properties. The assets will have to be separated into different exchange groups for purposes of calculating gain, both realized and recognized, as well as basis.

About Scarpello Consulting

We have been conducting Cost Segregation studies for over 15 years – ever since we developed the practice while working within one of the "Big Four" accounting firms. Many Fortune 500 companies and some of the largest national CPA firms trust us with their studies, and you should too. Visit scarpelloconsulting.com for more information.