

Cost Segregation and Estate Planning

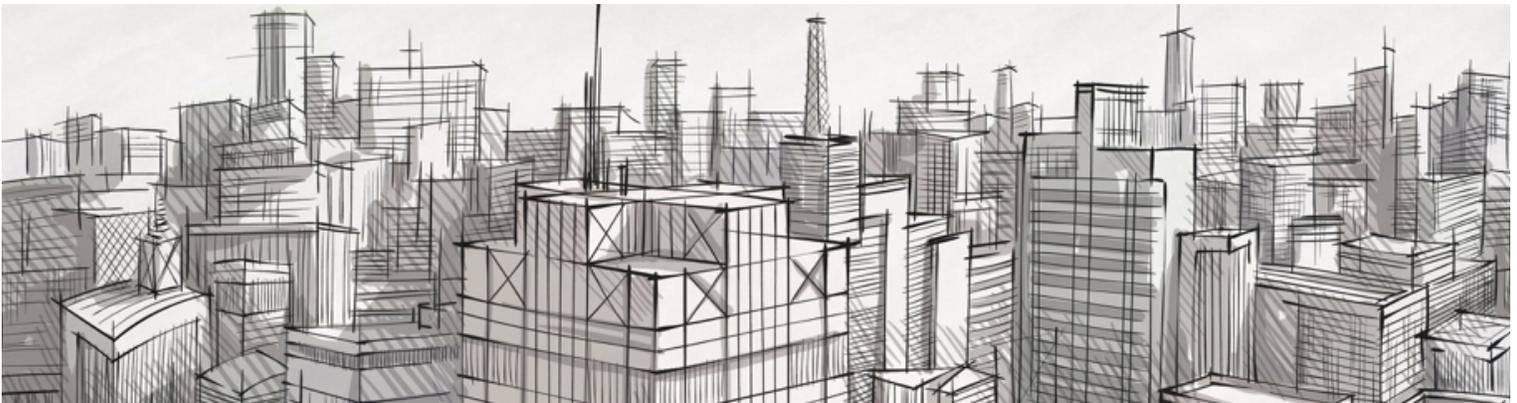
Traditionally, the most cited drawback of a cost segregation study has to do with the potential recapture of depreciation deductions under Internal Revenue Code § 1245. As the primary purpose of a cost segregation study is to reclassify § 1250 property to § 1245 property, upon a subsequent disposition of the property a taxpayer subject to a high marginal tax bracket could find themselves recapturing depreciation deductions at ordinary income tax rates in excess of the maximum 25% rate under § 1250.

Even for dispositions of § 1250 property, a taxpayer subject to a high marginal tax bracket would incur the maximum 25% rate on any unrecaptured depreciation gains.

However, two code sections create an estate planning opportunity that can significantly enhance the value of a cost segregation study. Those code sections, §§ 1250(d)(2) and 1245(b)(2), exempt transfers of property at death from the depreciation recapture rules that typically reduce the benefits of a cost segregation study.

Additionally, § 1014(a)(1) provides that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death. Therefore, any depreciation deductions taken during the decedent's ownership of the property do not diminish the basis of the property in the hands of the estate or ultimate beneficiary as there is no "transferred basis" rule to contend with.

Accordingly, it is highly advantageous for a tax professional to maximize any depreciation deductions for a deceased taxpayer on that taxpayer's final individual



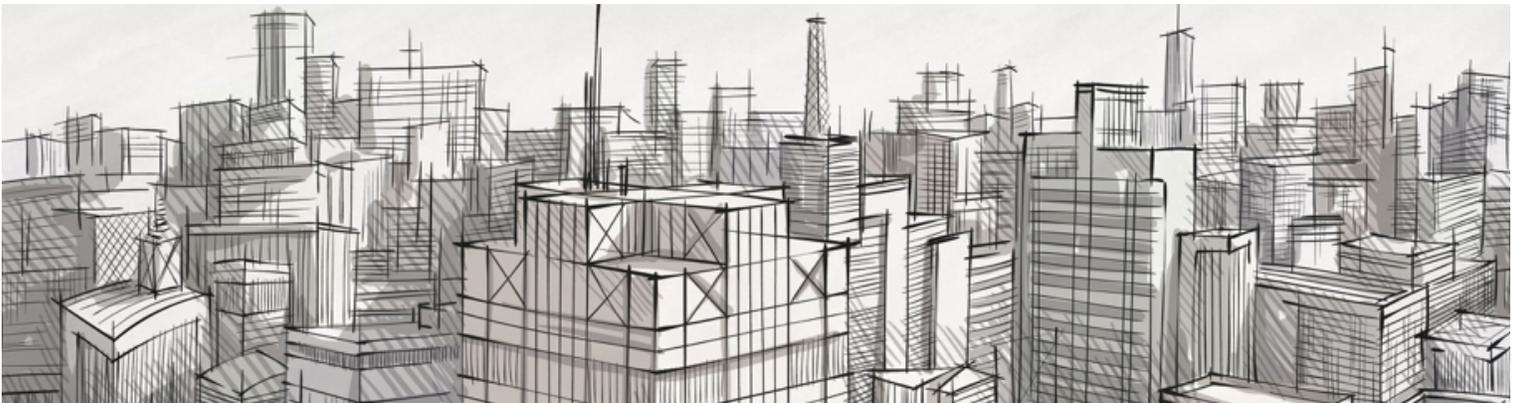
income tax return. (Unless all of the property that is the subject of the cost segregation study was acquired in the same tax year as the tax year of the taxpayer's death, any reclassification of § 1250 property to § 1245 property would be considered a change in method of accounting that will require a Form 3115 to be filed with the original income tax return for the first year of change. However, under Rev. Proc. 2015-13, §6.03(4)(a), an automatic extension of 6 months from the due date (excluding any extension) of the federal income tax return for the year of change requested on the Form 3115 is granted to file a Form 3115 under the automatic change procedures provided the taxpayer timely filed (including any extension) its original federal income tax return for the year of change, and meets other certain requirements specified therein. The accounting method change for a cost segregation study is an automatic accounting method change.)

Consider the following example:

The taxpayer passes away on June 30th of the current year. After preparing the taxpayer's final individual income tax return there is \$500,000 of taxable income related to a number of commercial rental properties purchased 10 years ago for \$5,000,000. The FMV at the date of death for these properties is \$7,000,000. All of the properties were originally depreciated over a 39-year recovery period. Over the taxpayer's 10 years of ownership she took depreciation deductions totaling \$1,580,800 and had a remaining adjusted basis of \$3,419,200. The taxpayer's beneficiaries take a basis in the properties of \$7,000,000 under the provisions of § 1014.

A cost segregation study is prepared on the properties that reclassifies approximately 15% of the original \$5,000,000 basis as 5-year property and another 15% as 15-year property. This results in a 481(a) adjustment of \$782,160 to catch up the depreciation deductions for the prior 10 years. The taxpayer had a remaining adjusted basis of \$2,637,040. The taxpayer's beneficiaries take the same \$7,000,000 basis in the properties under § 1014.

The \$500,000 of taxable income related to the commercial rental properties on the taxpayer's final income tax return is reduced to zero. If the rental activity was not passive to the taxpayer, then a net operating loss has been generated that may be



carried back to the 2 taxable years preceding the taxable year of such loss per § 172(b)(1)(A)(i). If the rental activity was passive to the taxpayer, then under § 469(g) no amount of the loss (\$282,160) will be deductible by anyone because no amount of the loss exceeds the excess of the basis of the property in the hands of the transferees (the beneficiaries) over the adjusted basis of the property immediately before the death of the taxpayer. ($\$7,000,000 - 2,637,040 = 4,362,960$)

An additional cost segregation study should be performed for the beneficiaries' stepped-up basis that accounts for the condition of the property as of the date of death.

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.

