



## ESTATE PLANNING AND THE BENEFITS OF A COST SEGREGATION STUDY

As you are probably aware, a cost segregation study can be a valuable tool for increasing the net present value of a taxpayer's depreciation deductions through their accelerated recognition. Unfortunately, a cost segregation study does not create additional depreciation for a taxpayer. However, when used as an estate planning tool, it can result in the recognition of depreciation deductions for the decedent that would have otherwise gone unused; in effect, creating depreciation deductions.

If the decedent passes (or will pass) owning depreciable property, and if the decedent owes income tax on their final individual income tax return, the decedent's estate may be in a use-or lose situation regarding accelerated depreciation deductions that otherwise would have been available to offset the income of the decedent in their final taxable year. This is so, because unless all of the property that is the subject of the cost segregation study was acquired in the same tax year as that of the decedent's death, any change in the recovery period of the property will be considered a change in method of accounting that will require a request to be filed with the original income tax return for the first year of change. (Even if all the property was acquired in the final taxable year, it will still need to be correctly classified in order to properly calculate the depreciation.)

NOTE: 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, files an amended return within the 6-month extension period implementing the requested change in method of accounting 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.

Additionally, while one consideration of a typical cost segregation study concerns the potential recapture of depreciation deductions under I.R.C. §1245 upon a subsequent disposition (see next), §§1250(d)(2) and §1245(b)(2) exempt transfers of property at death from the depreciation recapture rules, creating another estate planning opportunity that will significantly enhance the value of a cost segregation study.

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The primary purpose of a cost segregation study is to reclassify §1250 property (generally, real property with a 27.5- or 39-yr recovery period) to §1245 property (typically, personal property with a 5- or 7-yr recovery period). Therefore, 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 exceeding the maximum 25% rate for unrecaptured §1250 gains or 28% rate for recaptured §1250 gains. See §1(h)(1)(E) & (F).

Finally, §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.

### TO ILLUSTRATE, CONSIDER THIS EXAMPLE

The decedent passes away in the current year. After preparing the decedent's final individual income tax return there is \$500,000 of taxable income related to several commercial rental properties purchased 10 years ago for \$5,000,000 (net of land value). The FMV at the date of death for these properties is \$10,000,000. All the properties were originally depreciated over a 39- year recovery period. Over the decedent's 10 years of ownership, they took depreciation deductions totaling approximately \$1,225,000, and had a remaining adjusted basis of \$3,775,000. The decedent's beneficiaries take a basis in the properties of \$10,000,000 under the provisions of §1014.

A cost segregation study is prepared on the properties that reclassifies approximately 10% of the original \$5,000,000 basis as 5-year property (\$500,000) and another 15% as 15-year property (\$750,000). This results in a 481(a) adjustment of approximately \$825,000 to catch up the depreciation deductions for the prior 10 years (assuming 50% bonus depreciation originally applied to the assets). The decedent's adjusted basis as of the beginning of the year of death decreases to approximately \$2,950,000. The decedent's beneficiaries take the same \$10,000,000 basis in the properties under §1014.

The \$500,000 of taxable income related to the commercial rental properties on the decedent's final income tax return is reduced to zero. If the rental activity was not passive to the decedent, then the excess depreciation of \$325,000 can be used to offset other income.

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However, if a net operating loss has been generated, under Rev. Rul. 74-175 that carryover is lost, as net operating losses arising in a taxable year ending after December 31, 2017, are no longer allowed. See I.R.C. §172(b)(1) and §13302(e)(2) of P.L. 115-97.

If the rental activity was passive to the decedent, then under §469(g)(2) no amount of the loss (\$325,000) will be deductible by any taxpayer because no amount of the loss exceeds the excess of the basis of the property in the hands of the beneficiaries over the adjusted basis of the property immediately before the death of the decedent [ $\$10,000,000 - 2,950,000 = 7,050,000 - 325,000 = (6,725,000)$ ].

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, and this study can be performed at the same time as the study for the decedent.

As you can see, the use of cost segregation in your estate planning practice can deliver considerable value for your clients. Do not overlook the opportunity to minimize their final individual income taxes owed.

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