The Intersection of Tax Strategies for Cost Segregation and §1031 Exchange

Two well known tax strategies - cost segregation and §1031 exchange – for commercial real estate can be used very effectively if careful analysis of outcomes and the benefits of reverse §1031 exchanges guides transaction execution.

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A useful tax management strategy called "cost segregation" enables owners of real property to identify and reclassify many building components into personal property and land improvement asset categories that have shorter depreciation schedules. The accelerated write-off of depreciation does not change the total cost recovery over the life of the assets but instead moves it forward in the ownership period and thereby increases the future value of the deductions.

Sale of a property to which a cost segregation strategy has been applied may result in both capital gains and gain due to recapture of depreciation, especially if bonus depreciation and other allowances have also been taken. Depreciation recapture is treated as ordinary income and, for taxpayers other than C corporations, taxed at higher rate.

However, if the property being sold is Relinquished Property in a §1031 exchange, then both capital gain on the sale *and* depreciation recapture may be deferred if the Replacement Property has the right combination of purchase price, debt and cost segregation characteristics. Caution and careful analysis are important, however, because the rules governing the interplay between depreciation recapture and §1031 gain deferral are complex.

The following analysis will suggest that optimal value and continuity of invested capital will be the result of a proactive strategy that includes the following elements:

- Determine the tax implications of a sale of an asset with segregated depreciation schedules, either without an exchange or without performing a cost segregation study on the Replacement Property
- Determine the implications of state and local law regarding what can be regarded as real property for purposes of a §1031 exchange
- Carefully evaluate the basis, depreciation taken and the FMV of re-classified assets in the Relinquished Property
- Develop a clear understanding of the FMV of potential cost-segregation assets in the (potential) Replacement Property in addition to the other acquisition parameters effecting a potential §1031 exchange
- Understand the available exchange options (forward or reverse) and the implications for optimizing the use of cost segregation

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Cost Segregation

Cost segregation studies result in grouping of building components into major categories (e.g. electrical, concrete, dedicated plumbing, etc.) that are not real property and have depreciation and recapture rules that are generally addressed by §1245 in the tax code[1]. We will henceforth refer to assets separately identified and treated according to the rules in §1245 as "CSAs".

For many types of facilities, a cost segregation strategy can result in between 20% and 40% of the original cost of the property being reallocated to CSAs[2]. Reclassification of the assets should be done by expert advisors who understand the intricacies of the relevant standards and historical actions of the IRS and local tax authorities.

In terms of financial benefit, a relatively simple calculation shows that for every $1million in CSAs the difference in the future value between a 5-year cost recovery schedule and a 39-year schedule is approximately $40,000 (or 4% of the value of the assets) if a 35% tax rate and 5% ROI are assumed[3]. For longer cost recovery schedules (i.e. 7 or 15 years), the benefit decreases but is still significant. And, of course, the benefit will be tied to the ROI that a particular business can generate with the extra cash. For example, if the cash can be invested in income-producing investment property with a CAP rate between 7 and 9, then the financial benefit of cost segregation can be proportionately higher than in the above calculation.

Section 1245 Property

Section 1245 property is described as tangible personal property that is contained in or attached to a building. It does not include land and improvements to land consisting of inherently permanent structures and their structural components.

Most assets falling under §1245 can be depreciated using a 5 or 7 year MACRS cost recovery schedule. Certain land improvements (e.g. sidewalks, fencing and landscaping) have a 15 year cost recovery schedule[4]. It is important to note that state and local law does not control for purposes of MACRS depreciation and §1245 recapture.

The recapture rules in §1245 come into play only when an asset that has been involved in a cost segregation strategy is going to be sold. There are two scenarios that need to be understood in order to develop an optimized strategy: a taxable sale of the property and a §1031 exchange of the property for a Replacement Property.

Sale with no §1031 Exchange

In a taxable sale of a property with CSAs, the §1245 recapture rules come into play. Recapture will generally be the difference between the "purchase price" and the basis of the CSAs after all applicable depreciation write-offs (MACRS, bonus depreciation, §179) have been taken. "Purchase price" refers to the portion of the price (to be) paid by the Buyer of the property that can be attributed to the CSAs. Recapture will be taxed as ordinary income, which is at a higher rate for all taxpayers except C corporations. If the purchase price exceeds the original cost basis of the CSAs, then the gain (purchase price less original cost) will be treated as capital gain and not as ordinary

[1] We will not address non-real estate §1250 assets separately because starting in 1986, all §1250 property must be depreciated using a straight-line method and, as a result, §1250 recapture rarely arises
[2] See analysis published by Core Solutions Group, a leading provider of cost segregation studies (www.coresolutions.com)
[3] Assuming an investment life of 5 years.
[4] Point to §1245 and §1250 in the IRC

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income. Clearly, it is critical that an assessment of the purchase price be made that is capable of withstanding scrutiny and/or challenge by tax authorities.

Sale Using a §1031 Exchange

If the property containing CSAs is to be treated as Relinquished Property in a §1031 exchange, then both recapture rules and §1031 rules must be navigated in order to optimize capital continuity.

It is important to note that if the intended Replacement Property is not subjected to a cost segregation study, and the cost segregation strategy is thereby terminated, then the §1245 recapture rules apply to the CSAs in the Relinquished Property no matter what the composition of the Replacement Property may be.

Assuming that the cost segregation strategy remains in place, it is still possible that taxable recapture may occur even though the Relinquished Property sale qualifies for non-recognition under §1031 since the §1245 recapture takes priority over the non-recognition of capital gain provided in §1031. However, if the CSAs in the Replacement Property have FMV equal to or greater than the FMV of those in the Relinquished Property, then there is no recapture of depreciation and the basis of the CSAs in the Replacement Property is the adjusted basis of the CSAs in the Relinquished Property plus the difference in their respective FMVs.

Some caution is needed due to differences in state and local laws regarding real and personal property. Generally a building and its improvements/components will be regarded as real property and §1031 relies on state law for this type of determination regarding the deferral of capital gain on the exchange of assets that are like-kind. However, there are some state-wise differences and local advisors should be consulted.

Perhaps the least complicated situation is one in which state law determines that both Old and New Properties are like-kind without regard to the amount of CSAs in either property. In this case, the capital gain from the sale of the Relinquished Property – treated as a single piece of real property - may be deferred pursuant to §1031 while any recapture resulting from the sale of the CSAs in the Relinquished Property is computed separately once the characteristics of the CSAs in the Replacement Property are know by way of a cost segregation analysis.

Scenario #1: Initial Foray into Cost Segregation

If the Investor owns investment real estate that has not been subjected to a cost segregation strategy, then there are two useful paths. First, the Investor may engage a cost segregation analysis firm and begin to take advantage of accelerated cost recovery as soon as possible. If the Investor has owned the asset for some time, the benefits of this approach may not be great as if the Investor had a property that was new or at least recently acquired. Secondly, if the Investor decides to exchange into a new investment property and start a cost segregation strategy then the following will be true:

- The sale of the Relinquished Property will not trigger §1245 treatment since no assets under the jurisdiction of §1245 have been identified.
- For §1031 purposes, both properties will be considered to be real property, unless some unusual state or local laws dictate otherwise.
- The full potential of the §1031 exchange can be realized and the benefits of the accelerated cost recovery can start as soon as the Exchangor takes possession of the New Property.

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- If the Investor has decided to use a reverse exchange (see below for the rationale) and the benefits of the cost recovery strategy are significant, it may be advisable to use the Exchange First form of reverse exchange. In this form, the Relinquished Property is pared in an EAT and the Investor would take title to the Replacement Property immediately upon the close of its acquisition, allowing the Investor to take the accelerated depreciation immediately.

Scenario #2: Relinquished Property and Replacement Property are segregated

If both the Relinquished Property and the Replacement Property in a §1031 exchange have CSAs, then the §1245 recapture rules must be navigated as described above.

There will be taxable gain and no taxable recapture if:

- The cost of the Replacement Property is higher than that of the Relinquished Property, and
- All of the equity in the Relinquished Property is translated to the Replacement Property, and
- The cost of the CSAs in the Replacement Property is greater than the cost of the CSAs in the Relinquished Property.

If one or more of these is not the case, i.e. the Investor is trading down or cashing out, then a qualified tax advisor should be consulted to make an accurate determination of the tax liability.

Scenario #3: Relinquished Property is segregated, Replacement Property is not

In the case where an exchange is done but the Investor decides not to carry forward with a cost segregation strategy and elects not to identify CSAs in the Replacement Property, then the §1245 recapture rules will be applied to all separately identified personal property in the Relinquished Property. Analysis suggests that, in general, there is still an advantage to using cost segregation even if for a (relatively) small timeframe.

Which Exchange strategy – forward or reverse?

§1031 exchanges have two basic forms – the forward or delayed exchange and the reverse exchange. In a delayed exchange, the Relinquished Property is sold and the cash proceeds entrusted to a QI who then provides them as (partial) payment for qualifying like-kind Replacement Property. In a reverse exchange, the Replacement Property is acquired before the Relinquished Property is sold and the Accommodator holds title to one of the properties instead of cash.

Assets to which §1031 can be applied are those held for income or investment and the whole point of the §1031 provision is to allow investors to keep capital continuously deployed when transitioning from one asset to another of similar nature.

In today's commercial real estate market, income property with strong positive characteristics is scarce and there is often intense competition for these assets when they go up for sale. While cap rates will therefore compress due to purchase price increases caused by the competition, the primary reason to acquire these properties is usually the income stream, as described by the cap rate. With interest rates at historical lows, many Investors find income-producing real estate to be attractive and secure, especially if both the real estate and the lease have strong collateral characteristics.

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When investment property is being exchanged, a delayed exchange will result in the cash proceeds of the Relinquished Property sale being held by the QI. Since interest rates are low, the Return on Capital ("ROC") for the Investor will be small, if not zero, during the exchange period. In addition, the Investor will have 45 days to identify the potential Replacement Property and 180 days to close the purchase of one or more of the identified properties. These deadlines are often not easy to manage. It is not always possible to identify one or more properties that an Investor can, with confidence, close in a 180 day window. Competition is often intense and the sellers of these assets are typically unsympathetic if they have better offers. The risk of losing the gain deferral with a delayed exchange can be very high and increases with the intensity of competition for the properties.

Reverse exchanges involve the acquisition of the Replacement Property before the sale of the Relinquished Property. There is a "parking arrangement" between the Investor and the Accommodator in which title to one of the properties in the exchange is held in an LLC owned by the Accommodator until the ultimate Buyer for the Relinquished Property is found and the transaction is closed. The Investor must supply the cash or arrange credit for the purchase of the Replacement Property in advance of the availability of the proceeds from the Relinquished Property sale. The Investor has 45 days to identify the asset(s) to be sold and 180 days to close the sale of the properly identified assets.

There are issues which sometimes make a decision about whether to use a delayed exchange or a reverse exchange a moot point. Some investors may simply not have the financial liquidity or credit required to acquire Replacement Property prior to selling Relinquished Property. In some cases, the timing of a transaction may determine which type of exchange needs to be done.

Assuming that an Investor has the ability to choose, the following considerations should come into play, all of which can contribute to the optimization of capital continuity:

- Return On Capital – investment property typical produces income for its owner and reverse exchanges enable the Investor to enjoy the income from both the Relinquished Property and the Replacement Property during the exchange period. Contrast this with a forward exchange in which the cash proceeds produce income for the QI and virtually nothing for the investor. There are virtually no situations in which the dual income stream does not far exceed both the cost of money for the Replacement Property acquisition plus the higher fee that is typically associated with a reverse exchange.[5]
- Transaction control – a desirable Replacement Property may be the subject of intense competition and, if so, the ability to make a non-contingent offer with a quick close is critical to making a successful acquisition.
- A reverse exchange provides time to engage cost segregation while the New Property is parked in the EAT because neither the taxpayer nor the EAT can claim depreciation during the parking period.
- If additional improvements to a Replacement Property are to be made while it is parked in a reverse, the improvements can be included in the cost segregation analysis.
- Since the 45-day identification requirement is satisfied using potential Relinquished Property in a reverse exchange, the Investor has time to identify assets to be sold that minimize the impact of recapture and simultaneously comply with exchange rules, if possible.

[5] See our ROC calculator for a detailed method of calculating the financial impact of forward and reverse exchanges

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- In the case where the depreciation benefits of the Replacement Property far outweigh those in the Relinquished Property, the option of a reverse exchange in which title to the Relinquished Property is held by the Accommodator may provide additional financial benefits to the Investor.
- Reverse exchange can be extended beyond 180 days if no Buyer for the Relinquished Property can be found. The complexity and cost of such extensions are high and the benefits of must be significantly higher in order to justify their use. However, this option exists with a reverse exchange and simply does not exist with a delayed exchange.

Conclusions

A continuous cost segregation strategy provides proven, long-term and consistent advantages in terms of the accelerated cost recovery allowed for personal property. Separately, §1031 exchanges provide proven, potentially perpetual deferral of gain on the sale of real property.

These two proven strategies intersect when one or more assets involved in a cost segregation strategy are or will also be involved in an exchange. The goal is to optimize the use of both strategies in terms of financial benefit, transaction control and risk reduction for the Investor.

The most complex aspect of optimizing these strategies is the potential for taxable recapture of depreciation applicable to the CSAs in the Relinquished Property. As with most complex tax analysis, the use of a qualified tax advisor is strongly recommended. However, if the Investor is “trading up” – that is acquiring a Replacement Property that does not create taxable boot from a 1031 perspective and that has CSAs that are valued above those of the original cost of the CSAs in the Relinquished Property, then a complete deferral of tax can be achieved. In addition, while there will be a translation of the depreciated basis of the Relinquished Property and its CSAs to the Replacement Property, a fresh set of tax benefits derived from the accelerated cost recovery schedules for the CSAs in the Replacement Property can now be applied.

Although the beneficial intersection of cost segregation and §1031 exchange can be achieved using either a delayed exchange or a reverse exchange, the reverse exchange strategy is often optimal because it allows real estate investors to

- Acquire the New Property with timing and terms that are advantageous,
- Identify Old Property for the exchange that is optimal in terms of ability to sell, deferral of gain and reduction of recapture
- Optimize Return on Capital because all the rent from both Old and New Properties inures to the Exchangor during the exchange period
- Perform the cost segregation study on the “parked” Replacement Property without loss of depreciation benefits
- Increase both gain deferment potential and depreciation benefits by making needed improvements to the “parked” Replacement Property during the exchange period since the improvements will both increase the value of the Replacement Property and can be included in the cost segregation analysis
- Increase the depreciation benefits by parking the Relinquished Property instead of the Replacement Property (i.e. an Exchange First) if the depreciation from the Replacement Property is significantly higher than that in the Relinquished Property

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While getting the most from the intersection of cost segregation and reverse §1031 exchanges requires thoughtful and proactive planning, with the assistance of a qualified professional, the strategy is front-loaded in terms of the cost and learning curve but has the potential to be a long-term strategy that has significant benefits.

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