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Estate Planning Strategy Using Cost Segregation

Real estate owners and investors often use cost segregation studies to accelerate depreciation deductions, generate current income tax benefits, and improve cash flow. But did you know that a cost segregation study can also be used as a powerful estate-planning tool?

One of the advantages of transferring property at death (rather than by lifetime gift) is that it receives a “stepped-up basis” in the hands of the beneficiary. In other words, the property’s tax basis resets to its date-of-death fair market value (FMV). As a result, any capital gains that accrued during the decedent’s lifetime avoid taxation permanently. Typically, when a client dies, estate planners and tax preparers focus on how the stepped-up basis affects the beneficiaries’ income tax liability. But when an estate includes buildings, they often overlook a valuable opportunity to manage the decedent’s tax depreciation basis ***before*** death to reduce the decedent’s tax liability on his or her final individual income tax return. Taking advantage of this opportunity requires a cost segregation study, which can be conducted after the death, but must be completed before the decedent’s final income tax return is filed.

Ordinarily, buildings are depreciated over an extended time period (27.5 years for residential buildings; 39 years for nonresidential). A cost segregation study uses engineering and cost-accounting techniques to identify building components that qualify for accelerated depreciation as tangible personal property (typically, over five, seven, or 15 years). This is an IRS approved process that is commonly recommended by CPAs for real estate investors. Cost segregation studies don’t increase total depreciation deductions over an asset’s life, but by accelerating these deductions they create significant net present value.

One-Time Catch-Up Deduction

If a cost segregation study of a decedent’s buildings reveals missed depreciation opportunities, the decedent may be entitled to a sizable current-year “catch-up” deduction under Internal Revenue Code Sec. 481(a). To do this, a Form 3115 must be filed on the final tax return since current rules prohibit the form from being filed in a later tax year by amending. This can substantially reduce or even eliminate tax liability on the decedent’s final federal income tax return.

What’s more, conducting a cost-segregation study in an estate-planning context offers a decided advantage over one conducted during life: It avoids the recapture tax “whipsaw.” Generally, a cost segregation study is not advised when a building owner plans to sell the building within five years or less. Why? Because when the building is sold, the owner must pay recapture tax (at ordinary income tax rates) on gains attributable to previous depreciation deductions,

which may counteract the benefits of the study. This is not an issue for a building purchased by the decedent in a prior tax year.

Case Study 1

Michael owns two residential rental buildings that he purchased in 2008. He dies on Aug. 31, 2015, leaving both buildings to his son, Max. The decedent's final federal income tax return — which is due April 17, 2016 (October 16, 2017, if extended) — shows a tax liability of about $500,000. Michael is in the 39.6 percent federal income tax bracket.

At the time of death, the buildings' original unadjusted depreciable tax basis (after subtracting land value) is $1 million, with $728,810 of depreciation remaining. Michael also owns several other rental buildings that are fully depreciated and generate substantial cash flow with minimal deductions to offset income tax.

The decedent's executor arranges a cost segregation study, which reveals $174,000 of missed depreciation deductions. Using Form 3115, *Application for Change in Accounting Method*, decedent's tax preparer makes a Sec. 481(a) adjustment to claim the missed deductions on the decedent's final tax return. The result: $68,904 in permanent tax savings. Max then receives a stepped-up basis — equal to the buildings' FMV on Aug. 31, 2016 — and begins the depreciation process all over again.

Comment: To enhance the tax benefits of depreciation, Max should consider a second cost-segregation analysis, updating the previous study to reflect the building's current value and condition.

Proactive Estate Tax Planning.

Estate planners and tax preparers should consider cost segregation studies for their elderly clients who own depreciable real estate. If clients are unlikely to sell these assets before death, a cost segregation study can help them avoid wasted depreciation deductions and maximize tax efficiency by ensuring that deductions are taken as early as possible. Again, if the client passes away while owning the property, there is no recapture tax typically associated with a cost segregation study. In fact, proactive estate tax planning can potentially double the depreciation deductions a building generates.

Case Study 2

John and Anita acquire a rental property in 2001, with a $1 million basis in the building. In 2006, their CPA conducts a cost segregation study, which supports reallocating 20 percent of their cost basis to five-year property. The result: A $163,000 Sec. 481(a) adjustment, which offsets passive income generated by the couple's various rental properties.

John dies in 2007 and Anita receives a stepped-up basis of $2 million. She arranges a second cost segregation study, which identifies $300,000 in additional depreciation deductions over the next five years. So far, cost segregation techniques have yielded an additional $463,000 in deductions that will never be subject to recapture taxes.

When Anita dies in 2012, her children inherit the building, together with a basis step-up to $3 million. The children obtain a third cost segregation study, which identifies $600,000 in five-year property depreciable through 2016.

Without the three cost segregation studies, John and Anita's building would have produced approximately $870,000 in depreciation deductions over 15 years. By implementing a cost segregation estate-planning strategy, the family enjoys a total of $1.8 million in depreciation deductions over that same period.

Get an Early Start

The stepped-up basis rules are designed to avoid exposing an estate's assets to both estate and capital gain taxes. Combining these rules with cost segregation techniques can be a powerful strategy for reducing income tax liability on a decedent's final federal income tax return.

To take advantage of this strategy, it's critical for estate planners and tax preparers to recognize the potential benefits and coordinate with a reputable, experienced cost segregation firm. If a cost segregation study is appropriate, it must be conducted and implemented before the final return's extended due date. Generally, any missed depreciation deductions must be claimed on the decedent's final income tax return and cannot be recovered on an amended return. If the deadline is missed, these deductions are lost forever.

Gian Pazzia, CCSP, is a principal with KBKG and its National Practice Leader for Cost Segregation Services, as well as a subject matter expert on repair vs. capitalization issues. He has served as President of the American Society of Cost Segregation Professionals and currently holds a seat on their Board of Directors.