

How to Co-ordinate Cost Segregation with Like-kind Exchange

The Tax Cuts and Jobs Act (TCJA) was signed by the President on December 22, 2017. The TCJA is the most significant overhaul of Internal Revenue Tax code since the 1986 Tax Act under President Reagan. The Committee Report has over a thousand pages of modifications to many areas of the tax code. One piece of the new legislation (that concern most real estate investors) involves changes to the like-kind exchange rules.

When certain conditions are met, no gain or loss is recognized when a taxpayer exchanges property of like-kind (used in a trade or business or for investment purposes). Before the TCJA, a taxpayer could exchange real property for real property; and personal property for personal property (with some restrictions) without recognizing gain on the exchange. For exchanges completed after December 31, 2017, the TCJA limits this tax-free treatment to an exchange of real property only. Personal property no longer qualifies for like-kind exchange after this date. Many taxpayers and tax preparers are asking the question: How does this impact an exchange of real property that went through a cost segregation study?

Cost segregation is a valuable tax strategy to accelerate depreciation deductions. When the timing is right, this strategic tool can save taxpayers thousands of tax dollars. The primary goal of a cost segregation study is to identify all costs that can be depreciated over shorter depreciable lives. By accelerating depreciation, a taxpayer can defer federal and state income taxes and increase cash flow. If timed correctly, a taxpayer can claim more deductions in a high marginal tax year and less deductions in low marginal tax year resulting in a permanent tax savings.

The building costs identified with shorter depreciable lives (by the cost segregation study) are depreciated as Section 1245 property. Most tax preparers believe that means that these assets are personal property. The distinction that needs to be made is between the personal property (machinery and equipment) from the real property fixtures that qualify as 1245 property for tax purposes but are deemed to be real property by state law. State law generally determines the classification of property as real or personal. For like-kind exchange purposes, the courts have held that state law, although not controlling, is generally followed to determine whether property is real or personal. As such, fixtures can be 1245 property with a shorter depreciable life for depreciation purpose but real property for like-kind exchange purpose. Taxpayers still need to be aware of the potential recapture rules under 1245(b)(4) and 1245(d)(4) but this personal property vs. real property distinction should help taxpayers navigate like-kind exchanges with more comfort.

Finally, according to the Committee Report, it is the intention of the Congress that real property eligible for like-kind exchange treatment under prior law continue to be eligible under TCJA. It is our belief that this language means that the treatment of real property that went through cost segregation study should continue to be eligible for like-kind exchange treatment as it has in the past.

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