

Depreciation 201: How to carve out assets



MY VOICE
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Depreciation would appear to be one of the simplest areas of tax law: You buy an asset and you write it off over a period of years. It is a straightforward concept, and yet there are probably more dollars of tax deductions left on the table in this area than any other. This stems from overlooking a critical step in the tax accounting process: cost classification.

The idea behind cost classification is properly assigning tax lives to depreciable assets. Under the modified accelerated cost recovery system (MACRS) assets are assigned depreciable lives based on their class lives. Personal property is typically 3-, 5-, 7- and 10-year property, and real property is assigned MACRS lives of 15, 20, 27.5 and 39 years. Personal property is typically depreciated using an accelerated method of depreciation, and real property is generally depreciated using an accelerated method for 15- and 20-year property and the straight line method for 27.5 and 39 year property.

Most of the lost, or actually deferred, depreciation deductions come from not properly identifying the personal property acquired in conjunction with the purchase of real property — not carving the cost of personal property out of the total cost of a building and depreciating the personal property over its correct life, normally 5 or 7 years. The IRS resisted allowing taxpayers to carve the cost of short-lived property from the cost of real property, but after losing numerous cases finally acquiesced. (The controlling cases in this area are Hospital Corporation of America, 109 TC 21 (1997) and Brookshire Brothers, 320 F.3d 507 (5th Cir. 2003)).

The bulk of the case law and ruling regarding what is or is not personal property comes from the days of Investment Tax Credit, or ITC. ITC was a credit equal to 10 percent of the cost of tangible personal property, thus the dollars were huge and a great deal of effort went into identifying property that would qualify for the credit.

Examples of items that are often included in the cost of a commercial office building that qualify for shorter lives and accelerated depreciation are the parking lot, exterior lighting, signage, landscaping and fencing. All are considered land improvements and qualify for 15-year depreciation and the 150 percent accelerated

depreciation method. Examples of personal property often overlooked are carpeting, built-in cabinetry, public address systems, low-voltage exit signs, movable partitions, decorative lighting and certain types of wallpaper. Those assets qualify for a 5-year depreciation life and 200 percent accelerated depreciation.

How big a deal is all this? Assuming an 8 percent interest rate and a 35 percent tax bracket, the increase in the present value of the tax deductions for each \$100,000 of property reclassified from 39-year property to 5-year property is \$18,396. That is present value, like cash in the bank the first year you acquire the property. The increase for reclassifying 39-year property to 15-year property is \$9,628. Ever see a commercial building with no parking lot, landscaping or exterior lighting? Me either. Some kinds of property are replete with personal property. I did a cost classification study for a hotel-casino and mined close to \$2 million of personal property out of the building account at the completion of construction. That resulted in an increase in the present value of the tax benefits of \$360,000. Not bad for a day's work!

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