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Qualified Improvement Properties; Are Cost Segregation Studies Necessary?

In a previous PLC article we discussed recent changes to the treatment of Qualified Improvement Property ("QIP") as part of the CARES Act; most importantly that QIP placed in service in 2018 and after can now be considered 15-year Property and is eligible for 100% bonus depreciation. QIP is defined as *the Improvements that must be made by the taxpayer to an interior structural portion of a building which is nonresidential, placed in service after the date the building was first placed in service, must be section 1250 property, and excludes expenses attributable to the enlargement of the building, elevators, escalators, or internal structural framework of the building*.

While a taxpayer may consider taking the costs associated with a construction project and classifying those costs as 15-year Property it is important to consider some guidelines as provided by the IRS Audit Techniques Guide:

1) A cost segregation study is strongly recommended by the IRS to be performed by someone with extensive knowledge of a how to correctly identify Commercial Real Property (39-year Property), QIP (15-year Property) and Personal Property (5-year Property) costs associated with an interior improvements project. Taxpayers and their preparers that classify all construction costs as 15-year Property may be including costs that should be 39-year Property, which would be an issue upon IRS audit review.
2) An experienced cost segregation professional will have knowledge of legal case studies and appropriate methodology to determine when a unit of property is considered 39-year, 15-year, or 5-year property. This helps support your conclusions under an IRS audit review.
3) A cost segregation study is directed to have a report that includes appropriate methodology, legal case support, a description of the property, a schedule of values for asset groups and individual assets, and a reconciliation of classifications to the project costs. A cost segregation study performed by a taxpayer or preparer may not have a report outlining these topics which will be an issue upon audit review.

In addition to the guidelines as outlined above a cost segregation study is also beneficial for tracking 5 and 15-year property for future planning purposes when detail is not available (General Categories such as Electrical and Finish Carpentry) and costs are material. Itemized assets/building components will provide the detail necessary (takeoffs) to assist in the calculation of partial or full asset dispositions for future renovations or a sale of the space, helping to avoid double depreciation of the assets which could be of concern when/if recapture is involved.

In summary, a taxpayer or preparer should strongly consider utilizing the services of a cost segregation professional to ensure IRS guidelines are met in terms of identifying QIP and to provide valuable information needed for bookkeeping and other accounting functions.