KBKG Tax Insight: Using Cost Segregation in Estate Planning

When a client dies, a critical estate planning area for tax professionals involves managing the step up in basis on inherited assets for estate and income tax purposes. The general rule for real estate is that when a property is inherited, any gains built up during the decedent's life are not recognized. The beneficiary also receives a "step up," which means the property's tax basis is reset to fair market value on the date of death.

While most tax professionals focus on how the new stepped up value will impact taxes on the decedent's estate and the beneficiary's income tax liability, many overlook the opportunity to manage the decedent's ***original*** tax basis for real estate assets that are recorded on their tax depreciation schedule ***before death***. This change to the property's original basis can be done even after a death occurs, but it must be done before filing the decedent's final income tax return.

One of the most significant ways to reduce the federal income tax burden experienced by the estate of a recently deceased's loved one is by conducting a cost segregation study on the original pre-stepped up basis of buildings the decedent held. This typically generates an immediate large accelerated depreciation deduction that can eliminate tax owed on the final federal income tax return, all while reducing the building's pre-stepped up tax basis. However, since the federal income tax basis on the building is reset to fair market value on the date of death, neither the decedent nor the heirs realize any offset to future deductions typically associated with cost segregation studies. Additionally, the recapture tax whipsaw that is paid upon sale of property on the accelerated depreciation deductions does not occur in estate planning situations.

A cost segregation study allows building owners to accelerate depreciation deductions that typically are taken over an extended period (i.e., the 27.5 or 39 year periods that apply to depreciate residential or nonresidential buildings) into a much shorter span that applies to other types of property other than buildings (5, 7, or 15 years), often providing a sizeable current year "catch up" depreciation deduction under Sec. 481(a).

Cost segregation studies usually don't create extra deductions over the life of the property. They simply accelerate them, which results in a net present value. The number one reason a property owner would not want to undertake a cost segregation study is when they plan on selling the property within a short period (typically within 5 years of the study). After all, if accelerated deductions are recaptured soon after implementing a study, the value of accelerating deductions is negated.

> **KBKG Insight:** Considering cost segregation as an estate planning tax strategy creates a use-it-or-lose-it tax situation, as the accelerated depreciation deductions are never recaptured upon sale and the building's depreciable tax basis is reset upon death. This strategy works even if the cost segregation study is completed after death, but must be implemented before the extended due date of the decedent's final income tax return.

Case Study 1: The decedent passes away on August 31 in the current year. Federal income tax liability for the decedent's final return is approximately $400,000 and is due on April 15 of the following year (October 15 if extended). The decedent's federal tax rate is 39.6%.

At death, the decedent owned two residential rental buildings that were acquired in 2008 (8 years ago). After subtracting land value, the buildings have an original unadjusted depreciable tax basis of $1 million with $728,810 of depreciation left. In addition, the decedent owned several other rental properties that are fully depreciated and generating significant cash flow with minimal deductions to offset income tax.

After death, a cost segregation study is performed on the original basis of the decedent's 2008 acquisitions and identifies $174,000 of additional deductions. The decedent's tax preparer files Form 3115, Application for Change in Accounting Method, with a Sec. 481(a) adjustment to claim all those missed deductions on the decedent's final tax return. This results in a permanent tax savings of $68,904. After the cost segregation study reduces the decedent's tax basis, the decedent's heir receives a full step up to the property's fair market value as of the date of death, and starts depreciation all over.

KBKG Insight: A second cost segregation analysis can be performed for the heir's new stepped up tax basis. To do this, the previously conducted cost segregation study (performed as of the 2008 acquisition date) should be revised to reflect the current value and condition of the property as of the date of death. This can generally be done by the same cost segregation firm for a small additional fee.

Unfortunately, if the cost segregation study is not implemented for the decedent before their final tax return is filed, an amended return is generally not permitted and the missed deductions cannot be recovered. Therefore, it is critical to identify this opportunity early and proactively coordinate with a reputable cost segregation firm that has experience implementing this estate planning strategy.

CPAs and tax preparers with elderly clients should note the same rules also provide similar incentives to conduct cost segregation studies on real estate assets when it is unlikely a property will be sold before an owner's death. This ensures maximum tax efficiency as depreciation deductions will not get wasted by using them as early as possible while the elderly taxpayers are still alive. In fact, savvy estate tax planning has the potential to double the amount of depreciation deductions a property can produce.

Case Study 2: An elderly husband and wife acquired property in 2001 with a building basis of $1 million. In 2006, they had a cost segregation study performed on the property resulting in approximately twenty percent of the cost basis being reallocated to five-year property. This generated a Sec. 481(a) adjustment of approximately $120,000 that was used to offset passive income from this and other rental property.

In 2007, the husband died and the wife received a step up resulting in a new basis of $2 million. A second cost segregation study is applied to the wife's tax basis providing approximately $300,000 of additional deductions over the next five years. As a result of the application of cost segregation to this point, there are approximately $420,000 of deductions that are never recaptured through gain on sale.

Upon the wife's death in 2012, the property receives another step up to $3 million. The children then apply a third cost segregation study identifying roughly $600,000 of five-year property that is depreciated through 2016.

Without utilizing cost segregation studies, the property would have produced approximately $970,000 of depreciation deductions over a 15 year period. However, by using the cost segregation estate planning strategy over the same period of time, the property produced approximately $1.9 million of depreciation deductions.

While the purpose of the step up rule is to prevent assets in an estate from being subjected to both capital gain and estate tax, when coupled with cost segregation, it offers a highly effective way to mitigate income tax owed on the decedent's final tax return. As discussed, however, if tax preparers are not quick to identify and implement this strategy before the extended due date of the decedent's last tax return, the tax savings will be lost forever.

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