

SMALL BUSINESS BRIEF

**COMPONENT DEPRECIATION:
A TAX PLANNING STRATEGY FOR SMALL BUSINESSES**

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ABSTRACT

Recent federal court and Internal Revenue Service (IRS) decisions have opened up an excellent opportunity for both small and large businesses to once again use component depreciation, thus accelerating depreciation deductions and reducing cost of buildings and improvements in present value terms. Minor changes in the design or in the procedures followed in purchasing a building make it possible to shorten the depreciable lives of portions of the "building". The savings can easily exceed the additional design, construction, and bidding costs especially if the changes are minor. Small business owners, who may not always retain a fulltime tax advisor, should be aware that it is necessary to involve a tax consultant at the beginning of the design process for construction projects or early in the search for a building purchase.

INTRODUCTION

In order to maximize benefits, many tax planning opportunities require that the tax consultant be involved from the outset of the project. Planners refer to such a situation as an open-fact situation. Before transactions and contracts are entered into, the facts can be controlled or planned. After the fact, there is less control as to the tax effects. One planning opportunity of potential benefit to small businesses is the "reincarnated" component depreciation.

One of the in vogue tax planning ideas in the sixties and seventies was component depreciation. Companies could account for a building, for example, not just as a building, but as the sum of its individual components. The depreciation schedule included such assets as roof, plumbing, electrical hardware, partitions, and exterior walls, each with individual estimated lives and salvage values. Using component depreciation (as opposed to

"composite" or "whole asset" depreciation) resulted in accelerating depreciation deductions since most of the components had lives shorter than the building.

Although the "component depreciation" of the sixties and seventies was outlawed, it has been "reincarnated" in a new form. In the current form, proper planning may allow one to classify part of a "project" (e.g., the carpeting or the electrical service) as depreciable personalty, rather than depreciable real estate (i.e., the structure itself), similarly resulting in shorter aggregate depreciable lives under the statute. This article summarizes the applicable statutes and cases and illustrates how planning can be effective.

STATUTES AND CASES

Assets placed in service under current law are depreciated using the Modified Accelerated Cost Recovery System (MACRS). MACRS, and its predecessor ACRS, specifically disallowed component depreciation. Under MACRS, real estate is either residential rental property, with a 27 ½ year life, or nonresidential real estate, with a 39 year life. Real estate is depreciated using the straight-line method with certain assumptions about when the asset was placed into service.

The recently reincarnated component depreciation is an outcome of the Tax Court case of *Hospital Corp. of America*.¹ The court concluded that parts of a building project that are not part of the structural components and that qualify as depreciable personal property can be depreciated over much shorter lives as personalty and, possibly, even be expensed. More recently, the IRS has issued guidance as to what factors must be considered by taxpayers to take advantage of the "new component depreciation."ⁱⁱⁱ

This case, and the subsequent guidance, are just as applicable to small businesses as to large publicly-traded corporations. It substantially affects the after tax costs of buildings, making them less expensive and possibly affecting the decision as to whether to own or lease corporate properties.

COMPONENT DEPRECIATION—THE OLD WAY

In the case of *Herbert Shainberg*,ⁱⁱⁱ the Tax Court concluded that a taxpayer had properly applied IRS regulations in depreciating a shopping center. The regulation provided that "...depreciable property may be accounted for by treating each individual item as an account, or by combining two or more assets in a single account." When assets were combined, a composite life was used. Thus, the life of a building is a weighted average of all its parts.

In *Shainberg*, the shopping center was accounted for as building, wiring, plumbing, roof, etc. Each component was assigned its own estimated life and salvage value. Depreciation was calculated for each component. It was especially easy to determine the component cost in this case since the building was constructed under a cost plus contract. The IRS subsequently ruled that if a taxpayer presented expert testimony as to the relative fair market values, estimated lives, and salvage values, component depreciation could also be used for newly acquired previously used buildings.

THE NEW COMPONENT DEPRECIATION

Depreciation for most property placed in service after 1986 is calculated using the methods and conventions provided in the Modified Accelerated Cost Recovery System [MACRS]. The basic provisions of MACRS are summarized in the appendix. In general, accelerated depreciation is allowed for personalty (i.e., generally property other than real property) and

straight-line depreciation is required for realty (i.e., most real estate). However, it is not always clear which category some assets fall into.

Nothing in MACRS changes the definition of personalty (sometimes referred to as § 1245 property)^{iv} or depreciable real estate (§ 1250 property)^v related to component depreciation. Component depreciation of real estate was disallowed by MACRS (and its predecessor ACRS^{vi}) because all residential rental property and nonresidential real property, respectively, placed in service during a year has the same life. Assets that were personalty before ACRS are still personalty—and this is exactly the conclusion of the Tax Court in *Hospital Corporation of America* (HCA).^{vii} Thus, the small business may depreciate these assets over a shorter time period than the building structure and obtain the associated after-tax benefit.

The IRS had tried to deny taxpayers the ability to take more rapid depreciation deductions on non-structural building components that qualified as personalty. In many instances in their HCA opinion, the court disagreed with the position of the IRS, and the IRS has subsequently acquiesced in much of this result. As such, many parts of a construction project or purchased facility can qualify for more rapid depreciation.

AN EXAMPLE

Consider a situation in which a business owner purchased or constructed a building to house production facilities, say a phone bank and computer facilities for a telemarketer at a cost of \$500,000 (not including the value of the land). Modern construction methods were applied and costs were held to a minimum. Chances are the entire \$500,000 would need to be depreciated over 39 years.

Alternatively, consider a situation where the plans for the structure are such that the building consists of specifically identifiable components such as foundation, walls, exterior doors, roof, basic electrical service and plumbing service and anything else that is needed for the building to function as a building. Interior partitions, wall coverings, floor coverings, electrical and lighting serving the production area, communications components such as wiring and fiber optics can be designed such that they are not part of the building or its structural components. Since they qualify to be depreciated using shorter lives and accelerated methods, the depreciation deductions are allowed much earlier.

Say, for example, that one-half of the total cost, or \$250,000, can be successfully reclassified as seven-year MACRS property, resulting in more rapid write-off for this amount. Also assume that the business's marginal tax rate is 35 percent and its cost of capital is 12 percent. The present value of the tax savings related to the depreciation for the \$500,000 building is \$36,943^{viii} resulting in an after-tax cost of the building of \$463,057; while the present value of the tax savings related to the depreciation for the \$250,000 building and \$250,000 of components is \$83,055^{ix} resulting in an after-tax cost of the building of \$416,945. So, for example, if the design changes cost \$20,000 an additional savings of \$26,112 (\$463,057 - \$416,945 - \$20,000) in after-tax cost savings could be enjoyed (in present value terms). This may seem trivial, but it is more than five percent of the total cost of the project and if there had been no additional design and construction costs, the savings would have exceeded 9 percent. Furthermore, for owners with higher tax burdens and higher costs of capital, the differences will be even more significant.

STRATEGIES TO MAXIMIZE TAX BENEFITS

The significant opportunities for tax deferral are not limited to large corporations with massive investments in depreciable property like Hospital Corporation of America. Small

business managers can also apply *HCA* in many new construction projects, as well as when a used building is acquired. Since they do not ordinarily have in-house tax managers, they may need to rely on independent tax professionals for advice and counsel, and a basic understanding of the component depreciation concept will assist in this process.

Small businesses are often quite sensitive to cash flow variations, perhaps more than larger businesses. So, any efforts like those outlined in this article, that provide cash flow in excess of the related costs might be critical. In essence, a tax deferral is the equivalent of an interest-free loan.

It is also important to realize that this is solely a tax issue. Selecting this approach to tax depreciation does not affect the depreciation calculations for the company's financial statements. Thus, the straight-line method, or whatever other acceptable method the company selects, can still be used in determining financial statement (book) net income. So, this tax deferral can be enjoyed without affecting the amount of income reported to lenders and other investors.

By altering the engineering of a building and making certain that the design conforms to the above discussion, it is possible to qualify certain "building" components for rapid depreciation by making them something other than "building" for tax depreciation purposes. The use of partitions that can be relocated, carpets and wall coverings than can be moved, or the installation of special-purpose electrical circuits which only support a computer system are simple examples. These decisions, of course, must be accompanied by contemporaneous design and cost studies which support the cost allocated to the component. Obviously, the type and function of a building affects the ability to control these factors, but the earlier in the process they are addressed, the more control the small businessperson will have. In addition, the more flexible the taxpayer is, the more likely they will be willing to accommodate certain design changes made to take advantage of the new component depreciation. In addition, certain strategies such as the use of cost-plus contracts or a wider use of subcontractors may make supporting information easier to acquire.

Used buildings also qualify. It is important that the small businessperson employ qualified experts to carry out contemporaneous cost allocation studies to support the allocation of costs to be allocated to qualifying personalty.

The use of a qualified accountant and/or construction experts should increase the likelihood of the IRS accepting the account classifications as valid. The experts should be brought into the process at the earliest possible time—when the building is being designed. In many instances it is likely that the tax savings will be greater than the additional costs of construction and paying for experts.

The payoff, in the form of tax savings, varies widely depending on the amount of the costs that can be considered personalty, since this determines the amount of the depreciation deductions that can be accelerated (due to the shorter lives and the use of accelerated depreciation methods). This is only a timing issue—eventually 100 percent of the cost of the project will be claimed as depreciation regardless of the depreciation method—but, by utilizing component depreciation, taxes can be deferred. Hence, the time value of money becomes an issue. As is shown in the following section, the amount of the savings may be significant. As is demonstrated, this analysis is amenable to simple computation in an electronic spreadsheet that any small businessperson may access.

The most significant aspect for managers is that they be aware that planning early in the process is important. Yes, the tax advisor should be a key contributor in the building design process.

FINANCIAL EFFECTS

Although the tax savings related to component depreciation are evident, their magnitude may or may not be worth the marginal planning effort. Since the benefit is in tax deferral, the actual savings vary widely with changes in marginal tax rates and discount rates. The following table provides estimates of the savings, as a percentage of the total cost of a project, assuming a marginal tax rate of 40 percent. The discount rate is varied from 6 to 10 percent and the percentage of the project that is reclassified as personalty is varied from 10 to 60 percent.

Portion of Project Reclassified	Discount Rate				
	6%	7%	8%	9%	10%
10%	1.88%	1.97%	2.03%	2.07%	2.09%
20%	3.75%	3.93%	4.05%	4.14%	4.18%
30%	5.63%	5.90%	6.08%	6.20%	6.28%
40%	7.51%	7.86%	8.11%	8.27%	8.37%
50%	9.39%	9.83%	10.13%	10.34%	10.46%
60%	11.26%	11.79%	12.16%	12.41%	12.55%

Take, for example, a situation where the discount rate is 10 percent and 30 percent of a project could be reclassified as personalty. The present value of the tax savings is 6.28 percent of the total cost of the project. For a \$100,000 project, this savings is \$6,280. If the additional design and construction costs are less than \$6,280, a net savings is enjoyed. Otherwise, the redesign should be rejected, unless there are other benefits.

The reclassification may be as simple as altering the design so certain components can be removed or reused. It could involve changing the methods of attachment.

CONCLUSION

Small business managers have long been aware that accelerated depreciation provides benefits in the form of deferred taxes. This study illustrates that magnitude of the savings available when steps are taken to reclassify certain costs of construction projects as personalty rather than realty. The desired results can best be accomplished by involving the tax consultant in the building design or purchase project earlier rather than later.

ⁱ 109 TC 21 (1997)

ⁱⁱ IRS Legal Memorandum 199921045

- iii 33 TC 241 (1959)
- iv IRC § 1245. Section 1245 includes depreciable personalty plus certain real property other than a building and its structural components, as specified in this paper.
- v IRC § 1250. Section 1250 property includes all depreciable property other than § 1245 property.
- vi *Accelerated Cost Recovery System* (Internal Revenue Code [IRC] § 168 as applicable for assets placed in service from 1981 to 1986).
- vii See Note i
- viii This is the present value of the annual deduction for depreciation ($\$500,000 / 39$) for each year for 39 years. The mid-month convention was ignored since it is immaterial to this comparison.
- ix This is the present value of $\$250,000$ depreciated over 39 years and $\$250,000$ depreciated over 7 years (14.29, 24.49, 17.49, 12.49, 8.93, 8.93, and 4.46 percent, respectively, for years 1 through 8).

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APPENDIX--ACCELERATED COST RECOVERY SYSTEM

ACRS applies to all eligible tangible assets placed in service after 1980. It was subsequently modified for assets placed in service after 1986 (MACRS). Under MACRS tangible personal property falls into one of six classes, with most assets falling into the five or seven year depreciable life classes. Real estate is either 27½ year residential property or 39 year nonresidential real estate.

Tangible personal property generally qualifies for the double declining balance method of depreciation. Salvage value is ignored and a half-year convention usually applies.

Taxpayers may also elect to expense the cost of a limited amount of depreciable tangible personal property placed in service in an active business. For property placed in service in years beginning in 2001 and 2002, the limit is \$24,000, increasing to \$25,000 thereafter. Excess amounts must be depreciated under the above methods.

Real estate is depreciated using the straight-line method. Salvage value is ignored and certain conventions apply. Under MACRS, the definition of real estate is relatively straight forward, but property law is not always consistent with the definition. Residential rental property is any building or structure if 80% or more of the gross rental income is from dwelling units. Nonresidential real property means § 1250 property (i.e., realty) that is not either residential rental property or property with a class life of less than 27.5 years. Thus, § 1250 property is real property, excluding certain assets that are § 1245 property (i.e., equipment).

Assets that may, in fact, be real property under state law, but still qualify as § 1245 property, include properties that are not part of a building or its structural components, are tangible, and are used as "an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage services." Additionally, certain single purpose agricultural structures, horticultural structures, and storage facilities also qualify. These assets qualify for more rapid depreciation.

Nonresidential real property specifically excludes § 1245 property (equipment), including certain real property that qualifies as § 1245 property. Examples of the latter would be a single-purpose milking parlor for a dairy farm. Another, more common example, would be wiring designed into a building and installed when the building was constructed for the purpose of providing power to the company's computers.