What is Cost Segregation?

Cost Segregation is a strategy for accelerating depreciation, reducing taxes, and increasing cash flow. Through an engineering-based cost segregation study, costs associated with the purchase, construction, or renovation of a building are segregated into components. Before a cost segregation study, these costs are typically assigned a 39 or 27.5- year depreciable life for tax reporting. But by using the study results, a taxpayer can reclassify component costs to shorter depreciable lives of 5, 7 or 15 years, accelerating depreciation deductions and increasing cash flow by deferring federal and state income taxes.

What Qualifies

The determination of what property qualifies for shorter depreciable lives is ultimately based on asset-specific facts and circumstances and precedents existing in both case law and IRS guidance. Determinations are made based on the data obtained from construction/cost records and information gathered during the site inspection. Key considerations include whether the property can be easily or readily moved, was it intended to remain in place, and does it relate to the basic operation and maintenance of the building.

Anyone who owns real estate and expects to pay income taxes during the period of ownership can potentially benefit from a cost segregation study. Studies are most beneficial for properties with a cost basis greater than $500,000, but even lower basis amounts can find value from a study.

Benefits

There are numerous benefits from obtaining or performing a cost segregation study. By accelerating depreciation and increasing tax deductions in the early years of property ownership, a property owner:

- Increases their cash flow, not only potentially improving investment returns, but also positively affecting relative debt service coverage ratios,
- Is provided with the opportunity to correct previously misclassified assets, allowing the taxpayer to claim a catch-up adjustment for the difference, and
- May be able to reduce real estate taxes.

Are you ready to increase the cash flow of your investment? Contact us today!

*Information is provided by A.C.R.S. (Bradley Leggett)

FREQUENTLY ASKED QUESTIONS

How much should I expect to save with a cost segregation study?

The average study will allocate, or reallocate in the case of a look-back study, anywhere from 20 – 35% of the depreciable cost basis to a shorter life. For every $100,000 moved from 39-year to 5-year, the 10-year net present value savings is approximately $28,000 (based on a 40% tax rate and a 4% discount rate).

Are cost segregation studies recognized by the Internal Revenue Service (IRS)?

Yes. The Internal Revenue Service recognizes properly prepared cost segregations as a valid tax benefit. And current IRS procedures allow a taxpayer to reflect the tax benefits on a current return without amending prior year returns.

Will a cost segregation study put me at higher risk of an IRS audit?

Studies performed in the first year property is placed in service do not generate any higher risk. However, retroactive studies are slightly more susceptible to audit, because they require the filing of a Form 3115 that is reviewed by a special unit within the IRS. The risk is generally very low and can be mitigated by using a reputable, qualified firm to perform the study.

Can cost segregation studies be performed on buildings placed in service in the past?

Look-back studies can be performed on properties placed in service as far back as January 1, 1987. Of course it may not make sense to perform a study on a property that was place in service more than 20 years ago, but the facts and circumstances will ultimately be the deciding factors.

Doesn’t my CPA already do cost segregation for me?

Probably not, because CPAs simply do not have the engineering expertise necessary to properly break-out all of the assets (costs) that are considered in a cost segregation study.

What is the impact on the subsequent sale of a property?

When a property is sold, a gain or loss will be recognized. Typically, gains are taxed at the lower capital gains rate. However, the amount of gain equal to prior depreciation deductions will be taxed at ordinary rates. This is referred to as “depreciation recapture.”

When should a cost segregation study be performed?

Circumstances vary, but generally studies are beneficial in situations where building costs are at least $500,000 and the owner intends to hold the property for at least five years. However, under the new 100% bonus depreciation rules, studies may be feasible at lesser amounts. Ask for a free benefits analysis to be sure.

Is the positive impact of a cost segregation study usually immediate?

Yes. First year’s tax savings usually exceed the cost of the study and the fees are tax deductible.

Does a cost segregation study increase the depreciation deduction?

No. It just allows businesses to accelerate a portion of the depreciation instead of taking it equally over a longer period of time. This increases cash flow in the early years of property ownership via reduced taxes.

What types of businesses typically benefit from a cost segregation study?

Acquisitions, renovations, or new construction projects may benefit as well as buildings constructed or purchased years ago.

Types of property that often benefit from a cost segregation study include:
• Apartments
• Automobile Dealerships
• Banks
• Grocery Stores
• Hotels/Motels
• Manufacturing Facilities & Plants
• Medical Centers
• Office Buildings
• Restaurants
• Retail Stores
• Senior Living Facilities
• Warehouses