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November, 2009

Cost Segregation: Why You Can Benefit From a Comprehensive Study

Have you or your clients constructed, purchased, expanded or remodeled any kind of commercial real estate in the last 10 years? If so, cost segregation is a strategic tax deferral tool that allows companies and individuals to increase cash flow by accelerating depreciation deductions on their buildings.

How Cost Segregation Works

A cost segregation study is an engineering process, recognized and accepted by the Internal Revenue Service (IRS), that identifies building costs and land improvements that traditionally are depreciated over long periods (27.5 to 39 years). The study is the vehicle to re-allocate a significant portion of these costs to asset classes with shorter lives. This results in accelerated depreciation, significant tax savings and therefore increased cash flow.

What qualifies for a Cost Segregation Study?

Nearly any type of commercial property can benefit from a cost segregation study, including (but not limited to) office buildings, industrial/manufacturing facilities, retail centers, single tenant retail, hotels and apartment buildings. As a general rule, anyone who has purchased or constructed a commercial property since Jan. 1, 1987, with a depreciable basis in excess of \$900,000, or who has made interior improvements of \$450,000 or more, will likely benefit from having a cost segregation study preformed.

Because of depreciation recapture, cost segregation is generally not cost effective for taxpayers who plan on holding the property for three years or less. However, taxpayers who have the right type of exchange strategy in place can utilize this to defer any depreciation recapture, along with any gains, as long as they perform a cost segregation study on the replacement property.

Since cost segregation helps those with taxable income, timing is important. If clients are in a situation where they can make use of additional deductions, cost segregation studies should be employed as soon as possible to take advantage of the time value of money. However, clients who never utilized cost segregation in the past, since their property was not generating enough income at the time, can have the study performed and retroactively correct the depreciation as if they had previously completed the study. This is allowed via Revenue Procedure 2008-52. By performing this "look-back" cost segregation study, all missed depreciation deductions from prior years can be used to offset income in the current tax year through the filing of *Form 3115 – Application for Change in Accounting Method*. All this without having to file an amended return!

What Are The Methodologies Used in Preparing a Study?

A successful cost segregation study comprises elements of the engineering, architectural, accounting and tax disciplines. The IRS prefers the more accurate use of an engineering-based approach in identifying and reclassifying construction costs into applicable segregated categories.

According to the *IRS Cost Segregation Audit Techniques Guide*, preparation of cost segregation studies requires knowledge of both the construction process and tax law involving property classifications for depreciation purposes: "The detailed engineering approach from actual cost records, or 'detailed cost approach,' uses costs from contemporaneous construction and accounting records. In general, it is the most methodical and accurate approach, relying on solid documentation and minimal estimation."



Case Study

A client purchased an Ambulatory Surgical Center for \$2.7 million. Results of the cost segregation study provided for reclassification of \$170,000 to 15 year property and \$1.3 million to 5 year property. This resulted in additional depreciation in year 1 of \$230,000 and additional depreciation in years 2 – 4 of \$745,000. The study provided the client a savings of approximately \$390,000 in taxes over the 4 year period.

Why Do You Need a Specialist?

While many CPA's are aware of the benefits surrounding cost segregation, they often do not employ true engineering-based methods: therefore, only a small number of building components are identified for accelerated depreciation. Many times, where building cost information is not available, the entire cost of the building is depreciated over the 39 or 27.5 year life assigned to real property. In this situation, property owners are incorrectly depreciating their assets and not taking full advantage of the benefits currently available from the tax code. But through an engineering-based cost segregation study, a wide range of building components, such as electrical installations, plumbing, mechanical components and finishes can be identified and reclassified into the shorter-lived asset classes. The studies allow property owners to accelerate the depreciation on as much as 25-60 percent of typical buildings.

Cost segregation specialists do not replace the essential role the CPA plays in tax planning and preparation; rather the two complement each other. The cost segregation firm is merely assisting the CPA with one line item of the clients' tax return. Cost segregation utilizes a unique combination of construction estimating and tax expertise to properly dissect construction information, compute estimates, and identify subcomponent costs. For new construction, a review of construction invoices alone is not sufficient and for acquired properties, construction cost information is frequently not available or is incomplete. Many CPA firms lack either the necessary tax expertise to properly segregate the different types of property, or the engineering expertise necessary to analyze construction drawings and conduct engineering cost estimates. It is important to understand that IRS agents are trained to review the preparer's credentials and level of expertise as part of an audit, since that can influence the quality and accuracy of a cost segregation study.

Additionally, there are no set rules that you can use to determine if property is eligible. For example, a light fixture in one room may qualify as Sec. 1245 property (property eligible for a shorter accelerated depreciable life), while the exact same light fixture in the very next room may not qualify because of various factors and circumstances on how and why it's being used. This applies to every asset in the building, and the onus – to prove and substantiate that each asset qualifies – is on the taxpayer. This is done by understanding the characteristics of each asset and knowing the circumstances for which your position can be supported.

A Valuable Strategy

Cost segregation is one of the most valuable tax planning strategies available to commercial real estate owners today. Effectively, cost segregation studies provide more precisely segregated property information, enabling building owners to achieve the maximum tax benefit allowed by law, which can have a direct and sizable impact on their cash flow.

Without utilizing this tool, taxpayers are providing the IRS an interest free loan for many years.

There was a period when having a cost segregation study preformed was a good idea. In today's economic environment –it's not only a sound idea, it's critical in order to protect your cash flow.

About the author: *Garry E. Adams, CPA, CCIM has over 25 years of CPA, finance and commercial real estate development experience. Garry is President of Capital Realty, Inc., a financial and real estate services firm based in Sherman Oaks, CA. He is also associated with Cost Segregation Partners. Cost Segregation Partners is a full service firm with CPAs and construction engineering professionals backed by the 5th largest CPA firm in the U.S. (RSM McGladrey). Garry E. Adams can be reached at (818) 907-7235 and gadams@CapitalRealty.net.*