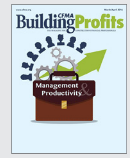

BY RICH SHAVELL

Understanding Cost Segregation Studies & Potential Tax Benefits

Most CFMs know about depreciation and the specialized rules that should be scrutinized to ensure all potential tax deductions are considered. A cost segregation study can help CFMs and property owners accelerate depreciation deductions, resulting in increased tax deductions and thereby increasing cash flow.

This article will present an overview of the cost segregation study process and its potential tax benefits.

Overview

A cost segregation study is a financial and engineering study of new or existing properties or improvements to identify tangible personal property and other improvements that qualify for shorter tax depreciable lives. The study enables acceleration of federal (and sometimes state) income tax depreciation, which can result in federal income tax savings.

Let's consider an example: A business owner purchases or builds a facility for his or her operation that would be depreciated over 39 years. If a portion of the property can be depreciated quicker, then the owner's taxes would be lower in the immediate future because of the increased deductions. In the end, the entire cost of the property (except land) is depreciated, but the cost segregation study enables the acceleration by identifying assets that are 5-year, 7-year, or 15-year property.

Let's quantify the example and assume the commercial property is purchased for $4 million, with 15% representing land; that is, $3.4 million will be depreciated. The cost segregation study determines that $450,000 of the purchase price represents land improvements that can be depreciated over 15 years and another $400,000 represents 5-year property. Thus, $850,000 of the $3.4 million – or 25% – can be depreciated more quickly.

At the end of the 39-year period, the entire $3.4 million is depreciated, but 25% of the depreciation deductions were taken earlier than they would have under the lengthy 39-year schedule.

It's critical to evaluate the present value of the accelerated deductions tax impact *after* vs. *before* the study. Notwithstanding the current low rate of borrowing, which is quite favorable, a realistic rate for the discount factor might be the company's internal rate of return. The result is often favorable regardless of the chosen discount rate.

The Cost Segregation Study Process

Before proceeding with the cost segregation study, a feasibility analysis should be conducted to conclude if sufficient tax benefits exist. There are several limitations and factors to consider, including:

- The legal entity structure and whether there is sufficient tax basis in pass-through entities to take accelerated depreciation deductions must be assessed. In some cases, property in S corporations with limited shareholder basis can restrict tax losses that could be reported. The results of the cost segregation study could produce or augment tax losses. C corporations can also produce net operating losses resulting in limited or no immediate tax benefit.
- The owner's strategy for the property. If the property is expected to be sold in the near future, it may not make sense to increase depreciation deductions only to face recapture of those tax benefits in a relatively short period of time.
- The nature of the owner's business and the effect of the passive activity loss (PAL) rules, which can limit the taxpayer's (or other partners/shareholders/members) ability to immediately use the increased deductions. However, if the property owner meets the criteria for a real estate professional, then the PAL rules may not be a limiting factor.
- The alternative minimum tax (AMT) could also limit immediate use of the increased deductions.

Before moving forward with the study, be clear on whether or not the increased tax benefits can actually be utilized.

Next Steps

A cost segregation specialist typically performs the following steps:

A cost segregation study can help CFMs and property owners accelerate depreciation deductions, resulting in increased tax deductions and thereby increasing cash flow.

1) Conduct a physical inspection of the property to visually see and discuss special or unique building construction.

2) Evaluate the purpose and function of specific property that can be considered "tangible personal property" or "non-structural building components" for accelerated tax depreciation.[1]

3) Review and analyze data provided by the property owner (e.g., appraisal reports, blueprints, as-built drawings, etc.).

4) Photograph special building components to visually document specific items that would qualify as tangible personal property or non-structural building components.

5) Develop a list of items considered to be tangible personal property or non-structural components and determine the appropriate cost of the items as adjusted for the condition of the property.

6) Determine if cost allocations and owner-incurred costs may be considered part of tangible personal property or non-structural building components.

7) Compile documentation for the qualifying assets and develop schedules that isolate:

- Qualifying items;
- Direct costs for each item; and
- Allocable fees and overhead items.

8) Specify appropriate cost recovery periods and consider existing tax authorities (e.g., the IRC, regulations, IRS rulings, and court opinions) to determine the cost recovery life for each asset group.

9) Assist with and coordinate the reconciliation of the identified costs to the books and records (or accounting ledgers) with the CFM and external CPA.

10) Provide a written report of conclusions that meets IRS documentation requirements.

11) Provide a present value calculation showing the estimated cash flow (tax savings) resulting from the cost segregation study to the owner.

12) If necessary, complete IRS Form 3115, Application for Change in Accounting Method and requisite schedules for filing.

New Construction

For new properties, other rules – such as bonus depreciation, special expensing rules for leasehold improvements, and (in certain cases) section 179 expensing – may have an impact.

Each of these, if applicable, will likely enhance the benefits of the cost segregation study. In some cases (particularly for bonus depreciation and section 179 expensing), the impact is quite dramatic.

Conclusion

According to the IRS Chief Counsel Advice 199921045, "An accurate cost segregation study may not be based on non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records."

Accordingly, to realize the potential increase in cash flow, CFMs should consider a cost segregation study close to when new construction is completed or acquisitions by purchase are closed.

A cost segregation study can save the property owner taxes, mitigating the carrying cost of the property. A CFM's financial acumen and ability to communicate the value of this study can put the contractor in the best position to ensure it is effectively completed once the project concludes. ■

Endnote

1. A full discussion of these terms for federal tax purposes is beyond the scope of this article. Refer to "Cost Segregation Studies: Accelerating Tax Depreciation" in the November/December 2002 issue of *CFMA Building Profits (www.cfma.org/nd2002_tax)* for an in-depth review, including pertinent court cases such as *Hospital Corporation of America v. Commissioner*, 109 TC 21 1997) and *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975).

Catch-Up **Depreciation**

Form 3115 reports the change in depreciation lives and the tax impact to the IRS.

Form 3115 is only necessary if there is "catch-up" depreciation due to the property being placed-in-service prior to the current tax year. For properties placed-in-service after 1986, a study can be done after the initial year and the cumulative increased depreciation for those prior years can be deducted on the very next tax return to be filed.

In some cases, property owners have delayed studies because they have not faced significant tax liabilities subsequent to the onset of the Great Recession. However, a potential cost segregation study can be revisited now that profits and corresponding taxes have a more pronounced impact.

Additional **Resources**

1. **Shavell, Rich. "Cost Segregation Studies: Accelerating Tax Depreciation."** ***CFMA Building Profits*** **November/December 2002.** *www.cfma.org/nd2002_tax.*

2. **Internal Revenue Manual Cost Segregation Audit Techniques Guide.** *www.irs.gov/Businesses/Cost-Segregation-Audit-Techniques-Guide---Chapter-1---Introduction.*

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