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Cost Segregation: Real Estate Owners Can Receive Tax Savings and Put Immediate Cash in Pocket

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Businesses, Real Estate Investors and individuals can enjoy many economic advantages by owning real estate, but many property owners fail to take advantage of all the benefits available from the real estate they own. A cost segregation study can provide tremendous tax benefits and substantially increase cash flow for real estate owners.

There are well-known advantages for a business to own real estate—it effectively locks the monthly expense of office and operating space instead of paying escalating rent to someone else and the property's appreciation adds additional value to the business.

There are also tax benefits to consider such as interest, property tax, and depreciation deductions. The problem with depreciation deductions is that properties are depreciated evenly over 39 years even though many parts of the properties must be replaced before 39 years. This long period of time greatly reduces the tax benefit because of the time value of money. Even worse is that the cost of land is not recovered for tax purposes until it is sold.

Cost Segregation can help remedy the deprecation problem. Changing the way depreciation is taken by using cost segregation can tremendously improve the available tax benefit. Cost segregation is a valuable tax strategy that views depreciable property not just as a single building and land but as several elements of personal property and land improvements. The tax advantages and resulting tax savings come from accelerating depreciation. This acceleration reduces current and near future taxes and generates an immediate cash flow benefit. That's right cash in you pocket now!

A LITTLE HISTORY

To understand the significance of this opportunity, it is helpful to understand how it is different from prior tax treatment. Before 1981, taxpayers were allowed to break their real estate into components. A building, for instance, would be sorted into separate components. The roof would be one component while the shell would be another component. Each component was depreciated over a different lifetime. The shell in this case would be depreciated over 40 years and the roof over a 15 or 20-year recovery period. The result of this "componentization" was that the building as a whole would be depreciated on average over a composite life of 20 to 25 years.

With the passing of the Economic Recovery Act of 1981, the use of component depreciation was repealed. The new tax act introduced the accelerated cost recovery system (commonly abbreviated as ACRS, pronounced as "acres"), which required real estate to be depreciated over a 15-year life. The loss of component depreciation to business was not a big issue since it was replaced with a short depreciable life.

But the 15-year life did not last long. The Tax Reform Act of 1986 increased the depreciable life of real estate to 31.9 years for nonresidential property and 27.5 years for residential property. The depreciable life for nonresidential property is now 39 years. The result of the 1986 changes is that real estate owners are limited by long depreciation lives that are not economically realistic and that reduce the tax advantages of owning real estate. Since componentization was previously done away with, there was no longer a way to depreciate parts of a building, like a roof, that will not likely last 39 years.

Although the introduction of ACRS, and its successor modified accelerated cost recovery system (MACRS), eliminated the component method of depreciation, the courts have upheld that businesses can still use cost segregation to break out some of the costs of real estate.

The authority to segregate costs comes from the 1997 case *Hospital Corp. of America*[i]. The court found that the definitions of personal property used in related sections of the Internal Revenue Code allowed Hospital Corp. of America to use a segregation technique that resulted in many parts of their hospitals being classed as personal property with depreciation lives much shorter than 39 years.

The IRS reluctantly agreed[ii] that cost segregation does not constitute component depreciation and accepted cost segregation as a qualified method of allocating costs to personal property. However, the IRS also said in part[iii] "accurate cost segregation study may not be based on noncontemporaneous records, reconstructed data or taxpayers' estimates or assumptions that have no supporting records". The IRS has since provided additional guidance regarding what is considered to be sufficient support for a cost segregation study.

SEGREGATING COSTS

Cost segregation studies make it possible to identify assets installed in a building and account for them separately. The costs attributable to those segregated assets are reclassified from the building or real estate costs and allocated to the segregated assets. This personal property can then be depreciated over lives ranging from 3 to 20 years. The most common lives of personal property segregated from a building are 5, 7 or 15 years.

The savings can be significant. To illustrate, for each $100,000 in assets that can be reclassified from a 39-year recovery period to a 5-year recovery period can result in a net present value of $16,000[iv].

A cost segregation study segregates costs of real estate into four basic categories—personal property, land improvements, building, and land.

Personal property is typically depreciated over 5 or 7 years. In addition to a shorter life, personal property is depreciated using an accelerated rate that frontloads depreciation in the earlier years (the double-declining-balance method). This method generates the most dynamic tax benefits. This category includes assets such as furniture, carpeting, fixtures, window treatments, and equipment.

Land improvements include sidewalks, paving, fences, and landscaping. This category is depreciated over a 15-year recovery period also using an accelerated method, but not as accelerated as personal property (the 150% declining-balance method). A significant benefit can be derived from this category as well.

Although the most significant benefits from a cost segregation study results from maximizing the costs allocated to personal property and land improvements, there are also benefits to segregating the costs associated within the building category. All costs associated with the building structure will still be depreciated over a 39-year recovery period using the straight-line method but if the building costs are segregated into separate building components and if one of the components is later replaced, the un-recovered costs allocated to that component are then fully deductible for tax purposes.

The key to a cost segregation study is that it must be conducted by professionals with expertise in tax regulation, building and engineering. This typically requires a team of CPA's and engineers to produce a report that satisfies the IRS' requirements and that is substantiated to withstand the scrutiny of the IRS if audited. The good news is that there is solid guidance compiled from court decisions and IRS publications that qualified professionals can rely upon to conduct an accurate study and produce a quality report.

TIMING OF A STUDY

A cost segregation study can be used for buildings under construction, recently built or purchased, or existing buildings in service. Even if a business doesn't own the building but made leasehold improvements to it, the company may be able to benefit from a cost segregation study. Many types of buildings qualify for studies they include: Auto Dealerships, Apartment Complexes, Golf Courses, Health Care Facilities, Hospitals, Hotels, Motels & Resorts, Industrial, Investment, Manufacturing, Medical Centers, Nursing Homes, Office Buildings, Recreation Facilities, Restaurants, Retail Chains, Sports Facilities, Strip Malls, Supermarkets and others.

For buildings that are already in service there is a catch-up provision that could make it very attractive to do a study—any amount that could have been deducted previously had the study been conducted when the building was first placed in service by the current owner can be deducted in one lump sum on the current period's tax return. This can be a tremendous benefit if a building was placed into service in a year from 2001 to 2003 because the personal property may also qualify for a 30% or 50% bonus depreciation deduction.

ADVANTAGES & DISADVANTAGES

There are many other advantages to cost segregation; in addition to the immediate tax savings and cash flow increase mentioned above, some other advantages (*or benefits*) include insurance savings and estate tax planning.

Cost segregation may allow you to get insurance savings. By providing a cost segregation report to you insurance underwriter, the insurance company can better understand their risk and accurately rate insurance. The insurance savings alone can often be more than the cost of the study.

Cost segregation in estate planning can create wonderful benefits by accelerating deprecation on the same property multiple times.

Many of benefits of a cost segregation study are pretty apparent. Although there are some potential disadvantages that should be considered—however they are usually outweighed by the advantages.

Anyone considering a study should always consult experts in this area to analyze any impact and all the facts surrounding this technique.

Deprecation is a deduction based on time and is subject to recapture rules when the depreciated asset is sold. Any gain associated with the sale of real estate that is made up of deprecation recapture cannot be deferred in an installment sale. Even though this can be negative it can be planned for if known about in advance.

CONCLUSION

The bottom line with real estate deprecation is that there are benefits available to those willing to do some homework and segregate the costs of buildings. Accelerating the depreciation will allow one to maximize current tax savings and enjoy increased cash flows. This means significant benefits for those that employ component experts to conduct a study.

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[i] *Hospital Corp. of America, v. Commissioner,* 109 TC 21 (1997)
[ii] IRS Decision No. CC-1999-008
[iii] IRS Chief Counsel Advisory 199921045
[iv] Assuming a 5% discount rate and a 35% marginal tax rate.

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