Release the Cash in Your Property by Applying Cost-Segregation Techniques

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Publication: East Bay Business Times

Publication Date: September 26, 2005

If your clients own commercial or residential rental property and dutifully deduct 1/39th or 1/27.5th of its value each year, they are leaving money on the table. The 39-year figure represents the depreciable life of a commercial building while 27.5 years represents the depreciable life of a residential income property.

While the entire value of the property or leasehold improvement is recovered during the 39- or 27.5-year span, the IRS allows components of the costs to be recovered much quicker, over five, seven or 15 years. This means more money in your client's pockets immediately, not later.

Ask the client if they would rather recover the costs today or wait 39 years. Approximately 20 percent to 30 percent of a building's components can be reclassified into shorter-life property and the corresponding costs recovered that much sooner. For every dollar a cost segregation specialist moves from 39-year property to a five-year property, the total net present value benefit equates to approximately 22 cents. Any structure used in a business environment is eligible for the benefits of cost segregation.

If you are a CPA, or an attorney who has real estate clients, and haven't heard the term 'cost segregation' yet, you will undoubtedly hear more about it in the near future. Since the IRS released its 121-page Cost Segregation Audit Techniques Guide last September, the buzz about the topic has never been greater.

Even though cost segregation has been around for more than 20 years, it is only now finally becoming mainstream. In 1986, Congress abolished the Investment Tax Credit and stretched the depreciable lives of buildings from 19 to 31.5 years, and now to 39 years - 27.5-years for residential income property. Taxpayers saw their normal deductions on property reduced significantly. It was around that time the Big Eight accounting firms began to pioneer cost segregation in its current form and started recommending it to their larger clients. The idea was simple: All buildings contain components and fixtures necessary for taxpayers to run their businesses. These items are not necessary for the ordinary operation and maintenance of a building and should not be considered 'structural components' of the building. Conversely, they are defined as tangible personal property or land improvements. Even though the IRS did not allow component-depreciation under MACRS (the Modified Accelerated Cost Recovery System), the Tax Court ruled in 1999 that items in a building that qualify as tangible personal property under the former ITC rules may be separately depreciated under MACRS as personal property.

So how does all of this translate into dollars?

Consider the following example. A taxpayer constructs an apartment building for $2.1 million and places it in service in the same year. The client's CPA identifies that $100,000 is for furniture and equipment such as stoves, dishwashers and other appliances. The remaining $2 million of project costs are treated as 27.5-

year property until a cost segregation study is performed. The cost segregation specialist finds that an additional 16 percent of the construction-related costs should have been reclassified to a five-year life and 9 percent of the cost to a 15-year life. Further assume a combined 41 percent federal and state tax rate. The potential benefits derived from a cost segregation study could be significant whether a company is adding a $500,000 expansion or building a new $40 million hotel.

It gets better. Let's assume that your client purchased that building within the last 18 years, and has been depreciating the building with the traditional straight-line approach. What happens to the 16 percent to 25 percent of the property that should have been fully depreciated at this point? Surprisingly, your client can recover in one year. The IRS allows an automatic change in depreciation (IRS Form 3115). Take the depreciation - all of it - in one year. Write it off against this year's income. Pay fewer dollars in income tax, without amending past returns.

Typically, cost segregation clients achieve a return on investment of 20 to 1. Each building and every study is different. Different types of buildings require a more detailed analysis, such as hospital vs. warehouse, and different information is available from each company. These factors figure into the cost of the engineer's time to complete the study. A good cost segregation firm will give you and your client a complete fee proposal, including estimated tax savings, so that you and your client can determine how the benefits outweigh the costs for your specific situation.

For many taxpayers that own commercial real estate, cost segregation is a slam dunk. It offers an easy, turnkey opportunity to significantly reduce taxable income. Today, more attorneys and CPAs are recommending the service to their clients.

If you would like more information on Cost Segregation please contact Chattel With Us, LLC. at (866) 788-4925.