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REAL DEAL

COST SEGREGATION MEANS TAX SAVINGS

BY CATHERINE MILLER

ITEMS THAT MAY BE CONSIDERED personal property include light fixtures, landscaping and some wiring and plumbing.

What is cost segregation? The short answer is, "A smart tax strategy for many commercial property owners."

Cost segregation is identifying the parts of a piece of real property that qualify as personal property and depreciating those parts separately from the rest of the property. This accelerates federal tax depreciation on segregated components, reducing current income tax payments and increasing net cash flow.

"Cost segregation allows property owners to access some of the most taxpayer-friendly changes to the tax law in recent history," says Ed Allen of DASI Consulting, a firm specializing in cost segregation studies. "Current year benefits can be substantial for properties ranging from privately owned doctors' offices to trophy properties in downtown metropolitan areas. In most cases, thousands of tax dollars can be deferred."

A cost segregation study should be conducted by qualified engineers to determine what parts of the structure are personal property. Items as diverse as light fixtures, landscaping and certain wiring and plumbing potentially qualify.

The study can be done after a building is completed. An outside consulting firm would review blueprints and invoices and do an on-site inspection to determine what components qualify as personal property.

The additional accounting and engineering costs involved with cost segregation mean that not every property is ideal for this accounting method. According to Allen, ideal properties are those with capitalized costs of more than $750,000 or capitalized net leasehold improvements of more than $350,000. If a taxpayer owns multiple commercial properties, the properties can be aggregated to meet these guidelines.

Triggering events for considering cost segregation are purchase or acquisition of a property; building a new facility; renovating, expanding or remodeling an existing property; leasing a property and paying for buildouts or leasehold improvements. Taxpayers with unclaimed depreciation benefits from as far back as January 1987 could also benefit from such a study.

Before 1997, the Internal Revenue Service did not allow taxpayers to depreciate components separately from a building. In that year, the Tax Court ruled in favor of a taxpayer who separated building costs into personal and real property components. Since then, the Internal Revenue Code has become even friendlier regarding cost segregation.

Automatic consent of change from one permissible method of depreciation to another is allowed, with no filing fee and no automatic review process after filing. This means taxpayers can correct tax returns back to January 1987 for property that qualified for cost segregation.

Even better, beneficial adjustments can be taken into account in the year of change rather than being spread out over several years.

Best of all, first year expensing election (Section 179) for certain personal property is now $102,000.

Cash flow savings can be substantial considering that indirect construction costs may contain 15 to 25 percent personal property that qualifies for accelerated depreciation. Even expenditures considered direct costs may incude personal property that meets cost segregation requirements.

Section 179 depreciation deduction is limited to taxable income. If income is less than $102,000, the excess can be carried to the succeeding year. All figures mentioned so far have been for 2005. For qualifying property in 2004, the Section 179 election is $100,000, but it is possible to take advantage of bonus depreciation, which in many cases can increase the deduction even more than in the example.

While the example is simplistic, actual computations take into account the different types and classifications of personal property and other complexities of the tax laws. Many other factors such as legal entity structure, alternative minimum tax considerations, passive loss rules and length of time the property will be held should factor into the decision about whether or not to segregate costs.

Cost segregation is not recommended without an independent cost segregation study performed by qualified engineers, nor is it recommended without consulting your tax preparation professional.

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COST SEGREGATION versus STRAIGHT-LINE DEPRECIATION

New commercial building valued at $2 million after land costs are removed, purchased on January 1, 2004.

Using Straight-Line Method

$2,000,000 / 39 years, straight-line depreciation	
First-Year Depreciation without Cost Segregation	**$51,282**

Using Cost Segregation Method

The cost segregation study determined that 15 percent of the building is personal property that qualifies for the Sec. 179 election (up to $100,000) and that it has a seven-year personal property life.

Non-Personal Property Portion	
$2,000,000 × 85% / 39 years	$43,590
Personal Property Qualifying for Sec. 179 Election	100,000
(expensing immediately of $100,000)	
First Year 50% Bonus Depreciation of Personal Property	
$2,000,000 × 15% = $300,000	
Less $100,000 Sec. 179 Election = $200,000	
$200,000 × 50% Bonus	100,000
(write off remaining $200,000 at 50 percent rate)	
Remainder of Personal Property	
$2,000,000 × 15% = $300,000	
Less $100,000 Sec. 179 Election and $100,000 Bonus Depreciation = $100,000	
$100,000 × 14.29% (MACRS 7 year, half year convention).	14,290
(Only $100,000 of the $300,000 is left to depreciate over time)	
First-Year Depreciation with Cost Segregation	**$257,880**
Increase in First-Year Depreciation Using Cost Segregation	**$206,598**

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