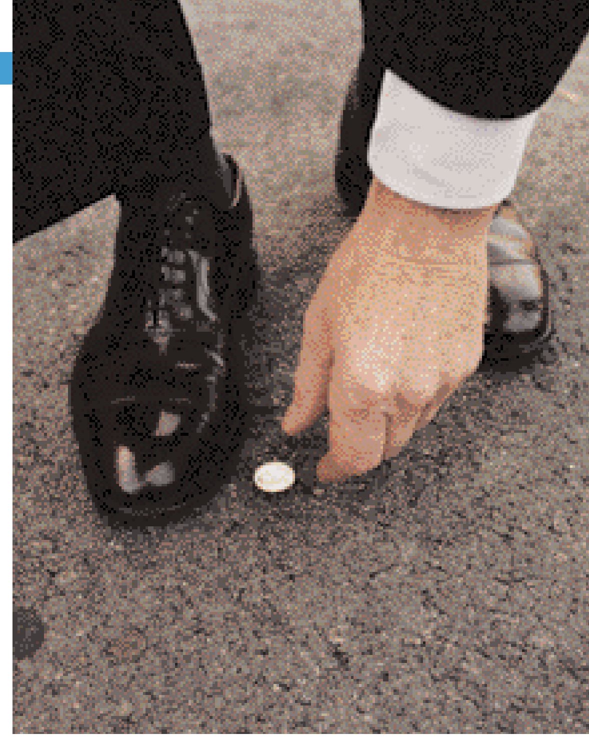


Money Found

Cost Segregation Studies Can Help Clients Realize Tax Savings

BY ANGIE GRAINGER, CPA

Cost segregation is one of the IRS' cash-flow secrets that CPAs, financial planners, real estate investment managers and other professionals can use to realize tax savings for their clients.

Such studies separate personal property (fixtures, lighting, etc.) that have shorter cost recovery periods than real property, such as commercial buildings, assisted living facilities and residential rental units. This allows accelerated tax depreciation deductions on shorter life assets that may have been originally classified as real property ("The Best of Both Worlds," *Journal of Accountancy*, August 2005).

COST SEGREGATION GUIDANCE

Seeing an increasing number of taxpayers use cost segregation studies, the IRS issued the *Cost Segregation Audit Techniques Guide* in 2004 to assist their examiners in reviewing such studies and how the IRS evaluates them during an audit.

The ATG also provides guidance on substantiation related to costs versus estimates, requirements of documentation of backup sources and discusses cost segregation's evolution from its origins in the Investment Tax Credit to current practices.

As the legal support to use cost segregation studies for computing depreciation, the ATG cites *Hospital Corporation of America v. Commissioner* [109 T.C. 21 (1997)].

The sunsetting of investment tax credit in 1981 raised concerns about the sustainability of cost segregation as a means of classifying assets. The U.S. Tax Court ruled in *Hospital Corporation* that property qualified as personal property under the investment tax credit rules would also qualify for purposes of federal tax depreciation under IRC Sec. 168.

Following the court's ruling, the IRS acquiesced to the use of investment tax credit rules for asset classification purposes (AOD CC-1999-008).

Following the court's decision, the IRS issued a Legal Memorandum in 1999 which stated that reclassification of assets into shorter lives for purposes of depreciation would not be contested by the IRS (ILM 199921045. TNT 104-65 Apr. 1 1999).

The Memorandum advises IRS field agents to confirm that the classifications are based on a detailed cost segregation study performed by qualified experts with appropriate technical skills.

FEASIBILITY STUDY

The first step in a cost segregation study is determining whether it's feasible, which includes:

- determining whether the taxpayer will benefit from the accelerated tax deductions;
- reviewing the asset to preliminarily determine the expected amount of personal property to reclassify;
- determining the net present value of the estimated tax savings;
- asking whether the taxpayer intends to hold the asset for the long term;
- determining the effect of the study on any IRC Sec. 1031 transactions relative to the property; and
- comparing these factors to the expected cost of the study.

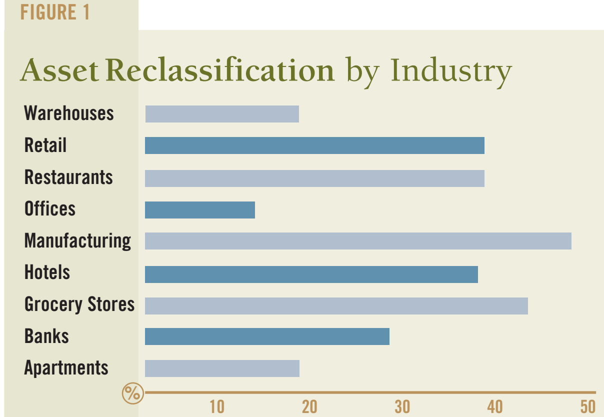
If the asset is a good candidate for the study, the impact of the reclassification is usually significant, allocating between 15 percent and 50 percent of the assets depending on the industry (Figure 1) and can generate more than a 10-to-1 return on the cost of the study ("Cost Segregation and the Role of The Contractor," *Journal of Construction Accounting and Taxation*, January/February 2005).

And the greater the reclassification from real to personal property, the greater the potential benefits.

The next step is to gather information about the asset details of the building. Whether new construction projects, new purchases or leasehold improvements, the qualified expert will review drawings, building specifications, change orders, invoices and other documents prior to conducting a site visit of the building. Once reviewed, costs are then reclassified.

The final steps include documenting the processes used and the results, then preparing a detailed report of the assets and the reclassification ("How Project Owners Can Obtain Faster Write-Offs of Their Building Costs and Increase Their Cash Flow," *Journal of Construction Accounting and Taxation*, Jan./Feb. 2002).

FIGURE 1



WHY A STUDY?

A cost segregation study is tax deferral strategy, not a tax reduction strategy. The benefits of a study can include the net present value of the tax savings from the accelerated depreciation deduction; the increased internal rate of return; and, where applicable, decreased realty-transfer taxes and annual real estate taxes.

FIGURE 2

NPV of Tax Deferral
without Bonus Depreciation

	Cost	Life	Total Depreciation*
Before Cost Segregation			
Building	$5,000,000	39	$892,094
After Cost Segregation			
Building	$3,250,000	39	579,861
Land Improvement	750,000	15	373,575
Personal Property	1,000,000	7	955,400
	5,000,000		$1,908,836
Difference			$1,016,742
Tax Deferral (45%)			$457,000
NPV (7%)			$337,000

*Based on building placed in service in 2004 and the cost seg.in 2006 with the 5-year benefit for years 2006-10. Depreciation based on 39/year=s/l and 7 & 15/year = MACRS HY

Figures 2 and 3 show a sample benefit with a net present value of a tax deferral of $337,000 or $396,000 (with 50 percent bonus depreciation) due to the increased tax deductions and income tax deferral.

To stimulate the economy after Sept. 11, 2001, a "bonus depreciation" deduction under IRC Sec. 168 allowed taxpayers an additional depreciation deduction on new property purchases of 30 percent, which was increased to 50 percent for assets placed in service between May 5, 2003 and Jan. 1, 2005. These bonus depreciation deductions can increase the tax savings of reclassified new personal property placed in service during these years.

For example, without these bonus deductions, if a real estate owner builds a manufacturing facility for $5 million, not including land, and all of the costs were depreciated over 39 years, tax depreciation would be $128,200 per year.

After a cost segregation study and a reallocation of 20 percent of the costs to seven-year property and 15 percent to land improvements (15-year property), the depreciation deduction will increase by approximately $1 million within the first five years.

The net present value of this tax deferral (discounted at 7 percent with a 45 percent combined federal and state tax rate) is approximately $337,000 *(see Figure 2)*.

If the 50 percent bonus depreciation was applicable on the seven and 15-year property, the net present value of the tax deferral would be approximately $396,000 (Figure 3).

The ability to write off an asset's remaining tax basis—should an asset with a shorter life need to be replaced—is another benefit to performing a study.

For example, if an investor used a cost segregation study and allocated $25,000 to a telephone system, when

FIGURE 3

NPV of Tax Deferral
with 50% Bonus Depreciation

	Cost	Life	Total Depreciation*
Before Cost Segregation			
Building	$5,000,000	39	$892,094
After Cost Segregation w/50% Bonus			
Building	$3,250,000	39	579,861
Land Improvements	750,000	15	561,788
Personal Property	1,000,000	7	977,700
	$5,000,000		$2,119,349
Difference			$1,227,255
Tax Deferral (45%)			553,000
NPV (7%)			$396,000

*Based on building placed in service in 2004 and the cost seg.in 2006 with the 5yr benefit for years 2006-2010. Depreciation based on 39/yr =s/l and 7 & 15/yr = MACRS HY the system needed to be replaced, the remaining (undepreciated) portion of the system could be expensed. If it were not separated in the study, it would remain intertwined as part of the building's basis and continue to be depreciated over the remaining 39 years.

The IRS has made it advantageous to use these studies for real estate investors. Even for buildings placed in service in earlier years, a cost segregation study could be performed and all the "catch-up" depreciation resulting from reclassification can be taken in the year of the study with an Application for Change in Method of Accounting. This can result in large current-year depreciation deductions.

WHAT TO LOOK OUT FOR

Despite the advantages, there are some cautions to keep in mind in reclassifying assets under a study. The most obvious is the study's cost, which can total between $10,000 and $100,000, depending on the size and complexity of the project.

Another disadvantage is the reclassification from IRC Sec. 1250 property to Sec. 1245 property. IRC Sec. 1250 property is real property subject to an unrecaptured Sec. 1250 capital gain, which is taxed at 25 percent. IRC Sec. 1245 property is tangible personal property subject to depreciation recapture at ordinary income tax rates.

At the sale of the property, if any of the capital gain is being deferred, either through a like-kind exchange or an installment sale, any depreciation recapture and gain on Sec. 1245 property must be excluded from the deferral and recognized at the time of the sale.

A cost segregation study reclassifies future gain from capital gain to ordinary income through depreciation recapture, and can be to an investor's disadvantage if the property is sold or exchanged in a short period of time.

In a like-kind exchange under Sec. 1031, real property must be replaced with real property to defer any realized gain. Keep in mind that real property is defined and determined under state law, not federal law, for purposes of like-kind exchanges. This is in contrast to the definition of real and personal property for purposes of tax depreciation under Sec. 168.

This means that property such as wall coverings, carpet, special wiring or other installations affixed to the building can be considered real property under state law, like-kind property under federal law for purposes of Sec. 1031 and personal property in the cost segregation study for purposes of depreciation under Sec. 168.

Thus, real estate owners can benefit from both the gain deferral under Sec. 1031 for deferred exchanges as well as the accelerated depreciation reclassed by a cost segregation study ("The Best of Both Worlds," *Journal of Accountancy*, August 2005).

Before performing a study, it is also important to look at whether the taxpayer has the ability to deduct the losses that most likely will be generated through a study. Passive activity real estate losses can generally be deducted only against other passive activity income. Excess passive activity losses will not be deductible in the current year, but can be carried forward into future years. If the taxpayer does not have the opportunity to utilize the tax deferral savings, the net present value benefit is lost. CPA