Cost Segregation Studies – The Gift That Keeps on Giving

By: Kevin Leifer

In a dark world of increasing tax rates and ever-diminishing tax deductions for the wealthy, tax depreciation continues to be a bright ray of light that shines upon us taxpayers.

In general, business assets are depreciated over statutorily-prescribed recovery periods, the most common ones being: 39 years for commercial real estate, including leasehold improvements; 27.5 years for residential real estate; 15 years for land improvements; and 5 or 7 years for personal property.

Over the last decade or so, Congress has seen fit to use bonus depreciation as a tool to assist with the rebuilding of lower Manhattan in the wake of 9/11 and then later to help jump start the economy during the economic recession. Bonus depreciation has enabled a taxpayer to deduct either 100% or 50%, depending on when an asset was placed in service, of the cost of the property in the year it was placed in service, with the balance, if any, depreciated over the prescribed recovery period.

In addition, a significant added benefit of the depreciation of rental real estate (commercial and residential) is the rate arbitrage that is provided by the Internal Revenue Code for those taxpayers who are subject to a capital gains tax rate that is lower than that for ordinary income. That is, even though an individual taxpayer in the highest tax bracket potentially gets a Federal income tax benefit equal to 39.6% of the depreciation deductions claimed on rental real estate, the tax gain recognized on the sale or exchange of the real estate that is a direct result of the total amount of depreciation deducted on the property is taxed at only a Federal income tax rate of 25% (provided the property is held for more than a year). So, for example, if Carol purchased an office building for $39 million all of which is classified as commercial real estate, she would be entitled to claim $1 million of depreciation each year, which would reduce her annual tax liability by $396,000. If she holds the property for 5 years, her combined tax savings would be $1,980,000. When she sells the property at the end of the fifth year for a sales price equal to what she paid for it ($39 million), she would recognize a tax gain of $5 million, which is solely due to the depreciation deductions claimed over the years. Her Federal income tax on the gain would be only $1,250,000, resulting in an economic benefit of $730,000 which is solely attributed to the difference in rates.

Unfortunately, many real property owners have left a lot of money on the table by not making use of cost segregation studies to maximize the amount of tax depreciation deducted in the early years of a property's life. In the simplest situation (where the real estate is held for its entire recovery period) the total amount of depreciation deducted will be the same regardless of whether a cost segregation study is performed. However, the economic benefit achieved by doing the study is based on the time value of money concept; that is, a deduction claimed today is more valuable than a deduction claimed the future.

In a cost segregation study, elements of a purchased or constructed building are analyzed by using engineering and cost-estimating technologies which are then segregated into their proper class lives for depreciation purposes based on Treasury regulations, IRS rulings and case law. For example, costs that were initially classified as a commercial building (that would be depreciated over 39 years) may be reclassified as a parking lot (15-year recovery period), decorative lighting (7-year recovery period) and computer room flooring (5-year recovery period).

The following represents the net present value of the tax savings that would result from the reclassification of $1 million of costs from a 39-year recovery period to one of the

following recovery periods (based solely on time value of money concepts, using a 35% tax rate and an 8% discount rate, and excluding the added benefits of bonus depreciation):

5-Year	$181,000
7-Year	$165,000
15-Year	$100,000

Certainly, a cost segregation study can be performed on newly-acquired or constructed real estate. In addition, cost segregation studies can be performed retroactively on properties acquired in past years even if the statute of limitations (generally 3 years) has run on the year of acquisition. This is accomplished by requesting a change in accounting method from the IRS. Once the cost segregation study is completed, the difference between the depreciation that should have been claimed (based on the results of the study) and the actual amount of depreciation claimed through the year of the study is deductible in full in the year of change. Besides the obvious benefits, a retroactive cost segregation study can be extremely valuable when done in a year in which a taxpayer has a significant amount of unexpected or phantom (i.e., non-cash) income such as cancellation of debt income.

It is important to note that the real estate upon which a cost segregation study is performed does not have to be directly owned. It can be owned in a flow-through entity, such as a partnership (including an LLC) or an S corporation, in which case the benefits would presumably be shared by the all of the owners. By virtue of certain tax rules, partnership-owned real estate allows for more cost segregation opportunities.

Cost segregation studies performed for taxpayers who are subject to capital gains rates that are lower than ordinary income rates (such as individuals) can get the benefit of the rate arbitrage in addition to the time value of money benefits mentioned above if the property is sold before the end of the property's recovery period.

In addition, some unique applications of cost segregation studies that can be extremely valuable include (i) real estate sold in a prior "open" year; (ii) real estate owned or previously distributed by an estate; and (iii) as an estate planning tool.

As a final note, one may believe that having a cost segregation study done can be perceived as being aggressive that would result in an IRS audit. In actuality, the opposite is true. Without a cost segregation study, the entire building cost will be depreciated as real estate and will result in less tax depreciation being claimed; however, at the end of the day, this is incorrect. A cost segregation study allows the taxpayer to properly classify its assets and to deduct the correct amount of depreciation on its tax return.

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