



Tax Planning

Wedge Issue

Done right, cost segregation can yield great tax savings for your property-owning client

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Many taxpayers and even their advisors may be unaware that recent tax code changes now provide for an accelerated depreciation deduction beyond that which is included in IRC sections 168, 179, and 1400. By using a technique called cost segregation, you can take advantage of these changes on behalf of your clients. The technique provides benefits in the areas of income tax, property tax, insurance, and more. Since cost segregation is based on depreciation, let's first review how depreciation works.

Depreciation is the accounting process of allocating and deducting the cost of an asset over a period of years, a time known as the recovery period, which is set by the Internal Revenue Service. Non-residential real estate is depreciated over a 39-year period, residential rental real estate over a 27.5-year period, and personal property is depreciated using a 20-, 15-, 10-, seven-, five-, or three-year time frame. As this depreciation deduction is taken each year, the income tax basis of the property is reduced by an amount equal to the depreciation taken. For instance, if a taxpayer bought a building as an investment for \$100,000 and sold it 12 months and one day later for \$150,000, the gain of \$50,000 would be a capital gain. If \$2,564 were taken as depreciation, the tax basis for the building would have been reduced to \$97,436 (\$100,000 - \$2,564). This would create a gain of \$52,564 (\$150,000 - \$97,436). So each year the basis is reduced by the amount of depreciation taken.

The Internal Revenue Code contains several sections which provide additional tax benefits. *Section 179* allows taxpayers to elect to deduct the cost of certain types of property on their income taxes as an expense, rather than requiring the property to be capitalized and depreciated. This property is generally limited to tangible, depreciable, personal property which is acquired for use in the active conduct of a trade or business.

Section 168 is part of the Jobs and Growth Reconciliation Tax Act of 2003 and increased the amount of bonus depreciation available to 50% for qualifying property acquired after May 5, 2003 and placed in service before January 1, 2005.

Section 1400L provided a similar benefit for qualifying property used by a business in the New York Liberty Zone.

Section 1400N, as enacted by the Gulf Opportunity Zone Act of 2005, provided additional tax relief for qualifying property acquired after August 28, 2005 and before December 31, 2007. Code section 1400N, or "GO Zone" as it is nicknamed, was made available for residential rental and nonresidential real property in areas hit by Hurricanes Katrina, Rita, or Wilma.

Cost Segregation Explained

Cost segregation is a process which allows certain items to be “reclassified” as tangible personal property and deducted over a much shorter period of time than would otherwise be the case. Properly reclassifying items can be complicated and is a primary reason why you should engage a qualified firm to do the analysis. Cost segregation is an engineering function and, as such, can get very meticulous. Generally, property can be classified into four primary categories: tangible personal property; land improvements; buildings; and land. Land Improvements can include items such as fences, sidewalks, docks, etc. Land, of course, cannot be depreciated, so the lower the land value the better.

Distinguishing between tangible personal property and the structural components of a building is a point of significant controversy. Because of this, I’ve included the IRS’s definition of tangible personal property:

“... ‘tangible personal property’ means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures).”

This same subsection of the IRC states that “tangible personal property” includes “...all property (other than structural components) which is contained in or attached to a building.” Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Furthermore, all property that is in the nature of machinery (other than structural components of the building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

Clearly some items can easily be reclassified and then depreciated over a shorter time frame. Cost segregation will identify these items, allowing for accelerated depreciation. In the 1997 landmark court case, *Hospital Corporation of America v. Commissioner*, the Tax Court allowed additional items to be reclassified. The list included certain components of the wiring and electrical distribution systems; conduit, floor, and power boxes; carpeting; vinyl wall and floor coverings; kitchen water piping; doors and partitions; patient corridor handrails; and kitchen hoods and exhaust systems.

The key here is to hire a qualified firm that will prepare a thorough and accurate study, so you’ll be on solid ground in the event of an IRS audit. According to Jim Shreve, principal and managing member of Cost Segregation Services, Inc. in Baton Rouge, Louisiana, “Cost segregation does not increase the chance of being audited.”

A taxpayer who purchases or constructs a qualifying building can benefit from this technique, even if the taxpayer purchased or built several years ago. Qualifying property is classified as residential rental and non-residential real estate. Business owners are great candidates, assuming they own their building, as are individuals who own rental real estate.

How Cost Segregation Works

Normally, a taxpayer who obtains a building will depreciate it over a period of 39 years. Let’s assume that such a building cost \$1 million. Under “straight-line” depreciation, the taxpayer would have a depreciation deduction of \$25,641 per year. This “deduction” would have the effect of reducing taxable income, and hence, the client’s income tax liability. If the client were in a 35% federal income tax bracket, his tax reduction would be approximately \$8,974 ($\$25,641 \times 0.35$). If the client were able to shorten the depreciation deduction period, they would be able to reduce their income tax by an even greater amount. Basically, the

shorter the depreciation period used, the greater the tax benefit.

There are several different ways to do a cost segregation study, including Detailed Engineering from Actual Cost Records, Detailed Engineering Cost Estimate, Survey or Letter, Residual Estimation, Sampling or Modeling, and Rule of Thumb. The first, Detailed Engineering from Actual Cost Records, is the most methodical and accurate approach while the Rule of Thumb is the least accurate method. There is no specific method required by the IRS, but the more accurate, the better. So if you're going to consider this for a client, make sure the engineering firm will take the time necessary to prepare a thorough and accurate report. IRS agents are trained to scrutinize specific areas of your report. According to Pam Freeman, an associate at Cost Segregation Services, Inc., "An IRS auditor will audit the business and have engineers on staff to assist in the review of a cost segregation study." She also suggests, "You should have an accurate detailed study on file to support your depreciation categories."

A cost segregation study should always include three essential ingredients: it should classify assets into property classes such as land, land improvements, building, equipment, etc.; it should explain the rationale behind the property classifications; and it should substantiate the cost basis of each asset and reconcile the total allocated costs with the total actual costs. See the Web Extras section of InvestmentAdvisor.com for more information from the IRS regarding what it looks for in audits.

The Technique Illustrated

Now, let's take a look at how this technique would play out in the real world. Let's assume you have a client with non-residential real property valued at \$3 million. Perhaps it's a business owner who owns his building. Scenario A uses straight-line depreciation over the required 39 years. Scenario B assumes that 10% of the total value is reclassified as five-year property, 6% is seven-year property, 4% is 10-year property, and 2% of the total is 15-year property. The remaining value is attributed to the building and is depreciated over the required 39-year period.

Looking at the numbers in the second year (the first year is assumed to be a partial year), you'll see the total depreciation under scenario A is \$76,920, using a 39-year period and straight-line depreciation. In scenario B, some of the property has been reclassified and is now depreciated over a shorter time period. The total amount of depreciation in year two under scenario B is \$227,380 (\$59,998 + \$5,700 + \$21,600 + \$44,082 + \$96,000). This represents an increase in depreciation of \$150,460 (\$227,380 - \$76,920). For a taxpayer in the 35% marginal tax bracket, this would create an additional income tax savings of \$52,661 (\$150,460 x 35%). Because of the accelerated tax savings during the early years and the time value of money, the end benefit would be even more significant. This is derived by calculating the tax savings each year, discounting these totals, then adding the discounted totals. The total income tax savings at the end of the 39-year period is \$94,665 in present dollar terms and represents a significant amount of additional capital for use by the taxpayer.

Costs and Benefits

It's not possible to quote a specific price for the analysis that would be done by a cost segregation engineering company because it is based on a variety of factors, including the property's location and type, whether it's a new or existing building, and the time required to complete the study. A study may cost as little as \$3,000 or as much as \$100,000 depending on the situation. What can be said is that the outlay for this service is small when compared to the benefit received. It is also less expensive today than in the past due to technological advances. Most companies should provide you with an initial estimate of your benefit before embarking on a formal study. Of course, the cost of this study may be deducted as a business expense.

Obviously, the taxpayer would experience a reduction in federal income taxes. Also, since the building receives a lower value, property taxes may also be reduced. Lower insurance premiums are yet another potential benefit due to the reduced value of the building. Because of the reduction in taxes paid and

insurance premiums due, the taxpayer's cash flow is increased. This additional cash flow is now available to reinvest into alternative wealth building strategies.

Additionally, lenders view this technique as a positive. This is because the greatest risk of default occurs in the first five years of a loan. Since this technique will significantly increase a client's cash flow, there is more money to pay the note.

To illustrate yet another benefit, let's assume a client uses this technique on a building which cost him \$1 million but he dies a few years later when the building is worth \$1.3 million. The property would receive a step up in basis at death, and his heirs who inherit the building, can have a new cost segregation study completed, on a building worth \$1.3 million. Essentially, they will receive the benefits on a building with a higher value by starting the cost segregation process again.

There's at least one other benefit of cost segregation. Assume we have a business owner with a building that costs \$1 million. Assume that the roof has an initial value of \$150,000, and the owner has done a cost segregation study. Over the next three years he takes a total of \$15,000 in depreciation on the roof, so its adjusted tax basis now stands at \$135,000 (\$150,000-\$15,000). If he should need to replace the roof at this point, he would be able to write off the remaining adjusted basis of \$135,000 as a loss. If he had not done a cost segregation study, the roof and the building would have been depreciated together as one item and no loss would exist.

The Recapture Downside

The downside of cost segregation is the potential for recapture. Recapture occurs when a property that has been depreciated is disposed of before the depreciation period has expired.

There are a few strategies that can be employed to minimize or even eliminate this problem. One such technique is a 1031 exchange. Here, the taxpayer would exchange his property for another of "like kind." If done properly, the basis of the old property would transfer to the new property and no tax would be due. Also, if the property is disposed of, the tangible personal property would be subject to IRC section 1245 requiring the taxpayer to realize ordinary income. This could potentially be taxed at a rate of 35%. The real property will be subject to IRC section 1250 and taxed at a rate of 25%.

The key here is to get qualified counsel so you'll know your risks. Obviously, cost segregation would make more sense if you plan to hold the property for a while.

Cost segregation can be highly beneficial for your clients. You should consult with a qualified firm to do the study and enlist the services of a CPA. Though there is some downside here, the benefits clearly outweigh the risks. However, if you don't hire a qualified engineering firm, you will likely have a problem with the IRS if you are ever audited. No one wants to pay taxes, interest, and penalties, so if you're going to suggest that your client (or yourself) do a cost segregation, do it right.

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