Selective Depreciation Can Boost Bottom Line

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By Tatiana Prophet - Industry Focus Editor

Not all assets are created equal in the eyes of the Internal Revenue Service. Some assets purchased during construction of a new building (like light fixtures and lab equipment) have a shorter life span than the building itself -- carrying the potential for a greater tax deduction.

A tangible asset, for example, can have a life span of five to 15 years, which is much shorter than the 39 years allowed on a building. The resulting spread can generate significant savings to a corporate taxpayer, says Warren Kitchens, a senior manager in the Strategic Federal Tax Services Group at Grant Thornton LLP. And a new law passed by Congress allows additional savings until 2006.

Historically, allowing tax credits on depreciable assets has been a way to stimulate the economy, according to the IRS, offering a tax incentive to modernize and expand.

After Sept. 11, 2001, Congress passed the Job Creation and Worker Assistance Act of 2002, allowing an additional bonus depreciation of 30 percent of the cost of "eligible" property until Oct. 22, 2004.

Companies can realize even further savings with the Jobs and Growth Reconciliation Tax Act of 2003, which bumps the bonus depreciation up to 50 percent for qualifying property acquired between May 5, 2003, and Jan. 1, 2006.

The process of categorizing tangible assets with various periods of depreciation is called cost segregation, and there are auditors with engineering backgrounds who spend much of their time conducting cost segregation studies that are submitted along with corporate tax returns.

Such studies are necessary, Kitchens said, because general contractors don't analyze buildings with an eye for taxes.

"A construction contract has extensive cost detail, but they don't necessarily have it organized by tax category," Kitchens said. "But if you go to them and say, 'I need a breakout of the electrical wiring that goes to the computer or the lighting' -- they just know they have 500 feet of wire."

In the above scenario, the wires that go into a computer outlet would have a five-year life, but the wires that go into a chandelier would have a seven-year life, Kitchens said. Further, the wiring to the lights in the parking lot would have a 15-year life. But the electrical outlet in a wall has a 39-year life.

Cost segregation has become so common that the IRS now publishes a Cost Segregation Audit Techniques Guide online. The agency also employs auditors with engineering backgrounds to verify cost segregation reports.

The agency may challenge a cost segregation study, in which case corporate auditors must defend their methodology. Because there is no "bright line" test, according to the IRS audit guide, or clear methodology for determining cost segregation, the tax world goes by case law -- which is voluminous.

Cost segregation might be a valid consideration for any corporate taxpayer that spends $1 million or more on a new or acquired property, Kitchens said.

But, he cautioned, cost segregation is not for everyone. For example, property owners with extended net operating losses would not benefit much from tax deductions. And, investors who flip property would be selling it off too quickly to realize the full benefits.