Study your assets

How a cost segregation study can help you get the most out of your properties **Interviewed by Troy Sympson**

If you've acquired, constructed or improved a building in the last three years, you may want to consider a cost segregation study. A cost segregation study identifies and reclassifies personal property assets (nonstructural elements, exterior land improvements and indirect construction costs) to shorten the depreciation time for taxation purposes, which reduces current income tax obligations.

Analysis of capital expenditures is used to determine appropriate asset classifications. Cost segregation identifies building costs and reclassifies them to permit a shorter, accelerated method of depreciation for certain building costs. Costs for nonstructural elements (wall coverings, carpet, accent lighting, portions of the electrical system) and exterior site improvements (sidewalks and landscaping) can often be depreciated over five, seven or 15 years.

"Cost segregation studies can be very beneficial," says Kevin Lovins, CPA, a tax shareholder with Briggs & Veselka Co. "Tax depreciation deduction is accelerated, which reduces income taxes and increases cash flow. It should be noted, however, that income taxes are only deferred, not eliminated."

Also, component costs are usually not easily identifiable and the IRS will not allow a taxpayer to estimate the components.

Smart Business asked Lovins about cost segregation studies, how to conduct one and why they are so helpful in today's economy.

Kevin Lovins, CPA
Tax shareholder
Briggs & Veselka Co.

What problems can a company face when acquiring, purchasing or improving real estate property?

When the individual component costs of a building are unavailable, the costs are generally classified as a 27.5- or 39-year property. The acceleration of depreciation expense is missed when the entire costs of a building is classified this way. Generally, the individual component costs of acquiring, constructing or improving a building are not readily available. When purchasing a building, the cost is usually just a lump-sum amount. Since depreciation expense is missed, taxes are accelerated and cash flow is negatively impacted.

How does a cost segregation study work?

Usually, an accountant and an engineer will analyze architectural drawings, mechanical and electrical plans and other blueprints to segregate the structural and general building electrical and mechanical components from those linked to personal property. The study also allocates 'soft costs,' such as architect and engineering fees, to all components of the building. While the building itself and any structural components are required to be depreciated over 27.5 or 39 years, parts of a building, including tangible personal property and land improvements, may qualify for an accelerated deprecation method over a much shorter recovery period (five, seven or 15 years). A cost segregation study identifies costs eligible for accelerated depreciation method over a shorter recovery period. By identifying costs eligible for accelerated tax depreciation expense, current taxes are reduced, which improves cash flow. Taxes are only deferred, not eliminated.

What are the benefits?

Cost segregation studies are performed by trained tax and engineering professionals. The professionals separate the individual cost components by analyzing the construction drawings and methods and applying their knowledge of the internal revenue code, revenue rulings and court cases. A cost segregation study not only identifies the component parts of a building, but also substantiates the allocation of cost of a building among the individual components.

In addition to providing tax relief, a cost segregation study can benefit businesses by maximizing tax savings by adjusting the timing of deductions. When an asset's life is shortened, depreciation expense is accelerated and tax payments are decreased during the early stages of a property's life. This, in turn, releases cash for investment opportunities or current operating needs.

A cost segregation study also creates an audit trail. Improper documentation of cost and asset classifications can lead to an unfavorable audit adjustment. A properly documented cost segregation helps resolve IRS inquiries at the earliest stages.

Finally, taxpayers can capture immediate retroactive savings on property added since 1987. Previous rules, which provided a four-year, catch-up period for retroactive savings, have been amended to allow taxpayers to take the entire amount of the adjustment in the year the cost segregation study is completed. This opportunity to recapture unrecognized depreciation in one year presents an opportunity to perform retroactive cost segregation analyses on older properties to increase cash flow in the current year.

What can go wrong if a cost segregation study isn't done?

If a taxpayer does not obtain a cost segregation study from a qualified professional, the taxpayer may not be able to substantiate his or her tax position upon challenge from the Internal Revenue Service (IRS). The IRS does not allow the taxpayer to estimate the individual component costs. <<

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