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Cost Segregation: The Art of Maximizing Depreciation Deductions

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Property owners typically depreciate commercial, investment, or residential properties over a long period of time without realizing that there is an alternative to maximize annual depreciation.

Generally, commercial property is depreciated over 39 years and residential property is depreciated over 27.5 years. Cost segregation allows many building improvements that would otherwise be depreciated over these long periods of time to be reclassified, resulting in shorter depreciable lives of five, seven, 10, or 15 years.

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Creative and ambitious accountants in the past have tried to differentiate tangible personal property from a building's structural components but they have always faced the risk of audit. In *Hospital Corporation of America v. Commissioner*[*], the Tax Court opened the door for cost segregation and listed some criteria that help distinguish inherently permanent property from tangible personal property. In 1999, the Internal Revenue Service formally acquiesced to the Tax Court's decision by providing guidance for reclassifying certain components of a building so that they may be depreciated over a shorter period of time.

[*] 109 T.C. 21 (1997).

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Cash Flow Improvements

There are many tax benefits when utilizing cost segregation effectively. By shortening the period of time over which an item may be depreciated, larger deductions may be taken over a shorter period of time. This in effect can minimize other tax obligations by appropriately matching these larger deductions with other taxable gains. These tax savings then improve one's liquidity by increasing cash flow, since there is money that no longer has to be paid in taxes.

Depending on one's financial situation, especially in light of the current market conditions, the benefit of immediate cash flow could be enough of a reason to justify cost segregation. Improved cash flow can be used to pay down debt and lower the cost of capital.

Another beneficial result that cost segregation offers involves the time value of money (TVM). Based upon economics, a tax deduction today is worth more than the same deduction in the future. There is a value to the certainty of presently holding capital. One does not know what the future will bring—whether the capital will be worth as much as it is now or what the costs involved in collecting the capital might be.

There is also an additional value to the opportunity costs of potential investments and returns that cash flow possesses. To illustrate, assuming a 5 percent discount rate and a 35 percent marginal tax rate, assets worth $1 million that are depreciated over five years (instead of 39 years) yield $160,000 in net-present-value savings.

Accelerated Depreciation

In addition to shortening the period of time over which the depreciation deductions can be taken, alternate methods of depreciation can be utilized to actually accelerate the rate of depreciation. By accelerating depreciation deductions, the present value of such deductions is thereby increased.

Reclassified items that can now be depreciated over 15 years can also accelerate their rate of depreciation by using a 150 percent declining balance method under the corresponding modified accelerated cost recovery system (MACRS) tables.

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An even more advantageous depreciation schedule is available for items reclassified as qualifying for five-, seven-, and 10-year shorter depreciable lives. Such items can use the double declining balance method of depreciation, which has an even more accelerated rate of depreciation than the accelerated 150 percent declining balance method.

By utilizing these front-loaded accelerated depreciation deductions for personal property and land improvements, the positive benefits of liquidity, advantageous tax rates, and TVM are further compounded.

Other Tax Benefits

There are other various tax benefits when applying cost segregation. Inevitably, building components and other assets become outdated or damaged. Cost segregation allows for easier write-offs when such items need replacement.

Cost segregation offers another possible tax benefit since it may lower local realty transfer taxes and reduce some states' local property taxes.

Yet another benefit of reclassifying tax code Section 1250 real property as Section 1245 personal property is that under Section 179 a taxpayer is permitted a current deduction of up to $100,000 of the cost of personal property, which is not available for property classified as Section 1250 real property.

Lastly, under the 2008 Economic Stimulus Act (Pub. L. No. 110-185), the reclassified property can now be eligible for an additional first-year depreciation of up to 50 percent of the purchase cost of such property.

Option for Construction, Acquisition

A key feature of cost segregation is that it is not limited to new buildings. It can be employed with both new buildings undergoing construction (renovation, remodeling, restoration, or expansion) and when acquiring older buildings, as long as they were placed into service by Jan. 1, 1987.

It can also be applied in the event a building or qualifying structure was acquired several years earlier. Under Revenue Procedure 2002-19, a taxpayer can claim ''lookback'' depreciation on previously misclassified assets. In such a scenario, the taxpayer does not have to amend earlier tax returns and only needs to apply for a change of accounting method (Form 3115). All ''catch-up'' depreciation is recognized in the first tax year that is affected by the cost segregation study.

Certain building improvements that can be reclassified as either personal property or land improvements, rather than structural components of a building, yield more depreciation benefits. Common structures used for cost segregation analysis include restaurants, grocery stores, office buildings, hotels, and warehouses.

Some of the items that are commonly reclassified to have shorter depreciable lives are accent lighting, carpet, cabinetry, floor covering, signage, specialty plumbing, electrical equipment, and heating, ventilation, and air conditioning equipment.

Land improvements, such as sidewalks, driveways, fencing, and landscaping, qualify for a 15-year recovery period. Personal property items, such as wall coverings, supplemental air conditioning, dedicated wiring, fixtures, and machinery qualify for a five- to seven-year recovery period.

Considerations for Taxpayers

If cost segregation offers so much, then why are more people not taking advantage of its numerous benefits?

The first answer is that many people do not know about cost segregation since it is a fairly new accounting technique. The Internal Revenue Service will not automatically reclassify your assets and issue a refund unless you actually employ the cost segregation technique.

Secondly, the total depreciation does not change, only the timing of the deductions changes. Thus, the accelerated depreciation feature might not be tactical in the event that one would not be able to use the front-loaded deductions immediately or would actually prefer having the deductions available in later years.

Another consideration would be the cost of conducting the engineering study. In general, it is not cost effective when used with a building having a tax basis of less than $500,000. One must weigh the tax benefits of employing a cost segregation study against the cost of undergoing such a service.

Another concern is that of triggering depreciation recapture where the cost segregation analysis was not applied in conjunction with proper tax management. Finding the accounting and engineering consultants to perform the study that are both affordable and competent is crucial, especially because there are understatement penalties for taxpayers that use cost segregation too aggressively. Taxpayers can perform a cost segregation analysis on their own, but without the third-party backup such an analysis would likely be subject to added scrutiny by IRS.

In sum, cost segregation can be a very effective tool when properly applied. IRS now not only accepts this technique, it has published clear guidelines to follow in order to facilitate compliance.

It pays to learn about when and how to employ cost segregation, as it is a fairly new technique that is not being exploited enough and can safely provide taxpayers with significant tax benefits.

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