Cost Segregation
Frequently Asked Questions

What is a cost segregation study?

A cost segregation study is an engineered analysis of the costs of depreciable real property that allows the owners to accelerate depreciation deductions by reclassifying costs to asset classifications that benefit from shorter recovery periods and accelerated calculation methods.

When do cost segregation studies apply?

Cost segregations studies generally benefit any owner of depreciable real property if

1. The owner pays income taxes and
2. The cost of the property is $1 million or more.

What is the cost and benefit of a typical study?

Although the specific cost and benefit varies by the type of property and how and when it was acquired, a typical study will cost from $8,000 to $15,000 and will produce net present value benefits of from $75,000 to $300,000 over the first six years. With look back studies the full benefit can occur in the first year.

What types of property benefit?

Any depreciable real property that is owned by a taxable entity may benefit from a study.

1. Constructed buildings
    a. New buildings
    b. Additions
    c. Renovations
    d. Leasehold improvements
2. Purchased buildings

Does the property have to be a new purchase or new construction to benefit?

No. Property placed in service in years as far back as 1987 may benefit from a study. Studies for property placed in service in prior years are called “look back” studies.

If a look back study is performed, does the owner have to file amended income tax returns?

No. The change is treated as a “change in accounting method.” The “catch up” depreciation expense amount is deducted on the owner’s next income tax return.

How does the Internal Revenue Service view cost segregation studies?

The IRS effectively endorses cost segregation studies. The IRS *Cost Segregation Audit Techniques Guide* describes cost segregation.

> When only lump-sum costs are available, cost estimating techniques may be required to "segregate" or "allocate" costs to individual components of property (e.g., land, land improvements, buildings, equipment, furniture and fixtures, etc.). This type of analysis is generally called a "cost segregation study," "cost segregation analysis," or "cost allocation study."

The primary concern of the IRS is that the study be performed following detailed methodologies by architects, engineers and other professionals with expertise in construction cost estimating techniques.

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Over the life of the property, doesn't the owner receive the same amount of depreciation expense, with or without a study?

In most situations, yes. A cost segregation study generally only accelerates deductions. However, by reclassifying property from a 39 or 27 ½-year classification to 5, 7 and 15-year classifications, the amount of accelerated deductions can be substantial. These accelerated deductions reduce the owner's income tax liability in the early years. The owner can pay down debt or invest the additional cash to produce a significant benefit.

The effect of a study is an interest-free loan. The cost of the study is analogous to closing costs on that loan. The net present value of those benefits is generally at least eight times the cost of the study.

In many situations, a permanent benefit can also result. For example, in some situations a permanent benefit can result when the owner disposes of the property. (See below.)

Another example occurs in the area of estate planning. If the property owner passes away before the accelerated deductions reverse, the remaining benefit never reverses. For most studies, no significant reversal amount begins until 16 years after the year that the property is placed in service. As a result, if the property goes into the owner's estate within 15 years, the full benefit becomes permanent.

In effect, the estate planning benefit is analogous to an interest-free loan that is forgiven if the owner passes away. The result is that the owner retains more cash prior to death, which he or she can either spend or the estate can use to pass on to family, charities or to pay estate taxes. For most taxpayers the choice of paying the IRS or keeping the cash is an easy decision.

What if the owner plans to dispose of the property in the near future? Doesn't the loss of net present value tax benefits negate the benefit of a study?

1. For property owned by a corporation taxed as a C Corporation, a study may not benefit the owner enough to justify the cost.
2. For property owned by a flow-through entity with individual owners or by individuals directly, a permanent benefit may offset the loss of net present value benefits.
    a. The additional depreciation deductions that result from a study offset ordinary income, which is generally taxed at a 35% income tax rate.
    b. Although those deductions reduce the owner's basis in the property, thereby generally increasing the gain on sale, part or all of that additional gain is taxed at capital gain rates of 25% or 15%, resulting in a 10% or 20% permanent benefit.
    c. In many cases, if the professionals who calculate the gain on the sale properly analyze the transaction, the permanent benefit alone will result in a benefit that justifies the cost of the study.

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What types of property benefit from a cost segregation study?

Any type of depreciable real property owned by taxable entities or individuals, including

Automobile Dealerships
Commercial Rental Property
Commercial Rental Property
Residential Rental Property
Skilled Nursing Facilities
Assisted Living Facilities
Hotels and Motels
Retail Stores
Retail Strip Centers
Banks
Convenience Stores
Hospitals
Self Storage Facilities
Grocery Stores
Manufacturing Facilities
Warehouses
Restaurants
Casinos
Entertainment Facilities
Medical Offices
Hospitals
Golf Courses
Distribution Facilities
Manufactured Housing Parks
Public Storage Facilities