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Consider a cost segregation study to help increase your up-front cash flow

December 17, 2007 - Owners Developers & Managers

What is a Cost Segregation Study?

A cost segregation study (commonly termed "cost seg") is a popular asset depreciation method that views a real estate acquisition as consisting of four categories, not only of land and buildings but also tangible personal property and land improvements. A "cost seg" allows you to apply IRS rules to increase annual after-tax cash flow through accelerated depreciation. It is applicable not only when the taxpayer acquires a new or existing structure, but also on previously acquired or improved structures. Typically, however, it is most effective when applied early in the planning or development of a construction project - whether new construction or renovation.

Regardless of when it is conducted, either currently, going forward or when recouping missed depreciation as far back as 1987, a cost seg study can increase your up-front cash flow on real estate projects through reduced federal and state income tax.

How Do I Benefit From a Cost Segregation Study?

The goal of cost seg is to provide benefits to the taxpayer by segregating the cost of assets into different categories and then accelerating the depreciation on those assets. Due to the complexities of our current tax laws, most taxpayers depreciate an entire building cost using a straight line method over 39 years for commercial property, or 27.5 years for residential property. However, under specific IRS tax codes, certain tangible building components and improvements can be depreciated over five, seven or 15 years instead. When these nonstructural components are reclassified into a shorter depreciation cycle, taxes are deferred and the result is faster depreciation.

Thus, you, the taxpayer, can enjoy increased cash flow as a result of reduced taxes that may go back as far as 1987. Depending on the building's size, length of ownership and value of the assets that can be reclassified, using cost seg methods to more accurately categorize property can result in savings of real magnitude.

As a taxpayer you must work closely with experts who can distinguish between tangible property and a building's structural components. The IRS tax code has set forth detailed criteria that must be used when making the determination of whether a property is inherently permanent, and therefore excluded, or is defined as tangible personal property, and can be included, such as cabinets, millwork, carpeting, swimming pools, overhead lighting, certain wiring, vinyl wall and floor coverings, bathroom accessories, accordion doors and partitions and the like. There are now about 300 court cases and Internal Revenue Service (IRS) rulings supporting the use of this legitimate, proven technique.

What Type of Properties Are Applicable?

Although almost every property may realize some tax benefits by conducting a cost seg study, certain types of properties have more of an advantage than others due to the nature of their tangible components. The more specialized and function-specific the property is, the greater the benefit derived from a reclassification. Manufacturing facilities, hotels and resorts, corporate headquarters, retailers, warehousing and distribution centers, self-storage facilities and multifamily buildings are all excellent candidates.

How Do I Get Started?

To begin the process, as the taxpayer you can answer a few questions:

* Did you construct or acquire the property after 1986?
* Did you renovate or improve the property after 1986?
* Is the property currently under construction, or in the planning stage?
* Do you expect to hold the property for at least three years?
* Does the property have positive earnings before taxes (EBT)?
* Could additional depreciation help reduce current tax liabilities on other portfolio assets?
* Is the property valued at $1 million or more?

Who Conducts a Cost Seg Study?

The IRS has outlined a specific procedure that it sanctions. There is an up-front examination of prior year tax forms in any cost seg study in order to determine: (1) the established depreciable basis, (2) the accumulated depreciation and (3) the year the building was placed in service.

A cost seg study will be subject to rigorous scrutiny from the IRS and to be successful it must be conducted by a combination of well-trained professionals across several disciplines. These competencies include architectural, engineering, accounting and tax. In fact, the IRS requires that an engineering based approach be used to identify and re-classify construction costs into the appropriate categories.

Conclusion

When done correctly, a cost seg study (despite the cost to conduct one) can be well worth the effort and its tax savings capabilities should not be overlooked.

Andrew Martin, CPA, is a partner at The Resnick Druckman Group, New York, N.Y.