nyrej

Examining the benefits of utilizing a cost segregation study in a challenging economy

June 07, 2010 - Spotlights

When a taxpayer hires an engineer to perform a cost segregation study of their real property, the purpose is to separate the construction cost or purchase price of the property into the following four categories: land, land improvements, personal property and real property. In order to qualify as personal property, the asset cannot be a structural component of the building. While land is not depreciable, the land improvements would generally be depreciated over 15 years and the personal property over 5 to 15 years. Commercial buildings are depreciated over a 39 year life and residential buildings over a 27.5 year life.

The benefit to having a cost segregation study performed is the increased tax depreciation deduction that is derived by having property classified with shorter lives and accelerated depreciation methods. For example, if $1 million of a $10 million commercial building is classified as personal property with a 5 year life, this classification would yield additional depreciation of $ 174,359 in the first year and $ 294,359 in the second year. At the end of the five years, the additional depreciation deducted would be $871,795. Taking this 5 year acceleration benefit even at the lowest corporate tax bracket of 15% yields a tax savings of $ 130,769. Given the dramatic difference in the depreciation that is allowed and the time value of money, it can be seen that if the property has a relatively high cost that is all being depreciated over a life of 39 years, the cost of having a cost segregation study performed may provide a good return on investment.

During more prosperous economic times, taxpayers were eager to avail themselves of the benefits of having a cost segregation study. The impact of the increased tax depreciation deductions results in lower taxable income leaving more net cash flow for the property owner. In difficult economic times, there are some specific situations that may bring immediate benefits to taxpayers as well.

A taxpayer can receive a current benefit when there is a net operating loss (NOL) in 2009 and significant taxable income in any of the 5 previous years, and the taxpayer has not yet filed their 2009 tax return or wishes to amend their 2009 tax return. This is because of the increased carryback period from 2 to 5 years which was part of the American Recovery and Reinvestment Act of 2009. While originally the increased carryback only applied to "eligible small businesses" with average gross receipts under $15 million, a second act expanded the period to all taxpayers other than those that received benefits under the TARP act. However, the carryback to the fifth preceding taxable year is limited to 50% of the taxable income before the NOL carryback. Also, if a taxpayer is contemplating a loss in 2010 and had significant income in either 2008 or 2009, it may also justify the expense of cost segregation. If the amounts to be received from the potential tax refunds exceed the expense of the cost segregation, it justifies incurring the expense to perform the study. It should also be considered that a taxpayer, who has current taxable income before the additional depreciation, may have an NOL after the additional depreciation.

During difficult economic times, real estate operators unfortunately have tenants that break their leases. Anticipating that tenants may be vacating a property, valuable tax benefits can be provided by having a cost segregation in place when the reality of losing a tenant takes place. The space being vacated was likely originally built out with specifications for that tenant that will be dismantled for either a new tenant or to simply market the space more for general use. Having the costs segregated to both personal property and removable building improvements would allow for an immediate write off of the net taxable basis of those assets that are being removed. In turn, this would reduce current taxable income and hence current income tax. In addition, if the write off creates a loss, the taxpayer could benefit from the net operating loss carryback as described in the previous paragraph.

Sandy Klein, CPA, is a partner at Shanholt Glassman Klein Kramer & Co., New York, N.Y.