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Cost segregation is timely strategy for commercial property owners who filed tax extensions this year

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While the economy struggles to improve, owners of investment property and property used for business are looking for every tool to improve their bottom line, especially as the deadline on tax returns on extension for this year draw near. Individuals and companies looking at a large tax liability as of September 15 or October 15 are sure to celebrate any business strategy that provides a tax benefit and increases cash flow. Cost segregation does just that. It is no wonder cost segregation is very popular this time of year with owners of investment property and owners of property used for business.

Just what is cost segregation? As most investment property owners know, in general, buildings can be depreciated over a 27.5-year or 39-year period. However, according to the Internal Revenue Code (IRC), certain categories of fixed assets can be depreciated more quickly, over five, seven or 15 years. Identifying and reclassifying these eligible assets can accelerate part of the building's tax depreciation and create a reduced tax liability. A cost segregation, or "cost seg," study is the tax and engineering analysis that identifies and segregates these eligible assets, assesses their value and determines the resulting asset classes and corresponding accelerated depreciation. The bottom line? Cost segregation saves property owners money by justifying larger upfront tax deductions and in turn, lowering their taxable income, thus lowering their tax payments.

What assets qualify for accelerated depreciation? Eligible assets are systems, fixtures or related elements that are either unnecessary for the operation of the building itself or are temporary structures. They include such elements as decorative lighting or moldings, certain floor or wall coverings or redundant HVAC systems. Using the guidance set forth in the IRS Audit Techniques Guide, experts in the areas of tax and engineering separate out, or segregate, these elements. This process provides maximum tax benefits to property owners with facilities built or bought in the last seven years, as well as those with significant construction in progress, or with newly renovated or expanded facilities.

For example, a real estate investor with 30 apartment buildings recently considered performing cost segregation studies on several of his holdings. Some buildings were upscale garden-style apartment complexes, while others were city-style apartment buildings. Some had been purchased recently, while others had been held for many years. After answering some basic questions, he decided to proceed with a Cost Segregation study on four garden-style complexes that he had owned for five years. The reasons for this were twofold: first, as opposed to city-style apartment buildings, the garden-style apartments had more assets that could be accelerated from 27.5-year to 15 and 5-year properties. The second was that older properties generate a catch-up adjustment (more about that below). By working with his CPA and Madison SPECS, the investor was able to identify the buildings that would generate the most depreciation and did cost segregation studies on those. The studies resulted in a combined tax benefit of over $2.2 million.

In cases of new construction, it is best to incorporate cost segregation as early as possible in order to save money on federal, and possibly state, and local tax returns. For existing properties, understated depreciation can be caught up for past construction, purchases, expansions, renovations and qualified leasehold improvements. Owners can recapture missed depreciations with a simple change in accounting method. Amended tax returns are not required; instead, "catch-up" depreciation can be taken in one year by filing IRS Federal Form 3115 (Change in Accounting Method, with IRS consent granted automatically). Please note that the IRS Form 3115 was recently updated in December 2009.

As the tax deadlines approach, cost segregation studies may be among the most valuable tax strategies available to owners of investment and business real estate. To download Madison SPECS free publication entitled "All About Cost Segregation," go to www.madisonspecs.com.

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