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Cost segregation - wait a minute...Exercise caution and research all scenarios

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Cost segregation is basically an engineering study that breaks large assets into components with shorter lives to attain an accelerated depreciation benefit. Under the tax code, real property typically has a depreciable life of between 27.5 and 39 years depending on whether it is residential or non-residential-use property. A cost segregation study dissects the building into components with shorter depreciable lives, therefore throwing off larger depreciation deductions in earlier years. It sounds like a no-brainer but there is a thought process you should conduct before you undertake the cost. Although this can be a significant benefit to a flow-through entity investor in a real estate partnership, there are certainly some cautions to research before "jumping in."

First, you must realize that depreciable basis is finite-you aren't getting any extra depreciation, you are just accelerating it into earlier years. In an atmosphere of indecision, it may be wise to wait. Congress has become a bunch of bad weather forecasters. Every day you don't know if you should carry an umbrella or wear sunscreen. One consensus is pretty certain: taxes won't go down, and since most cost segregation benefits are in the initial year of an existing building, it may be wise to wait to see where income tax rates go. By the time the political dust has settled, it may be 2014.

Second, if you have a lot of partners and a self-amortizing mortgage, you may not want to go through this exercise. By accelerating depreciation you will be a hero for a few years, but as you know, partners can have short memories. All of a sudden you have depleted the depreciable basis significantly enough and inadvertently created phantom income because your mortgage principal payments exceed the depreciation. For example, if your mortgage principal payments are $100,000 per month and there is only $50,000 of annual depreciation left due to the acceleration of the depreciation, you will be paying tax on $1.15 million with no cash to distribute. Ouch! Now, the only happy partner you have is your cell phone provider due to the increased usage on your phone from unhappy partners. A well-thought-out estimate of cash flow vs. taxable income should be considered and discussed with your tax advisor before proceeding. If you have significant real estate tax losses to offset it, then it may not matter. That gets into a "qualified real estate professional" and another novel to explain those rules, so I will pass on that for another time.

Third, another possible issue is sales tax. If the results of the cost segregation are not presented properly on your tax returns, you may have unknowingly converted real property into personal taxable property, and along comes the tax man and issues a sales tax bill. This issue remains somewhat dormant in many states; therefore, the results of cost segregation must be carefully reported by a knowledgeable tax advisor. You may even want to consider filing zero sales tax filings (if you do not currently file) to allow any state statutes to run in order to protect yourself from an aggressive sales tax auditor.

Fourth, make sure your building isn't too old and therefore has a low depreciable basis to begin with.

As with any tax position, do your research before taking on cost segregation for a real estate partnership. Make sure you have knowledgeable tax advisors who can guide you in this process. A cost segregation can be a very valuable tool to obtain tax benefits. Transferring typically 30% of a building's basis into a 5-15 year property from a 27.5-40 year property can give you immediate tax savings of millions, depending on the basis of the asset. A study performed by a reputable cost segregation firm is a must.

However, careful consideration of the side effects will save you costly professional fees and potential taxes down the road. Each situation is unique and the aforementioned issues should be well thought out. The timing with tax rates, the presentation on the tax return in the initial year, the reputation of the professional, and the consideration of potential risks all will contribute to a successful and proven tax-saving method.

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