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Cost segregation forecast to be hot tax strategy in 2009

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With the economy slowing, many businesses are bracing for a dismal year. Job losses, a weak stock market, declining real estate prices, and distressed financial markets all point to a tough year ahead. This means that any business strategy that can reduce taxes and increase cash flow will be in high demand. One tax strategy that accomplishes this is cost segregation, which will make it very popular this year with owners of investment property and owners of property used for business.

What is Cost Segregation?

In general, buildings can be depreciated over a 27.5-year or 39-year period, but certain categories of fixed building 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.

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, 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 constructed, renovated or expanded facilities.

The bottom line? Cost segregation saves property owners money by justifying larger upfront tax deductions and in turn, lowering their tax payments. For large companies, it can also increase shareholder value and improve the overall financial picture for the property's holding company.

How "Cost Seg" Works

With tax season ahead, cost segregation will be particularly appealing to property owners who were profitable in 2008 but who are anticipating losses in 2009. They can use the accelerated deprecations now to offset their 2008 tax bill, rather than wait until next year when there will be less need for depreciation deductions because of the declining economy.

Other benefits also come into play when choosing cost segregation. For example, a real estate investor with 30 apartment buildings was recently considering whether to do cost segregation studies on one or 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 a few basic questions, he decided to proceed with a feasibility analysis on seven garden-style complexes that he had owned for five to seven years. The reasons for this were twofold: first, the garden-style apartments had more assets that could be accelerated from 27.5-year to 15-year property. The second is that older properties generate a catch-up situation, as described below. The investor chose to analyze the buildings that would generate the most depreciation in order to get the most bang for his buck.

If dealing with new construction, it is best to incorporate cost segregation as early as possible in order to save money on federal, and possibly state, tax returns. For existing properties, understated deprecations can be recaptured for past construction, purchases, expansions, renovations and qualified leasehold improvements. Owners can recapture these missed deprecations with a simple change in accounting method. Amended tax returns are not required; instead, a "catch-up" depreciation can be taken in one year by filing IRS Federal Form 3115 (Change in Accounting Method, with IRS consent granted automatically).

Without a doubt, cost segregation studies are among the most valuable tax strategies available to owners of investment and business real estate, and are sure to be one of the hottest business strategies in 2009.

To download the free "All About Cost Segregation" handbook, go online to www.madisonspecs.com.

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