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## How Can A Cost Segregation Study Help My Business?

Purchasers of real estate anywhere from individual investors, to investment funds, to real estate investment trusts (REITs), and all the other players in between know the real estate mantra – “you make your money when you buy.” Even business owners know the wealth creating power of real estate. Ray Kroc, former CEO of McDonald’s, has been quoted saying “...I’m not in the hamburger business. My business is real estate.”

Many in the real estate market also know that, aside from the potential operating income generated by the real estate and any potential appreciation in value, real estate provides significant tax benefits in the form of tax depreciation. When real estate is purchased, portions of the purchase price are typically assigned to both the land and the building. The costs assigned to the building can then be depreciated for tax purposes and this “paper” deduction can offset operating income thereby reducing taxable income.



Few real estate investors and business owners fully understand the tax benefits available to them using a technique called cost segregation. As mentioned above, a portion of the real estate’s purchase price is assigned to the building and typically depreciated over 39-years (or 27.5-years in the case of residential real estate). Cost segregation allows an owner to assign costs further into the component parts that make up a building which enables the owner to accelerate the tax depreciation deductions which can significantly reduce taxable income. For example:

Henry is a high net worth individual investor who acquired commercial real estate for \$5M of which \$4M is assigned to the building and \$1M is assigned to the land. This property would generate a little more than \$100K in tax depreciation deductions. If operating income from the property was \$500K (a 10% cap rate), this could potentially reduce taxable income to approximately \$400K.

### How does cost segregation work?

Cost segregation does not create any additional costs; it simply applies a more surgical approach to the allocation of purchase price to the various categories of real estate including personal property, land improvements, buildings (including its component parts), and land.

- **Personal Property.** This category typically includes furniture, carpet, and some fixtures.
- **Land Improvements.** Generally included in this category are items such as sidewalks, walkways, and fences.
- **The Building.** After allocating costs to the above two categories, all remaining purchase price not associated with the land will be allocated to the building.
- **Land.** All other remaining cost purchase price be allocated to land which is not depreciable for tax purposes.

In order for a cost segregated purchase price to be respected by the IRS, the real property owner will likely need to engage a professional with appropriate engineering qualifications to conduct a study on the subject property. The IRS specifically instructs its agents on how to conduct an audit of a cost segregation study and has dedicated Chapter 4 of its audit technique guide to assessing the principal elements of a quality cost segregation study and report. Thus, it is important that the purchase price allocations be conducted by a professional.

### What are the tax benefits?

What is the return on investment for the amount of time, money, and effort necessary to conduct a cost segregation study? The benefit is in the time value of money for accelerated tax depreciation deductions which would have occurred slowly and evenly over nearly 40 years. Additionally, current tax policy favors and incentivizes companies to incur capital expenditures by providing them “bonus” depreciation (IRC Section 168(k)) for certain assets (typically new property with less than a 20-year tax life) placed in service between now and December 2019.



Assets which qualify for bonus depreciation can take an immediate 50% deduction of that property’s cost if placed in service before December 2017 (decreasing to 40% in 2018, 30% in 2019, and zero thereafter). This can be illustrated best with numbers – continuing from the example above, let’s update some of the facts.

Henry decides to construct a new commercial building for a total cost (including land acquisition cost) of \$5M and engages a professional with expertise and experience to conduct a cost segregation study. Further, let’s assume this property has significant common areas which

require updating such as a retail mall, hotel, a hospital, or perhaps a mixed use property.

The cost segregation study determines that \$1M is appropriate to assign to the land but assigns the remaining cost as follows:

- **5-Year - \$900,000**  
This category could include carpeting, certain aspects of an electrical system (such as wiring, conduit, boxes, etc.), certain specific plumbing applications, certain wall and floor coverings, etc.
- **15-Year - \$150,000**  
This category might include building out sidewalks or walkways, fences, and other general site improvements.
- **39-Year - \$2,950,000**  
The remainder of the cost is allocated to building.

This example of a newly constructed commercial property is summarized in the table below. Only the depreciable amounts (i.e. the \$4M) have been presented below.

Year	Cost Segregated Purchase Price				Standard 39-Year 4,000,000	Additional (Decreased) Depr	Tax Impact at 40%	Cuml. Tax Impact
	5-Year 900,000	15-Year 150,000	39-Year 2,950,000	Total				
Year 1	540,000	78,750	37,821	<b>656,571</b>	<b>51,282</b>	605,289	242,115	242,115
Year 2	144,000	7,125	75,641	<b>226,766</b>	<b>102,564</b>	124,202	49,681	291,796
Year 3	86,400	6,413	75,641	<b>168,454</b>	<b>102,564</b>	65,890	26,356	318,152
Year 4	51,840	5,775	75,641	<b>133,256</b>	<b>102,564</b>	30,692	12,277	330,429
Year 5	51,840	5,198	75,641	<b>132,679</b>	<b>102,564</b>	30,115	12,046	342,475
Year 6	25,920	4,671	75,641	<b>106,232</b>	<b>102,564</b>	3,668	1,467	343,942
...								
Year 7-40	-	42,068	2,533,974	2,576,042	3,435,898	(859,856)	(343,942)	(343,942)
<b>TOTAL</b>	<b>900,000</b>	<b>150,000</b>	<b>2,950,000</b>	<b>4,000,000</b>	<b>4,000,000</b>	-	-	-

As the table shows, significant tax benefits can be obtained during the initial years of placing a property in service with the use of a cost segregation study. In this particular example, the 50% bonus depreciation makes up a very significant portion of the first year deduction. Beyond year 6, the math flips the other direction providing less tax depreciation in future years.

Also important to note is the potential availability of the IRC Section 179 deduction which allows for the expensing of 100% of the cost of qualified property (generally personal property) up to a \$500k limit. However, this \$500k limit is reduced dollar for dollar to the extent all property eligible for Section 179 is placed in service during the year and is in excess of \$2M. Thus, if an individual acquires \$2.5M of property eligible for Section 179 the \$500k limit is reduced to zero.

So while this is simply a timing difference, the greatest benefit is the time value of money. Larger tax deductions today in today's dollars means a real estate investor or business owner can then invest those cash tax savings into additional properties or invest back into the business.

#### Are there any disadvantages to a cost segregation study?

Generally, there are few significant disadvantages to having a cost segregation done on property recently acquired or recently built.

**Cost Segregation Study.** It is recommended that a study be performed by a professional who is considered, by the IRS, to have the expertise and experience necessary. As such, these reports vary in price and typically start around \$5k but can increase depending of the complexity of the project, property scale, location, property type, and so on.

**State taxes.** If the property owner builds or acquires property in a state which has not adopted the federal bonus

depreciation rules, this could significantly impact the cost-benefit analysis of whether a cost segregation is beneficial.

**Depreciation recapture.** Unfortunately, what the IRS giveth they also taketh away. If the property is sold, any proceeds allocated to these categories with shorter lives can give rise to depreciation recapture. Basically, this causes all of the accelerated depreciation deductions to be recaptured at “ordinary” tax rates before any of the more favorable capital gains rates kick in.

A like kind exchange would be an excellent planning opportunity in this situation which could allow a property owner to “trade up” their current property for other real estate without having to pay taxes on the gain and without recapturing depreciation. Like kind exchanges are complex and outside the scope of this article. Please contact us for more information.

### **When should a cost segregation be done?**

There is no set deadline or timeframe in which cost segregation must be done. If fact, the IRS has provided streamlined procedures to request and obtain an automatic change in accounting method for properties placed in service in prior tax years. This streamlined approach provides a great benefit since it does not require amending prior tax returns. However, if a study is not done within the first 5 (or maybe 10) years of a property being built or acquired, there may be inadequate benefit to a cost segregation study as little tax basis remains to accelerate.

Additionally, it generally only makes sense to accelerate depreciation deductions when a taxpayer can achieve a cash tax benefit. In the example above, a cost segregation study could have generated approximately \$605k more tax depreciation so that means the property owner would likely need at least that much in taxable income to offset to realize a cash tax benefit (although there are some situations where this could be advisable but requires careful tax planning).

### **Next steps**

While there are many rules, definitions, and general nuances to be considered and handled, cost segregation is a powerful tax planning tool which can significantly increase cash flow in those earlier years of property ownership. This increased cash flow can enable real estate investors and business owners to scale faster, reach their goals sooner, and to realize their full potential.

Please contact us if you or your company could benefit having a cost segregation done on any of your property.

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