Cost Segregation

A Little Known but Valuable Tool for Commercial Real Estate Clients

by Teresa M. Beasley and Jennie L. Church

COST SEGREGATION IS A RELATIVELY new and somewhat obscure accounting tool that can help owners and lessees of commercial real estate realize significant cost savings. Attorneys may be unaware of this potentially valuable tool that could prove helpful to their clients who are active in commercial development or other aspects of commercial real estate.

Cost segregation identifies personal property assets that are grouped with real property assets, and then separately allocates the personal property for tax and accounting purposes. These personal property assets can be deducted over a shorter period of time. They are moved from a 39 year depreciation time period to five, seven or 15 year periods. This can reduce the taxes owed in the first few years dramatically. The taxes are gradually repaid through decreased depreciation deductions in the later years. This acceleration allows the taxpayer to maximize the present value of money.
Cost segregation can be used by any for-profit entity that has purchased commercial real estate since 1986. It may also be used by those constructing a commercial building, by tenants who are constructing significant leasehold improvements, or under other circumstances that trigger a substantial step-up in basis. Cost segregation experts generally recommend an initial threshold of $500,000 to $750,000 in acquisition or construction costs to consider the use of cost segregation. One CPA put the estimated savings using cost segregation this way: for every $10,000 of property that is reclassified to five or seven year property, the present value of the tax savings is about $2,000; for every $10,000 of property that is reclassified to 15 year property, the present value tax savings is about $1,000. Cost segregation may also be used retroactively to "catch up" on depreciations that could have been used in past years. Despite what many people believe, a taxpayer does not need to file an amended return if he or she wishes to utilize cost segregation for past years. The taxpayer would simply file a Form 3115, which is an Application for a Change in Accounting Method.

Besides the acceleration of deductions, cost segregation offers additional advantages to the taxpayer. One of these advantages is the ability to write off building components if they need to be replaced. For example, suppose the initial value of the siding of a building is $200,000 and then, five years later it must be replaced. Now, its adjusted basis is $150,000. Under cost segregation this $150,000 can be written-off as a loss. Without cost segregation, no part of the value of the siding could be written-off as its value would remain tied into the basis of the building as a whole.

The range of projects that can utilize cost segregation is wide and includes manufacturing, retail, apartments, office buildings, hotels, hospitals, restaurant and golf course, among many other examples. The direct costs that may be accelerated through cost segregation include decorative lighting, signage, decorative wall coverings and flooring, fire alarm systems, cabinets, appliances and portions of the electrical, plumbing and HVAC systems. It can also encompass indirect costs, including building permits, architect fees, soil testing, construction period interest under Section 263a and negative basis adjustments.

In order to take full advantage of the benefits of cost segregation, a taxpayer should obtain a cost segregation study from a qualified firm that has both the engineering expertise and tax expertise to produce a useful and dependable study. To prepare a cost segregation report, an architect, appraiser, engineer or other representative of the firm will inspect the building and allocate the costs of the property inside and outside of the structure between personal property (the portion that can be accelerated) and other property. So that the study is as accurate and thorough as possible, the taxpayer should be able to produce as much documentation to support the costs of the items identified by the firm to be reclassified as personal property. The IRS has warned that an "accurate cost segregation study may not be based on non-contemporaneous records, reconstructed data or taxpayers' estimates or assumptions that have no supporting records." Separately, a business entity must also utilize the services of an experienced certified professional accountant in order to apply the results of the cost segregation study to the tax situation.

The big four accounting firms often offer cost segregation services, but there are also smaller firms that specialize in providing cost segregation services. The IRS has published a "Cost Segregation Audit Techniques Guide" that provides internal guidelines for reviewing cost segregation reports. This Guide may be found at

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http://www.irs.gov/businesses/article/0,,id=134180,00.html. A formal report is not strictly required by the IRS to take advantage of cost segregation. A certified public accountant may be able to do the allocations without a study prepared by a third party. However, these do-it-yourself attempts at cost segregation are more likely to miss potential opportunities to allocate property, and thus, pass up valuable depreciation. They may also to fail to pass muster in the event of an audit by the IRS.

Potential downsides exist to utilizing cost segregation. The first is the cost of obtaining the report itself. Some firms may provide a free quote and estimate of the potential tax savings. A common range of costs for a study is $7,000 to $35,000, but the final cost will vary depending on the size of the project, the property's location, whether the building is new, the nature and relative amount of improvements that may be allocated as personal property and whether there are any unusual time pressures to complete the study. A well-done cost segregation study may provide many times more in savings than the cost of the study itself. A business entity can deduct the cost of the study as a business expense.

Further, the structure of the entity contemplating cost segregation and the financial condition of the entity must be considered. If an entity is not profitable, cost segregation will not be useful. Similarly, in the context of a partnership, depending on the state of an individual partner's finances at the time, one partner will not find it advantageous to go through the cost and effort of obtaining a cost segregation study if he or she cannot reap the benefits on his or her taxes. In either case, however, the ability to use cost segregation retroactively should be kept in mind if and when the entity or partner's financial state improves.

Due to its somewhat new and novel nature, many people may be worried about the risk of an IRS audit should they utilize cost segregation. However, those who work in the field say that cost segregation does not increase a taxpayer's risk of being audited. In the event of an audit, a thorough and well-supported cost segregation analysis that adheres to the IRS guidelines set forth at the web address listed above should withstand the IRS's scrutiny.

One reason for the relative lack of awareness about cost segregation is its relatively new arrival. No legislation was passed to implement cost segregation. Early users of cost segregation simply utilized existing parts of the tax code in a new way. The IRS often challenged these isolated uses of cost segregation until it was established as a legitimate accounting technique in Hospital Corporation of America v. Commissioner, 109 TC 21 (1997). It has since been developed through court cases and further publications from the IRS.

Attorneys active in the commercial real estate field should keep cost segregation in mind for their clients who might be able to enjoy its potentially valuable tax savings. ■

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