Cost Segregation Analysis: Uncovering Your Buried Treasure

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By Larry Brewster

I remember the day when I thought the bottom had fallen out of my fiscal world. My 19-year-old daughter told me she could not get enough financial aid to cover her $30,000 college tuition, and my wife found out she was expecting. Even though I am a successful business owner, I had not financially prepared for this type of situation. So, I asked myself, how can I find additional cash to address these unexpected financial needs? The answer came the next week when I received a flyer indicating how real estate investors can increase their cash flow by using cost segregation.

That flyer came to be my golden ticket. I met with a cost segregation expert and $50,000 later my daughter was back in school and my wife was making plans for the new baby room.

Real Estate Investors Increase Cash Flow with Cost Segregation

Cost segregation is a strategic tax savings tool that allows companies and individuals who have constructed, purchased, expanded, or remodeled real estate—acquired or built after 1986—to increase their cash flow by accelerating depreciation deductions and deferring their federal and state income taxes.

Cash flow is significantly affected when selected improvements are depreciated over five, seven, or 15 years, rather than 39 years for commercial property and 27.5 years for apartments. Savings for real estate investors are meaningful—exceeding $50,000 to $100,000 in the first year. Cost segregation converts income taxes at 35 percent (ordinary income) to income taxes at 15 percent (capital gains). Cost segregation also defers payment of income taxes, often five to 10 years.

Effects of Higher Depreciation

Most real estate investors do not understand the benefits of increasing real estate depreciation. They often ask, "Doesn't increasing my depreciation just mean that I will be shifting taxes from now until when I sell the property?" This is a popular misconception.

Revising a depreciation schedule makes a difference if you recently sold a property because the additional depreciation will be taxed at the capital gains rate instead of the ordinary income rate. For example, assume an investor sold a property in late 2005, does a cost segregation study, and increases depreciation by $100,000. The net result is that the ordinary income taxes will be reduced by $35,000 ($100,000 x 35 percent) and the capital gains taxes will be increased by $15,000 ($100,000 x 15 percent). This nets the owner $20,000 in federal tax savings by simply correcting an error in the depreciation schedule after the property has already been sold.

Proportion of Short Life Property

The proportion of short life property typically ranges from 20 percent to 50 percent of the cost basis of the improvements. There are more than 130 components in a commercial property that can be depreciated on a five, seven, or 15 year schedule, all in accordance with IRS guidelines.

Examples include:

- Five year: carpet, vinyl tile, decorative moldings, cabinetry, among others
- Seven year: signage, wall coverings, selected telephone and other communications equipment.
- Fifteen year: asphalt paving, landscaping, metal railings, exterior light fixtures

It is key for the expert who is visiting the property to determine which of these components are part of the subject property and the remaining depreciable life of those re-categorized components. Items that typically affect if it falls at the low end of the range or the high end of the range include: age, condition, intensity of landscaping, amount of surface parking, and land value.

Catch-up

Catch-up is reporting depreciation that has been underreported from the date the property was placed in service. A real estate investor can "catch-up" underreported depreciation by filing a Form 3115 with the current tax return. Moreover, you can file a Form 3115 without including the tax returns for each under reported year; only the current year is needed. The IRS has reported that filing a Form 3115 is not a red flag for an audit. The example below is based on a $1 million apartment complex. The amounts in the table are the year-one federal tax savings based on different levels of short

	Year 1 without catch-up				Year 1 based on catch-up	
	Without cost segregation	Annual depreciation	With cost segregation	Annual depreciation	Depreciation w/o cost segregation	Depreciation with cost segregation
Land	$200,000		$200,000	-	-	-
5 year property	$0		$225,000	$45,000	$0	$225,000
7 year property	$0		$32,400	$4,630	$0	$32,400
15 year property	$0		$378,000	$18,900	$0	$255,226
39 year property	$1,800,000	$44,298	$1,164,000	$28,661	$459,666	$297,404
		$44,298		**$97,191**	**$459,666**	**$810,030**

Year 1 Tax Saving	Without Catch-up	With Catch-up
Depreciation with Cost Segregation	$97,191	$810,030
Depreciation without Cost Segregation	$44,298	$459,666
Increase in Depreciation	$52,893	$350,364
Tax Savings at 35%	$18,512	$122,627
Fee of $5,000	$5,000	$5,000
Year 1 Payback Ratio	3.7	

Table 1

Typical Percentage of Short-Life Property

	5-year	7-year	15-year
Apartments	4-20%	1-2%	8-25%
Office	7-20%	1-5%	10-25%
Retail	2-15%	1-3%	11-40%
Industrial	3-8%	1-3%	13-35%

life property and different periods of ownership. Many investors have owned property for five to 15 years and have the opportunity to catch-up underreported depreciation. The numbers shown in this table will give you some idea of the amount of depreciation and federal tax savings achievable by obtaining a cost segregation study. The tax savings are based on a 35 percent tax rate. If you are subject to a state income tax, resulting savings will be higher.

Practical Example

The following example is for an office building purchased 10 years ago for $2 million. The value of the land is 10 percent or $200,000. The analysis without cost segregation assumes all the value for improvements is placed on the building. The analysis with cost segregation estimates a value of:

"... cost segregation study can also materially reduce local property taxes ..."

- $225,000 for the 5-year property,
- $32,400 for the 7-year property,
- $378,000 for the 15-year property,
- $1,164,600 for the 39-year property.

	5 years held	10 years held	15 years held
5-year property	$150,000	$150,000	$150,000
7-year property	$14,286	$20,000	$20,000
15-year property	$50,000	$100,000	$150,000

The year-one savings without the benefits of catch-up is $18,512. The year-one tax savings for a building purchased 10 years ago, including catch-up depreciation, is $122,627.

Cost Segregation Study Benefits

The first step to reducing your federal income taxes is to obtain a cost segregation study. Year 1 federal income tax savings are typically at least two times the cost of a cost segregation study. In many cases, the present value of tax savings is as much as 30 to 50 times the cost of the report. The cost segregation study is only required once. Its cost is not recurring, but the benefits are recurring during the term of property ownership. A cost segregation study can also materially reduce local property taxes by separating real and personal property for newly constructed properties.

When Should You Obtain a Cost Segregation Study

The best time to obtain a cost segregation study is when you build or purchase a property. Documentation is most readily available at that time for performing a study, and a contemporaneous property inspection can be performed to best document results. However, even if you have a portfolio of properties acquired 10 years ago or more, a cost segregation analysis can still be obtained and be useful.

Elements of Preparing a Cost Segregation Study

The appraiser starts by gathering documents from the property owner and visiting the site. As necessary, depending on the special-use property found during the site visit, the appraiser would confer with tax counsel and review relevant tax court decisions. For newly constructed properties, most of the costs detail can be obtained from construction draws or invoices from contractors. For existing properties, the appraiser performs a quantity take-off for 5-year, 7-year, and 15-year property and estimates replacement cost using recognized sources. The appraiser then values land, 5-year, 7-year, 15-year, 27.5-year and 39-year property based upon inspection, analysis, as well as IRS regulations and court rulings.

Carry-Forward/Carry-Backward Flexibility

One option to consider when using a cost segregation study is whether or not to use the extra depreciation immediately or for an earlier tax year. The IRS allows property owners up to two tax years to research for a tax credit, but this will require filing amended tax returns. Another option to consider is to apply your tax credit to your future federal taxes. To minimize federal income taxes, make a cost segregation study a routine part of future real estate investments.

"To minimize federal income taxes, make a cost segregation study a routine part of future real estate investments."

Still not convinced cost segregation is right for you? The following testimonials are by real estate investors who were also once skeptical but discovered how to uncover their buried treasure.

Editor's Note:

As with any financial endeavor of this sort, always consult your tax attorney prior to embarking on this course.