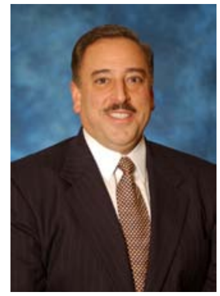
Cost Segregation Study – A Genuine Tax Opportunity Worth Pursuing



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Whether you are constructing a new building, expanding an existing one, purchasing real estate, rehabilitating an old facility or relocating with leasehold improvements, your property can generate much bigger tax and cash flow savings than you realize. Substantial tax and cash flow savings can be achieved by taxpayers who properly classify their construction or acquisition costs between real and personal property.

A cost segregation study carefully breaks down construction and/or acquisition costs and allocates them to specific categories – maximizing accelerated depreciation for qualifying building components. The shorter the depreciation period, the greater the tax savings. A detailed cost segregation study pays for itself many times over, starting with the first year the property is placed in service.

In general, a cost segregation study makes sense if your property cost is at least $1 million; you are in a high tax bracket; you have owned the property for ten years or less.

Usually, benefits are greatest if you meet these conditions. Return on investment is generally greater as the cost of the subject property increases. The benefits of a cost segregation study are derived from tax savings, which result in improved cash flow. It all boils down to a simple time value of money issue. Therefore, a study may not make sense if you are in a low tax bracket or if you pay no tax (e.g. you have a net operating loss).

The longer you own a property, the more cost you will have recovered through depreciation expense. However, even though you may have owned a building for several years you can still take advantage of missed depreciation deductions for prior years. The Internal Revenue Code and regulations allow for "catch up" of those missed deductions by filing an application for change in accounting method with the IRS. The IRS will automatically consent to the change, and because of a recent change in the regulations you can deduct the "catch up" entirely in your current tax year. This creates the potential for a deduction of hundreds of thousands of dollars in one year depending, of course, on the cost of the property involved and time period involved.

How a Cost Segregation Study Works

Typically, the cost of commercial real estate is depreciated over 39 years and residential rental real estate is depreciated over 27.5 years. Both commercial and residential real estate is depreciated using the straight-line method. A properly conducted cost segregation study will result in the identification of shorter-lived assets that are included in the "lump-sum" cost of a commercial or residential building. For tax depreciation purposes, these shorter-lived assets are shifted from 39 or 27.5 year depreciation periods to 5, 7 or 15 year depreciation lives. Certain soft cost can also be allocated to shorter-lived assets. A real estate owner will enjoy much greater depreciation expense deductions and faster write off of costs that formerly would have been included as part of a building.

Building costs are generally classified for federal income tax purposes into three categories. Each category has a different depreciation recovery period and method under the Modified Accelerated Cost Recovery System (MACRS).

- Tangible Personal Property.......................5 or 7 years
- Land Improvements ....15 years
- Real Property..27.5/39 years

A cost segregation study will help you identify items that should be properly classified. For example, a taxpayer who owns a manufacturing facility could classify the cost of certain equipment foundations, exhaust and ventilation systems, security systems and electrical distribution as tangible personal property. Certain site improvements such as landscaping, underground utilities and site lighting could qualify as land improvements. Knowing the difference is critical. So is the ability to support and document the decisions.

For further information on how you can realize significant tax savings from a cost segregation study, contact Stephen Reed at 732-676-4100 ext. 4070 or sreed@cowangunteski.com.

About Cowan, Gunteski & Company, P.A.

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