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## **Cost Segregation: Real Estate Owners Can Receive Tax Savings and Put Immediate Cash in Pocket**

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Businesses, Real Estate Investors and individuals can enjoy many economic advantages by owning real estate, but many property owners fail to take advantage of all the benefits available from the real estate they own. A cost segregation study can provide tremendous tax benefits and substantially increase cash flow for real estate owners.

There are well-known advantages for a business to own real estate—it effectively locks the monthly expense of office and operating space instead of paying escalating rent to someone else and the property's appreciation adds additional value to the business.

There are also tax benefits to consider such as interest, property tax, and depreciation deductions. The problem with depreciation deductions is that properties are depreciated evenly over 39 years even though many parts of the properties must be replaced before 39 years. This long period of time greatly reduces the tax benefit because of the time value of money. Even worse is that the cost of land is not recovered for tax purposes until it is sold.

Cost Segregation can help remedy the depreciation problem. Changing the way depreciation is taken by using cost segregation can tremendously improve the available tax benefit. Cost segregation is a valuable tax strategy that views depreciable property not just as a single building and land but as several elements of personal property and land improvements. The tax advantages and resulting tax savings come from accelerating depreciation. This acceleration reduces current and near future taxes and generates an immediate cash flow benefit. That's right cash in you pocket now!

### **A LITTLE HISTORY**

To understand the significance of this opportunity, it is helpful to understand how it is different from prior tax treatment. Before 1981, taxpayers were allowed to break their real estate into components. A building, for instance, would be sorted into separate components. The roof would be one component while the shell would be another component. Each component was depreciated over a different lifetime. The shell in this case would be depreciated over 40 years and the roof over a 15 or 20-year recovery period. The result of this "componentization" was that the building as a whole would be depreciated on average over a composite life of 20 to 25 years.

With the passing of the Economic Recovery Act of 1981, the use of component depreciation was repealed. The new tax act introduced the accelerated cost recovery system (commonly abbreviated as ACRS, pronounced as "acres"), which required real estate to be depreciated over a 15-year life. The loss of component depreciation to business was not a big issue since it was replaced with a short depreciable life.

But the 15-year life did not last long. The Tax Reform Act of 1986 increased the depreciable life of real estate to 31.9 years for nonresidential property and 27.5 years for residential property. The depreciable life for nonresidential property is now 39 years. The result of the 1986 changes is that real estate owners are limited by long depreciation lives that are not economically realistic and that reduce the tax advantages of owning real estate. Since componentization was previously done away with, there was no longer a way to depreciate parts of a building, like a roof, that will not likely last 39 years.

Although the introduction of ACRS, and its successor modified accelerated cost recovery system (MACRS), eliminated the component method of depreciation, the courts have upheld that businesses can still use cost segregation to break out some of the costs of real estate.

The authority to segregate costs comes from the 1997 case *Hospital Corp. of America*<sup>i</sup>. The court found that the definitions of personal property used in related sections of the Internal Revenue Code allowed Hospital Corp. of America to use a segregation technique that resulted in many parts of their hospitals being classed as personal property with depreciation lives much shorter than 39 years.

The IRS reluctantly agreed<sup>ii</sup> that cost segregation does not constitute component depreciation and accepted cost segregation as a qualified method of allocating costs to personal property. However, the IRS also said in part<sup>iii</sup> "accurate cost segregation study may not be based on noncontemporaneous records, reconstructed data or taxpayers' estimates or assumptions that have no supporting records". The IRS has since provided additional guidance regarding what is considered to be sufficient support for a cost segregation study.

### **SEGREGATING COSTS**

Cost segregation studies make it possible to identify assets installed in a building and account for them separately. The costs attributable to those segregated assets are reclassified from the building or real estate costs and allocated to the segregated assets. This personal property can then be depreciated over lives ranging from 3 to 20 years. The most common lives of personal property segregated from a building are 5, 7 or 15 years.

