Cost Segregation & 1031 Exchanges

Combine Both to Maximize Cash Flow

1031
Knowledge

Cost segregation and tax-deferred exchanges under IRC Section 1031 are two valuable tax-planning strategies available to commercial real estate owners today. Section 1031 exchanges permit a taxpayer to defer taxes that would otherwise be generated on a sale of an investment property, and, as explained below, cost segregation studies can generate accelerated depreciation benefits that help increase after-tax cash flow earlier in the ownership period. With proper tax planning, both tax strategies can be used on the same property to obtain better available tax benefits.

Commercial real estate owners can utilize a cost segregation study to increase current depreciation deductions on newly acquired improved real property and property that may already have been placed in service. In the absence of cost segregation, certain equipment associated with the property is lumped together with fixtures and classified as "improvements." Improvements to real property are generally depreciated using the straight-line depreciation method over periods as long as 39 years. By engaging a cost segregation expert, certain equipment associated with improvements are carved out and more accurately classified as property eligible for accelerated depreciation. Using cost segregation, depreciation recovery periods for certain items associated with the property can be reduced to a period as short as 5 years. Moreover, by reclassifying such property, a taxpayer may be able to use an accelerated depreciation method available under current tax law. In general, a shorter depreciation recovery period will generate larger depreciation deductions in the early years of ownership. Increased deductions reduce taxable income and can generate significant cash flow benefits.

A §1031 tax-deferred exchange allows a taxpayer to defer payment of capital gain taxation upon the sale of a relinquished property, if the owner acquires like-kind replacement property and follows the IRC §1031 rules and Treasury guidelines. Most investment real property is generally considered like-kind to any other type of investment real property.

RELATIONSHIP BETWEEN COST SEGREGATION AND 1031 EXCHANGES

- Both strategies can be used on the same property.
- Both techniques are used to defer taxes and, therefore, improve cash flow.
- Both can be performed on every type of commercial property held for investment.
- Both encompass complex areas of tax law and necessitate the use of specialists.

TAX PLANNING AND CONSIDERATIONS

A cost segregation proposal will help the building owner and taxpayer determine if a study will be beneficial for the replacement property in a 1031 exchange, given the carryover tax basis. In general, cost segregation studies are most advantageous when the building has a basis greater than $1million. Taxpayers who choose to proceed with a cost segregation study should also plan for the possibility of future depreciation recapture which may generate taxes in a later sale.

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