

# Cost Segregation Studies

Accelerated Cash Flow with Cost Segregation

1031

Knowledge



## IMPROVING CASH FLOW WITH COST SEGREGATION

Commercial property owners may realize significant tax savings through an IRS approved procedure known as a cost segregation study (CSS). In most cases, all depreciable costs are lumped together and depreciated using the straight-line method with recovery periods of 39 years for commercial real property and 27.5 years for residential real property. A CSS will properly identify assets (e.g. special-use electrical and mechanical) as well as land improvements that can be depreciated more rapidly under the taxpayer's method of accounting. Certain assets identified in a CSS may be eligible for accelerated depreciation with recovery periods of 15, 7 or 5 years. Thus, the CSS can increase after-tax cash flow by reducing taxable income in the early years of ownership.

The primary benefit of cost segregation is based on the time value of money. A cost segregation study will provide access to deductions sooner, allowing an owner to defer substantial tax payments into future years, thereby creating a significant net present value benefit. Deferring tax payments increases current cash flow and allows taxpayers to utilize their funds for other means. Further, taxpayers who do not depreciate assets over the shortest allowable recovery periods may be losing money.

## COMMONLY OVERLOOKED APPLICATIONS OF COST SEGREGATION

While many taxpayers and their advisors know that cost segregation studies can be used on newly constructed or acquired properties, most are still unaware of the benefits of using cost segregation for properties already placed in service. Look-back studies allow investors to modify their existing depreciation schedules and reclassify costs that were listed as 39 or 27.5-year property, but could have been allocated to 5, 7 or 15-year recovery periods. These studies correct previous deductions resulting in significant "catch up" depreciation. The catch-up adjustment can now be taken in a single year per *Revenue Procedure 2002-19* by completing [IRS Form 3115](#) which notifies the IRS of an automatic change in accounting method – all without the need to amend prior tax returns. Many taxpayers and advisors are not aware that this significant tax benefit may still be available via a look-back study.

Taxpayers who recently made improvements to existing properties are allowed to classify the majority, in some cases all, of their costs into a 15-year recovery period instead of the usual 39-year category. A CSS will properly identify all assets eligible for this special treatment as well as the 5 or 7-year property.

## 1031 EXCHANGES AND COST SEGREGATION

With regard to 1031 exchanges, it is important that the investor consult with their tax advisors to make certain they have acquired enough real property to fully meet the 1031 exchange requirements, especially if they perform a CSS on a newly acquired replacement property.

## Compliments of:



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