

Cost segregation FAQs

How a cost segregation study can help your bottom line **Interviewed by Matt McClellan**

Many executives are curious about cost segregation studies, but are unsure how they work, or even if their business would benefit from one.

Basically, a cost segregation study looks at specific components of your business' facilities to find which components can be separated out and depreciated over shorter time periods therefore speeding up the related tax deductions. The true value of a cost segregation study is realized by looking at the time value of those tax deductions — being able to take the related tax deductions sooner provides more value for the taxpayer.

"The benefit of a cost segregation study is that you would get more deductions in the first five, seven or 15 years than you would if you didn't do one," says David R. Walter, CPA, MBA, a manager with Skoda Minotti. "Without one, you would get more deductions between years 15 to 39. When you're looking at value of money over time, you've actually lost out without the cost segregation study."

Smart Business spoke with Walter about the frequently-asked-questions he receives about cost segregation studies.

What does a cost segregation study entail?

A cost segregation study is the review of a building by a qualified individual (engineer) to identify items qualifying for quicker depreciation. These studies are a combination of reviewing the blueprints and the cost report (for constructed buildings) or appraisal report (for purchased buildings) to evidence the building make-up and a visiting the actual building to see if there are any other items that can be split out even though that's not clear in the source documents.

How is the tax deduction calculated?

A building is depreciated using the straight-line method for 27.5 years (residential) or 39 years (commercial). In most cases, the cost of the building is made up of the total cost to construct or purchase the building. This study can separate out parts that can be depreciated over five, seven or 15 years, essentially speeding up tax deductions.

For example, let's say the total cost of a commercial building was \$975,000. Without a cost segregation study the annual depreciation expense would be \$25,000 ($\$975,000/39$). If the study determines that \$195,000 of the building's total cost is land improvements which can be depreciated over 15 years, the annual deduction for the first 15 years in-



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creases to \$33,000 ($(\$975,000-\$195,000)/39 + (\$195,000/15)$).

Even though the taxpayer will get the same amount of deductions over the life of the building either way, speeding up that depreciation on those specific assets speeds up tax deductions.

What if you purchased or built your building several years ago?

The good news on this issue is that even if a study is done in a year subsequent to the construction or purchase of a building, the taxpayer is able catch up the depreciation expense on the tax return for the year in which the study is done. This gives the taxpayer a huge deduction in the year of the study, and the ability to use the quicker depreciation method over the remaining useful life of those assets. This catch-up depreciation expense will reflect the total depreciation deduction over the years as if it was done from day one.

To build on the previous example, assume all facts are the same except that the cost segregation study was done in the sixth year of owning the building. The taxpayer can take a total depreciation deduction of \$73,000 ($\$33,000$ (annual depreciation) + $\$40,000$ (catch-up depreciation)) in that year. The \$40,000 catch-up in depreciation is calculated by comparing the depreciation to date using the study ($\$165,000$ ($\$33,000 \times 5$)) to that not

using the study ($\$125,000$ ($\$25,000 \times 5$)).

Why do you need experts to do a cost segregation study?

Some people will think, 'I can estimate what portion of the total building cost that qualifies from my blueprints and cost reports, so I'll just depreciate those quicker.' The IRS has made it very clear that, for these pieces to be pulled out and to get the study's benefits, you need an engineer-based report to support the speed up of depreciation.

Are tax savings the same on every building?

You have to consider many factors (i.e. size, finished space, and purpose) of the building to determine the potential for tax savings. A warehouse would have the least potential; with just four walls there isn't as much to be depreciated quicker. If that warehouse has an office within it, there is more potential as the office portion would have more separable items. Going to the extreme, if you have a manufacturing or medical facility, there is a lot of potential there. They have not only more finished space, but they have specialized areas that can be depreciated quicker in those facilities.

If I do a cost segregation study, am I more likely to get audited?

A cost segregation study doesn't raise any red flags with the IRS. At this point, they have seen many of these studies. The study alone won't raise a red flag, but other things might. You want that cost segregation study in your files to support those deductions.

How can businesses know if they qualify for a cost segregation study and if it will be cost-beneficial?

Every building is unique. But usually, buildings valued at \$500,000 or more typically see a net present value of tax benefits compared to cost that would make the cost segregation study cost beneficial. Your CPA should be able to conduct a free feasibility study to help you quantify the amount of tax savings you could receive and determine if any obstacles may prevent you from realizing the full effect of the increased tax deductions. Comparing the amount of tax savings to the cost of the study will help you make a decision. <<

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