

# Cost Segregation Strategies

## Property owners can utilize the IRS to improve cash flow

By Roger T. Gingerich, CPA/ABV, CVA

If you have purchased, constructed or invested in real estate in the last few years, you may have heard the term “Cost Segregation Study” (CSS). Although the overall concept of a CSS has existed for a while, it is still not widely utilized, nor is it completely understood how it can enhance cash flow and be the cornerstone of a property owner’s overall tax plan.

A CSS operates on the same principal that most good tax planning relies on – by decreasing current income through depreciation, you defer income taxes to a later tax period and gain financially due to the time value of money related to the taxes deferred. Simply put, a tax deduction today is worth more than a tax deduction next year, and worth a lot more than a tax deduction 27.5 to 39 years from now (the length of time it takes to depreciate a building). This usually saves the real estate owner \$75,000 or more.

Property Type Reclassified	Average % Eligible for Reclassification
Office Buildings	15-30%
Manufacturing	25-75%
Auto Dealers	35-60%
Hotels	25-40%
Apartments	18-35%
Industrial Buildings	22-60%
Shopping Centers	25-40%
Restaurant	25-60%
Healthcare Facilities	35-50%
Leasehold Build-Out	50-80%

Table A

The premise is to think of your overall real estate acquisition or new construction not just in terms of land and building, but also in terms of tangible personal property and land improvements.

### Cost segregation defined

Cost segregation is an Internal Revenue Service-approved method of reclassifying components and improvements of

commercial and larger residential real property from real estate to personal property. The process allows the assets to be depreciated over five, seven or 15 years instead of the 39- or 27.5-year depreciation lives for real property.

Cost segregation is not a tax shelter, nor is it often challenged by the IRS if executed and documented prop-

erly. In fact, the Internal Revenue Service has essentially approved the process as long as it is properly backed with an engineering-based study. The study must follow specific guidelines that the IRS has laid out in a series of court cases, authoritative pronouncements and its own Audit Techniques Guide published at [www.irs.gov](http://www.irs.gov). Since a CSS is a combination of both tax law and construction knowledge, you should make sure the firm you work with has both areas of expertise.

### Some examples of what qualifies

The following are examples of types of properties that qualify for cost segregation:

*Personal property* – items such as carpeting, cabinetry, decorative lighting, generators and other fixtures

*Land improvements* – landscaping, sidewalks, site preparation, and paving

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Illustrated in *Table A* are the types of buildings eligible for potential reclassification as well as the typical percentage of the building that can be reclassified.

### Is my property the right fit?

An investor can utilize cost segregation when constructing a new building or acquiring an existing one. In addition, a provision exists that allows you to “catch up” depreciation on a building you have already owned for several years by taking the entire accelerated deduction in the current year – in other words, no amended returns. “Catch-up” cost segregation studies yield the greatest immediate tax savings.

Cost Segregation studies are applicable for nearly any real estate placed in service after 1986, however for practical purposes, buildings placed in service after 1993 will yield the greatest economic results.

The starting threshold for a study to make economic sense is about \$500,000 in hard building and

Facility Cost	\$2,100,000
1st Year Increased Cash Flow	\$49,000
Net Present Value of Increased Cash Flow	\$168,000
Benefit-to-Cost – Net Present Value	24:1

Table B

improvement costs. For build-outs and leasehold improvements the threshold amount is reduced. In addition, recent changes in depreciation tax law regarding Qualified Leasehold Improvements, Bonus Depreciation, and Section 179 expensing can dramatically increase your savings. For example, if you built a building in 2008, the IRS allows you to write off half of your land improvements, such as landscaping and paving.

### A sample project

Table B (above) details a cost segregation study conducted on a newly constructed self-storage facility.

### How to get started

It is simple:

1. Identify real estate holdings that you feel may qualify. You should also consider buildings that you or your tax advisors feel have already been “segregated,” because you may have left tax dollars on the table.
2. Get a copy of your tax depreciation schedule (not Form 4562, but the schedule that supports it).
3. Get your building’s address.
4. Contact an experienced Cost Segregation Specialist who has both tax and construction knowledge.
5. Most Cost Segregation Specialists will prepare a projection of your potential tax savings at no charge.
6. Weigh the potential benefits against the cost of having the study performed. **P**

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