Cost segregation, though known by many commercial real estate owners, is often overlooked.

It is a methodology used to reclassify certain building costs into separate identifiable components that can be depreciated over shorter lives (5-, 7- & 15-years). The primary purpose of a cost segregation study is to reclassify as much of the qualifying building costs between land improvements and tangible personal property (§1245). The more costs allocated to personal property, the greater the desired tax benefit. Personal property creates tax benefits because of it's shorter depreciation period while normal "real property" (§1250) building costs are depreciated over 27.5 or 39 years.

A cost segregation study may be performed for commercial or residential rental real estate already in service, for new construction and acquisitions. Generally, it is easier to analyze a building's cost structure during initial construction or expansion since building plans are readily available and can be utilized to identify various components that may qualify as personal property. Additionally, if cost segregation is engaged at an early enough phase, it can be used to actually "create" §1245 property by changing the method used to construct or connect the components.

Costs that may be reclassified to land improvements consist of, but are not limited to, certain landscaping, sidewalks, curbs, wheel stops, and fencing which are depreciated over a 15-year recovery period. Costs that may be reclassified to personal property include, but are not limited to, movable partitions, secondary (decorative) lighting, redundant systems (e.g., back-up generator and AC for computer room), removable carpeting and wallpaper, certain fixtures and window treatments, and cabinetry, just to name a very few. Support systems that are needed to run certain equipment or machinery could be considered personal or "tangible" property under most circumstances.

There are several internal levels of cost segregation studies ranging from a detailed engineering approach through a less formal rule-of-thumb appraisal. The Internal Revenue Service prefers the engineering approach since it will produce the most accurate results as it is performed by those trained and licensed in construction knowledge, techniques and experience.

All businesses that acquire, construct or renovate real property would benefit from a cost segregation study. The real benefit of a properly documented cost segregation study is the enhanced depreciation deductions it yields. A major advantage of the study is not necessarily that it produces more depreciation deductions, but that expenses accelerate more rapidly, producing a greater benefit due to the time value of money.

The ability to write off specific components identified as they are replaced is yet another advantage. For example, when a study is performed, the cost of the roof would be specifically identified. As the roof will eventually be replaced, the remaining cost could be written off.

One disadvantage of a cost segregation study is the potential triggering of depreciation recapture and possible understatement penalties a taxpayer could incur for studies that are too aggressive in classifying costs. To avoid penalties, and pass IRS scrutiny, the study must be objective and supported by contemporaneous records. Studies supported by an engineering study add credibility and produce the most accurate cost allocations.

Overall, cost segregation studies can produce tremendous tax savings for those who build or purchase real property (§1250), acquire §1250 property via 1031 Exchange, make leasehold improvements, or the investor who buys/builds with the intention of selling in 5 or more years out. The increased tax-savings increase cash flow, which in turn, businesses can reinvest, reduce real estate & use taxes, and lower property insurance premiums.

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