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Cost segregation for owners lowers taxes

For the last decade, owners have been taking advantage of the CSS tool to lower taxes.

BY DENNIS DUFFY AND RANDY VESCO

The concept of cost segregation, and its benefit to building owners, has been receiving increased attention from accounting and tax professionals and their clients since the Hospital Corporation of America case in 1997 and the IRS acquiescence in 1999. These events established a philosophy and direction for cost segregation studies.

A Cost Segregation Study (CSS) is a strategic tax tool that allows owners to allocate building costs between real estate and personal property based on case law and IRS guidance using qualified construction engineers and estimators to perform the study. The result is to accelerate depreciation in the early years of a project's life, producing deferred taxes and increasing cash flow during that period. Costs are legitimately moved from longer real estate lives (39 years for commercial and 27.5 years for nonresidential real estate) to shorter class lives of 5, 7 and 15-years, respectively. Savings are measured in the net present value of deferred taxes over the project's life.

IRS Legal Memorandum 199921045 established that it is the "ultimate use" of the item that dictates its classification as an item for tax purposes. Take for example, a facility's electrical distribution system. The cost of the system necessary for the operation of the building would be 39-year property, while the costs related to the operation of a press or a computer could be 7 and 5-year property. The portion of the system that provides lighting to the parking lot may qualify for a 15-year life.

How does it work?

Using the example of a $2 million building, in the absence of a CSS, there is no basis to depreciate a commercial building over less than the 39 year MACRS period. After a CSS has been performed by qualified engineers/estimators, $350,000 of the cost has been moved to 15-year property and $250,000 to 7-year property. As a result, $425,000 of depreciation has been accelerated and additional cash flow of $200,000 has been generated from the tax savings from accelerating the depreciation. The net present value of these cash flows at 6% over the life of the building is $132,000. If the aftertax cost to do the study was $6,600, the taxpayer would have received a 20 to 1 ROI.

Under what circumstances can the costs be reclassified to shorter depreciable lives? The IRS Legal Memorandum says, "As a practical matter, it should be noted that the use of cost segregation studies must be specifically applied by the taxpayer…An accurate CSS may not be based on noncontemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records." A CSS is necessary to segregate the costs, and that it must be based on documented records, not percentages or estimates. Using qualified professionals to perform the study will satisfy this requirement and maximize the savings, while providing the independent documentation that the IRS will look for.
Identifying items to be segregated is just the beginning. Actually determining the costs legitimately associated with each item is the hardest part. Using the example of the electrical distribution system, it's one thing to know that portions of the wiring and electrical load can be depreciated over shorter lives. It's another to "unbundle" those costs from one contract amount or invoice into the shorter depreciable lives.

It’s not only the direct costs that can be segregated, but also a portion of any indirect costs such as architect fees, legal and engineering fees, contractor’s general conditions, permits, bonds, capitalized interest, appraisal, design and construction management, to name a few. A CSS does not create additional personal property tax for Ohio; the costs remain nontaxable as real estate.

What properties can benefit? In general, properties constructed, purchased or with substantial leasehold improvements made since 1987, such as manufacturing, distribution, retail, auto dealerships, health care, office buildings, golf courses, hotels & motels, apartments, restaurants, funeral homes, banks, airports, and so on, can benefit. In actual practice we have found that those buildings constructed or purchased since 1994 seem to have the best potential for net present value savings. However, all buildings purchased or constructed since 1987 should be evaluated on a cost/benefit basis.

What typical costs
can be reclassified?
These can be portions of site preparation, site utilities, asphalt paving, concrete walks and curbing, exterior lighting, fencing, landscaping, railings, flagpoles, retention basins, decorative flooring, wallpaper, observation windows, interior fencing, decorative millwork, dock equipment, fire extinguishers, cabinets, electrical distribution systems, and plumbing, among others. What happens with buildings built or purchased prior to the current year? Can you go back? Yes! You may claim “catchup” depreciation since the building was placed in service by filing a Form 3115 for a change in accounting method in the current year. This is now an automatic consent by the IRS (Rev. Proc. 9949). The adjustment created by the increased depreciation is taken against taxable income in the year of change. If it can’t all be used in the current year, it can be carried back or forward depending on the taxpayers situation, and possibly generate tax refunds.

Is CSS for everyone? No! The expected benefit from the net present value savings from the study must exceed the cost of the study. There are several points to investigate. First, the client must be able to use the additional depreciation deductions currently or in the foreseeable future. Second, the benefit can be significantly reduced if the client is in an AMT position. Third, if the client contemplates the sale of the building, depreciation recapture and 1031 exchange issues need to be explored. BXM
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