Cost Segregation:

If you are a CPA and haven't heard the term "Cost Segregation" yet, you will undoubtedly hear more about it going forward. Since the IRS released it's one hundred and twenty page Cost Segregation Audit Techniques Guide last September, the buzz about the topic has never been greater.

Even though Cost Segregation has been around for over 20 years, it is only now finally becoming mainstream. In 1986, congress abolished the Investment Tax Credit (ITC) and stretched the depreciable lives of buildings from 19 to 31.5 years, and now to 39 years (27.5-years for residential rental property). Taxpayers saw their normal deductions on property reduced significantly. It was around that time the Big Four Accounting firms began to pioneer cost segregation in its current form and started recommending it to their larger clients. The idea was simple. All buildings contain components and fixtures necessary for taxpayers to run their businesses. These items are not necessary for the ordinary operation and maintenance of a building and should not be considered "structural components" of the building. Conversely, they are defined as "tangible personal property" or "land improvements". Even though the IRS did not allow component depreciation under MACRS, the Tax Court ruled that items in a building that qualify as tangible personal property under the former ITC rules may be separately depreciated under MACRS as personal property. (Hospital Corp. of America, 109 TC 21, Dec 52,163)

What has taken so long for CPAs to jump on the bandwagon?

The IRS initially did not agree with the concept of cost segregation. Over the years they contested the idea that items inside and attached to buildings should be treated differently than the building's themselves. As the IRS continuously lost hundreds of court cases on the use of these studies and the types of building fixtures that qualify as personal property, the foundation for cost segregation continued to develop. More CPAs would recommend these studies as the benefits that were realized were too large to ignore. Each time the IRS lost a case involving cost segregation, it opened the door for other CPAs and taxpayers to draw parallels to their properties. For instance, in 1986 Illinois Cereal Mills argued that a portion of their building's electrical system should be considered personal property because 95% of the load was being used by manufacturing equipment. The tax court agreed and 95% of the cost of that system was allowed to depreciate as personal property. Today, every taxpayer who uses a cost segregation study will have this same type of load analysis performed on their building to get the same types of benefit!

The most recent landmark case was Hospital Corporation of America in 1997-1999. After trying one last time to make the argument that building items should not be treated differently, the IRS lost. Shortly after the case, the IRS formally acquiesced to the use of cost segregation studies with the issuance of Chief Counsel Advice 199921045. This official guidance laid some basic ground rules for the use of cost segregation. It was at that point that the larger accounting firms began to focus on building their cost segregation practices. Even then, smaller companies and taxpayers had to pay high fees to have this very specialized service done. It is only recently that enough expertise has entered the market to make the service affordable to smaller companies and investors who own buildings as small as $750,000.

The recent issuance of the Cost Segregation Audit Techniques Guide in September of 2004 is another signal that cost segregation is on the rise. In this guide, the IRS states to its field agents that "the use of cost segregation studies will likely continue to increase". These developments, along with bonus depreciation and rules that make it easier to do studies in prior tax years, have created more interest in cost segregation than ever before.

So how does this translate into dollars?

Consider the following example: A taxpayer constructs an apartment building for $2.1 million and places it in service in the same year. The client's CPA identifies that $100,000 is for furniture and equipment such as stoves, dishwashers, and other appliances. The remaining $2 million of project costs are treated as 27.5-year property until a cost segregation study is performed. The cost segregation specialist finds that an additional 16% of the construction-related costs should have been reclassified to a 5-year life and 9% of the cost to a 15-year life. Further assume a combined 41% federal and state tax rate.

Any structure used in a business environment is eligible for the benefits of Cost Segregation. A study can generally allow a property owner to accelerate depreciation on 20%-30% of a property's cost for typical buildings. For every dollar a cost segregation specialist moves from 39-year property to 5-year property, the total net present value benefit is about 22 cents.

How exactly is the study performed?

The cost segregation process utilizes an engineering based approach to identifying assets in a building that can be reclassified into a much shorter depreciable life. A Cost Segregation expert has a unique blend of knowledge in construction, tax, and accounting. A quality Cost Segregation Study evaluates all available information on the property and presents the findings in a clear, well documented format. At a minimum the study should include the following.

- A review of all cost detail for the property including but not limited to: the general contractor's application for payment, change orders, depreciation schedules, and appraisals.
- An inspection of the facility to fully understand its nature and use, as well as to gather information that further supports the classification of capitalized costs into their appropriate class lives.
- Photographs should be taken of qualifying construction components and included in the report.
- A review of all blue prints, if available, and the performance of quantity take-offs and cost estimates for personal property not segregated in the cost information.
- A reconciliation of all construction costs and estimates to the actual amounts incurred by tax life: This step includes trending estimates to account for location, time, and physical condition.
- A pro-rata allocation of soft costs, such as capitalized interest and engineering fees, to any direct cost in each category to maximize total benefits.

IRS Encouragement:

The IRS has made it easier than ever to file a Form 3115, which allows a taxpayer to go back and do a cost segregation study in a prior year without IRS consent. This form provides for an "automatic change". The recently issued Rev. Proc. 2004-11 permits a taxpayer who has only filed one tax return with errors in depreciable lives the option to file a Form 3115 to claim missed depreciations instead of amending the return. This is effective for tax years ending on or after December 30, 2003. Prior to this Revenue Procedure, a Form 3115 "Change of Accounting Method" was only permissible if a taxpayer failed to claim the correct amount of depreciation in two or more consecutive tax years.

For many taxpayers that own real estate, Cost Segregation is a slam dunk. It offers an easy, turnkey opportunity to significantly reduce taxable income. Today, more CPAs than ever are recommending the service to their clients.