

Generating Cash Flow Through Cost Segregation

While considerable profit can be made on real estate investments, it's important to remember that real estate costs are charged to income in tax returns through depreciation deductions over 39 years. Such a lengthy cost recovery period can make location and expansion decisions difficult due to potential pressure on cash flow.

Based on a new set of rules approved by the Internal Revenue Service, a significant portion of real estate can now be classified as personal property, resulting in potential depreciation lives of five, seven or 15 years instead of 39 years. The cash flow generated from tax savings by higher depreciation deductions in the early years of property ownership can be enormous. This type of cost segregation program works well for both new construction and assets already placed in service.



Real Versus Personal Property

Cost segregation is based on determining whether property is part of the overall building operation and maintenance or if it's employed in a particular function or ultimate use. It is not the same concept as the now outlawed component cost system where, for example, electric and plumbing were considered to have different depreciable lives than the brick and mortar structure.

Under the cost segregation rules, for example, the portion of the electrical installation that relates to building operation and maintenance remains a 39-year asset. However, electrical installations for special services unique to a business, such as hospital operating rooms, restaurant equipment or showroom lighting in an auto dealership, can be as low as 5 years. By understanding the new definition of real and personal property, we can examine and determine which fixtures and equipment within a business may be classified or reclassified as personal property and, as a result, be eligible for faster depreciation.

Morrison, Brown, Argiz & Farra helped a retail business in Maryland, with 505,000 sq feet of property, realize nearly \$1.2 million in tax savings through a cost segregation study.

Cost Segregation Study

A cost segregation study involves consulting with an engineering or architectural firm that will review the plans and cost breakdown of your real estate. The new rules require an item-by-item study with professional determinations and documentation of the factors used. Without a document based on specific application rather than allocation, the IRS will not permit cost segregation to be used. The rules do not allow non-contemporaneous records, reconstructed data, taxpayer's estimates or assumptions without supporting records.

An MBAF client deferred \$99,000 in taxes by classifying 60% of construction as short-lived property in the development of an auto dealership.

To complete the study, we first apply the U.S. Tax Court test for classifying real and personal property, based on the engineer's report. The study is finalized by assigning new depreciation lives under the Class Life System in accordance with IRS published procedures. In the case of newly constructed or acquired property, cost segregation is allowable once the cost study is finalized.

In situations where property was already placed in service, the courts have stated that any adjustment for missed depreciation can be deducted in the current year. The bottom line is that every \$1,000,000 of property reclassified to a 5-year life has an after tax present value of



\$210,000. With 7-year property, the value is \$180,000 and for 15-year property \$100,000. These figures are based on a 10% discount rate and a 40% combined tax rate.

One word of caution -- the IRS chief counsel's office has issued a detailed opinion on the acceptable methods of implementing cost segregation and the required documentation. It is imperative that these rules be followed carefully to obtain the benefits and avoid costly administrative and legal proceedings with the IRS.