How Cost Segregation Studies Can Increase your Tax Savings

All real estate owners and investors are concerned about how they can reduce and/or defer their taxes. Cost segregation studies and 1031 Exchanges are two powerful tax strategies that investors can utilize to both reduce operating expenses and defer capital gains taxes. There are several factors that investors should take into consideration.

The Role of Depreciation

Depreciation allocates the cost of a tangible asset over its useful life and operates differently depending upon whether the property is residential or commercial. Both utilize "straight line" depreciation methods as follows:

- Residential Real Property (including apartment complexes) is generally depreciated over 27.5 years;
- Commercial Real Property is generally depreciated over 39 years

Personal property, and not real property, has always been afforded accelerated depreciation. Generally, personal property is allowed to be depreciated over five, seven or fifteen-year periods. This accelerated method of depreciation represents the value of a cost segregation study. That is, an investor can obtain a cost segregation study to reclassify value from real property to personal property and obtain "accelerated tax benefits" by writing off those assets in a much more expeditious fashion. The new Tax Reform Act of 2018 additionally enables investors to immediately expense qualified personal property in the year of acquisition. This therefore means that in certain situations, 100% of the depreciation deductions can be taken in the first year of ownership!

The foregoing makes it clear that an investor can obtain significant tax savings by strategically utilizing depreciation, cost segregation and 1031 exchanges in their tax planning analysis. For example, $1,000,000 of depreciable value using a 39-year straight-line depreciation will produce an annual depreciation deduction of $25,641. However, the same $1,000,000, if depreciated as personal property over a seven-year period, will produce a deduction of $142,857 for the first year and a deduction of a whopping $200,000 if depreciated over five years! Therefore, a property owner can generate large tax savings by reclassifying parts of a building for depreciation purposes from real property (§1250 property) to personal property (§1245 property).

For more information:

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How A Cost Segregation Study Works

As noted above, a cost segregation study enables an investor to reclassify real property to personal property on certain assets for depreciation purposes. To have a valid cost segregation study, the IRS requires that an actual study be performed by companies or accounting firms who specialize in this area and employ engineers and/or construction management professionals. A thorough knowledge of accounting, tax law and construction is therefore required for a comprehensive study.

The engineering report should divide the real property into four categories: land, land improvements, building/structural components, and tangible personal property. A good cost segregation study will reclassify at least 20-30% of a building as personal property for depreciation purposes. As a result, depreciation deductions are dramatically increased and taxes are correspondingly reduced.

While the benefits of a cost segregation study include increased cash flow and reduced taxes, it may potentially complicate a future like-kind exchange under Section 1031. If the replacement property contains less Section 1245 personal property than the relinquished property had, the investor may have to recapture the prior depreciation (to the extent of the gain) as ordinary income. To avoid depreciation recapture, the investor may need to find replacement property that either had a valid cost segregation study or perform a study on the replacement property prior to closing.

Similarly, the immediate expensing after a cost segregation study under the new Tax Reform can potentially create tax consequences when the property is sold. If those items (that have a zero basis) have value when sold, the seller will have to recapture the prior depreciation (to the extent of the gain) as ordinary income. An investor may therefore wish to employ an appraiser at the time of sale to ascertain the value of any real property that is being sold to determine if the previously reclassified personal property has any remaining value. Although immediate expensing represents a huge benefit under the new tax law, it is important to be certain the advantages outweigh the disadvantages.

While cost segregation studies provide real benefits to investors considering a 1031 exchange transaction, it is critical to discuss the pros and cons with your tax adviser to avoid any unexpected tax consequences.

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