



Isn't my CPA already doing this?

Most approve of cost segregation to lower federal tax on real estate – but few apply it.

By Patrick O'Connor, MAI

Most commercial property owners, even those who use professional accountants, fail to take advantage of cost segregation, a tax mechanism that could generate substantial savings in federal income taxes.

While most accountants are familiar with the approach, some are hesitant to recommend it without a documented analysis of correct depreciation amounts. The numerous intricacies of IRS designated building components make it difficult for some accounting professionals to be cognizant of all applicable items on a specific property. CPAs recognize that in order for the client to fully benefit, it is usually necessary to seek a real estate specialist to provide an independent report supporting the owner's depreciation schedule.

Although it is vastly under-utilized, cost segregation is no wildly speculative accounting tool.

It's a conservative, yet powerful technique for generating federal tax reductions by properly applying tax regulations to depreciate commercial buildings or apartments.

In fact, the American Institute of Certified Public Accountants' *National Journal of Accountancy* has published numerous articles in support of cost segregation.

Cost segregation identifies applicable components and establishes the value and correct time line for depreciation. Under typical circumstances, depreciation is spread out over as long as 39 years. However, cost segregation applies depreciation to parts of the property in 5-, 7- and 15-year increments. This acceleration in depreciation time reduces the income subject to federal taxes. This method does not dictate alternative minimum tax issues.

Professionals Prepare Detailed Reports

To perform a cost segregation analysis, initially the building's cost basis for construction, renovation and

repairs is reviewed. A technician goes on site to take detailed measurements and observe the quality and condition of the property. After the site visit, he or she calculates the value of the property using widely accepted pricing resources and local economic conditions.

A cost segregation study produces a professional document that is backed by careful research.

The results are summarized in a detailed report, documenting the amount of 5-, 7- and 15-year property that qualifies for short-life depreciation.

Real estate appraisers or engineering firms typically have the knowledge to perform the detailed cost segregation studies, frequently at the recommendation of the owner's tax preparer. Preparing the study requires expertise in evaluating real estate and complete command of the regulations that detail these depreciation options. Internal Revenue Code regulations outline approximately 130 categories of property, which qualify for shorter lives.

Cost segregation regulations contain a lot of variables that are not necessarily intuitive. The 5-year property includes items such as carpet and vinyl flooring. Seven-year property may reflect unexpensed office furnishings or cluster mailboxes. Fifteen-year property encompasses paving and landscaping.

Many CPAs Recommend Cost Segregation

Most property owners instinctively believe their CPAs are performing cost segregation for them, but research has suggested that this tool is used only 5% - 10% of the time. CPAs and other tax preparers may not routinely perform the study because it involves real estate appraisal methodology and specialized knowledge outside the scope of a typical tax practice. Even though cost segregation may be unfamiliar territory to some accounting professionals, it is highly praised by many accountants.

"Cost segregation is a powerful and necessary part of accurately calculating depreciation for real property,"



comments CPA Bill Bandy of Blakely and Bandy, a Houston-based accounting firm. “A properly prepared study is invaluable to me as a CPA because it provides reliable support for preparing the depreciation schedule and reducing my client’s taxes.”

Recent changes in tax regulations make cost segregation more attractive and allow it to be implemented years after the completion of a real estate purchase.

How Does It Work?

Historically, most depreciation schedules are split between land and long-life property. Long-life property depreciates over 27.5 years for apartments and 39 years for most commercial properties. A cost segregation study can typically allocate 20% to 40% of the improvement basis to short-life categories, and sometimes more.

High-income owners typically pay a 35% federal tax rate on ordinary income and a 15% rate on capital gains. The mechanics of reporting the gain on a sale usually allocate most of the gain to capital gains, which is taxed at 15%.

A cost segregation study actually reduces the amount of long-life property, which is recaptured at 25% by allocating more of the basis to the 5-, 7- and 15-year property. If cost segregation is utilized from inception until a gain on the property is recognized, it can reduce the federal tax rate from 35% to 15% for most investors. The exceptions are C corporations, which pay the same tax rate for either ordinary income or capital gains.

How Much Can It Save?

The annual tax savings through cost segregation can be significant. The following table summarizes actual first-year tax savings generated in cost segregation reports prepared by O’Connor & Associates, a national real estate consulting firm.

Property Type	Range of Year 1 Tax Savings 100,000 – 500,000 sq. ft. property size
Office	\$35,500 - \$160,000
Apartment	\$19,240 - \$96,200
Retail	\$36,500 - \$182,600
Industrial	\$10,800 - \$54,000

A recent client of the firm realized a payback ratio for the first year savings at 4:1 and the payback ratio for the first five years at 20:1.

Who Prepares Cost Segregation Studies Today?

Appraisal and engineering firms, Big Four firms and spin-offs of Big Four firms are the primary providers of cost segregation studies. Some accounting firms offer the service but frequently outsource the actual report preparation to an appraisal or engineering firm. With the introduction of new providers, the price gap has widened between very low cost analytical studies and much higher large firm rates.

Do All Properties Benefit From Cost Segregation?

Cost segregation is typically effective and financially feasible for properties that have an improvement basis of \$500,000 or higher.

Properties with a great deal of site-improvement, including landscaping and parking, generate great results.

Cost segregation can be performed for properties anywhere in the United States. It is effective for apartments, office, retail, industrial, self-storage and many special use properties.

“Clients expect us to seek out and utilize tools which will minimize their federal taxes,” says CPA Sheldon J. Donner of Donner Weiser & Associates, P.C., an Atlanta-based CPA and consulting firm. “Cost segregation is an appropriate, conservative and cost effective tool to substantially reduce federal and state income taxes. Our clients have been extremely pleased with the results.”

When Should I Obtain A Cost Segregation Report?

“We routinely obtain a cost segregation study after purchasing an investment property,” said Jeff Harris, chief financial officer of Boxer Properties, a national property investment firm. It typically makes sense to obtain a cost segregation report the year a property is purchased or built. Property owners who purchased or constructed property after 1986, often can benefit substantially by recouping previously under-reported depreciation without filing amended tax returns.

About the Author

Patrick O’Connor, MAI is president of O’Connor & Associates. The firm, in business since 1974, specializes in nationwide real estate appraisals, research, and state and federal tax reduction services. O’Connor is frequently acknowledged by national publications as a respected source of information on real estate trends. Visit www.poconnor.com.