



Appraisers Lower Costs for Federal Tax Savings on Small Property Depreciation

By Patrick O'Connor, MAI

Tax savings through cost segregation is no longer out of reach for investors in small and medium size properties. With appraiser expertise, fees for analysis are often one-third to one-half lower than those charged by traditional preparers.

Several years ago a definitive court case ruled that tangible personal property included in an acquisition or in overall costs should be depreciated as personal property for asset recovery, using the old Investment Tax Credit principles to classify personal property.

This meant that owners of improved properties could distinguish between real property and personal property to depreciate component costs over varying useful lives. Basically, instead of depreciating an entire commercial property over 39 years, or residential property (single-family rentals or multifamily) over 27.5 years, certain components are correctly identified as depreciating in much less time. For about 135 items, useful life periods can be 5, 7 or 15 years. This is known as cost segregation.

The result of increasing depreciation is lower taxable income (which would have been taxed at 35%) and more income taxed at the capital gains rate (15%) when the property is sold. Furthermore, it works for any type of improved property.

Until recently, primarily large accounting firms or engineering firms implemented cost segregation studies, addressing large and newly built properties and sometimes outsourcing the analysis.

Prices for those analytical reports, usually in the \$10,000 to \$40,000 range, were out of reach for owners of small

properties, especially those holding less-than-new assets. Unfortunately, those owners representing the largest segment of real estate investors in the country were mostly overlooked by previous providers of cost segregation services.

Now a revolutionary paradigm shift is opening the door to very significant savings for owners of small properties. Much of the change is based upon introducing the efficiencies of highly knowledgeable real estate appraisers who often apply industry-accepted cost estimation techniques before determining remaining asset life. By not “over-engineering” the staffing or production process, professional fees are lower. Yet, results can usually meet or exceed those of far more expensive reports. This approach has been successfully field-tested by IRS auditors.

Changes that appraisers are introducing to cost segregation analysis and reporting are addressing: 1) the size of the property being analyzed, 2) the age of the property, and 3) an affordable price point. O'Connor & Associates, a nationwide real estate service firm, is taking advantage of such techniques to effect these beneficial changes:

- 1) Owners of property with an improvement basis as low as \$500,000 can benefit from cost segregation. This compares to the limited properties worth \$5 to \$10 million and above that previously benefited.

Now owners pay one-half less and get the same tax saving results as higher priced cost segregation studies for similar properties.



- 2) Existing properties built or purchased after 1986 offer significant savings in year-one of cost segregation, even without producing original cost documents. Capturing non-segregated depreciation from prior years is perfectly allowable by the IRS. This compares to firms previously applying the methodology only to new construction.
- 3) Fees are no longer prohibitive. To prepare an analysis and report for many small properties, prices are low enough to generate at least 3 times the report cost in the first year. This compares to the traditional fees ranging from \$10,000 to \$20,000 and up for comparable size properties.

It is wise to keep the owner's CPA or tax preparer abreast throughout the process. For older properties, the CPA may need to complete a Form 3115 to submit with the tax return so the owner can realize savings on items not previously depreciated - without filing an amended return.

Income producing properties worth as little as \$500,000 can achieve a 3:1 payback ratio of tax savings over the modest price of a cost segregation report. If owned for 3 or more years, the typical payback ratio is 10:1.

Properties worth \$1 million or more can achieve at least a 4:1 payback ratio of tax savings over the cost of a report. The typical payback ratio jumps to 12:1 if owned for 3

or more years. The table below summarizes actual results generated through cost segregation reports prepared by O'Connor & Associates for properties located throughout the country:

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

In late 2005, O'Connor's pipeline of cost segregation work was up more than 100%. As owners are preparing for 2005 federal tax filings, many are tapping into this opportunity to lower their federal taxes. Even general partners who are not paying federal income taxes should use this depreciation method since K-1s will reflect lower taxable income to benefit their limited partners.

Patrick O'Connor, MAI, is president of O'Connor & Associates. The firm, in business since 1974, specializes in state and federal tax reduction services, real estate appraisals and research and consulting nationwide. With offices in Houston, Dallas, Los Angeles and Newport Beach, the firm employs more than 130 people. Patrick O'Connor is frequently acknowledged by national publications as a respected source of information on real estate trends. Visit www.cutmyfederaltaxes.com.

Frequent Cost Segregation Frequent Questions

How does cost segregation differ from accelerated depreciation?

Unlike cost segregation, accelerated depreciation is a method that shifts a higher percentage of the depreciation deduction to the early years of an asset's life. Many taxpayers avoid accelerated depreciation because of its possible Alternative Minimum Tax (AMT) consequences. However, cost segregation itself does not lead to AMT. It simply allocates asset value to its correct depreciation life classification.

Is cost segregation a red flag for an audit?

No. Using cost segregation is considered a conservative approach to more correctly reflect taxable income. In fact, our report provides back-up documentation on which tax return preparers can rely.

Is cost segregation limited to newly acquired properties?

No. Catch-up of prior year(s) undocumented depreciation is legitimate for older holdings. The IRS Technical Advisory Dept. for Changes in Accounting Method has supported the use of Form 3115 in these circumstances, as opposed to amending prior tax returns.

How is a report prepared?

O'Connor & Associates works closely with property owners and their CPAs or financial/tax managers to collect minimal property data. An appraiser then visits the property to identify and assess eligible items, calculate their remaining life value, and allocate each to its correct depreciation life. From a group of as many as 135 possible short-life items, we typically find 30-40 items that qualify for short-life depreciation.