Reinhart

What Is Cost Segregation and Should I Be Using It?

POSTED:

Jul 5, 2009

RELATED PRACTICES:

[Real Estate](https://www.reinhartlaw.com/practices/real-estate)

https://www.reinhartlaw.com/practices/real-estate

RELATED PEOPLE:

[Nathan J. Wautier](https://www.reinhartlaw.com/people/nathan-wautier)

https://www.reinhartlaw.com/people/nathan-wautier

As the nation's economic recovery spurs new construction, cost-segregation is an accounting concept that can aid real estate owners and developers in realizing significant cost savings by allowing them to maximize the present value of money and obtain write-offs currently not utilized by most real estate professionals. Cost Segregation works by allowing real estate owners and developers to separately allocate personal property assets that are grouped with real property assets for tax and accounting purposes. These personal property assets are reclassified from a 39-year depreciation period (or 27.5 years for residential property) to a 5-, 7- or 15-year period of time. This reclassification creates dramatic cost savings during the first few years of a real estate project's operation while the taxes are gradually repaid through decreased depreciation deductions in later years.

CPAs have estimated that for every $10,000 of property reclassified to a five- or seven-year depreciation period, the present value of the tax savings is about $2,000 and about $1,000 for every $10,000 of property reclassified to a 15-year period.

In addition to depreciation savings, cost-segregation can also be used to write-off the replacement of building components. By way of example, suppose the siding of a building costs $300,000 and then five years later it must be replaced. At the time of replacement the adjusted basis is $250,000. Under cost-segregation, this $250,000 can be written-off as a loss. Without cost-segregation, no part of the value of the siding could be written-off as its value would remain tied to the basis of the building as a whole.

There are many examples of the benefits of cost-segregation and the concept can be used by any for-profit entity that has purchased commercial real estate since 1986. In addition, developers constructing commercial buildings and tenants constructing significant leasehold improvements can also benefit from the strategy. In addition, despite a common misperception, no amended return is needed to utilize cost-segregation for past years. Rather, these tax savings can be applied retroactively by filing with the IRS an Application for a Change in Accounting Method, Form 3115.

In order to learn more and to take full advantage of these benefits, a real estate professional should consult with and obtain a cost-segregation study from a qualified firm that has both the engineering expertise and tax expertise to produce a useful and dependable study. One cautionary word is to make sure whatever you are classifying as short-lived personal property can be defended against IRS scrutiny as there is a wealth of case law precisely identifying what does and does not qualify.

As with all your real estate needs, the Reinhart team is available to discuss with you the possible benefits of cost-segregation to your real estate projects.