WANT MORE AFTER-TAX CASH FLOW FOR YOUR COMMERCIAL PROPERTY? A COST SEGREGATION STUDY MIGHT BE THE ANSWER FOR YOU

By: Todd Gebhardt, CPA

A cost segregation study can be a very advantageous planning tool for real estate owners, investors, and developers by accelerating tax depreciation to increase after-tax cash flow. By increasing the allowable depreciation expense deductions and utilizing current 100% bonus depreciation expensing early in an investment, a real estate owner could potentially write off a significant percentage of an investment property in the first year, have zero taxable income and benefit from significant positive cash flow. Commerce Trust Senior Tax Accountant Todd Gebhardt, CPA, walks you through the steps on this potentially overlooked game changer for property owners managing their assets.

WHAT IS A COST SEGREGATION STUDY?

A Cost Segregation Study is a tax planning tool used by real estate owners, investors, and developers for all types of real estate to accelerate depreciation expense deductions to increase after-tax cash flows.

Cost segregation studies identify and reclassify components of the real estate instead as personal property, which may be depreciated using shorter class lives than the underlying real property. By identifying specific costs as personal property with useful lives of 5, 7 and 15 years, the costs of those assets can be recovered using a much shorter life (and more advantageous method) than real estate with a useful life of 27.5 or 39 years

HOW DOES A COST SEGREGATION STUDY WORK?

When a property is acquired there are various allocations of the original purchase price that need to be made. The first allocation is to determine an amount or percentage of the purchase price as the value of the land. Depending on many factors such as location, condition of the building/structures and other various attributes of the property, the land allocation could be just about any percentage of the original purchase price. The land allocation of the original purchase price is a very important factor to consider because unlike real and personal property, land is a non-depreciable asset under the United States tax laws.

After the land allocation of the original purchase price has been determined, the remaining basis is depreciated over the asset's useful life, which varies depending on the type of property. Residential non-personal real estate is depreciated over 27.5 years and commercial property is depreciated over 39 years (in both cases, using a straight-line method).

As an example, a shopping center is acquired for $10,000,000. Of this amount it is determined, usually using county real estate assessment information or appraisal, an appropriate land allocation is 25% or $2,500,000. The remaining basis of $7,500,000 is then depreciated over 39 years which allows for just over $192,000 per year depreciation expense deduction. The annual rental income received, less depreciation expense and other deductible expenses, are the factors used to calculate net taxable income.

In some cases, the land allocation may be the only allocation of the original purchase price that has been done. If this is the case, this creates an opportunity for a cost segregation study, which could provide tremendous value and be used as a tax planning tool.

Cost segregation studies are performed by independent engineering firms and professionals, which specialize in analyzing building components to determine appropriate asset classifications. Non-structural building components are generally considered personal property and have shorter useful lives of 5 and 7 years. Examples of personal property assets include signage, carpet, wall coverings, special doors, cabinets, countertops, lighting, equipment, and appliances. In some situations, such as medical office buildings, walls with customized shielding may be treated as personal property, as those walls were needed solely for the related medical equipment. In other situations, such as a data center, the costs of HVAC, normally a building component, may be treated as personal property to the extent that added venting or cooling capacity was needed to support the computer equipment. Other non-structural items include land improvements that have 15-year tax lives. Examples of land improvements include items outside a building such as parking lots, driveways, curbing, sidewalks, stairs, fences, retaining walls and landscaping.

WHAT ARE THE NEXT STEPS IN A COST SEGREGATION STUDY?

After a cost segregation study identifies, separates, and reclassifies various asset types with different useful lives, a CPA must update the depreciation schedules to recalculate the annual depreciation expense deduction. The results of cost segregation studies can vary significantly depending on many factors such as the age, condition, and type of property. Generally, more personal property and land improvement assets will be identified at an office building property compared to an industrial warehouse property, which may only consist of walls, roof and a floor that are all structural components (though note that overhead cranes can often result a benefit). Typically cost segregation studies performed for apartment complexes and hotel properties identify a higher percentage of personal property assets with shorter useful tax lives.

Continuing with the previous example of a shopping center acquired for $10,000,000 with a 25% land allocation. Before performing a cost segregation study, the annual depreciation expense deduction was just over $192,000 per year. Using hypothetical amounts that could vary significantly, a typical study for a retail shopping center property could identify $1,000,000 (10%) of land improvements and $500,000 (5%) of personal property. Using the revised metrics above, after updating the depreciation schedules to recalculate the annual depreciation expense deduction, the cost segregation study resulted in an increase in annual depreciation deduction expense to over $320,000 per year.

The cost segregation study in this example increased the annual depreciation expense deduction by over $125,000 per year, using straight-line depreciation and NOT utilizing current bonus depreciation. As you can see in the example the results of a cost segregation study could have a significant effect on cash-flow by reducing net taxable income through increased depreciation expense deductions in the early years after acquisition.

CAN "CURRENT BONUS" DEPRECIATION ALSO HAVE AN IMPACT?

Yes, it can. As previously mentioned, the results of the example above do not use the current allowable bonus depreciation tax laws. Under the Tax Cuts and Jobs Act of 2017 ("TCJA"), taxpayers may use bonus depreciation to deduct 100% of the cost of certain qualified assets. Under TCJA, real estate owners, investors and developers can receive an immediate first year depreciation deduction (100% bonus) on certain 5, 7, and 15-year property. In our example, this represents $1,500,000 that a taxpayer could expense in year one.

Additional advantages may also apply. You don't need to have a cost segregation study done while you still own the building. A seller may have a cost segregation study done that produces these same benefits, after the close of the sale, but before filing the related tax return. This practice could also serve to reduce the amount of recapture on the sale by allocating the sales proceeds to the relative fair market values of assets sold.

In the shopping center example, if the center was sold after being owned for 10 years, and the shorter-lived property (signs, lights, parking lot, fencing and landscaping) were in need of replacement, they would be fully depreciated (with catch-up depreciation) on the final return (using bonus depreciation). As part of the sale, very little (if any) of the sales price would attach to those assets, potentially eliminating any recapture on the sale.

Without a cost segregation study, all depreciation taken would be attributed to the real estate improvements and would potentially trigger recapture as Section 1250 gain, with rates as high as 25% on that recapture.

To conclude, a cost segregation study can be a very advantageous planning tool for real estate owners, investors, and developers by accelerating tax depreciation to increase after-tax cash flow. By increasing the allowable depreciation expense deductions and utilizing current 100% bonus depreciation expensing early in an investment, a real estate owner could potentially write off a significant percentage of an investment property in the first year, have zero taxable income and benefit from significant positive cash flow.

It is safe to say there are many factors contributing to the escalating trend in the commercial real estate market for the last few years. Bonus depreciation is just one factor. The current rules allowing 100% bonus depreciation are set to expire in 2023. Other changes related to depreciation tax laws have been proposed, so the window of opportunity may be closing quickly. Please consult a Commerce Trust Company advisor for more information.

*Always consult with your CPA and professional advisor on matters involving taxes.

ABOUT THE AUTHOR

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