

FREQUENTLY ASKED QUESTIONS

What is cost segregation

Cost segregation is a highly beneficial and widely accepted tax planning strategy utilized by commercial real estate owners and tenants to accelerate depreciation deductions, defer tax, and improve cash flow.

What is a quality cost segregation study?

A quality cost segregation study is based on a detailed engineering analysis which involves a thorough review of relevant information such as cost data, building plans, and lease agreements, as well as an on-site inspection of the property conducted by a qualified professional, preferably an engineer. Following document review and a site visit, the engineer will produce a detailed breakdown of costs and properly allocate them to the appropriate recovery periods (primarily 5, 7, 15, 27.5/39-year) depending on the facts and circumstances of the project. Soft costs such as architectural and engineering fees, and builder's overhead and profit are then allocated in accordance with the findings of the study. Once all of the costs have been accounted for, the numbers must be properly reconciled to the property's total depreciable cost basis.

When is the best time for a cost segregation study?

The best time for a cost segregation study is typically the year the property is placed in service by the current owner. It is generally most beneficial to maximize depreciation deductions from year one.

What types of properties qualify for cost segregation?

Any type of commercial property placed in service after December 31, 1986 will qualify for a cost segregation study. Additionally, any size property will qualify. However, the cost / benefit analysis may prohibit lower valued properties from being good candidates. Typically, cost segregation starts to make sense for properties that have a depreciable cost basis of \$1 million or more, although there are certainly exceptions. Bedford has conducted numerous studies where the basis was less than \$500,000.

How much does a cost segregation study cost?

The fee for a cost segregation study can vary greatly depending on the property type, size and complexity as well as the quality of the provider and their work product; not all cost segregation studies are the same. The good news is that fees have come down considerably over the past four or five years.

Whatever the situation, the fee for a cost segregation study should be based on time and materials or fixed fee basis and NEVER on a contingency basis (% of savings). The IRS specifically states in the Cost Segregation Audit Techniques Guide (ATG) that, "examiners should closely scrutinize studies performed on contingency fees." The reason for this is a contingency fee arrangement creates an incentive for the cost segregation consultant to be overly aggressive and utilize inappropriate estimating techniques. Property owners and their advisors should avoid cost segregation providers charging on a contingency basis.

How much should I expect to save with a cost segregation study?

It is not uncommon for a cost segregation study to generate hundreds of thousands or even millions of dollars in net present value savings. The average study will allocate, or reallocate in the case of a look-back study, anywhere from 20 – 40 % of the depreciable cost basis to shorter lives. For every \$100,000 moved from 39-year to 5-year the 10-year net present value savings is approximately \$25,000 (based on a 35% tax rate and a 6% discount rate).

Will cost segregation put me at risk of an IRS audit?

No, you are not more likely to get audited simply because you had a cost segregation study performed. However, look-back studies require the taxpayer to file a change of accounting method (Form 3115) which is reviewed by the IRS national office. These studies are then sent to IRS units specializing in cost segregation where they may be selected for audit. Although there are no statistics to support this, it is logical to assume that a look-back study may be slightly more susceptible to audit than a study performed on a property in its first year of service.

Additionally, the general feeling throughout the cost segregation industry is that the IRS has been getting a bit more aggressive about the review of cost segregations studies; specifically with respect to the methodologies being used and the qualifications of the preparer. Per the IRS Audit Techniques Guide, studies being performed by unqualified individuals and those using an abbreviated methodology will receive higher scrutiny than the ones performed by qualified professional who utilized the detailed engineering approach. Therefore, it is more important than ever to have your studies performed by an expert in the field. One way to ensure you're working with a good provider is simply to ask the right questions during your selection process. You should also make sure you are working with a provider that employs Certified and/or Senior Cost Segregation Professionals as recognized by the American Society of Cost Segregation Professionals.

Can I use cost segregation on buildings I placed in service in the past?

Yes. Look-back studies can be performed on properties placed in service as far back as January 1, 1987. Of course it may not make sense to perform a study on a property that was placed in service 20 years ago, unless significant improvements have been made. This is because the majority of the depreciation has been taken and the cost of doing the study would not necessarily be worth the benefit derived. However, this is not always the case. The facts and circumstance will ultimately be the deciding factor.

Doesn't my accountant already do cost segregation for me?

Probably not, at least not with the appropriate level of detail or defensibility. CPAs simply do not have the expertise necessary to properly break-out all of the assets (costs) that are considered in a cost segregation study. And why should they? After all they are CPAs not engineers. That said, some accounting firms do have trained engineers on staff to perform cost segregation studies. In the days before the IRS's Audit Techniques Guide many CPAs made an effort to segregate costs on their own, but now realize that doing so may be putting their clients at greater risk in the event of an audit. As the cost segregation industry matures, more and more accounting firms are choosing to partner with cost segregation specialists such as Bedford. These firms employ engineers, construction experts and tax professionals that have specific expertise with design, cost estimating, tax depreciation and other related tax matters.

What is the impact of a cost segregation study if I sell my property?

Regardless of whether you've had a cost segregation study performed or not, when you sell a property you will recognize either a gain or a loss. When you sell for a gain you pay taxes on that gain. The amount of tax is based on the capital gains rate for real property (§1250) and the taxpayer's ordinary income rate for personal property (§ 1245). When a cost segregation study is performed, items that would normally be considered real property are instead allocated to personal property. The ordinary income rate can be higher or lower than the capital gain rate, depending on the situation. If higher, the amount of tax due upon a sale would most likely be more if a cost segregation study were performed. However, the financial impact of the cost segregation study will often outweigh the adverse effect of the ordinary income rate. The bottom line is that this is truly a "facts and circumstances" situation and will require some additional analysis on the front end.

It should be noted that Rev. Proc. 2008-52 includes a provision that allows taxpayer to benefit from cost segregation after sale, in the year of disposition. The recapture issues discussed above still apply, but this may be an opportunity worth considering, especially if you sold your property at a loss.