Cost segregation studies:
A way to get faster write-offs

For years, many business owners have taken advantage of cost segregation studies to help them accelerate depreciation deductions on their properties. These studies identify property components and their costs, which can enable you to use shorter lives and faster depreciation rates. Bottom line? You'll likely see a substantial savings on your tax bill.

How it works

Real estate can be segregated into four categories of property: buildings, land, land improvements and personal property. Buildings are generally depreciated over 27.5 years (residential rental) or 39 years (commercial) using the straight-line method. This recovery period applies to real property, which includes buildings as well as structural components, such as walls, concrete floors, paint, windows, ceilings and HVAC systems.

Land isn't depreciable at all. But you can typically depreciate land improvements over 15 years using 150% of the straight-line rate on the declining balance and most personal property over five or seven years using 200% of the straight-line rate. Often, however, these property components are misclassified.

A cost segregation study identifies property components and their cost, allowing you to maximize current depreciation deductions by using the shorter lives and faster depreciation rates available for the qualifying parts of the property. For example, if $400,000 of assets were reclassified as seven-year vs. 39-year property, depreciation deductions in the first year, assuming the building was placed in service about midyear, would increase from around $5,000 to more than $57,000.

Depreciation rules

There are no hard-and-fast rules for distinguishing personal property eligible for accelerated depreciation from structural components that are depreciated as part of the building. The answer depends on various factors, including how the property is affixed to the building, whether it's designed to remain in place permanently, and how difficult it would be to move or remove.

Examples of personal property that can qualify for a faster depreciation deduction include decorative fixtures, cabinets and shelves, movable wall partitions and carpeting.

Certain plumbing, wiring, and heating and air conditioning vents and lines — which you'd normally think of as part of the building — may be eligible for shorter lives if they're specifically required for equipment that has a shorter life (such as wiring for certain specialized equipment). You can also depreciate the allocated portion of certain capitalized indirect or overhead costs — such as architectural and engineering fees.

Examples of land improvements you can isolate with a cost segregation study include parking lots, sidewalks, fences and landscaping.

Understand the limits

Consider a cost segregation study when you buy, build or remodel — or when you have done so within the last few years. But be mindful that the overall benefit of a cost segregation study may be limited in certain circumstances, such as when the business is subject to the alternative minimum tax. Passive activity loss rules can also defer the benefits.

The cost of the study generally pays for itself if the building or remodeling expenditures are fairly substantial and were completed or purchased fairly recently. Also, keep in mind that taxpayers who perform a cost segregation study may be able to qualify for an automatic accounting method change — a fairly simple procedure.

What have you got to lose?

Cost segregation studies can be an excellent means for gaining faster write-offs on your real estate and construction projects. But be aware that such studies involve a lot of variables. Ask your attorney to help you determine whether you're likely to benefit.

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