"Cost Segregation"

Taxpayers and their advisers constantly are looking for ways to legally reduce their taxes by implementing planning solutions that will help them to shelter income against tax. In recent years, cost segregation has emerged as a popular method for reducing taxable income for taxpayers with real estate investments or commercial entities with leasehold improvements.

Cost segregation is a process by which the basis of real property is segregated into various assets classes that qualify for shorter depreciable lives resulting in accelerated depreciation and deferred taxes.

Cost segregation benefits are usually measured by comparing the net present value of the tax savings using the tax strategy against the net present value of not using it. The highest net present value benefit always is generated if the taxpayer deploys the strategy at the time the asset is placed in service, or purchased.

When a real estate investor has a cost segregation study performed on a property that was acquired in a prior year, the benefits can seem much more dramatic. A cost segregation study on a real estate property that was placed in service in a prior year is known as a look-back study. The benefit for taxpayers in a look-back study is that the difference between what they actually depreciated and what they could have depreciated had they utilized a cost segregation study are expensed in the current period.

This difference is known as the Sec. 481(a) adjustment and is expensed in one year by employing procedures described in IRS Revenue Procedure 2002-19 and 2004-11.

The current procedures allow a taxpayer to reflect this adjustment on a current return, without amending prior year returns, by filing a Form 3115, Application for Change of Accounting Method.

To use the benefits of cost segregation a taxpayer must have taxable income associated with the real property assets that will be segregated. A taxpayer that already has passive losses associated with a property cannot benefit from increased depreciation in that property unless they have other passive income to offset.

Likewise, if a taxpayer were planning on selling a property in the near future, it's typically not advisable to perform a cost segregation study as the benefits are reduced when property is held for a shorter period of time. However, this should be evaluated on a case by case basis.

SEC. 1031 EXCHANGE STRATEGY

Many tax professionals have found ways to incorporate the benefits of cost segregation into clients' tax plans. One such strategy involves combining cost segregation with a 1031 exchange.

For example, a taxpayer acquired a strip mall in June 1998 for $2.6 million, which allocated $1.8 million to building and $800,000 to land. When the property was placed in service a cost segregation study was not performed. During the first six years the taxpayer depreciated $323,064 of the building using 39-year, straight-line depreciation.

During 2006, a cost segregation study was performed and the building assets were reallocated into five-year and 15-year categories, in addition to the 39-year depreciable category.

Depreciation was then recalculated based on the fact that $126,000 of property was allocated to a life of five years, $270,000 of property was allocated to a life of 15 years and $1,404,000 remained in the 39-year category. The recalculated depreciation from the time the asset was placed in service amounted to $520,446 - $197,382 greater than the amount that had originally been depreciated. This amount becomes the IRC Sec. 481(a) adjustment that was referenced earlier.

The next step in this transaction was for the taxpayer to complete the 1031 transaction.

The fair market value of the strip mall in our example was $5 million in 2006. Instead of selling the property the taxpayer entered into a 1031 exchange transaction and deferred the gain. The replacement property qualified for the exchange, involved no step-up, and the taxpayer elected out of the regulations.

Based on our research, since the taxpayer has $197,382 Sec. 481(a) adjustment they could have removed cash from escrow during the exchange and created boot up to the amount of the Sec. 481(a) adjustment without further tax consequence.

The complexities related to using a 1031 exchange and cost segregation generally are related to the proper matching of true furniture and equipment. Using a segregation report will help identify what type of property and how much of it should be acquired to avoid a matching problem.

The additional consideration, however, revolves around Sec. 1245(b)(4) recapture.

In our example we had identified $126,000 of Section. 1245 five-year "personal property" (fixtures). If the fair market value was $175,000 and it was replaced with property with a value of $100,000 then the original property would be subject to recapture up to an amount of $75,000 ($175,000 less $100,000).

If the original cost of $126,000 were fully depreciated then there would be recapture of $75,000. This would be mitigated by the Sec. 481(a) adjustment on the relinquished property.

Similar to the 1031 exchange example above, if the taxpayer were selling the property outright in the above example for its fair market value of $5 million, the taxpayer would have a tax liability of approximately $715,000. Provided that the taxpayer had other properties that a cost segregation study had never been performed on, they could shelter a portion or all of the

taxable gain with the Sec. 481(a) adjustment from the look-back studies performed on the other properties.

Under IRS rules, a taxpayer can correct the depreciation as a result of a cost segregation study when the study is performed. If the study is performed in a year when there is another taxable event, the adjustment can be used in many cases to offset that income. The taxpayer is essentially able to pick and choose when they apply the strategy's benefits.

ESTATE PLANNING

Cost segregation also can work with estate planning, illustrated by the following:

A husband and wife acquired property in 2001 with a building basis of $1 million. In 2006, they had a cost segregation study performed on the property resulting in approximately 20 percent of the cost basis being reallocated to five-year property, which resulted in a Sec. 481(a) adjustment of approximately $110,000 and was used to offset passive income from this and other rental property.

In 2007, the husband died and the wife received a step up resulting in a new basis of $2 million.

Depending on the amount of time that passed between the original cost segregation study and the death of the husband, it may not be necessary to have another study performed. This requires professional judgment, but for simplicity we will assume that the original study could be applied to the revised basis.

Applying our original result against the new basis would allow for approximately $400,000 of additional property to be depreciated over the ensuing five years.

Upon the death of the wife, the property would receive a new basis of the current value at the time, which for our example is $3 million. As a result of the application of cost segregation to

this point, there is approximately $600,000 that is never recaptured through gain on sale. The children would then be able to have a cost segregation study performed on the new basis and enjoy the benefits of the accelerated depreciation deductions.

Over a 15-year period the total depreciation would have been approximately $770,000 without the benefit of cost segregation inclusive of the step up in value. The depreciation over the same period utilizing the cost segregation strategy would have amounted to approximately $1.9 million.

AFTER-THE-FACT PLANNING

The benefit of using cost segregation is often greatest when the unexpected occurs.

For Example, an auto dealer has an unexpected last-in first-out adjustment. Since it was unanticipated and the end of the year has passed, it would appear that it is too late to do anything to mitigate the unexpected taxable income.

Prior to filing the tax return the company conducts a cost segregation look back study on its real property improvements. Depreciation is recalculated and the Sec. 481(a) adjustment is then used to offset the unexpected income.

These are just a few of the planning ideas that have used cost segregation to shelter current income.

Cost segregation is an effective and widely used application to defer tax and increase cash flow for real estate investors today.