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Money Doesn't Grow on Trees

But could it be hidden in the walls?

What would you say if someone offered you a dollar in exchange for a dime? To skeptics, that would sound too good to be true. Yet some CPA firms provide a service that can help clients to return as much as one dollar in tax savings for every ten cents spent on the service. This service, known as cost segregation, brings significant tax savings, recognized by the Internal Revenue Service (IRS), to building owners interested in retaining cash.

Even the skeptics are convinced

It is generally understood that carpeting and cabinets are classified as personal property for federal income tax purposes in order to capture the cash-flow benefits associated with shorter depreciable lives. Typically, this amounts to less than 3% of a building's component costs. At the same time, the remainder of the facility is assigned a depreciable life of 39.5 years (27.5 years for multifamily facilities). A comprehensive and appropriately documented cost segregation analysis maximizes a building's tax benefits by identifying, classifying, and segregating a much larger percentage of a building's assets for accelerated depreciation for federal income tax purposes. This can mean three, five, sometimes twenty times more savings than the 3% found in cabinets and carpeting.

A cost-segregation specialist looks for many items when working to identify tax savings in a building. Questions that such a specialist would ask include:

- Is there more than one power source in your office?
- Do the walls in your office penetrate the ceiling tiles, and are they load bearing?
- Is the decorative paneling in your reception area and conference room glued, nailed, or hung on the wall?
- Is your cooling system oversized in order to cool your data-processing room?

Do you have a kitchen?

A yes answer to any of these questions indicates the need for cost segregation. A cost-segregation specialist can perform a nonintrusive yet detailed engineering study of a building's walls, flooring, and ceilings; and its plumbing, electrical, lighting, telecommunications, heating, and cooling systems. For the maximum benefit to the client, the professionals prefer to work from building plans and cost documents rather than strictly relying on a building tour.

Planning ahead

Planning ahead makes the facility walk-through much less time intensive and is a better way to identify the maximum number of building components into short-term depreciable categories. Comprehensive documentation means less reliance on national cost manuals to arrive at the costs of the building components. Together, planning ahead and good documentation provide a lower fee for service because the cost-segregation professional won't need to spend as much time on the assignment. That translates to added savings for the client.

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The assets are grouped under several asset depreciation range (ADR) classifications, including:

- Office furniture, fixtures, and equipment
- Information systems
- Land improvements
- Manufacture of electronic components, products, and systems
- Distributive trades and services
- Personal property with no class life

The cost-segregation professionals then identify which components of each system that, according to federal tax law, can be assigned accelerated tax lives of five, seven, or fifteen years rather than the straight-line 39.5 years (27.5 years for multifamily facilities). These savings drop right down to the bottom line.

Although every situation is different, the chart on this page is an example of typical savings to expect from a cost-segregation study depending on the type of facility.

Start early

Cost-segregation studies should be initiated as early in the construction or acquisition process as possible to obtain maximum savings. Consider these three points:

1. If a cost-segregation specialist is given the opportunity to spend 60 minutes with the architect before the design of a building begins, he or she can show the architect how to make a larger percentage of the building's components qualify for short-term depreciation, thereby increasing the tax savings to the building owner.
2. Special-order building components, such as granite countertops for reception desks, chandeliers, window coverings, and other components, usually are invoiced at a higher cost than can be substantiated from cost-estimating guides. Proof of these costs is required in order to report the higher value to the IRS. Thus, if a cost-segregation specialist is granted access to the construction chief before the project breaks ground, he or she will request that the cost of five to 10 items be set aside for reporting purposes, which avoids the difficulty of tracking down cost documents later on in the construction process.
3. If a cost-segregation study can be performed before the acquisition of a building, personal property can be separated from the building costs. The two costs can then be broken out in the sales agreement, and the real property transfer tax basis can be reduced. As a result, significant cost savings can be realized once the project or the acquisition is complete.

Adjusting the property's tax position

Other questions may arise. For example, what about those buildings that have been in a portfolio for a few years? Can they still contribute tax savings to the owner? The answer is, yes, at times. If two or more years of tax returns have been filed on the property, the CPA can file an IRS Form 3115, Change of Accounting Method. The CPA then files a Section 481 Adjustment to adjust the property's federal tax position from the straight-line 40-year depreciation to the new accelerated depreciation mapped out in a cost-segregation study.

Short-term depreciable items are then put through a correction schedule and the overpayment in tax is returned to the property owner in equal increments over the next four years. For example, if the building has been in a portfolio for five years, all the "five-year components" should have been fully depreciated, but instead only 5/40 were depreciated. The owner may now recoup the 35/40 remaining life spread over the next four years. "Seven-year components" in this scenario have been 5/40 depreciated but should have been 5/7 depreciated.

| Typical Savings from Cost Segregation Studies According to Facility Type | | | | |
|--|--|------------------------------|--------------|----------------|
| Facility | Building Construction and Acquisition Cost | Present Value of Tax Savings | | |
| | | Year 1 | Years 1 to 6 | Total Tax Life |
| Restaurant | \$ 5 million | \$ 102,500 | \$ 410,500 | \$ 346,000 |
| Light Manufacturing | \$ 10 million | \$ 205,000 | \$ 821,000 | \$ 691,500 |
| Distribution Center | \$ 10 million | \$ 82,000 | \$ 344,000 | \$ 296,000 |
| Distribution Center (REIT) | \$ 10 million | \$ 185,000 | \$ 774,000 | \$ 666,000 |
| Class A Office Building | \$ 10 million | \$ 126,500 | \$ 600,000 | \$ 533,000 |
| Senior Living Facility | \$ 10 million | \$ 132,500 | \$ 538,000 | \$ 459,000 |
| Auto Dealership | \$ 2 million | \$ 25,000 | \$ 107,000 | \$ 95,000 |
| Bank | \$ 2 million | \$ 32,000 | \$ 136,000 | \$ 118,000 |
| Cold Storage | \$ 2 million | \$ 46,000 | \$ 182,000 | \$ 155,000 |
| Laboratories | \$ 10 million | \$ 164,000 | \$ 681,000 | \$ 592,000 |
| Computer Data Center | \$ 10 million | \$ 220,000 | \$ 950,000 | \$ 800,000 |
| High Technology | \$ 10 million | \$ 239,000 | \$ 966,000 | \$ 828,000 |
| Golf Course | \$ 10 million | \$ 126,000 | \$ 672,000 | \$ 604,000 |
| Hotel | \$ 10 million | \$ 164,000 | \$ 681,000 | \$ 592,000 |
| Strip Mall | \$ 10 million | \$ 107,500 | \$ 450,000 | \$ 386,000 |
| Medical Office Building | \$ 10 million | \$ 88,500 | \$ 442,500 | \$ 372,000 |
| Multifamily | \$ 10 million | \$ 91,000 | \$ 341,000 | \$ 264,000 |
| Class C Office Building | \$ 10 million | \$ 82,500 | \$ 395,000 | \$ 361,000 |

Providing a construction allowance

Another cost-segregation savings technique is for a building owner to provide a construction allowance to tenants for tenant buildouts (improvements). The building owner charges the tenant more rent because the owner is providing an improved space and the owner captures the federal tax depreciation benefit from the improvements and a cost-segregation analysis.

Once the cost-segregation study is complete, the results are methodically reorganized into three other useful reports:

1. Property tax
2. Fixed-asset and deferred-tax liability and asset management
3. Insurable value

Imagine finding out that your property value is lower than what the assessor has recorded and that you have been overpaying your property taxes! The owner can file for a restatement and if applicable, a refund. At the same time, the owner can make sure the facility is insured for as much as is actually appropriate. For example, parking lots and sidewalks don't burn, so why include them in a fire insurance policy?

A good relationship with an established, experienced cost-segregation provider is important so that, if the IRS inquires about a cost-segregation study three or more years down the line, the provider is willing and able to stand behind the work.

A Resource for Cost Segregation Studies

The Internal Revenue Service has issued a Cost Segregation Audit Techniques Guide, which was revised as of January 14, 2005. The Guide's table of contents is available at the IRS Web site <http://www.irs.gov/businesses/article/0,,id=134180,00.html>. On that Web page, each chapter can be accessed by the links provided in the table of contents.

The chapters cover:

1. Legal Framework
2. Principal Elements of a Quality Cost Segregation Study and Report
3. Review and Examination of a Cost Segregation Study
4. Appendix
 - 1) Uniform Capitalization
 - 2) Change in Accounting Method
 - 3) Depreciation Overview
 - 4) Relevant Court Cases
 - 5) Statistical Sampling
 - 6) Construction Process
 - 7) Information Document Requests
5. Industry Specific Guidance
 - 1) Casinos
 - 2) Restaurants
 - 3) Retail Industries

A good cost-segregation study is based on well-founded interpretations of the Internal Revenue Code sections, applicable court cases, and revenue rulings. The cost segregation professional should be able to demonstrate the relationship of the analysis to relevant laws, rulings, and precedents as support for the positions recommended in qualifying components as accelerated depreciable property.

William J. Barnes, CPA, CFP, CDFM MST, is currently the Senior Tax Compliance Officer at Groen, Kluka & Company Troy, Michigan. In addition, Ralph Consola, Vice President of Marshall & Stevens, contributed to this article.

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AICPA, 1211 Avenue of the Americas, New York, NY 10036

