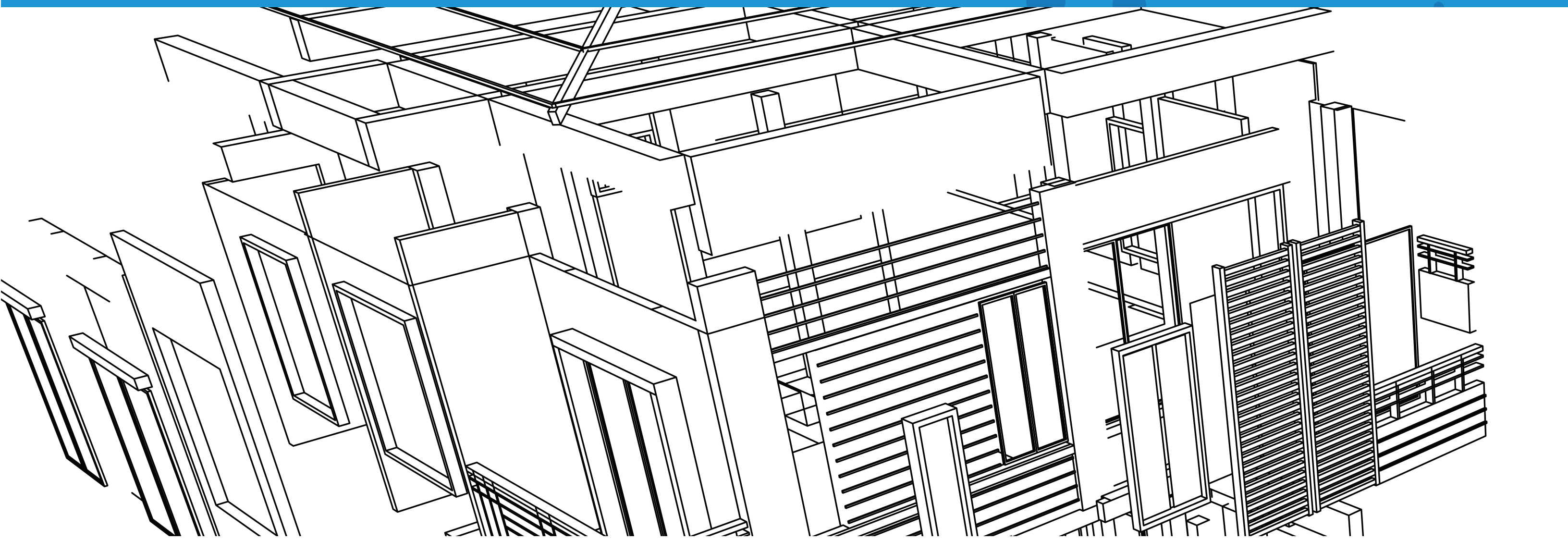
THE BASICS OF COST SEGREGATION ANALYSIS



A cost segregation analysis can be a huge source of tax savings for owners of commercial or income producing residential real estate. The aim of a cost segregation study is to identify the personal property of a building that can be depreciated at an accelerated rate relative to the rate applicable to structures. A properly conducted and documented study can unlock a dramatic source of tax losses all in one taxable year, which can be used to offset income.

What is depreciation?

Depreciation is a method for writing-off the cost of an asset over its useful life rather than in the year it is acquired. IRS rules divide assets into distinct categories, each with mandated recovery periods. Each year in the recovery period, the taxpayer claims a portion of the asset's value as a depreciation expense on the taxpayer's returns. Depreciating how long it will take for the value of the money you spent on your real estate to fully reduce your tax liability.

Decoupling assets for better tax results

In a typical commercial real estate transaction, the buyer acquires land along with a bunch of other assets—buildings, fixtures, and so forth—for a single purchase price. The land itself cannot wear out and lose value so it can't be depreciated. Buildings do eventually lose value over time, but because they have long useful lives they are subject to long recovery periods. A typical commercial building is depreciated over 39 years; residential rental property is depreciated over 27.5 years. Other asset types, like personal property included with the building such as office fixtures or land improvements such as a parking lot are depreciated over 15 years or less. These non-building assets are eligible for bonus depreciation in their first years of service.

A cost segregation analysis categorizes each part of a commercial property by class and recovery period. The goal is to segregate out personal property from the building itself, which allows the taxpayer to take advantage of the shorter recovery periods for personal property. Without conducting a cost segregation analysis, a business can be stuck applying the long recovery period of a building to the purchase price of assets that otherwise could be depreciated more quickly.

What qualifies for depreciation?

To be eligible for depreciation an asset must meet four requirements, set out in IRS Publication 946:

1. **The asset must be property owned by the taxpayer.**
2. **It must be used by the taxpayer's business or income-producing activity.**
3. **It must have a determinable useful life.**
4. **It must be expected to last more than one year.**

As you might imagine, the scope of assets subject to depreciation is quite broad. Businesses are often surprised by how specific a well-executed cost segregation analysis gets, and how many distinct assets can be identified in and around a commercial building.

A cost segregation study puts assets into four different buckets, each of which has distinct depreciation rules:

	Personal Property	Land Improvements	Buildings and Structures	Land
What is it?	Tangible assets that can be moved: machin-ery, non-structural fixtures, furniture, etc. fixtures, furniture, etc.	Things that make the land more useful, such as parking lots, fences, pools, drainage.	The structural components of a building, such as its roof, foundation, and walls.	The bare real estate underly-ing the property.
Typical depreciation term	5 or 7 years with the potential for bonus depreciation.	For qualifying improvements, 15 years with the potential for bonus depreciation.	39 years for a typical commercial building.	No depreciation permitted.

The personal property category offers extensive opportunities for accelerating deprecation expenses. Properly categorized and identified, even components that have been built into the walls of a structure can be categorized as personal property. For example, a hospital owner classified as personal property the electrical and oxygen distribution systems built into the walls of its hospital, tapping into a short depreciation schedule for an expensive asset. A cost segregation analysis specifically identifies every piece of a property that can be parsed out in this way.

The Whittaker & Company Cost Segregation Process

At Whittaker & Company we strongly recommend cost segregation studies to clients who have acquired or constructed income-generating property. A properly conducted study requires careful planning, extensive documentation, and technical expertise from tax and engineering experts. In short, it's a complex process, but one that can generate substantial tax savings in the first five to ten years of ownership.

WHEN SHOULD A COST SEGREGATION ANALYSIS BE RUN?

Taxpayers always bear the risk of being selected by the IRS for audit. Filing Form 3115 requires diligent support. The form should be prepared as though its results will be subjected to audit. If an IRS auditor should ask for evidence that the client's Form 3115 is accurate and supported, a cost segregation report prepared by Whittaker & Company provides all the necessary backup. they were doing R&D work.

These are the steps of a typical cost segregation analysis:

Step 1: Gather information

Because the study's goal is to identify distinct components of a property that each can be assigned a value (or cost basis) for tax purposes, a study begins by gathering detailed documentation about a property. The list of documentation can be long and varies according to factors such as whether the client has acquired an existing property or completed new construction. Examples of necessary documentation include any purchase contracts, the client's general ledger, blueprints, tax assessor records, construction drawings, and contractor invoices.

Step 2: Engage the engineers.

Accountants don't have the necessary expertise to correctly categorize every part of a building. Whittaker & Company partners with an engineering firm that specializes in cost segregation analysis. The documents we gather in step 1 are sent to the engineers. They compile the data about the property into a detailed database, essentially reconstructing on paper every piece of the building into an asset schedule that captures every distinct component: every window, every door, paint, tiles on the floors, wiring, pipes, and so on.

Step 3: Field verification.

The IRS requires an on-site verification of the details identified in the prior steps. Guided by our engineering partners, the team at Whittaker & Company visits the client's location to gather support for each claim. We use laser measurement tools and associated apps to confirm the key details the engineers require to certify their determinations.

The goal of the inspection is to double check the existence of the assets reflected in the paper records. When a property contains many copies of a particular asset, we will analyze a single instance of that asset and apply a multiplier. For example, in a newly constructed hotel, we inspect one instance of each unit floorplan to verify the contents of all other instances.

COST SEGREGATION ANALYSIS AND AUDIT RISK

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Step 4: Prepare the report.

With field measurements in hand it's time to compile the full cost segregation report following the requirements in the IRS Audit Techniques Guide. The report classifies every asset into its applicable depreciation grouping. Whittaker & Company works closely with the engineering firm to review every detail and verify that it has been properly documented and confirmed in the field.

Step 5: File Form 3115.

At the end of the process, we use the details of the report to prepare the client's Form 3115 for filing with the IRS. In technical terms, a cost segregation analysis results in a change of accounting method for the assets that are recategorized from one type to another. The IRS automatically accepts the results of a properly conducted cost segregation analysis. In other words, a business does not need IRS approval to begin claiming its new depreciation deductions right away.

How much can cost segregation save your business?

If your business recently purchased or constructed a commercial property, we recommend exploring the potential benefits of a cost segregation analysis. The team at Whittaker & Company is happy to answer your questions and conduct a preliminary review of your property to determine if a study would be justified. Give us a call today at (888) 415-0527.