Firms laud the benefits of cost segregation

For those who lived and breathe cost segregation work, there's an element of surprise surrounding how little most people (CPAs included) know about the tax savings strategy.

"On a recent proposal opportunity, a tax principal and I met with a potential client who owns 15 properties," said Lawrence Knutson, CPA/ABV and consulting senior manager at Ehrhardt Keefe Steiner & Hottman PC in Denver. "The potential client had developed the properties over the last 20 years. He had a sole proprietor doing his tax return who is retiring. We came in and the first thing we mentioned was cost segregation. He had never heard of it. We see that more and more. I don't think we've fully realized the size of the cost segregation market."

Cost segregation, is an engineering-based study of a building, with the goal of allocating as much value as possible to assets with the shortest depreciable life. It can often save clients thousands of dollars if they're willing to invest in a study that will categorize the real and personal property of their real estate.

Pricing for studies varies according to the firm retained, but can be anywhere from $7,000 for a small retail shopping center to $35,000 on building in excess of 1 million square feet.

The reason for this type of study can perhaps be explained best by. The faster items can be depreciated, the larger your depreciation deduction. The larger your depreciation deduction, the lower your taxable income, the lower your taxes.

Anybody who is buying depreciable, commercial real estate should have some form of a cost seg study done.

STUDY THIS

Cost segregation studies can be performed when someone purchases a building or when a building is being constructed. The study can take place before, during or after the buyer's acquisition of the property.

The IRS Audit Technique Guide defines a "quality" cost segregation study as one that is both accurate and well-documented in regards to classifying assets into property classes (e.g., land, land improvements, building, equipment, furniture and fixtures); explaining the rationale (including legal citations) for classifying assets as either personal or real property; and substantiating the cost basis of each asset and reconciling total allocated costs to total actual costs.

To do a good study, you have to have an engineering group knowledgeable in tax law. That's just a tough mix to put together. I think a lot of people try to jimmy-rig studies by buying some canned software and working on that type of basis, but in the end, when you're subject to IRS examination and the IRS brings in its engineer who is well-versed in the law, you are essentially in a difficult situation.

SEGREGATING THE BENEFITS

Many cost segregation providers will point to the 1996 legal dispute between the IRS and the Hospital Corporation of America ("HCA") as the watershed event that pushed these studies forward. Prior to that skirmish, the IRS had eliminated investment tax credits, which was problematic because tax credits were what depreciation rules were based upon.

The IRS took the position that since investment tax credits were gone, the IRS could redefine what the depreciation rules were after that period, adding that HCA argued for more than $1 billion in assets. The courts finally decided that taxpayers were still allowed to do a cost segregation study and that the rules for investment tax credits still applied to depreciation, even though the investment tax credit rules were gone.

The IRS has since allowed cost segregation studies to be done on properties as far back as January 1987, without taxpayers having to amend their tax returns. Instead, an Application for Change in Accounting Method, or Form 3115, can be filed, even on closed years.

The opportunity now is that owners are able to go back and say maybe we should look into. The IRS is allowing you to go back and change the depreciation to what it should have been, then compare that back to where you were under the old system, and allowing you to take that adjustment on your tax return. That is the power of this revenue procedure.

The problem, is that because many CPAs still aren't familiar with the technique and are daunted by what it entails, they aren't offering up the service to heir clients. Additionally, many CPAs aren't aware that their clients can file Form 3115 as an added tax savings benefit.

Most CPA firms don't know you can go back and re-categorize assets. They think it's all prospective of current-year acquisitions or current-year-construction. They don't realize you can go back in time and re-examine the way they depreciated their assets. That's the greatest opportunity. It's not aggressive; it's black and white and it's taxpayers-and CPA friendly.

What firms are doing, however, is partnering with other firms that do offer the service when their clients come knocking for the expertise. Clients can get their cost segregation needs met by a firm that hires engineers, appraisers and architects to do a piece of the project; their CPAs can point them to an engineering firm that deals strictly with the engineering aspects of the study; or clients can engage a full-service cost segregation firm that encompasses engineers, appraisers and tax experts on staff.

As for clients, awareness of cost segregation is percolating, but word still needs to get out on how a study can benefit their bottom line.

People are getting more sophisticated. It is not nearly as prevalent in the marketplace as it should be. It's not some magic bullet that people came up with a couple years ago. Cost segregation has been around for 20 years, if not more. We're finding once we educate the client as to what it is, clients will do it. But it has to be the right client, the right circumstance and you can't recommend it blindly.