

Cost-Segregation Solutions

These studies can provide tax advantages even after property sales.

by **Harvey Berenson**



Cost segregation is an accepted Internal Revenue Service method of allocating the purchase price paid for real estate property. Generally, cost segregation enables owners to increase the depreciation deductions from their properties, providing substantial present value benefits by reducing income taxes during the initial years of ownership.

Although most cost-segregation studies are completed when the taxpayer acquires or constructs a building, the IRS allows owners to complete cost-segregation studies for buildings they have sold. This can generate significant tax savings in the year of sale — and owners do not need to amend prior tax returns.

A cost-segregation analysis breaks down construction and acquisition costs, allocating the costs to specific categories: tangible personal property, land improvements, and real property. Under the applicable tax rules, a substantial percentage of a typical building's cost often quali-

fies for shorter cost recovery periods, generating tax savings from accelerated depreciation.

How Does It Work?

The following example illustrates the cost-segregation concept. An owner buys a commercial property on January 1 of year one for \$10 million; \$2 million is allocable to land and \$8 million to the building. A cost-segregation study is not performed. The owner is entitled to \$196,580 of depreciation (11.5 months under the applicable rules) in year one.

Now consider the benefits if a cost-segregation study were performed. The cost-segregation expert allocates 10 percent (\$800,000) of the building's original \$8 million tax basis to five-year property depreciation and 5 percent (\$400,000) to land improvements qualifying for 15-year depreciation.

The cost-segregation study effectively converts \$1.2 million of the tax otherwise depreciable over 39 years into property that will be depreci-

A property owner saved more than \$168,000 in federal tax liability through cost segregation.

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Cost-Segregation Tax Savings

YEAR OF SALE	NO COST SEGREGATION STUDY	TAX BENEFIT (LIABILITY)	COST-SEGREGATION STUDY	TAX BENEFIT (LIABILITY)
Depreciation deductions	(\$8,500)	\$3,000	(\$817,900)	\$286,300
Gain on sale	\$1,025,600	(\$256,400)	\$1,835,000	(\$408,950)
Total tax		(\$253,400)		(\$122,650)

ated over five or 15 years. As a result, the owner deducts \$347,100 of depreciation in year one, which is \$150,000 in additional deductions. If the owner is in the 35 percent federal tax bracket, he saves almost \$53,000 in taxes.

The owner will continue to enjoy larger depreciation deductions for the next several years.

After a Sale

An owner is never precluded from benefiting from a cost-segregation study, even if the study is done after the owner sells the property, as illustrated by the following example.

The owner sells the property on the first day of year six for \$10 million. Except for depreciation and gain on sale, the owner does not have any taxable income or loss from the property. Prior to sale, costs were not segregated.

Based on a 39-year life for the building, the owner deducted a total of \$1,026,600 of depreciation during the period he owned the property. The depreciation deductions reduce the basis of the property from \$10 million to \$8,974,400 at the time of sale.

In year six, the owner deducts \$8,500 of depreciation and recognizes \$1,025,600 of gain (equal to the prior depreciation deductions), which will be taxable at a maximum federal rate of 25 percent. If the owner is in a 35 percent federal tax bracket, the owner pays \$253,400 in net tax in year six.

What would be the outcome if the owner

commissioned a cost-segregation study for the building following the sale? Assume that, as of the date of purchase, the owner's depreciable basis should have been allocated in the same manner as set forth above: \$800,000 to five-year property, \$400,000 to 15-year property, and \$6,800,000 to 39-year property.

Based on the study, the owner recalculates the depreciation deductions he should have taken for years one through five, which total \$1,769,100 instead of the \$1,017,100 actually deducted.

In year six, the owner is entitled to a deduction of \$752,000 to make up for the depreciation that he did not take in the first five-year period. This deduction offsets the owner's ordinary income, subject to a 35 percent federal tax rate.

In addition, for the short period that the owner had the property in year six, he is entitled to depreciation of \$65,900, which also reduces his ordinary income.

The owner deducts \$817,900 of depreciation in year six, as compared with \$8,500 before the cost-segregation analysis — without affecting the deductions he took in earlier years.

The property's tax basis is now smaller because the owner has taken more depreciation. When the owner sells the property for \$10 million, he will recognize \$1,835,000 of gain because the property's tax basis has been reduced to \$8,165,000.

The federal tax on the owner's gain is a more-complex calculation than in the simple case where his only depreciable asset was a 39-year property. Under the tax rules, any gain (up to the amount of the owner's prior depreciation deductions) on the five-year property or the 15-year property will be subject to a 35 percent tax rate. At the same time, it may be possible to convert a portion of the gain, which oth-

erwise is subject to a 25 percent tax rate, into gain treated as long-term capital gain that is subject to a 15 percent federal tax rate. The owner's tax cost from the sale of the property thus depends on the relative value of the various components of the building.

Assume that the owner determines at the time of sale that the value of the five-year property is \$200,000 (25 percent of original cost) and the value of the land improvements is \$270,000 (two-thirds of original cost). In this case, \$233,100 of gain will be taxable at 35 percent, but \$730,100 of gain will be taxable at 15 percent; the balance of \$871,800 will be taxable at 25 percent. Because not all of the additional depreciation deductions resulting from the property's reclassification as a five-year property or 15-year property are recaptured on sale, this excess amount (\$730,000) is taxed at 15 percent even though the owner received a 35 percent tax benefit from the prior depreciation deductions.

Substantial Tax Savings

The owner's net tax bill in year six is reduced from \$253,400 to \$122,650, a savings of more than \$130,000. (See chart.)

As the values allocated to the five-year and 15-year property decrease, the owner's tax savings increase. For example, if the five-year and 15-year properties are sold for their tax book value, the federal tax on the gain decreases from \$408,950 to \$362,500, and the owner saves more than \$168,000 in 2009 federal tax liability by undertaking the cost-segregation study. The owner does not amend his earlier tax returns. He is simply required to include the required information in his year six tax return.

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