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The Tax-Savings Power of Cost Segregation Studies

Cash flow is great, but are you tired of paying taxes on your cash-flowing investment properties? Are you a real estate professional who gets a surprise tax hit when relying on those cash reserves? This article will discuss what a cost segregation study is and how cost segregation can be used effectively by real estate investors for tax savings and increased cash flow.

What is a Cost Segregation Study?

Cost segregation is the process of properly identifying the portions of real estate that can be reclassified into various class lives. Certain portions of real estate can be depreciated at a faster rate than the typical 27.5-year or 39-year class lives that many people know. This allows accelerated depreciation expense, which can, in turn, increase tax savings and cash flow. Certified engineers perform an on-site study of the real estate. These engineers identify the varying asset classes that are a part of the property. A signed report is produced for the owner's records. This report supports the allocations to the various class lives.

Basic Example: $3.9 Million Building

If a taxpayer buys a commercial property for $3.9 million, the IRS allows them to depreciate that building over 39 years. This results in $100,000 of depreciation each year.

If the property still reports taxable rental profits, for example $200,000, even after $100,000 of depreciation expense is deducted, this can create current-year tax due on that $200,000 of taxable income. If the taxpayer is in a higher tax bracket, this income could be taxed as much as 37%. This would result in about $74,000 in taxes due on the taxable rental profits.

However, if the owner has a cost segregation study performed on the $3.9 million property, this can potentially eliminate the taxable rental profits for multiple years. In our example, the study allocated the total depreciable cost into three class lives: $400,000 to seven-year assets, $600,000 to 15-year assets and the remaining $2.9 million as a 39-year asset. This study resulted in $1 million being allocated to shorter class lives, the seven- and 15-year class lives. These seven- and 15-year assets are potentially eligible for bonus depreciation and/or Section 179 expensing. This additional depreciation reduces taxable income and eliminates tax due on the rental profits.

The less nerdy way to explain it is that the taxpayer can accelerate tax depreciation deductions, resulting in an additional $74,000 of cash flow per year for the next three years.

What would you do with $222,000 of cash savings over three years? For many of our clients, this allows for re-investment into new real estate deals or merely not paying unexpected taxes when you were relying on that income.

When Should Someone Perform a Cost Segregation Study?

There are many different tax savings/planning strategies that you can implement with a cost segregation study. The primary goal is to generate tax savings through accelerated depreciation.

Strategies to Consider:

1. You can perform a retrospective study and report the additional depreciation deduction in the current tax year. This is a section 481(a) adjustment. We recommend consulting a tax advisor when considering something like this.

2. If an investor sells one property for a large capital gain, he could offset that gain by running a cost segregation study on another property he owns. The passive tax loss from the one property may be able to offset the passive gain from the sale of his other property.

Many tax savings strategies can be implemented with a cost segregation study. If this interests you, you should work with a CPA to determine if a study could be beneficial.