



26: COST SEGREGATION STUDIES

A look at ROI opportunities.

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DEVIL'S DETAIL

INTRODUCTION

Contractors and real estate investors that have acquired, renovated, or built a building should consider conducting a cost segregation study. The benefits realized from a cost segregation study could be considerable under the Tax Cuts and Jobs Act (TCJA) of 2017. TCJA removed the restriction on taking bonus depreciation on used assets acquired after 27 September 2017 and placed into service prior to 31 December 2017. Personal property acquired as part of a building may qualify for immediate expensing by claiming 100 percent bonus depreciation. Real estate investors should consider a cost segregation study to determine if the property they acquired, renovated, or built qualifies for accelerated depreciation. Most professionals who perform cost segregation studies will provide a complimentary estimate on how much could be saved by doing a study, aiding the decision whether the cost is worth the benefit.



WHAT IS A COST SEGREGATION STUDY?

A cost segregation study is a means of identifying assets and their associated costs to determine if they qualify for accelerated depreciation. Qualified assets are re-classified from real property to personal property for federal income tax purposes and therefore have a shorter depreciable tax life. A 39-year or 27.5-year property could qualify as a five-, seven- or 15-year property. Accelerating depreciation on these assets can reduce costs, improve cash flow, and potentially save money on taxes. A change in accounting method may be required to correct the treatment of depreciation.

Generally, 20 to 40 percent of the property can be reclassified as personal property in a cost segregation study. Flooring, signage, landscaping, and parking lots are examples of building components that can be reclassified. Typically, the building should have been placed in service within the last five years, and the cost of the building, remodel, expansion, or build-out needs to be at least several hundred thousand dollars. Many consider \$750,000 as the threshold.

Tangible property regulations allow a cost segregation study to establish the depreciable value for each major component of a building that may be replaced in the future. This includes the roof, HVAC system, doors, windows, and bathroom fixtures. In this case, a retirement loss or partial disposition is claimed for the depreciable basis remaining on the component.

A cost segregation study can also be used to identify other tax-saving opportunities. These include the possibility of deducting repairs, retirement, and removal costs, as well as if the property qualifies for green building deductions and other tax elections. The study can also determine if the property meets IRS requirements for qualified leasehold improvements, qualified retail improvement property, qualified restaurant property, or qualified improvement property.



BONUS DEPRECIATION

Under TCJA, bonus depreciation on new construction increased from 50 to 100 percent for the first five years of the asset's life. The building must have been placed in service after 27 September 2017 and before 1 January 2023. After 2022, the bonus depreciation percentages for qualified property placed in service decreases to 80 percent for 2023, 60 percent for 2024, 40 percent for 2025, and 20 percent for 2026. If renovated property was expanded or exterior facades, HVAC systems, elevators, escalators, load bearing walls, etc., were added, a cost segregation study should be conducted to determine which, if any, of these assets should be re-classified.

A non-structural asset installed in the interior of a building after it is placed in service is considered a qualified improvement property. This type of asset does not qualify for bonus depreciation and therefore must be classified as a 39-year property.

It is no longer necessary to meet the "first use" test to qualify for bonus depreciation. Eligible assets acquired after 27 September 2017 (subject to limitations) now qualify for bonus depreciation.

Taxpayers have the option to elect out of bonus depreciation for any class of property annually. In addition, for the first taxable year after 27 September 2017, the taxpayer can elect to apply a 50 percent bonus rate instead of 100 percent.

ENGINEERING APPROACH

The IRS recommends taking an engineering-based approach when performing a cost segregation study to comply with IRS regulations. A Certified Cost Segregation Professional (CCSP) credentialed by the American Society of Cost Segregation Professionals (ASCSP) would be an appropriate first choice to conduct a study. Other qualified professionals include Registered Professional Engineers (PE) and Certified Public Accountants (CPA) with expertise in this area. Using a credentialed professional will ensure compliance with all applicable tax laws.

Most professionals who conduct cost segregation studies will first do a free feasibility study to determine the potential savings. This will include the amount of increased deduction and cash-flow projections for the lifetime of the building. Property owners can then determine the potential return on investment (ROI). The professional conducting a cost segregation study will examine each component of the building and divide them into four categories: land, land improvements, building components, and personal property. The report will specify the percentage of the total purchase price comprised of each category.



Differentiating between tangible personal property and building components is the most difficult part of doing a cost segregation study. The IRS defines tangible personal property as all property within or attached to a building that is not land, the building itself, or part of the building's structural components. The final determination usually comes down to whether the item is permanent or removable. IRS guidance suggests that when deciding if an item is personal property or a building component, taxpayers look at its mobility, expected useful life, physical means of attachment, and other factors. Function alone is not enough to make a distinction. Identifying land improvements is simpler. Land components are exterior items that are not attached to the building. They tend to be less permanent.

To avoid an audit, use an IRS-approved method when doing a cost segregation study. Document everything and use facts that can be substantiated instead of estimates.

OTHER ELECTIONS

A like-kind exchange (IRC1031) is another way to defer income. A taxpayer can defer tax on a gain from the sale of an investment property or business if it is exchanged for a like-kind property. After 31 December 2017, like-kind exchanges are limited to real property held for productive use in a trade, business, or for investment purposes. An exchange of real property held primarily for sale does not qualify as a like-kind exchange. Personal property and intangible property no longer qualify as tax-free like-kind exchanges under TCJA.

REAL PROPERTY

Real property is land and any property attached directly to it, including any subset of land that has been improved through legal human actions. Examples of real properties can include buildings, ponds, canals, roads, and machinery, among other things.



Demountable interior glass partition walls may qualify for accelerated tax depreciation (images courtesy AGI member glazing contractors)

PERSONAL PROPERTY

Personal property is defined as any movable property not attached to a home or building. Requirements for personal property tax vary from state to state and mostly affect businesses. Rules apply; in some cases, personal property will be classified as real property for IRC 1031 purposes. For example, fixtures that qualify for accelerated depreciation in a cost segregation study may be considered real property in a like-kind exchange.

The IRS takes the position that federal income tax law supersedes state law when determining if a property qualifies for a like-kind exchange. Although many people believe that the removal of personal property qualifying for a like-kind exchange was a mistake under TCJA, the government has not made a correction.

Section 179 allows taxpayers to deduct the cost of certain property as an expense when the property is placed in service. For tax years beginning after 2017, TCJA increased the maximum Section 179 expense deduction from \$500,000 to \$1 million. The phase-out limit increased from \$2 million to \$2.5 million. These amounts are indexed for inflation for tax years beginning after 2018. The maximum Section 179 expense deduction for 2019 is \$1,020,000 and \$1,040,000 for 2020. The phase-out for Section 179, based on asset additions is \$2,550,000 for 2019 and \$2,590,000 for 2020.

The Section 179 deduction applies to tangible personal property such as machinery and equipment purchased for use in a trade or business, and if the taxpayer elects, qualified real property. TCJA amended the definition of qualified real property to mean qualified improvement property and some improvements to nonresidential real property, such as roofs, HVAC systems, fire protection and alarm systems, and security systems.

DISMOUNTABLE WALLS

Since the IRS classifies demountable walls as furniture and fixtures (Asset Class 00.11: Nonstructural component of a building), the cost can be depreciated over seven years under the modified accelerated cost recovery system (MACRS) instead of 39 years.

Many interior glass wall systems fit into this category of demountable (demountable) interior partitions. AGI offers a variety of educational materials related to interior glass, including the AGI Interior Demountable Walls Expertise brochure, Interior Demountable Walls: Facts to Know brochure, and the Interior Glass Guide Specifications. All are available by request from AGI.

Dismountable walls generally qualify for the Section 179 deduction. The combination of the Section 179 tax deduction with bonus depreciation may allow a company to expense 100 percent of a demountable wall's cost in the first year it is placed into service (if it is done after 27 September 2017, and before 1 January 2023). The bonus depreciation percentage for qualified property acquired before 28 September 2017 and placed in service before 1 January 2018, is 50 percent. Special rules apply for longer production period property.

For tax years beginning after 2017, TCJA also expanded the businesses that must use the Alternative Depreciation System (ADS). TCJA changed the ADS recovery period of residential rental property. For property placed in service after 2017, the recovery period is 30 years. It was formerly 40 years.

THE BOTTOM LINE

Although there are many advantages of conducting a cost segregation study, there are also disadvantages. The process requires an investment of time and money working with an engineer, CPA, and other professionals to ensure that the study meets IRS requirements. The expense of a cost segregation report alone can be \$10,000 to \$25,000 based on the building and the number of components that need to be analyzed. Even so, the cost of the report is a deductible business expense. In addition, the tax savings realized from the study could pay for the report.

BENEFITS OF A STUDY

The benefits of a cost segregation study can outweigh the costs. One major benefit is based on the time value of money. This concept holds that money available at the present time is worth more than the identical sum in the future due to its potential earning capacity. Components of a building that are reclassified as personal property in a cost segregation study can be depreciated faster than the building itself, making that money available earlier in the life of the property. Larger deductions lead to lower taxes, which result in improved cash flow and increased investment opportunities. The gain in near-term cash can be reinvested in the property to improve its value or invested in other projects.

Another benefit of a cost segregation study is the ability to write off individual building components that fail and need to be replaced. Each component identified as personal property in the report is assigned its own tax basis. The costs of a major repair can therefore be an immediate write-off of the depreciated value.

A cost segregation study can also help with estate planning. The building components that qualify for accelerated depreciation can result in favorable tax treatment for estate tax purposes and on a decedent's final income tax return.

Contrary to some beliefs, in most cases cost segregation studies are not risky. If IRS regulations are followed and selected professionals have in-depth experience in cost segregation, there should not be an issue. Problems arise when owners cut corners or attempt to do a study without professional guidance.

The tax laws on cost segregation studies, as well as the depreciation of personal property and leasehold improvements, are complicated. Disclaimer: This white paper is for informational purposes only and doesn't constitute professional advice. Information contained in this article is not intended or written to be used as tax advice and cannot be used by the recipient to avoid penalties that may be imposed under the Internal Revenue Code. AGI and the author strongly advise seeking professional assistance with respect to specific issue(s).

About the Author

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About the Devil's Details

The AGI educational series illustrates and describes common glazing challenges as a means to communicate best practices for the design and construction industry, not as a sole source for design guidance. AGI recommends design professionals consult with an AGI contractor regarding specific project challenges. AGI contractor profiles may be accessed at www.theagi.org. To share a devilish detail of your own, contact info@theagi.org.