

HOW A COST SEGREGATION STUDY CAN PUT MONEY IN YOUR POCKET

What if you could get in a time machine and pay less taxes? I think most people would be thrilled and jump at the chance. It might sound crazy, but there may be a ticket onto a tax time machine for you.

This tax time machine would allow you to go forward in time to grab tax deductions and bring them back to today. In some cases, the time machine would allow you to go back to the past to collect deductions you didn't use and bring them to the present. The use of something called a cost segregation study is what makes tax time travel possible and may be your ticket onto the tax time machine.

I was surprised recently when I met with a banker in the real estate lending business who was unfamiliar with cost segregation as a tax strategy for real estate. I thought that this tax reduction and cash flow strategy was more well known. It is an awesome opportunity for individuals or businesses that either own commercial real estate or residential rental property or that have leasehold improvements of \$250,000 or more. I thought I would introduce it to you too.

Cost segregation studies provide the framework for you to write off your long term business assets over a few short years rather than many years to come. By accelerating the amount you write off for these assets each year, you end up with more deductible expenses now and pay less taxes today. In some cases these studies also allow you to pick up depreciation deductions in the current year that you would have had available in past years. This is the case even though the total amount you spent on the business asset doesn't change.

Before describing the basics of cost segregation, I feel compelled to give a very brief reminder on how depreciation works. So here is a warning! The next several sentences contain a quick refresher on how depreciation works for tax purposes. You should not operate heavy

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machinery or drive during or immediately after reading this refresher as it could, and likely will, cause drowsiness. But do keep reading because if you own real estate, have significant improvements to your leased space or are in the real estate business, this strategy could save you or your clients thousands of dollars in a hurry.

For tax purposes, the IRS knows that when you purchase a large asset for your business, it will often provide value to your business well beyond the year in which you bought it. So they don't allow you to write off the total cost of the asset in the year you purchase it, except in specific circumstances. Instead, they allow you to deduct a portion of the cost of the asset each year you file your tax return until the total cost has been deducted.

The annual amount allowed as a deduction is determined based upon several criteria beyond the scope of this introduction to cost segregation. But the general idea is that when you buy a long lasting asset that will help your business for several years, you only get to deduct a portion of the cost over the course of those several years. The IRS has already determined how long the useful life of different assets are and provided detailed tables for most everything you can imagine such as office equipment (5 years), software (3 years), office furnishings (7 years), and more.

Now, we return to the story. The IRS determined the useful life for commercial real estate is 39 years and residential real estate is 27.5 years. However, many of the components of your building will not last 39 years. These items have shorter lives. For example, the electrical system in your building may have a useful life of only seven years. If the electrical system was valued at \$50,000 in your \$750,000 building, you could write that portion of the building purchase price off over seven years rather than 39.

A cost segregation study breaks down the purchase price of your building by allocating its cost to the components of the building, such as electrical systems, mechanical systems, carpeting, and more. Some of the building will still have a useful life that can't be written off faster than the 39 year period. But, many of the components have a much shorter useful life thereby allowing you a much higher depreciation write off.

Imagine, if instead of depreciating \$780,000 over 39 years you were able to depreciate \$300,000 of that amount over five to seven years. That could make a huge difference in your tax liability. You would have a much higher depreciation deduction reducing your taxes, even though you didn't pay anything more for the building. This study must be prepared by a professional and meet very specific IRS requirements.

Oh, yeah, here is one other fancy feature of the tax time machine. If you have already purchased your real estate and started depreciating it, you don't have to amend any past tax returns to claim the accelerated depreciation you could have

already claimed. The IRS has established procedures for you to claim that depreciation on your next tax return! The first year after the cost segregation study is completed may result in a very large depreciation amount as you catch up on what would have been allowed using the segregation approach.

Most CPA's are not in a position to either prepare this kind of study or to direct you through it. So, they often never mention it as a viable tax reduction strategy. If you think there may even be a small chance you qualify for a ticket on this tax time machine, it is definitely worth getting more information. This strategy could literally put thousands of dollars in your pocket in tax savings each year.

This is intended for general interest and not as specific legal or accounting advice for anyone. You should consult your tax advisor to get more information.