#40: Cost Segregation

Cost segregation studies can produce tax savings in two ways. First, they can substantially increase the present value of depreciation deductions and increase cash flow. Without cost segregation, taxpayers must depreciate residential property using straight-line depreciation over a 27.5-year period[182] and non-residential property using a straight-line method over 39 years. Cost segregation may enable the taxpayer to depreciate part of the cost of a building over a shorter period of time using a faster depreciation method.

A second benefit of a cost segregation analysis is that it can increase the amount of property subject to depreciation by reallocating the purchase price of a building between building components and tangible personal property or between land and land improvements.

Cost Segregation Procedure

Cost segregation is accomplished by segregating building costs into five components—

- Five-year personal property
- Seven-year personal property
- Land improvements
- Buildings
- Land

<u>Five-Year Personal Property</u>

This is the most favorable property for depreciation purposes. Taxpayers cannot only depreciate it over a short five-year period, they can use the very favorable double-declining balance method. Property in this category includes office machinery (such as typewriters, calculators and copiers), computers and peripheral equipment, and any property used in research and experimentation. It also includes appliances, carpets, furniture, etc., used in a residential rental real estate activity. Taxpayers should attribute as much of the cost of a building as possible to this category.

<u>Seven-Year Personal Property</u>

This category of property can also be depreciated using the double declining balance method. Although the depreciation period is somewhat longer, it still receives highly favorable treatment. Seven-year personal property includes office furniture and fixtures (such as desks, files and safes), agricultural machinery and equipment and railroad tracks.

<u>Land Improvements</u>

Certain improvements made directly to land can be depreciated over a 15-year period using a 150% declining balance method. Property included in this category includes shrubbery, landscaping, fences, roads, sidewalks, bridges and docks.

[182] Assuming that the alternative depreciation system isn't being used.

Buildings

Although buildings are depreciated over a much longer period of time than personal property or land improvements and use the less favorable straight-line method, allocating purchase price to buildings is still much more favorable than allocating it to land. After allocating as much value as possible to personal property, buyers want to maximize the portion of the remaining value allocated to buildings because any residual value will be attributed to non-depreciable land.

Increasing the Present Value of Depreciation Deductions

The following example illustrates the economic benefit of shorter depreciation periods and more favorable depreciation methods.

> ***Example 1.*** In January 2024, T buys a non-residential building for $10,000,000 from an unrelated party. If T doesn't utilize cost segregation, it must use straight-line depreciation over 39 years. Instead, T has a cost segregation study done. The study concludes that $9,000,000 of the purchase price should be allocated to the building and $1,000,000 to 5-year property. Assume the following additional facts:
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> - The building is depreciated using the full month convention
> - The salvage value of the building is $0
> - T is in the 37% marginal income tax bracket
> - T's opportunity cost of capital is 7%
>
> A. No Cost Segregation
>
> The annual depreciation deduction will be $256,410.26 ($10,000,000/39). The present value of this payment stream discounted back to present value at 7% is $3,401,263 and the present value of T's tax deduction is $1,258,468 (.37 x ($3,401,263).
>
> B. Cost Segregation
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> If cost segregation is used, 39-year straight-line depreciation will still apply to 90% of the $10,000,000 total value. Thus, the present value of the straight-line depreciation on the building will be $1,132,621 (.9 x $1,258,568).
>
> However, the $1,000,000 worth of five-year property will be depreciated using the double declining balance method. The annual depreciation deductions will look like this:

Year	**Depreciation**	**P.V.**	**P.V. x 37%**
2018	$400,000	$373,832	$138,318
2019	240,000	209,625	77,561
2020	144,000	117,547	43,492
2021	86,400	65,914	24,388
2022	51,840	36,961	13,676
Total			$297,435

C. Tax Savings

The following chart shows the depreciation deductions in the two scenarios.

Scenario A	*Scenario B*
$1,258,468	$1,132,621
	+ 297,435
	$1,430,056

Thus, under the assumed facts the present value of the tax savings from using cost segregation is $171,588 ($1,430,056 - $1,258,468).

Increasing the Amount of Property that Can Be Depreciated

A cost segregation study may also increase the amount of property that can be depreciated by identifying aspects of a building that could be treated as tangible personal property and depreciated rather than components of a building. For example, the following are among the many items held to be personal property:

- Wall-to-wall carpeting in a motel (Rev. Rul. 67-349);
- Vinyl floor and wall coverings (*Hospital Corporation of America*, 109 TC 21);
- Chandeliers and hanging lanterns in a restaurant (*Shoney's Inc.,* TC Memo 1984-413);
- Ornamental lighting fixtures (*Laurence A, Duaine*, TC Memo 1985-39); and
- Clothes dryer vents, gas lines in common laundry rooms and electrical outlets for refrigerators, stoves, washers and dryers in an apartment complex (*Amerisouth XXXII Ltd*., TC Memo 2012-67).

If land improvements can be identified and segregated from the land, additional property can be depreciated.

Additional Benefits

A cost segregation study may produce two additional benefits. First, the study may identify assets eligible for bonus depreciation or IRC §179 expensing. Following the 2017 Tax Cuts and Jobs Act (TCJA), bonus depreciation allows taxpayers to immediately deduct 100% of the cost of qualifying property. Under the TCJA, qualified property is defined as tangible personal property with a recovery period of 20 years or less. Use of the property by the taxpayer need not be the original use provided that the taxpayer hasn't previously used the acquired property and the property wasn't acquired from a related party. In other words, it may be possible to get the bonus depreciation from used property. To obtain 100% expensing, the taxpayer must acquire the property after September 27, 2017.

Second, although taxpayers aren't allowed to depreciate components of a building separately, a cost segregation study can value a component to give it a basis if it later needs replacement.

Example 2. T buys an apartment building in 2019. A cost segregation study values the roof at $300,000. In 2022 when the value of the roof is $275,000, it is seriously damaged in a hurricane. T can claim a $275,000 deduction for the loss of the roof. Without the cost segregation study, the cost of the roof couldn't be separated from the cost of the building as a whole.

Disadvantages of Cost Segregation

A cost segregation study may have the following disadvantages:

- It won't be worth the time and expense if the taxpayer has little or no income or plans to sell a building within a few years after it is purchased;
- The tax savings may not be sufficient to justify the cost;
- There may be depreciation recapture subject to ordinary income rates;
- Possible § 1250 gain taxed at 25%;
- If a study is too aggressive or includes erroneous information, the IRS could assess penalties on the additional tax due to a substantial valuation misstatement.