How Cost Segregation Studies Help Real Estate Owners Defer Taxes

Companies and individuals who have purchased, constructed or renovated real estate often use a cost segregation study to increase their cash flow by accelerating depreciation deductions and deferring federal and state income taxes.

Real estate properties typically include the existing building structure, exterior components located on or connected to the property, and internal components such as HVAC and plumbing.

The Internal Revenue Service (IRS) has provided depreciation schedules for different types of assets related to real estate. Residential buildings are depreciated over 27.5 years, while commercial buildings are depreciated over 39 years. However, certain components of a property have shorter depreciation schedules of 5, 7, or 15 years. By separating the costs of a property, a taxpayer can realize the benefits of depreciation sooner than later.

Cost segregation studies identify the various components of a property and classify certain assets as personal property or land improvements to shorten their depreciation time for taxation purposes, reduce tax obligations and improve cash flow.

How are costs segregated?

A cost segregation study identifies four components of a property: personal property, land improvements, structures and buildings, and land.

Personal property assets have the shortest depreciation schedules, typically 5 or 7 years, and include non-structural elements such as carpeting, wall coverings, furniture, lighting fixtures, and storage tanks.

Land improvements have slightly longer depreciation schedules, typically 15 years, and include landscaping enhancements, sidewalk installations or improvements, moveable partitions, docks, bridges, fences, and any freestanding enclosures or waste receptacles.

The remaining costs are categorized as either building with a 39-year depreciation schedule or land, which is not a depreciable asset.

When should a cost segregation study be completed?

While many real estate owners choose to complete a cost segregation study when they first purchase or make significant improvements to a property, there is no deadline to complete one. With that said, the value of having a cost segregation study declines the longer a property is in service. Each year that passes is a missed opportunity for accelerated depreciation.

When it comes to timing, a cost segregation study doesn't need to be completed before the end of the tax year; however, it must be completed before the tax return is filed.

What are look-back studies?

It is not a requirement for a property to be newly constructed to reap the benefits of a cost segregation study. Cost segregation studies performed on properties that were previously placed in service and have filed tax returns in years past are considered look-back studies.

Look-back studies can be advantageous for some taxpayers because they can claim what is often referred to as catch-up deductions. Catch-up deductions are taken in a single year and are equal to the difference of what was depreciated compared to what could have been depreciated had a cost segregation study been completed earlier. The IRS permits taxpayers to implement cost segregation studies to adjust depreciation for properties placed in service dating as far back as January 1, 1987.

How does qualified improvement property impact cost segregation studies?

Cost segregation studies can be used in conjunction with Section 179 Depreciation, Bonus Depreciation, and Qualified Improvement Property to accelerate deductions.

<u>Section 179 Depreciation</u>

Section 179 allows a taxpayer to deduct the full cost of purchasing or leasing eligible new or used assets up to certain limits. Qualified assets include improvements to the interior portion of a commercial building after the building is placed in service. Roofs, HVAC, fire protection systems, and alarm or security systems are also included. The taxpayer can deduct up to $1.05 million of expense for assets placed into service in 2021. If the taxpayer purchased more than $2.62 million of eligible assets in 2021, then the amount the taxpayer can deduct is reduced dollar-for-dollar for expenditures over $2.62 million. This deduction can only be used to offset net income and can't be used to create a net operating loss.

<u>Bonus Depreciation</u>

Under the Tax Cuts and Jobs Act, 100% first-year bonus depreciation is available for qualified assets acquired and placed into service between September 27, 2017 and January 1, 2023. This generally applies to depreciable assets with a recovery period of 20 years or less and certain other property. There is no limit to the amount of 100% bonus depreciation, and the deduction can be used to create a loss, but the taxpayer must apply the same treatment to all assets of the same class.

<u>Qualified Improvement Property</u>

Qualified Improvement Property is generally defined as any improvement to a commercial building's interior after the building was placed into service. Qualifying improvements include plumbing, ventilation systems, alarm systems, installation or replacement of drywall, interior doors, and certain mechanical and electrical work. However, it does not include the enlargement of a building, an elevator or escalator, or improvements to the internal structural framework of the building. In 2020 the CARES Act assigned a 15-year depreciation to Qualified Improvement Property placed into service after 2017, and thus, assets classified as QIP qualify for the 100% first-year bonus depreciation.

How does qualified improvement property impact cost segregation studies?

A cost segregation study typically involves a team of tax advisors and engineers to categorize the assets and respective costs of a property. A study should include an in-person tour of the physical property as well the examination of various records and paperwork, including property titles, blueprints, site maps, inspection reports, and appraisals, as well as additional paperwork covering any past building upgrades, especially construction notes, architectural renderings, finance reports detailing project and contractor costs.

Many property owners find cost segregation studies beneficial because they accelerate tax deductions and improve cash flow. They help an owner take advantage of Section 179 depreciation and bonus depreciation.

Final Thoughts

If you would like to discuss whether or not you would benefit from a cost segregation study, please contact our office.

About Heard, McElroy & Vestal

In 1946, S. Berton Heard, Charles McElroy and Charles Vestal founded Heard, McElroy & Vestal, LLC in Shreveport, Louisiana. Together, this trio of professionals established the firm as a pillar of trust, integrity and competence, with the mission to create solutions and provide opportunities for our clients, our people, and our communities. HMV is one of the largest public accounting and consulting firms in Northwest Louisiana, servicing our clients throughout the states of Louisiana, Arkansas, Texas, Mississippi, Oklahoma and Tennessee from offices in Shreveport and Monroe. Our firm is comprised of over one hundred (100) employees: Partners, Of Counsel Partners, Senior Managers, Managers, additional Professional Staff and Administrative Staff. Our Professional Staff includes more than fifty (50) certified public accountants who obtain additional certifications which are Accredited in Business Valuation (ABV), Certified Fraud Examiners (CFE), Not-for-Profit Certificate holders, Certified Valuation Analysts (CVA), Personal Financial Specialists (PFS), and Certified Mineral Managers (CMM). Our team of professionals brings together many years and diversification of experience, providing a network of knowledge and resources and allowing for industry and niche specialization. Not one CPA can offer the range and quality of services a firm of our size is able to provide, while remaining small enough to deliver personalized service and attention to our clients with consistency on engagements. HMV's strategic associations include Aliign Mineral Management, LLC, Business Valuation Consultants, LLC and HMV Wealth Advisors, LLC.

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