

What Should You Know About Accelerated Depreciation?

The Internal Revenue Code (IRC) defines depreciation as a deduction for a reasonable allowance for the exhaustion and wear and tear of property used in a trade or business, or for production of income (including allowance for obsolescence).

When depreciating an item, you must know the: date placed in service, cost or other bases, property class and recovery.



Cost Segregation

Cost segregation is a formal engineering process accepted by the IRS that identifies building costs and land improvements depreciated over 27.5 to 39 years. It really allocates a significant portion of the building cost to asset classes with shorter depreciable lives (accelerated depreciation). This allows for properly identifying an asset cost basis, property class, and recovery. Qualifying construction cost should be depreciated over 5, 7, and 15 years of life. This results in accelerated depreciation deductions, reduced tax liabilities, and increased cash flow.

How does cost segregation accelerate depreciation?

Cost segregation breaks out what would normally be depreciated over 27.5 to 39 years into smaller segments, thereby accelerating the expense. This is known as front-loading.

The time value of money means a dollar today is worth more than a dollar tomorrow. The longer you hold onto the property, the greater the tax advantage. The increased depreciation expense offsets taxable income, therefore increasing cash flow.

When should a cost segregation study be performed?

Who benefits from cost segregation the most?

- Those who have expenditures for a structure including leasehold improvements, equal to or exceeding \$750,000
- Those using Section 1031 exchanges that allow tax deferral of the maximum amount of taxes

When should a cost segregation study be performed?

- Immediately after construction or acquisition
- During construction with properties larger than 20 million
- Building already in service even when no cost information is available
- Following major capital improvements
- After a change in ownership or estate step ups

This benefit applies to all commercial buildings, rental properties, manufacturing facilities, warehouses, restaurants, R&D facilities, wineries, grocery stores, hotels, etc. where the average allocation flows are somewhere between 20% and 60% of the valuation.

For every \$100,000 of 39-year-old property the reclassified 5 to 7-year property generates approximately 18 to 22,000 in tax savings. $B = ((1-F)*S)+F$ (B= Blended rate, S= State tax rate, F = Federal tax rate) assuming a tax payers tax rate is 41% and their return on investment factor is 8%.

Depreciation Basics

- Real property: 27.5 to 39 years
- Land improvements: 15 years/150% DB - sidewalk expenses and docks
- Personal property: 5 or 7 years/200% DDB - furniture, carpet, appliances, certain fixtures, and window treatments
- Land: non-depreciable
- Half-year convention applies to non-residential placed in service or sold mid-year
- Mid-month convention applies to residential property and non-residential placed in-service mid-month and is allocated based on the number of months
- Mid-quarter convention applies to all other property other than real property that is placed in service during the last three months of the year and more than 40% of the aggregate basis

What Constitutes 1245 Property?

Standards of use and determination are:

Functional Use Test: this test determines the structural components, of the building. If it is not structural, then it is a 1245 personal property. This determination hinges on whether it is an inherently permanent structure and how permanently the asset is attached to such a structure. For example, if the asset served a function normally attributable to the structural component or permanent structure, it was not treated as tangible personal property, even if it could be moved.

Permanency Test: in 1975, six questions were developed to ascertain if a property qualifies as tangible personal property.

- Can the property be moved and has it been moved?
- Is the property assigned or constructed to remain permanently in place? Are there circumstances that show the property may or will be moved?
- Is the property already movable?
- How much damage will the property sustain when it is removed?
- How is the property affixed to the land?

Sole Justification Test: for an item to qualify for a lower life even though it is a structural component of the building it is necessary to meet specific temperature or humidity requirements essential for the operation of machinery or the processing of materials or foodstuffs

Case Study

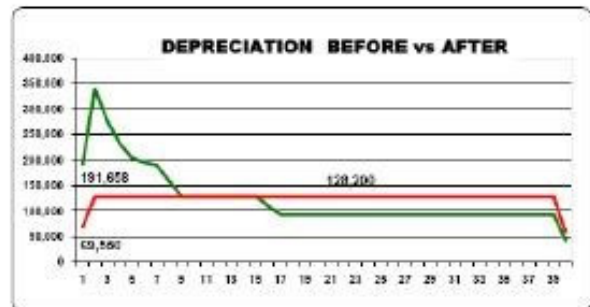
Case study performed on a \$5 million Office Building

Example 1 Current Year Acquisition

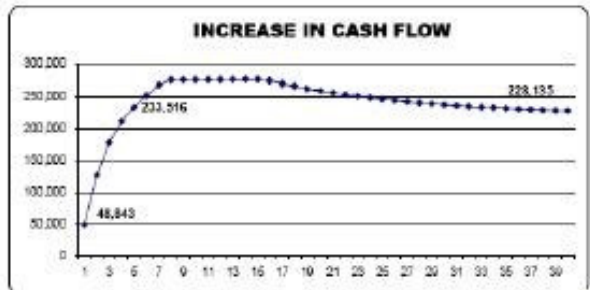
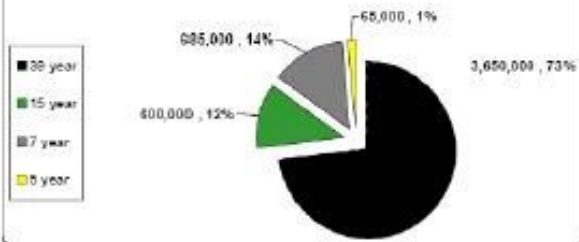


\$5M Office Building

INCREASED DEPR: Current Yr	\$122,108	(191658 - 69550)
INCREASED CASH FLOW: Current Yr	\$48,843	(122108 x 40%)
Yrs 1 - 5	233,516	see depr sch
30 Years	228,135	



REALLOCATION OF BUILDING BASIS



Change in Accounting Method

In order to take advantage of cost segregation, you must file a change form request 3115 to the IRS

Rev.Proc.2009-9 (supersedes Rev.Proc.99-49)- permits an automatic change in accounting method, filed in the year the change is selected and allows the taxpayer to catch up on deductions from previous years as a result of cost segregation study. The benefit must be spread over four years.

Rev.Proc. 2002-19 (supersedes Rev.Proc. 99-49) - adjustments can be expensed entirely in the year of change.

- Most of the time when form 3115 is used, there is no refund unless the taxpayer overpaid estimated taxes in the current year. Form 3115 is a current year deduction of benefits based on your current tax rate.

1031 Exchange

A properly structured 1031 exchange allows an investor to sell a property, reinvest the proceeds in a new property and defer all capital gain taxes.

IRC 1031 (a)(1) states: “no gain or loss shall be recognized on the exchange of property held for productive use in trade or business or for investment, if such property is exchanged solely for property of like kind which is to be held either for productive use in trade or business or for investment.”

Similarities between cost segregation and 1031 exchanges include deferred tax and therefore more cash flow can be realized on any type of commercial property and encompasses complex areas of tax law and does not necessitate the use of a specialist.

Conclusion

Cost segregation is experiencing explosive growth due to changes in tax law. Many building owners not previously aware of the benefits are changing their thinking about their investment strategies. The real key is a proper allocation to avoid IRS scrutiny.



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