LEE & ASSOCIATES
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HOW PROPERTY OWNERS CAN MINIMIZE THEIR TAXES THROUGH COST SEGREGATION

In the words of Ben Franklin, "In this world nothing can be said to be certain, except death and taxes."[1]

While neither can be avoided, both can be delayed and, with regard to taxes, can be minimized. In preparation for the next tax season, this report will explain how property owners, whether commercial or residential, can mitigate and reduce their tax liability by using a little-known IRS-approved accounting technique called cost segregation.

It's widely known that you can use real estate depreciation[2] rules to reduce your tax liability. Using the applicable depreciation rules on real estate assets, commercial property owners can reduce their taxable income by deducting a large percentage of the purchase price they paid for their building or the cost they incurred while improving the property.

Unfortunately, standard depreciation rules do not distinguish between the building as a whole and the particular fixtures and components of a building. For example, under standard tax law, your building is set to depreciate over 39 years if it is a commercial property.[3] However, many assets - like lighting, carpeting, cabinetry, and other building components - depreciate much faster. Oftentimes, their useful life spans never exceed 15 years. Which means it makes little sense to require the owner of these assets to wait 39 years to get a tax deduction for them.

Precisely for this reason, the tax code permits the use of cost segregation, an accounting technique, to rectify this inequity. Commercial property owners can factor in the shorter life spans of these components to accelerate depreciation calculations and reduce their tax liability.

The way cost segregation works is that the various interior and exterior components of a property are classified into four main categories:

- **Personal Property:** Decorative/removable finishes/fixtures, dedicated/specialty components, etc.
- **Land Improvements:** Landscaping, parking lots, sidewalks, retaining walls, etc.
- **Real Property:** Structural building components, foundations, general building systems, etc.
- **Land:** Non-depreciable

Components that fall into the personal property or land improvements categories can be depreciated over a span of either 5-years, 7-years, or 15-years. As a result, the property owner's income tax liability is lowered because they can deduct qualifying personal property and land improvement assets at a faster rate than standard depreciation rules allow, increasing their business's cash flow and profitability.

Cost segregation was an important tax strategy tool even before 2017, but with the passage of two pieces of congressional legislation – the Tax Cuts and Jobs Act of 2017 and the CARES ACT of March 2020 – it has only increased in value and importance. The savings a property owner can accrue by using cost segregation are immense.

Under the 2017 law, a taxpayer may opt to expense 100% of the cost of any item classified as personal property acquired and placed in service after September 27, 2017, and before January 1, 2023. This 100% deduction is available till the end of 2022. Afterward, it will be slowly phased out until it is entirely gone by 2027. This feature of the 2017 Jobs Act provides a massive initial benefit to real estate owners because it allows for all applicable cost-segregated assets with a life span of fewer than 20 years to be deducted in the first year.

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In March of 2020, the CARES Act retroactively modified the depreciable life of interior improvements on a nonresidential building (known as qualified improvement property or QIP) from 39 years to 15 years, delivering a much shorter depreciation period and making it eligible for 100% bonus depreciation.

Given these significant and obvious benefits, every property owner needs to be using cost segregation as part of their overall tax strategy.

To take advantage of the 2017 Jobs Act and the 2020 CARES Act mentioned above, you must have a cost segregation study done. The IRS requires all cost segregation studies to be "engineering-based," which means that various building components be analyzed, such as plumbing, electrical, and mechanical systems. Make sure those who conduct the study have a thorough understanding of accounting, engineering, construction methods, building materials, and construction costs, and all IRS requirements and applicable tax laws,

In commercial real estate, paying attention to details matters. If deployed properly, cost segregation can unlock significant hidden savings and after-tax cash flows for real estate owners and investors.

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Sources:

[1] Ben Franklin writing to Jean-Baptiste Leroy in 1789. See The Adam Smith Institute: https://bit.ly/3kxKSJS
[2] For a definition of depreciation, see here: https://bit.ly/3kyzPjK
[3] 27.5 if it's a residential property