Don’t Let Higher Taxes Creep Up On You

Slash Your Tax Liability with Cost Segregation

By Jeremy Smith, CPA
(480) 839-4900 ~ JeremyS@hhcpa.com

Are you missing out on saving money? It’s a scary thought, but the solution could be as simple as deductions that you don’t know you can take advantage of *right now* – specifically if you own property such as a building.

The IRS sets “depreciable lives” for buildings: 39 years for most commercial properties and 27 ½ years for residential rental properties (we are excluding agriculture or other special use properties). That’s a long time to depreciate over. The whole concept behind depreciation is time value of money. If you spend $10 million on a building, you can only write off $10 million. You may be thinking – I’d rather save money *today* than over 20 years. That’s where cost segregation comes in. It allows you to write off parts of the property over a shorter life span and save more in taxes during that time by breaking the building down into smaller components that are depreciable over shorter lives such as 5, 7 or 15 years.

Here are just a few examples of how we have helped business owners save money through cost segregation. The assumptions made are based on the maximum federal and Arizona tax brackets and an 8% discount rate. We will take a look at the type of facility, original investment, net present value of taxes deferred for years one through four, and the percentage of real property broken out into shorter lives.

Type of Facility	Original Investment	Net Present Value	% Real Property
Manufacturing facility for baked goods	$7,832,539	$817,952	55%
Airplane hangar	$38,047,226	$2,423,399	41%
Restaurant tenant improvements	$3,655,295	$448,770	55%
Auto dealership	$8,234,146	$707,482	41%
Commercial rental properties	$18,934,887	$837,998	27%
Manufacturing facility	$6856,649	$581,383	39%

Is a cost segregation study right for you?

There's time involved to a do a *full* cost segregation study. When we look for these opportunities, we typically use an engineering approach. Someone is looking at blueprints, walking the property and applying cost amounts to things like linear foot of wiring and plumbing.

There is usually a dollar threshold of when it makes sense to start looking at a property to do a cost segregation study. You can do this with a new build, a purchase of an existing property, or it could be a substantial renovation of a property you already own. Normally we look at:

- How much did you spend?
- What did you spend it on? (New build, renovation, etc.)
- What type of property is it?
- What is your tax situation?

If it's a warehouse, you're not going to have very much to break out. You get the biggest benefit from things that are not permanent in nature such as carpet and cabinetry, or from things that are process-related – i.e. manufacturing space is going to be more lucrative. For example, special wiring for computer systems or large machinery would qualify as process-related. That extra cost to beef up the electrical wiring from the outlet to the piece of machinery it is powering is what is costed and broken out.

The next step is to take all of this information and look at your estimated net present value. You can depreciate "X" amount of dollars over "X" amount of years. What is the possible benefit of this? Once we've got all of the numbers and facts, we then look at the tax situation and again ask *how will you benefit from this?*

There are two things to consider before making the final decision to move forward: Alternative Minimum Tax (AMT) and passive losses. Both of these issues could greatly limit your ability to realize the savings from a cost segregation study in the current year. You may be on track to save $100,000 but if you forget to take into account passive losses and AMT, you would end up saving much less.

Let's talk about passive loss. If all of the depreciation we're going to create results in a passive loss, you need passive income to offset that loss. One example of passive income is income from a passive investment – maybe you're part owner in a partnership but you did not actively participate. Another example is rental income, but you have to be careful – this area is tricky. One pitfall to watch out for here is the relationship of the rental. Generally, if you own a business in a building that you rent from yourself, that's called self-rental and the income is considered non-passive, but the loss is considered *passive*. On

the other hand, if you rent to someone *not* related to you, then the income will be considered passive, but the loss is still a passive loss. The worst thing the IRS can do to a taxpayer in this situation is to say your income is non-passive and your loss is passive. Now, if you can qualify as a real estate professional, you're not subject to passive loss limitations.

When doing a cost segregation study, we want you to get the most bang for your buck. Normally, we say you need to spend close to a million and a half to two million dollars before doing this makes sense. Another thing to keep in mind – don't just do it for the savings. Do your due diligence. You have to look at the utilization of the excess deductions that you're generating. If you can't utilize them, you're going through this mess for no reason. You want to be able to benefit. Cost segregation boils down to how do you save on taxes? We identify opportunities that are there and then work with you to help you get the biggest return on your dollar in the fastest manner possible.

How cost segregation relates to the final Tangible Property Regulations

The IRS recently released final Tangible Property Regulations which provide the framework for determining the deductibility versus capitalization of costs incurred for materials and supplies, repairs and maintenance, and other tangible asset costs. Specifically, the regulations provide rules in the following five general areas:

A. Materials and supplies

B. Capital expenditures in general (including the de minimis safe harbor)

C. Costs to acquire or produce tangible property

D. Costs to improve tangible property

E. Dispositions of applicable property (including components thereof) and general asset accounts

Cost Segregation is being utilized to assist with the above areas, specifically item "E" dealing with dispositions of applicable property.

The regulations allow taxpayers to claim a "partial disposition" for components of a unit of property (i.e. building or structural component) that have been disposed of. Cost segregation can be utilized to assist in the identification of those components that were not separately identified upon original acquisition or improvement. This enables the taxpayer to identify the remaining tax basis of those components, and the regulations allow taxpayers to claim the deduction for that disposition in the current year, even if it may have been disposed of in a prior year (via an account method change and filing of Form 3115).

The identification of these assets and their dispositions are important because in the event they are disposed of at a later date, the depreciation taken on those assets would be subject to "recapture" (taxed at ordinary income rates) upon sale. What is the point of re-capturing depreciation on something that didn't actually exist at the time of sale? Cost segregation allows you the ability to avoid this situation.

For a more in-depth analysis of how the Tangible Property Regulations apply to your tax situation, contact your Henry & Horne, LLP professional tax adviser.

Jeremy Smith, CPA is a Partner at Henry & Horne, LLP. He specializes in the area of taxation and cost segregation. Contact Jeremy at (480) 839–4900 or JeremyS@hhcpa.com.

HENRY & HORNE, LLP
Certified Public Accountants

Tempe	Scottsdale	Casa Grande
2055 E. Warner Road	7098 E. Cochise	1115 E. Cottonwood
Suite 101	Suite 100	Suite 100
Tempe, AZ 85284	Scottsdale, AZ 85253	Casa Grande, AZ 85122
(480) 839-4900	(480) 483-1170	(520) 836-8201

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