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Cost Segregation Q/A (FAQs)

What is cost segregation?

Cost segregation is one of the most common tax planning tools for anyone that owns real estate. It allows companies and individuals who have constructed, purchased, expanded or remodeled any kind of real estate to increase cash flow by accelerating depreciation deductions and deferring federal and state income taxes.

What is a cost segregation study? How does it work?

When real estate is acquired, it typically includes some sort of building structure, together with its interior and exterior components. Generally, real estate is depreciated (and generates tax deductions) over 27½ years (residential) or 39 years (commercial). Keep in mind land is not depreciable.

However, 7% to 40% of a building's components may fall into tax categories that can be written off much quicker than the building structure. A cost segregation study will analyze and break down the construction cost or purchase price of a property that would otherwise be depreciated over 27 ½ or 39 years.

These sub-categories may be eligible for depreciation over 5, 7 and 15 years. For example, certain electrical outlets that are dedicated to equipment such as appliances or computers may be depreciated over 5 years.

Side note: A cost segregation study will also catalog the different building structural components (such as the roof, windows or HVAC units) so when they are replaced, a loss deduction can be claimed on them under the Tangible Property Regulations.

What is involved in a cost segregation study?

A quality cost segregation study evaluates all information, including available records, inspections, and interviews, and presents the findings in a clear, well-documented format.

The process involves conducting a detailed review of any available cost detail for the property, any available architectural plans and a physical inspection of the property. A cost segregation study can still be performed if this information is unavailable, based on estimating component values on site. Our cost segregation team includes engineers with over 20 years of experience.

When should a cost segregation study be conducted?

Ideally, a cost segregation study should be done in the year a building is constructed, purchased or remodeled. However, there is nothing prohibiting a property owner from doing a cost segregation study done years after the property is acquired.

A cost segregation study can be prepared on existing assets and depreciation can be recomputed for prior tax years based on the reallocated asset costs. A filing of Form 3115 can be completed for the prior years or to simply deduct the additional depreciation from prior years on the first return filed after the study is complete.

What type of tax benefits can one expect from a cost segregation analysis?

Personal property such as furniture and fixtures, carpeting, millwork, decorative lighting and window treatments is depreciated over a 5 or 7- year depreciable life. Land improvements such as sidewalks, paving, or landscaping, are subject to a 15-year depreciable life.

Below is an example of what one can expect from a cost segregation study for various building types.

Apartments	10% to 30%
Retail Uses	10% to 30%
Office Buildings	7% to 14%
Restaurants	15% to 40%
Hotels	20% to 30%
Manufacturing Spaces	20% to 60%

Can a cost segregation study generate bonus depreciation?

Yes! Prior to the Tax Cuts and Jobs Act of 2017, bonus depreciation was only available to real estate owners for newly constructed property. However, under the TCJA, used assets that are acquired and placed in-service after September 27, 2017 and have a tax recovery period of 20 years or less can also qualify for the 100% bonus depreciation. Bonus depreciation allows a taxpayer to take an immediate write off of the components that qualify (as opposed to taking depreciation over 5, 7 or 15 years).

What is Qualified Improvement Property?

Qualified Improvement Property is defined as:

- Sec. 1250 interior improvements to a non-residential property (e.g. tenant improvements or fit-outs)
- “Made by the taxpayer” after the building was originally placed in service,
- Non-structural in nature,
- Not an elevator or an escalator,
- Not an expansion of the building

Is QIP eligible for bonus depreciation?

It depends. Under current law, QIP must be “made by the taxpayer” in order to be eligible for bonus depreciation. As a result, QIP done by the prior owner of an acquired building would not be eligible for bonus depreciation. On the other hand, QIP built by the taxpayer after December 31, 2017, is eligible for bonus depreciation.

What does not qualify for Bonus?

Mandatory ADS property does not qualify for bonus depreciation. Property which pursuant to any Code provision or regulation must be depreciated using ADS in that year that it is PIS does not qualify for bonus. However, property that a taxpayer elects to depreciate using ADS is not disqualified.

Types of ADS Property

- Tangible property used predominantly outside of the US during the tax year PIS
- Tax-exempt use property
- Tax-exempt bond-financed property
- Residential rental property, non-residential real
- Electing RPTB taxpayers

Prior to one deciding if a cost segregation study should be completed, property owners should consider the Interest Expense Limitation. The Net Interest Expense is limited to 30% of the adjusted taxable income. Taxpayers may be exempt from the Interest Expense Limitation if the average gross receipts over the prior three years are less than $25 million or if the taxpayer is electing real property business. However, electing real estate taxpayers are required to depreciate using ADS for all residential and non-residential real property as well as qualified improvement property. Assets depreciated under ADS are not eligible for bonus depreciation; however, a cost segregation would continue to be beneficial as personal property carve outs would continue to be eligible for bonus depreciation.

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