

How to determine if a cost segregation study is right for you

By Phil J. Seguin, CPA

Business has been good and your old space is getting cramped. You have a good product and the time has come to expand. Perhaps you need more capacity or plan to add a new product line. When the time comes for a business to make an investment in new or expanded facilities, it is worthwhile to consider the benefits of a cost segregation study.

What is a cost segregation study?

A cost segregation study is a process of reviewing and analyzing the costs a company incurs to acquire, construct or expand its real estate holdings. It examines an entire construction project and identifies personal property that can be depreciated over much shorter lives. The result is a faster write-off of asset costs that would typically have been classified as real property. A cost segregation study can also increase total deductions on your investment by identifying depreciable components of land cost that would normally not be deducted.

Construction projects generally include elements of tangible personal property (e.g. telecommunication and computer systems, process piping and storage tanks.) Some of these items are easy to identify and can be allocated shorter lives. A cost segregation study takes the process a step further by segregating tangible property in project costs that are embedded in the building. Items such as carpeting, wall coverings, partitions, millwork, lighting fixtures, suspended ceilings and doors are often segregated from the project and can be depreciated over shorter lives. A study might further conclude that a certain percentage of a building's electrical or mechanical systems directly support per-



sonal property and can therefore be depreciated over a shorter life.

Accelerated deductions sound great, but how do you know if a cost segregation study is right for your expansion? A proper and defensible cost segregation study involves substantial work. A qualified engineer usually is required to carefully examine the construction plans and documents. He or she determines which costs are legitimately associated with supporting non-building components of the project.

The value of the tax benefits have to be weighed against the cost of the study. Generally, buildings costing under \$500,000 will not produce enough accelerated deductions to justify the expense and effort of a study. For these expansions, any tangible personal property that is clearly identifiable should be separated from the overall project cost and depreciated over the shorter life.

Another important factor to consider is the ownership of the project. It is a common business practice to separate the ownership of business real estate from the entity that conducts the operations. If ownership is similar or the same, a cost segregation study may make more sense than if the project is owned by investors other

than the owner. A cost segregation study may result in the front-loading of substantial tax losses to the project owner.

Generally, rental real estate activities are considered passive activities under IRS rules. Passive losses can only be used to offset passive income. If you are able to show that the operating and rental activity are a substantial economic unit, there's a tax rule that may provide relief to this quandary. The determination of whether two activities comprise a substantial economic unit is based entirely on facts and circumstances. However, they rely heavily on the following factors: similarities in types of business, extent of common control, extent of common ownership, common geographical location and interdependence between or among the activities.

The capitalization and financing of the project should also be considered when contemplating a cost segregation study. In addition to the passive activity loss rules, the IRS can limit deductions from an activity to the amount you are "at-risk." When projects are heavily financed, owners should determine that the debt will be considered "qualifying nonrecourse financing."

You may run into restrictions on rent charges if you receive special financing, such as a loan from the Small Business Administration.

A cost segregation study can be a powerful tool to help accelerate deductions for substantial capital investments. The tax savings that result from these accelerated deductions can greatly increase cash flow from the project. There are pitfalls that you should be aware of before investing in the expense of a study. Careful analysis and discussion should be done with your tax adviser prior to breaking ground.



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