Is That Big Real Estate Investment of Yours Generating Maximum Tax Benefits?

by Tim Tikalksy, Tax Stockholder& Real Estate Group Chair

Although component depreciation (the ability to separately depreciate structural components of a building such as roofs, wiring and plumbing, over their estimated useful life in a taxpayer's business) was eliminated in 1981, an increasing number of taxpayers are taking advantage of a very similar alternative that is sanctioned by the IRS.

This "new version" of component depreciation, popularly referred to as cost segregation, only applies to elements of a building that are considered personal property. In spite of this limitation, however, cost segregation can generate significant tax savings by reducing the period over which depreciation deductions are claimed.

Under current IRS rules, a building is depreciated using the straight-line method over 27.5-years (residential rental property) or 39-years (nonresidential real property). Cost segregation, however, allows recovery of the personal property elements of a building over a five- or seven-year period (depending upon the taxpayer's business activity) using the 200-percent declining balance method. The classification of building elements as personal property can also reduce state and local taxes imposed on real property.

Cost segregation is not limited to newly constructed or purchased property. A taxpayer, who placed residential or nonresidential real property in service after 1986, without allocating any costs to personal property, can receive permission to change its accounting method. Under expedited IRS procedures, a taxpayer is allowed to reclassify building elements as personal property and claim a deduction for the depreciation that should have been claimed on those elements.

Example: A taxpayer purchased a factory building (39-year real property) in January 1997. No cost segregation study was performed. In 2005, the taxpayer conducts a cost segregation study that allocates $1 million of the original cost to 7-year personal property. If the taxpayer requests a change in accounting method that is effective for the 2005 tax year, a deduction of approximately $800,000 may be claimed on the 2005 tax return. This is the difference between the $1 million depreciation that should have been claimed between 1997 and 2004 and approximately $200,000 of depreciation actually claimed over that period.

If an item attached to or contained in a building can be easily removed without causing significant damage and the item does not relate to the operation and maintenance of the building, it can generally be classified as personal property.

Examples of items which have been classified as personal property under this standard include: removable carpeting; strippable vinyl wall coverings; window treatments; interior ornamentation, including molding, millwork, trim, finish carpentry, and paneling which is

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not integrated into the construction of the building; moveable partitions; counters, cabinets, shelving; specialized windows (e.g., bank teller's window); signs and lettering; raised floors; false balconies and other exterior ornamentation; emergency power generators; security lighting, emergency lighting and decorative lighting; specialized equipment and machines (e.g., kitchen equipment or factory machines), including electrical distribution systems and plumbing to the extent used for specialized equipment and machines, fire protection and air filtration systems dedicated to the equipment and machines, and HVAC and air conditioning units installed solely to meet the temperature or humidity requirements essential for the operation of machinery or equipment (e.g., computers) or the processing of foodstuffs.

The key to maximizing the benefits of a cost segregation study is working with a professional who understands the rules and the type of study which is acceptable to the IRS. The standards for such studies are high. Thus, it is generally advisable to work with a consultant who specializes in this area.

For more information about cost segregation studies, contact Tim Tikalsky at 925-210-2180 or by email at ttikalsky@rina.com.

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