



# Cost Segregation Studies FAQs

## ARE TAX SAVINGS EMBEDDED IN YOUR BUILDING?

### WHAT IS A COST SEGREGATION STUDY?

A Cost Segregation Study can help accelerate income tax depreciation deductions and generate significant cash-flow savings. Instead of waiting years to see a return on real estate investments, a Cost Segregation Study could help you recover major capital improvement costs more rapidly.

A Cost Segregation Study is a procedure for identifying and reclassifying capitalized amounts allocable to tangible personal property, other tangible property and land improvements from building costs, which typically depreciate over 39 years. Real estate cost segregation generates cash tax savings by identifying shorter-lived assets that qualify for 5-, 7- or 15-year write-off periods. Your property is reclassified into shorter-life classes based on applicable tax regulations.

### WHY HASN'T MY CPA TOLD ME ABOUT THEM?

Cost Segregation Studies employ engineering and cost-estimating procedures to identify shorter-lived assets qualifying for 5-, 7- or 15-year write-off periods, rather than the usual 39 years for building and acquisition costs. Most CPA firms don't have engineers on staff to physically inspect the property, examine architectural/engineering drawings and analyze cost data. Accountants may be able to capture some of the deductions, but without engineering expertise they may overlook substantial portions of a building to achieve tax savings.

Hutchinson and Bloodgood LLP's accounting professionals advise clients buying real estate to use an engineering report to segregate assets into four categories:

**Personal property.** Taxpayers normally can depreciate this property using a five- or seven-year recovery period and the double-declining method. Within permissible bounds, there is a huge tax-savings premium for valuing this property as high as possible. This category includes items such as furniture, carpeting, certain fixtures and window treatments.

**Land improvements.** Like the first category, these have a relatively short useful life (15 years) and are subject to an accelerated depreciation method, the 150% declining-balance method. Again, within permissible bounds, purchasers should maximize the values they attribute to this category, which ordinarily includes items such as sidewalks, fences and docks.

**The building.** As in the first and second categories, buyers should attempt to maximize a building's value. Any residual value will be allocated to nondepreciable land. Although a building's separate components (such as its roof) all are considered part of the building itself, there is merit to valuing and depreciating each component separately (albeit, on the same depreciation schedule). This way, if one of the building's components subsequently becomes worthless, the taxpayer can write it off immediately.

**Land.** Whatever amount of the purchase price is not accounted for in the three prior categories is allocated to land.



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A Cost Segregation Study allows a purchaser to achieve faster depreciation deductions as well as easier subsequent write-offs, so its cash flow will be increased. Assets allocated into the first two categories enjoy relatively short useful lives and accelerated depreciation methods. Furthermore, if the components of a building have been separately valued and a component subsequently becomes worthless, the taxpayer can write it off more easily.

## **HOW CAN I BENEFIT FROM A COST SEGREGATION STUDY?**

Cost Segregation Studies can potentially save property owners thousand of dollars over multiple years. The savings comes through properly allocating cost between real property and personal property for tax depreciation. Some direct benefits of Cost Segregation Studies include:

- Reduced Corporate Income Tax
- Reduced Individual Income Tax
- Increased Cash Flow
- Maximize Tax Credits
- Catch-Up Depreciation on Assets
- Reduced Property Tax

## **WHAT RETURN CAN I EXPECT?**

In general, clients routinely receive present value cash-flow savings at least 10 or more times their investment for the Cost Segregation Study. Hutchinson and Bloodgood LLP doesn't commit to performing a cost segregation study without providing a free initial evaluation and cost proposal to you. From that, you can evaluate the cost vs. savings factors up front before any work begins. The greater the present tax savings the greater the present cash flow, which in turn can be used to underwrite current or future acquisitions.

## **DO COST SEGREGATION STUDIES RAISE FLAGS WITH THE IRS?**

Engineering-based Cost Segregation Studies used to classify depreciation are an accepted standard approved by the IRS. Hutchinson and Bloodgood LLP's engineers are experienced in segregating costs and applying IRS rulings and regulations to your situation. We also can help you file the necessary IRS paperwork to obtain your tax deductions. Recent IRS legal memoranda, rulings and, judicial proceedings give the green light to taking accelerated depreciation deductions on real estate. Our professionals focus on documentation as a central issue to provide the requisite documentation.



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## HOW IS A COST SEGREGATION STUDY CONDUCTED?

The first part of a Cost Segregation Study involves determining or segregating the cost of a particular asset or group of assets.

Cost Segregation Study specialists perform a non-intrusive yet detailed engineering study of a building's walls, flooring and ceiling, plumbing, electrical, lighting, telecommunications, heating and cooling systems. For the maximum benefit to the client, cost segregation professionals prefer to work from building plans and cost documents rather than strictly relying on a building tour. Having the plans makes the facility walkthrough much less labor intensive and is a better way to identify the maximum number of building components into short-term depreciable categories. Our Cost Segregation Studies include:

- \* Quantifying the total investment in the projects.
- \* Analyzing the personal and real property capitalized.
- \* Allocating indirect project costs.
- \* Segregating costs based on classification of personal and real property.
- \* Reconciling the segregated costs to the client's records.
- \* Recalculating tax depreciation based on the new depreciable lives of the assets.
- \* Preparing the final cost segregation report.

## WHAT TYPE OF PROPERTIES ARE GOOD CANDIDATES?

The types of properties that benefit most from Cost Segregation Studies include:

- \* New building presently under construction
- \* Existing buildings undergoing renovation, remodeling, restoration or expansion
- \* Purchase of existing properties
- \* Office/facility leasehold improvements and "fit-outs"

Industries that benefit most often from Cost Segregation Studies include:

- |                                  |                              |
|----------------------------------|------------------------------|
| Manufacturing                    | Distributing and warehousing |
| Automobile and truck dealerships | Nursing homes                |
| Health care facilities           | Office buildings             |
| Medical centers                  | Hotels/Motels                |
| Apartments                       | Fast food restaurants        |



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## **WHY IS AN ENGINEER NEEDED?**

Cost Segregation Studies resulting in significant tax savings demand far more analysis than simply classifying line items (i.e. carpeting, appliances, etc.) from the contractor's invoices.

Our engineers analyze the detailed working drawings, mechanical and electrical plans and blueprints to segregate the structural electrical and mechanical components from those linked to personal property. Additionally, cost segregation considers the properties soft costs (architect and engineering fees) and allocates them to all components.

We provide full documentation in our Cost Segregation Studies, employing engineering and cost-estimating procedures recognized by the IRS in its rulings and by the courts. We derive unit cost from contract documents and other source data. During a Cost Segregation Study we:

- Physically inspect the property

- Examine architectural/engineering drawings and specifications for potential asset reclassification

- Analyze cost data, including the contractor's application of payment, charge-orders, owner-incurred cost and indirect disbursements

- Prepare an itemized list of property units qualifying for shorter-life classification

- Apportion direct labor, material components and indirect cost based on engineering drawings and specifications

## **HOW MUCH DOES A COST SEGREGATION STUDY COST?**

The cost of the study will vary depending on the project and the available documentation. Cost factors are the properties location, whether the building is new or existing, the nature of the property (residential vs. nonresidential) and time pressures for completion of construction.

As in any investment, the taxpayer must conduct a cost-benefit analysis. We don't commit to performing a Cost Segregation Study without providing a free initial evaluation and cost proposal to you.



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## WHAT ARE SOME EXAMPLES OF COST SEGREGATION STUDY?

Listed below are the estimated tax savings resulting from recent Cost Segregation Studies our firm has performed. For your free estimate of the potential income tax savings on your real estate investment please contact your Hutchinson and Bloodgood LLP team member and request your free Cost Segregation Study savings estimate or visit [www.hbllp.com](http://www.hbllp.com).

<u>PROPERTY TYPE</u>	<u>COST</u>	<u>FIRST YEAR TAX SAVINGS</u>	<u>FIRST SIX YEARS TAX SAVINGS</u>
Grocery Store	\$896,000	\$59,250	\$117,000
Medical Office Complex	\$2,147,000	\$53,450	\$260,300
Medical Office Building	\$251,800	\$16,530	\$75,386
Bank Building	\$1,677,000	\$23,215	\$137,577
Auto Dealership Facility	\$8,474,000	\$469,569	\$1,065,719
Auto Dealership Facility	\$1,644,000	\$24,000	\$139,564
Mini-Storage Facility	\$7,200,000	\$79,185	\$392,166
Manufacturing Facility	\$7,134,000	\$344,279	\$451,235
Manufacturing/Distributing Warehouse	\$882,600	\$13,406	\$76,954
Office Bldg. & Parking Structure	\$12,840,000	\$161,300	\$821,152



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