How Cost Segregation Studies Accelerate Depreciation and Free Up Capital

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Andre Williams:

Okay, Scott, let's jump right in and start off with the obvious question. On a high level, what exactly is a cost segregation study?

Scott Cress:

Yeah, well, the perfect place to start, Andre. So a cost segregation study is a technique that accelerates depreciation from the future. And what I mean by that is it really doesn't create a new deduction, but what it does is it borrows from potentially decades down the road.

Scott Cress:

So when you purchase or construct real estate, often you have to basically depreciate it slowly over 27 1/2 years if it's residential property, even as long as 39 years if it's nonresidential property. So a cost segregation study doesn't create the deduction. We're pulling those deductions forward for the time value of money savings. And we do that by going into the building and pulling out various components. So the building itself is more than just four walls and a roof.

Andre Williams:

So Scott, that's a great lead-in. So, what are some of the components of the building?

Scott Cress:

So, yeah, that's really where the art of the report comes in, right? So we can either starting with the interior, as you walk into a building, often times there's going to be removable flooring like carpet. There could be built-in cabinetry, built-in shelving, removable partitions in the office space. The office itself is supported by electric outlets, internet cabling, all those sorts of things that are used to run those office equipment we can assign costs to and depreciate faster.

Scott Cress:

As you move into the warehouse or manufacturing side of a typical building, inside of there that might have specialized electric, reinforced concrete floors, really the sky's the limit. So that's where the art of the study comes in.

Andre Williams:

So staying on the benefit topic, what is the typical benefit of a cost aggregation study?

Scott Cress:

Well, there's exceptions to every rule, but I would say our average study generates an allocation away from the building of between 17-and-23%.

Andre Williams:

Okay. So in that situation, if a taxpayer were to purchase say, a million dollar building, it would generate the study would generate about a $200,000 in accelerated depreciation?

Scott Cress:

I'd say that's a good rule of thumb, Andre. Then again, it all depends on how specialized the building is. So think of it this way. If you had an apartment building that had 100-plus units, that's a significant amount of kitchen appliances, kitchen cabinetry. There might be a common building there with a pool, all that will help generate a greater benefit for that particular piece of property.

Scott Cress:

On the other side, if you have a commercial building that's used for specialized manufacturing processes, and it has reinforced concrete floors, very high voltage electric, those sorts of things, and that also can help maximize the study.

Andre Williams:

That's great to know, Scott. So for our last question then who, is the ideal candidate for a cost segregation study?

Scott Cress:

All right. So I typically look at that in like a three-prong approach. First, the purchase of the building and/or the construction cost should probably be at minimum $500,000. And that's because the average cost of a study is about $5,000 and you want to have enough cost benefit for it to make sense.

Scott Cress:

The second piece is really what is the long-term plan of the taxpayer with the building. If they plan to flip it within a couple years, or maybe do a sale-lease back, dispose of the property in the not-too-distant future, then the cost benefit may not be there for a study. It's really better suited for those that want to hold the property long-term.

Scott Cress:

And the final piece really comes down to what will accelerated depreciation deduction mean for a taxpayer and their tax return? So oftentimes we might set up the entity separately from the business that holds the real estate. That activity could be passive to the taxpayer, while passive losses have specific rules before a taxpayer can deduct them. So we really take a holistic approach to make sure that the taxpayer is going to receive the ultimate benefit.

Andre Williams:

That was very insightful. So thank you for your time, Scott. For those of our audience members who would like to learn more, please go to barnesdennig.com.