Rochester Wealth Strategies

439 S Main St, Suite 250
Rochester, MI 48307
(248) 434-6550

What is a Cost Segregation Study

By Julie Lobaza

Many businesses and commercial property owners overlook a big tax savings opportunity for real estate. A cost segregation study can improve cash flow by accelerating depreciation deductions and deferring tax burdens. It's a strategy that allows certain assets to be reclassified to a shorter recovery period therefore allowing you to take a larger depreciation earlier in the asset's life.

Normally property owners and real estate investors depreciate residential property over 27.5 years and commercial property over 39 years. However, there are other assets within the building besides the actual structure and those assets usually have a different useful life. A cost segregation study looks at each component of the property and splits them into categories to allow you to benefit from accelerated depreciation for those parts of the building. For example plumbing fixtures, carpeting, sidewalks, HVAC systems, roofing and lighting all can be reclassified for accelerated depreciation.

Cost Segregation studies are performed by a team of tax advisors, engineers, and other specialists to identify and separate the assets into different categories like personal property, land improvements and building components. They also must determine how much each asset costs on its own. Once everything is identified and classified it can be given a depreciation category of five, seven or 15 years.

The benefits of cost segregation are twofold. First, you can reduce tax liability and increase cash flow because of taking larger depreciation early in ownership. Secondly, it reduces the owners overall tax liability by reclassifying the assets.

Ideally the best time to conduct a cost segregation is in the year the real estate was acquired, remodeled or constructed. However, you may perform a look-back study at any time and claim a catch-up tax deduction.

Cost Segregation is usually beneficial if you plan to own the property less than 20 years and you are in the 32% tax bracket or higher. The average deduction is usually 20%-30% of the value of the property. This could be a useful strategy for business owners who plan to sell their business, but still maintain the building as a rental. They may also be able to obtain a large deduction the same year they receive the proceeds from the sale of the business to offset the higher income.

It is important to understand that cost segregation is a complex tax planning strategy. It involves the expertise of specialists, and the cost can vary due to each property being unique. It requires proper documentation and support for all reclassification of assets.

In summary, cost segregation is a strategic tax planning tool that allows companies and individuals that construct, purchase, expand or remodel commercial real estate to improve cash flow and provide significant tax savings. This increased cash flow occurs by accelerating depreciation deductions and deferring taxes. Property owners should always consult with their tax advisor and specialists to determine if cost segregation is a viable strategy for their unique situation.