# Cost Segregation: Take Advantage of Tax Benefits That Were Extended or Made Permanent in 2015

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Office and residential building owners and their tenants have long understood the value of depreciation expense in relation to cash flow. Depreciation expense is a deduction that reduces taxable income and thereby increases after-tax cash flow. Generally, the shorter the depreciation period, the greater the tax benefit derived. Factoring in the time value of money, larger deductions over a short period of time are far more beneficial than smaller deductions over a long period of time. This is true even though the total amount of deductions is the same under both short and long depreciation periods. Front-loading deductions puts after-tax dollars in your pocket that can then be invested in something else or used to retire debt. Plus, there is an opportunity to increase those tax savings with certain tax incentives that were recently extended or made permanent.

## Extenders Package passed in December, 2015

Congress approved and President Obama signed the Protecting Americans from Tax Hikes Act of 2015 on December 18, 2015 ("the PATH Act"). Two provisions of the PATH Act that may benefit building owners are the extension of the bonus depreciation rules and increased expensing limits which were made permanent. These provisions are effective as of January 1, 2015. It may be beneficial to perform a cost segregation study to maximize these benefits.

**Bonus depreciation** results in a deduction of 50% of the cost of an item of qualified property in the year placed in service and depreciation, under the regular depreciation rules, for the remaining cost of the item. Bonus depreciation has been extended through 2019, however, it is phased down to 40% in 2018 and 30% in 2019.

Bonus depreciation applies to the following types of property ("qualified property"): tangible property with a depreciation period of not more than 20 years (machinery, equipment, other tangible personal property, and non-building land improvements) and certain leasehold building improvements. The property must be new (not used), i.e., new construction or leasehold improvements.

**Increased expensing limits** have been extended permanently. The expensing limits, commonly known as Sec. 179 expensing, were set to revert to $25,000 with an investment limit of $200,000 on January 1, 2015. The PATH Act permanently sets the Code Sec. 179 expensing limit at $500,000 with a $2 million overall investment limit before phase out (both amounts are indexed for inflation beginning in 2016).

The PATH Act also makes permanent the special expensing allowance for qualified real property. Qualified real property includes qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. The Act removes the $250,000 expensing limit for this type of property making it possible to expense up to $500,000 of qualified real property beginning in 2016.

Finally, the PATH Act extends permanently the 15-year straight-line cost recovery for qualified leasehold improvements, restaurant property and retail improvements. Thus, to the extent that the cost of qualified real property exceeds the $500,000 expensing limit or the investment ceiling, depreciation is allowed over a 15-year period rather and a 39-year period.

## Cost segregation may lead to greater cash flow

Commercial rental property is generally depreciated for tax purposes over 39 years and residential rental property over 27.5 years. Furniture and fixtures are depreciated over five or seven years. Land improvements, such as landscaping and parking lots, are depreciated over fifteen years. Leasehold improvement property is generally depreciable over 39 years; however, qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property is depreciable over 15 years. Unimproved land is not depreciated.

If one could take a portion of a building that would normally be depreciated over 39 years and instead depreciate it over five or seven years, there would be a substantial and immediate tax benefit. That is where cost segregation comes into play. A cost segregation study identifies certain portions of what typically would be considered part of a building, and breaks them into tangible personal property asset classes with shorter depreciable lives. The result is faster depreciation on a portion of a long-term asset. For new buildings or improvements, the benefits will be greater when bonus depreciation is applied. Same for the increased expensing limits.

Cost segregation studies can be performed on purchased buildings, newly constructed buildings and tenant improvements. Studies can be performed for buildings and improvements placed in service as far back as the mid-1980s. No amended returns are required to claim the additional depreciation. In 1999, the IRS announced that it would permit companies that have claimed less than the allowable depreciation in prior years to claim the omitted depreciation as a change in accounting method. In 2002, the IRS announced that all of the prior years' depreciation that is allowable under a cost segregation approach might be claimed in the change year. The ability to claim several years' worth of depreciation in a single year makes this a potentially lucrative tax benefit.

To take advantage of cost segregation allowances, you will generally need to hire a firm specializing in cost segregation studies. Such firms make detailed inventories of individual assets to distinguish between items of personal property and items of real property. According to these firms, typically 20 to 40 percent of the costs can be reclassified.

Next, you will need a CPA to calculate the amount of additional depreciation and prepare Form 3115 (Application for Change in Method of Accounting), in order to claim the deduction on your tax return. A newly placed in service building or tenant improvement in the year of study would not require an Application for Change in Method of Accounting.

The study may not be beneficial to some owners. For example, if an owner is subject to the passive activity limitations of IRC Sec. 469, additional depreciation deductions may not be of immediate benefit. Losses disallowed under Sec. 469 are suspended and carried forward to a year in which there is passive income, or where the property is disposed of in a fully taxable transaction. Another consideration is depreciation recapture if the building is sold. If you are planning to sell your building within a short period of time, the benefits described could be reduced.

**Examples of benefits from cost segregation studies**

### A Newly Constructed Tenant Improvement Project for the Taxable Year 2016

A $6,000,000 leasehold improvement project (assuming not qualified leasehold) was completed during January 2016. Without a cost segregation study, the 2016 depreciation expense is $153,000. If a cost segregation study were performed and 20 percent of the construction costs were allocated into 5-year property and 10 percent of the construction costs were allocated into 7-year property, the total depreciation expense, without taking into account the bonus depreciation provisions, would then be $433,000. However, since bonus depreciation is available in 2016, the 2016 depreciation expense would be $1,170,000. This would be an additional **$1,016,000** of depreciation expense in the first year alone. In a 39.6 percent tax bracket, the 2016 cash savings would be approximately **$402,000**. The benefits would be even greater if the leasehold improvements were qualified leasehold improvements that have shorter depreciable lives. Note the increased expensing allowance does not apply since the cost of the improvements exceeds the limit of $2,000,000.

### Pre-Existing Office Building for the Taxable Year 2016

An office building was purchased in 2010 for $30 million. Of that, $20 million was allocated to depreciable building improvements with a depreciable period of 39 years. The annual depreciation deduction was calculated to be $513,000. Therefore, between the years 2010 and 2015, $3,078,000 of depreciation expense was taken. A cost segregation study was performed for tax year 2016, and 20 percent of the depreciable cost was reclassified into 5-year property and 10 percent into 15-year property. The result would be a catch-up depreciation adjustment of approximately **$4,000,000** against 2016 taxable income. In a 39.6% percent tax bracket, this depreciation adjustment would translate into a possible cash savings of **$1,584,000**.

## Conclusion

A cost segregation study can be of enormous benefit in increasing cash flow to building owners. Such a study will identify the personal property components of a building, including land improvements, and thereby, allow you to claim faster depreciation. Owners who plan to build or remodel a building or make significant tenant improvements in 2016 stand to realize substantial savings as a result of performing a cost segregation study. Others who have owned their buildings for several years or who have made improvements in the past will likely benefit from this study as well.

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