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## Practical applications for cost segregation studies: Using a CSS with currently owned properties

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Properties already in service are often overlooked when it comes to cost segregation, but this is a big mistake. I have great news for those of you who are under the impression that a cost segregation study (CSS) cannot be performed on a property you've owned for more than three years. The IRS permits taxpayers to use a CSS to adjust depreciation on properties placed in service as far back as January 1st, 1987. Many property owners and tax advisors share a common misconception that once the three year statute to amend has expired, the taxpayer can no longer make a change. Fortunately, this is not true.

### The Look-Back Study

A CSS performed on a property placed in service in years past, where a tax return has already been filed, is known as a look-back study. This analysis is used to identify costs that were incorrectly classified as 27.5, 31.5, or 39-year property and reallocate them to the appropriate 5, 7, or 15-year recovery periods. Upon completion, the taxpayer is allowed to make an adjustment under IRC sect. 481(a) to catch up on depreciation. The catch

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up is equal to the difference between what was depreciated and what could have been depreciated if a CSS was performed on day one. The benefits can be dramatic. The real kicker is that the change can be made without filing an amended return. The taxpayer simply files form 3115 (change in accounting method), which receives automatic IRS approval in most instances.

Before 2002, taxpayers were required to take any adjustment greater than \$25,000 over a period of four years. However, the rules were modified by revenue procedure 2002-19 and taxpayers can now take a favorable adjustment (deduction) in the year of filing. An unfavorable adjustment still must be spread over four years.

It is not uncommon to have a look-back study conducted on a property that was placed in service as far back as 10-12 years ago, but this is typically about as far as you'll want to go. Of course the facts and circumstances must be carefully reviewed and it is not always prudent to go back that far. Conversely, it might make sense to go back even further. The key is making sure that you are working with a qualified cost seg consultant who performs a true engineering-based analysis.

### Example

Perhaps the best way to explain

the benefits of a look-back study is to provide an example. Let's use a \$10 million office building that was placed in service in March of 2000, where 100% of the property is being depreciated using a 39-year recovery period. We'll assume that a study was performed for the 2005 tax year which identified \$800K (8%) that could be reallocated to a 5 year recovery period. In this scenario the taxpayer realized a 481(a) adjustment of just over \$655,000. Combined with the first year depreciation the total deduction in year one was more than \$680,000. Using a 35% effective tax rate, the taxpayer realized more than \$238,000 in first year savings. Ten years out the net present value (NPV) is still almost \$190,000, and in year 40 of the property's life the NPV is still more than \$136,000. Needless to say, the financial benefits of front loading your depreciation deductions via a CSS are huge.

### Bonus Depreciation

Do you remember bonus depreciation? This incredible tax benefit was originally introduced as part of the Job Creation and Workers Assistance Act of 2002. Bonus depreciation allowed taxpayers to depreciate 30% or 50% of qualifying assets, with a recovery period of 20 years or less, in the first year.

For example, if you had \$500,000 of five-year property and qualified for the 50% bonus level you would have deducted \$250,000 in the current year as a bonus and then depreciated the remaining \$250,000 over the five years.

I know, many of you are thinking that bonus depreciation ended on December 31, 2004; so why bring it up? Although this is technically true, bonus depreciation is still available via a look-back study for taxpayers who did not specifically elect out of the bonus when they filed their tax return. If you meet the requirements for bonus depreciation then you can take this deduction as part of your Sect. 481(a) adjustment discussed above.

### Closing Thought

A cost segregation consultant, working in conjunction with your tax advisor, will be able to help determine the appropriate strategies to take advantage of this procedure. Since "look-back" studies often identify significant amounts of reclassified assets as well as very large 481(a) adjustments, there is a slightly higher probability that the study may be subject to IRS scrutiny. This further underscores the need to select a qualified cost segregation consultant with experience performing look-back studies that will stand behind their work in the event of an IRS challenge.

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