Cost Segregation: What It Is And How It Works

What Is Cost Segregation In Real Estate?

Cost segregation is a way for real estate investors to more quickly deduct the depreciation of a property – anything from a single-family home to an office building or retail storefront – against their taxable income.

The depreciation of any investment real estate you own can be written off on your income taxes over a period of time and varies depending on the type of investment property. Cost segregation though, allows you to speed up this depreciation schedule, increasing the amount you can deduct each year. By using this strategy, you will reduce the amount of money you owe on your income taxes each year. This also reduces the expenses of owning investment real estate.

It's important to note that cost segregation isn't available on your primary residence. You can use cost segregation on residential real estate, but only on residential properties that you own as investments, not those that you live in as a full-time residence.

How does cost segregation work? It's all based on the depreciation of your investment real estate. Depreciation is a deduction that real estate investors can claim on their income taxes each year to help them recover the cost of owning, operating and maintaining that property.

To start using this strategy though, you'll first have to pay for a cost segregation study. Cost segregation is a tax planning tool that gives real estate investors the chance to accelerate the depreciation of their investment properties. By doing this, they reduce their annual federal and state income tax payments, potentially freeing up their money for other investments or purchases.

How Do Cost Segregation Studies Work?

The key to taking advantage of cost segregation is to first order a cost segregation study. These studies can show you how to maximize the tax deductions from your investment property. It's best to hire a financial firm that can prove it has expertise in engineering, construction, tax law and accounting when creating a cost segregation study.

1. Complete A Feasibility Analysis

The first step your cost segregation team will take will be to analyze your investment property to make sure it is a good candidate for cost segregation.

This requires your team to study the different components of your investment property, including its plumbing fixtures, roofing, electrical systems, sidewalks, driveway, flooring and other materials.

Why? If you bought these items separately, you would be allowed under the IRS tax code to depreciate them over 5 to 15 years. But if these items were instead already part of a building that you purchased, you are only allowed to depreciate them over 27.5 years if you purchased a residential building or 39 years if you bought a commercial property.

In a cost segregation study, your team of engineering and financial experts will separate each part of your investment property and place them in their own categories. You can then benefit from an accelerated depreciation timeline for some of these building features.

2. Gather All Necessary Information

The experts performing your property's cost segregation study will typically need several documents to determine the value of your building and its systems. This could include a recent appraisal of the property, inspection reports or the closing documents you signed when buying your investment real estate.

3. Analyze The Property

Next, your team members will identify any operating costs of your investment property that you can depreciate over either 5, 7 or 15 years. Your team members will do this by studying any documents that you can provide them, such as blueprints, property records and inspection reports.

4. Complete A Report

Once your team members have analyzed the property, they'll prepare a report that you can use to determine how much you can save on your income taxes by using cost segregation strategies.

Cost Segregation Analysis Example

Say you own a warehouse that is valued at $800,000. If you were to follow the standard formula of depreciating your warehouse for 39 years, your total depreciation write-off each year would be $20,512. If you are taxed at a 37% federal income tax rate, you would save about $4,600 on your taxes each year that you own your property during this 39-year depreciation period.

If you pay for a cost segregation study, your team might discover that you can depreciate $100,000 of this property's plumbing fixtures during a 5-year period, $100,000 of electrical fixtures that can be depreciated during 7 years and $100,000 that you spent on new curbs, sidewalks and storm sewers that can be depreciated during a period of 15 years.

This now means that your building is worth $500,000 while the systems eligible for accelerated depreciation are worth $300,000.

Armed with this information, you can now claim more depreciation on your taxes during these years. In the example above, in the first year after you complete your cost segregation study you could write off about $12,820 in depreciation costs for your building; $20,000 for the plumbing fixtures that can be depreciated over 5 years; about

$14,285 for the electrical fixtures that can be depreciated over 7 years; and $5,000 for the exterior improvements that can be depreciated over 15 years.

Again, assuming a tax rate of 37%, this would result in a first-year tax savings of about $11,689. That's a big increase over the $4,600 in savings you'd realize without a cost segregation analysis.

You can only perform a cost segregation one time on any investment property that you own.

Who Will Benefit From A Cost Segregation Study?

A cost segregation study makes sense if you have purchased or built investment real estate during the past 15 years. You can take advantage of cost segregation strategies whether your investment properties are residential or commercial, so owning a single-family rental would not disqualify you from the benefits of a study.

Cost segregation isn't always the right move for investors, but it can help when investors want access to more cash to fund another investment. Maybe you already own a single-family home that you rent out. You might want to purchase an office building to add to your real estate portfolio. By cost-segregating the depreciation of your single-family property, you'll reduce the taxes you pay on that property in the following years, freeing up additional funds that you can use to help purchase that office property.

When Should Cost Segregation Studies Be Conducted?

You can order a cost segregation study any time after you buy, build or remodel a property. But the best time is during the same year that you buy, build or remodel your investment real estate. This will give you the most tax savings when you are also potentially spending the most dollars on your real estate.

Look-Back Studies

But what if you didn't perform a cost segregation study when you first built, purchased or remodeled a property? You can still take advantage of this tax strategy by ordering what is known as a look-back study.

This type of cost segregation study allows you to claim a catch-up tax deduction. Once the cost segregation study is complete, you can claim this catch-up deduction in a single year. The amount of the deduction will be equal to the difference between what you originally claimed as deprecation on your investment property and what you could have claimed had you performed your cost segregation study earlier.

Under IRS rules, you are allowed to perform a look-back study on properties that you bought, built or remodeled as far back as Jan. 1, 1987.

How Long Does A Cost Segregation Study Take?

Tax and engineering professionals consider several factors when performing a cost segregation study. Because of this, a study typically takes at least a month to complete.

The exact number of days it will take your team to complete such a study depends on the type of property you own, the size of your investment property and whether you are able to provide the paperwork that your analysts need. In general, though, you can expect a cost segregation study to take 30 to 60 days.

Potential Benefits Of Cost Segregation

The main benefit of cost segregation is that it can save you money. It does this by:

- Accelerating the depreciation you can claim on your investment properties: Instead of having to depreciate an entire property over 27.5 or 39 years, you can claim deductions for certain systems in your building – such as its electrical and plumbing fixtures – over 5, 7 or 15 years.
- Reducing the taxes you pay on your investment properties each year: If you can claim a greater amount of depreciation in a tax year, you'll pay less income taxes on your investment property during that year.
- Freeing up cash: This will leave you with more cash after you pay your taxes, giving you the opportunity to purchase additional investment real estate if you want to build your property portfolio.

Potential Drawbacks Of Cost Segregation

Cost segregation is an important tax tool for real estate investors. It does, though, come with two main drawbacks.

- It isn’t free: The amount you pay for a cost segregation study will vary, depending on the size and type of your property and the amount of documentation you can provide. You can expect to pay from $5,000 to $15,000 for a study.
- It takes time: You’ll have to be patient after ordering a cost segregation study. Depending again on the size and type of your property, you can expect a cost segregation study to take up to 2 months.

Cost Segregation FAQs

Cost segregation can be complicated. Here are some of the questions that most real estate investors have about this tax strategy.

What does cost segregation include?

In a cost segregation study, a team of tax and engineering experts will study the various components of a building – such as its wiring, plumbing, light fixtures, flooring and exterior improvements – to determine if you can accelerate the depreciation of some of them. By speeding up the depreciation schedule, you can reduce the amount of taxes that you pay on these properties in the years following your study.

How much does a cost segregation study cost?

The cost of a study will vary depending on the size and type of your property, but you can expect to pay from $5,000 to $15,000.

Can you do a cost segregation study on your own?

You can. But this isn’t recommended. You want to squeeze the greatest amount of tax savings from a cost segregation strategy. It’s best to rely on engineering and tax experts to do this.

Is cost segregation worth it?

Even with the high fees charged for a cost segregation study, using this tax strategy is typically a smart financial move. The amount in taxes you save each year following the study will more than cover the one-time fee of a study.

The Bottom Line On Cost Segregation

You can visit our learning center to learn more about the tax benefits of investing in real estate. And remember, these tax benefits will be even greater if you rely on cost segregation as a way to reduce the taxes you pay each year on your investment properties.