

# Cost segregation

How qualifying leasehold improvements can benefit your business **Interviewed by Kristen Hampshire**

**N**ow is the time to seriously consider how you classify real estate expenditures, including building purchases, major renovations, tenant improvements and smaller projects such as acquiring fixtures.

In the current tax environment, there may be an opportunity for your business to turn slowly depreciating cash expenditures (tax write-offs) into tax-deductible items that can be fully depreciated in one year. The result is a lower tax payment in the current year.

The key to claiming this benefit is to reclassify costs by unraveling items from your overall real estate investment. Then, you can identify which of those costs qualify for accelerated depreciation. The process is called a cost segregation study, and any business with real estate expenditures should consider having one done.

"Now more than ever, it's important to save on real estate and construction project costs. One of the ways to do that is to realize available tax benefits," says Cathy Goldsticker, member, tax services, Brown Smith Wallace LLC, St. Louis, Mo.

Many businesses are not aware of the tax benefits that a cost segregation study can uncover. And as tax planning season closes in, now is a good time for your business to discuss this opportunity with a CPA who has experience performing cost segregation studies.

"With this bonus depreciation tax law scheduled to expire at the end of fiscal 2011, we can't be certain there will be an extension of this tax benefit, so businesses should consider how they can take advantage of this remarkable write-off," says Nick Lombardi, manager of risk services and energy services practice leader, Brown Smith Wallace.

*Smart Business* spoke with Goldsticker and Lombardi about how cost segregation studies work, how they benefit companies and what your business can do to act on this opportunity now.

## What is a cost segregation study?

A cost segregation study involves moving portions of property development from long-tax-life assets to shorter-life schedules. Essentially, cost segregation is a tax planning strategy that allows businesses to accelerate deductions and defer tax payments for real estate expenditures, which include land improvements, furniture and equipment.

Items are unraveled from the total asset cost and assigned an individual cost amount. Qualifying items can be depreciated separately and many times more quickly. For exam-



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ple, you could depreciate decorative lighting or furniture 100 percent in the current year, when, historically, a typical real estate depreciation tax write-off schedule for commercial property is 39 years. Many times, costs can be reclassified from 'land,' a nondepreciable asset, to classifications that will provide an immediate tax benefit. Accelerated tax write-off schedules are a tremendous benefit for businesses. Engaging in a cost segregation study can tease out those qualifying expenses.

## What does a cost segregation study involve?

It requires formal documentation of the cost basis — the real estate expenditures that are being depreciated — and a reliable method for depreciating those assets on the accelerated schedule that allows 100 percent depreciation over one year. The process includes observation, pictures, measurements and an engineering analysis to determine which items can be unraveled from your real estate expense. The study involves a present value analysis that details how much qualifying items are worth, a mathematical analysis and the application of tax law. A team of professionals, including an experienced accountant and an engineer who specializes in cost segregation studies, is important to ensure that proper documentation is compiled to support the shorter-term depreciation schedule. While the process seems complicated — and it does involve many moving parts — cost segregation studies are quite efficient when professionals have the resources to perform them

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effectively. A study can take as little as four to six weeks to complete, and, considering the potential tax benefit, the time is well spent.

## When does it make sense to hire a professional to perform a cost segregation study?

Any business that has made a land improvement or purchased furniture or equipment in the last several years might be a candidate for a cost segregation study. And don't discount smaller projects. The cost of performing a study is less when the project scope is smaller, so there is a benefit to engaging in a study for less complex real estate endeavors.

## How can a cost segregation study directly benefit a business?

For one, faster depreciation on tax-deductible items frees up cash flow for a business. This is critical, especially now when so many companies are struggling to maintain a healthy cash flow. Cost segregation allows a business to maximize bonus depreciation or the depreciation of qualified leasehold improvements. These studies can be done at any time, with benefits realized very quickly. The study can be retroactive, meaning projects completed, or qualifying purchases made in the past several years, can be re-examined and costs segregated to take advantage of this tax benefit. Talk to your tax professional about lookbacks and projects that you've completed in the past one to four years that could warrant a cost segregation study.

## How can a business prepare for a cost segregation study?

Proper, specific documentation is critical, which is why hiring a professional who specializes in cost segregation studies is crucial. This person will create the documentation to support the rationale for depreciating items in a much more efficient manner for tax purposes. So when preparing for a study, ask the professional about the process, find out if there is a specialized engineer on staff to help and be prepared to assist with the documentation process, including taking pictures and measurements to create the necessary documentation. The process is seamless, and it doesn't take long to realize potential savings of thousands of dollars. <<

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