

IN DEPTH: ACCOUNTING

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Mapping a plan: Cost segregation marks the spot for hidden savings

[Stephen Roth](#)

Staff Writer

As many a business owner knows, the U.S. tax code requires that the costs of buying, building or improving a commercial property be deducted during a period of 39 years.

But what about the parts of a building -- carpeting, cabinets, vinyl walls or air conditioning units -- that will depreciate during a much shorter span of time?

The answer may come in the form of a cost segregation study, a detailed inspection of all the components of a commercial building. The study, which seeks to identify areas of a property that qualify for personal property tax deductions during a five- to seven-year period, must be conducted by an engineer or an architect. But the service is marketed by accounting firms such as Overland Park-based [Marks Nelson Vohland & Campbell LLC](#), which has been offering cost segregation studies as part of its real estate practice since the late 1990s.

"Our firm has really made this into a bona fide area of practice," Marks Nelson partner Jeffrey Marks said. "We don't just do it occasionally or as an afterthought. We've put this on our menu for clients to consider."

The result can be beaucoup tax savings, especially for real estate developers or companies in capital-heavy industries, said Larry Vohland, who leads Marks Nelson's real estate practice.

"When you look at the net present value of a depreciation deduction of seven years compared to 39 years, that results in a pretty astounding number," he said.

Frank Loeffler, a Johnson County insurance executive who also owns some commercial real estate properties, can appreciate that. He has enlisted Marks Nelson to conduct cost segregation studies on three properties he considered buying in recent years.

The tax savings that ensued on one building Loeffler bought for \$1.4 million, he said, meant the

difference between his investors receiving a rate of return of 8.9 percent and 11.5 percent.

"It can make the difference between a project working and not working," Loeffler said. "In two of the three cases we engaged them on, we determined that the cost segregation would allow us to go ahead with property acquisition."

Cost segregation became a reality several years after Congress passed the 1986 Tax Act. Approved in the wake of the savings and loan crisis, the legislation struck down an investment tax credit that allowed property owners to deduct certain property components during a period shorter than 39 years.

"In '86, with the bust in the savings and loan, (Congress) felt there was too much real estate investment going on," Vohland said. "It took the economics of owning a piece of property and made it horrible."

Property owners got a break a few years later thanks to [Hospital Corporation of America](#), which filed a U.S. Tax Court case asking for shorter depreciation periods for some components of its hospitals.

The company won the case in 1997, opening the door for cost segregation. The [Internal Revenue Service](#) even allowed businesses that used the cost segregation model to apply five- to seven-year depreciation retroactively to older fixtures or equipment.

Dan Powers, who leads [Grant Thornton LLP](#)'s Kansas City tax practice, said companies had been segregating depreciation cycles for technology-related components such as data rooms and elevated floors since the late 1980s.

But cases like Hospital Corporation opened the door to segregating other building components. Most of Grant Thornton's clients are familiar with the tax advantages of cost segregation, he said.

"It's kind of blocking and tackling now," Powers said. "I don't view it as a new offering."

But Vohland said he thinks few small to midsize businesses know there could be thousands of dollars in tax savings hiding in their walls.

"As time goes by, cost segregation becomes more of a cocktail party conversation. People are learning more about it," he said. "But this has been around for some time."

The formula for tax savings is simple, the experts say. A \$2 million building depreciating during 39 years declines in value by about \$51,282 a year.

However, if 20 percent of that property can be reclassified as personal property, the total assets would depreciate by about \$80,000 a year.

"So you're accelerating depreciation deductions by \$30,000," Vohland said. "Using a 41 percent marginal rate, you're saving \$12,000 a year in taxes over a five-year period. That's \$60,000."

Accounting and consulting firms that have been offering the service for several years warn business owners to be leery of cost segregation studies that don't do the proper amount of documentation or use a certified engineer or architect to lead the inspection.

Firms such as Marks Nelson start by confirming whether a company would benefit from a cost segregation and establishing a rough estimate of what the tax savings might be before launching a study. The study can take anywhere from four to 12 weeks, depending on the complexity of the property.

For some businesses, the time and cost of such a study might not justify the possible savings.

"I don't think cost segregation is for everybody," Loeffler said. "Just because you have an initial tax savings, you'd better go into it with your eyes wide open."

REACH STEPHEN ROTH at 816-421-5900 or sroth@bizjournals.com.

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