

Asset Exchange Company

Cost Segregation

Accelerate Your Wealth Building

An Introduction to Cost Segregation Analysis

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Every experienced real estate investor knows the importance of the annual depreciation deduction. Line 20 of Schedule E and the annual numbers entered on that line are valuable components of real estate investments. The value of depreciation is the cash component. Or rather, lack there of. Depreciation is a non-cash expense. Other allowable deductions on Schedule E are cash-based. You pay a plumber $200; you get a $200 deduction. Depreciation is different. Depreciation is better. Depreciation requires no cash outlays.

This article assumes the reader has a basic understanding of how depreciation works. The thesis of the article is how an investor can accelerate their annual depreciation deductions, thus taking full advantage of the time value of money. A dollar saved today is more valuable than a dollar saved tomorrow. The following analysis is how you can save that dollar today.

<u>DEPRECIATION BASICS</u>

Depreciation is the spreading of costs associated with acquiring an asset over the estimated economic useful life of the asset. Because land has an infinite useful life, it is not depreciable. So in order to determine annual depreciation deductions, a taxpayer must determine what percentage of their property's value pertains to land. Once that is determined, the remaining value is the depreciable value. For example, if a property is acquired for $1,000,000 and the land is estimated to be 20% of the total, then $800,000 is depreciable.

The next step in determining annual depreciation deductions is determining the useful economic life of the property. For this, the government has provided the answer. Residential investment property is deemed to have a 27.5 year useful economic life and commercial investment property a 39 year life. In our example, if the property was residential in nature, we would divide $800,000 by 27.5 to get our annual depreciation deduction. The amount, $29,090, would be the amount entered into line 20 of Schedule E. The annual depreciation deduction reduces your taxable income, thus saving you money. An annual deduction of $29,090 can potentially save you up to $14,000, depending on your tax bracket and which state you live in.

<u>ACCELERATED DEPRECIATION</u>

Let's all agree that a dollar saved today is better than a dollar saved tomorrow. Let's also agree that deductions are dollars saved. So, how can we increase the dollars saved today? How can we increase our deduction amount to something above $29,090? The answer lies in the investment property itself and the government's published schedule of useful economic lives. While true that residential real property is deemed to have a useful economic life of 27.5 years, all real property has components that are not considered to be real property for depreciation purposes. For example, certain fixtures in the property are considered to be personal property with shorter economic lives. Machines, telephones, lights, copper wires and microwave ovens all qualify as such. Such personal property is deemed to have 5 or 7 year lives by the government. Owner can accelerate their depreciation by dividing the depreciable amount by 5 or 7, rather than by 27.5. That creates more deductions and more dollars saved today. And a dollar saved today is better than a dollar saved tomorrow.

For example, let's say our investor performs a cost segregation study and determines that instead of an annual deduction of $29,090, they can instead deduct $39,090. That is a reasonable expectation. The additional $10,000 deduction can save them perhaps $4,500 in taxes this year.

<u>COST SEGREGATION STUDIES</u>

In order to accelerate depreciation and save a dollar today, the IRS generally requires the owner to get a cost segregation study performed on their property. The study will determine the value of the property that can be depreciated in an accelerated manner. Without getting a proper cost segregation study, the risks of being audited and owing unnecessary taxes are much higher. Everyone wanting to accelerate their wealth building by accelerating their depreciation should plan a cost segregation study.

<u>CONCLUSION</u>

Real estate investors love their annual depreciation deductions. They only wish they could deduct more. Accelerated depreciation allows for increased deductions. Performing a cost segregation study is a necessary component in accelerating your depreciation, increasing your deductions and saving a dollar today, rather than tomorrow.