A cost segregation study may cut taxes and boost cash flow

Is your business depreciating over 30 years the entire cost of constructing the building that houses your enterprise? If so, you should consider a cost segregation study. It may allow you to accelerate depreciation deductions on certain items, thereby reducing taxes and boosting cash flow.

Depreciation basics

Business buildings generally have a 39-year depreciation period (27.5 years for residential rental properties). In most cases, a business depreciates a building's structural components, including walls, windows, HVAC systems, elevators, plumbing and wiring, along with the building. Personal property — including equipment, machinery, furniture and fixtures — is eligible for accelerated depreciation, usually over five or seven years. And land improvements, such as fences, outdoor lighting and parking lots, are depreciable over 15 years.

Frequently, businesses allocate all or most of their buildings' acquisition or construction costs to real property, overlooking opportunities to allocate costs to shorter-lived personal property or land improvements. In some cases, the distinction between real and personal property is obvious. For example, computers and furniture are personal property. But the line between real and personal property is not always clear. Items that appear to be "part of a building" may in fact be personal property. Examples are removable wall and floor coverings, removable partitions, awnings and canopies, window treatments, decorative lighting and signs.

In addition, certain items that otherwise would be treated as real property may qualify as personal property if they serve more of a business function than a structural purpose. These include reinforced flooring that supports heavy manufacturing equipment, electrical or plumbing installations required to operate specialized equipment and dedicated cooling systems for data processing rooms.

Identifying and substantiating costs

A cost segregation study combines accounting and engineering techniques to identify building costs that are properly allocable to tangible personal property rather than real property. Although the relative costs and benefits of a cost segregation study depend on your particular facts and circumstances, it can be a valuable investment.

Speedier depreciation tax breaks

The Tax Cuts and Jobs Act (TCJA) enhanced certain depreciation-related tax breaks, which may also enhance the benefits of a cost segregation study. Among other changes, the law permanently increased limits on Section 179 expensing, which allows you to immediately deduct the entire cost of qualifying equipment or other fixed assets up to specified thresholds.

In addition, the TCJA expanded 15-year-property treatment to apply to qualified improvement property. Previously, this tax break was limited to qualified leasehold-improvement, retail-improvement and restaurant property. And the law temporarily increased first-year bonus depreciation from 50% to 100% in 2022, 80% in 2023 and 60% in 2024. After that, it will continue to decrease until it is 0% in 2027, unless Congress acts.

Making favorable depreciation changes

It isn’t too late to get the benefit of faster depreciation for items that were incorrectly assumed to be part of your building for depreciation purposes. You don’t have to amend your past returns (or meet a deadline for claiming tax refunds) to claim the depreciation that you could have already claimed. Instead, you can claim that depreciation by following procedures, in connection with the next tax return you file, that will result in automatic IRS consent to a change in your accounting for depreciation.

Cost segregation studies can yield substantial benefits, but they’re not the best move for every business. Contact us to determine whether this strategy would work for your business. We’ll judge whether a study will result in tax savings that are greater than the costs of the study itself.