

Cost Segregation: Extra Tax Depreciation & Cash flow Most Investors Overlook

By David V. Tran

Why Should You Care?

A Cost Segregation Study (CSS) allows you to claim 50-70% more depreciation on your commercial property. This reduces your income taxes and in turn increases your cash flow from the property.

What is a Cost Segregation Study?

This IRS-defined engineering approach accurately classifies an investment property into two asset groups:

1. Structural components which have a longer depreciable life, such as 27.5 or 38.5 years, classified as real property;
2. Non-structural components, e.g. furniture, carpets, landscaping, plumbing, electrical, HVAC systems, parking lot, which have a shorter 5, 7, or 15 year depreciable life, classified as personal property.

So, you may deduct more depreciation over a shorter period by classifying more of the property as non-structural components.

A CSS is usually performed by an appraiser or an engineering company. The company will visit your property for a site inspection to fully understand its use and condition. It then provides you with a CSS comprehensive report. This report includes pictures and information to support and document the classification of costs according to the strict IRS-approved methodologies. The result of a CSS is then given to your CPA or tax accountant for income tax reporting.

Without a CSS, you will just use the standard depreciation schedule for improvements: 27.5 years for apartments and 38.5 years for other commercial properties. As much as 90% of investors are claiming the standard depreciation over the longer period. So, if you have not heard of Cost Segregation, chances are you are missing the faster and additional depreciation.

Benefits to Investors

By shifting a portion of the property into the non-structural classification, the CSS allows you to reduce your income tax by generating an extra 50-75% in deprecia-

tion deduction and thus increase your after-tax cash flow. The extra depreciation basically converts ordinary rental income at your current higher tax bracket to tax-deferred capital gain in a 1031 exchange.

Of course, the higher your tax bracket (up to 35%), the more tax savings you will realize. The saving is even more if you also have to pay state income tax as a CSS is also allowed on your state income tax return. These tax savings are maximized during the first 5 years of ownership. Once the extra depreciation runs out, it may be a time to evaluate if you should exchange the property and repeat the whole process again.

A CSS allows you to increase tax depreciation. This is not the same as accelerated depreciation which simply shifts a higher percentage of depreciation deduction to the early years. This accelerated depreciation is subject to Alternative Minimum Taxes while depreciation from a CSS is not.

Who Can Benefit from a CSS?

If you own any of the following properties, you should be able to benefit from a CSS: Retail/shopping Center, Office building, Restaurant, Nursing Homes, Assisted Living Facilities, Hotel/Motel, Warehouse/distribution center, Industrial building, Public Storage, Resorts, Auto Repair Shop, Auto Dealer Property, Hospital, medical center, and Sport/entertainment Facility.

CSS Companies

Below are a few companies that perform a CSS. Most companies will provide you with a free estimate for the CSS of your property. The authors do not endorse any company.

- Commercial Cashflow Advisors, (408) 213-2530, www.ccashflow.com.
- O'Connor & Associates, (800) 856-7325, www.cutmyfederaltaxes.com.



David V. Tran, ext-201
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Eric Zhang

- Source Corp., (817) 732-5494, www.sourcecorptax.com.

Do's and Don't

- If you own commercial property valued at \$1M or more, you should explore the benefits of a CSS, especially when you are in a high tax bracket and can benefit from the additional depreciation deduction.
- Use the Cost Segregation Calculator on www.cutmyfederaltaxes.com. You just need to provide: property type, building cost, your tax rate, date of purchase, and it will give you an estimated tax saving. Use this as a go or no go test to see if it is worth pursuing further.
- Take advantage of the free estimates that most CSS companies offer. It tells you the costs of a CSS and the estimated potential tax savings over the first 5 years.
- Don't let the cost of a CSS deter you. It costs money to make more money.
- Discuss the estimate provided by the CSS companies with your CPA or tax accountant to see if your CPA would advise you to proceed.
- You may want to consider a CSS at the time of purchase of a commercial property as part of your investment and exit strategy.
- You will maximize the tax savings if you hold the property for 5 years; it probably does not make financial sense to perform a CSS and sell the property shortly after that.
- If you own the property for several years, the IRS may allow you to "catch up" underreported depreciation from prior years by filing a Form 3115 without restating all the tax returns.
- If you have remodeled and renovated your property, a CSS can also recover a significant portion of the asset value which you have abandoned.

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10. Real Estate Syndication & Partnership
11. Using IRA fund to invest
12. How to maximize cashflow with cost segregation study

To sign up, please email to creic@efundingcom.com.

Ask The Expert

Q: What's your thought on retail condos for sale in San Jose, CA?

A: There are a couple retail condo projects in San Jose. The price is about \$600-700/SF. The upside is they are in good location where there is a shortage of retail spaces. Retail condos are also available in Florida. The developer targets small business owners who wish to own their own unit. This is a good marketing strategy and market niche to get top price for a retail property. However, there are some drawbacks:

1. Most likely you will have problems financing your purchase because the unit is vacant initially. So you need to purchase in all cash. Even for owner-occupied unit, the SBA financing is not favorably low as the loan amount is relatively small.
2. With tenant improvement credit to tenant and leasing fee, the cost is close to \$700/SF. To get 6% cap, you will need to lease it at \$3.50/SF plus NNN. This is the fair market rent for retail space.
3. To maximize profits, the developer tends to provide a minimum number of parking spaces, e.g. 4/1000 SF. The parking spaces tend to be 6.5' wide for compact cars. As a result, the center may not attract customers driving big expensive cars like Benz or Lexus.
4. In a retail condo project, you don't have control about other tenants' businesses. If your tenant has a good business, others can open the same business next door to compete & take your tenant out of business. So you may see 2 nail salons, 4 real estate offices, and 3 cellular phone tenants in a 20 unit retail condo complex. Besides, if other units around your unit have businesses that need a lot of parking spaces like restaurants, you may have problem leasing your unit. Your tenants could also lose business because the customers cannot find parking spaces.

3 Free Seminars

1. How to invest in commercial real estate for retirement income **NOW**.
2. TIC: Strategy for small and self-directed IRA investors to acquire high-valued properties.
3. How to maximize cash flow with 1031 tax-deferred exchange.

All 3 seminars are presented by David V. Tran, **#1 Commercial Real Estate Expert Author** (out of 80+) on ezinearticles.com, a premiere internet magazine.

Call Maria at 408-288-5500 to for schedules & reservation. **There are absolutely no obligations from attendees.**

Testimonial from an attendee:

"At first I was a little skeptical coming to David's seminar. But in 2 hours, I learned more about Commercial Real Estate Investing than I have from books or other investment programs." Michael Cuthrell