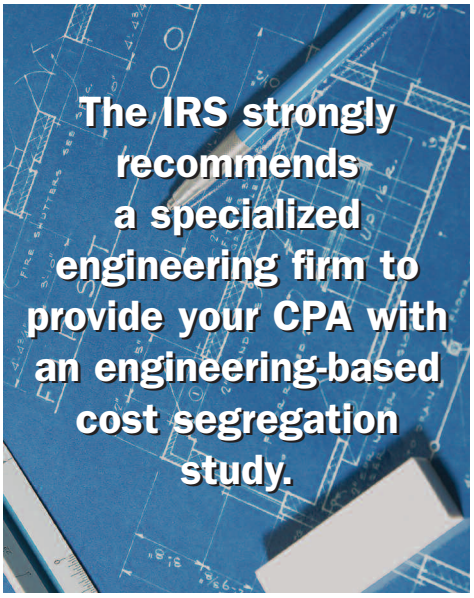
The History of Cost Segregation

IN BRIEF

The legislation and procedures used in an engineering-based cost segregation study have been in existence since the enactment of the Investment Tax Credit (ITC) in 1962. When the act was repealed in 1986, many assumed that cost segregation studies provided no further benefit under the new tax law. However, in a landmark 1997 tax court case, Hospital Corporation of America successfully defended the application of engineering-based cost segregation as a viable method to differentiate real and personal property under existing tax law. This landmark case continues to be the cornerstone of cost segregation studies today.



RECENT DEVELOPMENTS

In the past several years, a number of rulings have been issued by the government to spur economic growth. These can have a major impact for building owners with previous construction or acquired properties.

- In 2001 the government allowed taxpayers to catch up on all deductions from previous years for items reclassified into shorter tax lives as a result of a cost segregation study. (Rev. Proc. 2002-19). Previously, this beneficial adjustment had to be spread out across four years. Now it can be expensed entirely in the year of the change, reported as a reduction to current year taxable income.
- In 2002 the IRS consented to automatically allowing changes in the method of depreciation via Form 3115 and filed with the return in the year the change is elected. This simplifies the process of changing the method of depreciation to account for a cost segregation study without the nuisance of an amended return.
- In 2004 the IRS reversed the two-year waiting period required to change the method of calculation for depreciation on real property (Rev. Proc. 2004-11) allowing the method of depreciation to be changed in any given year.

AWARENESS

While most accounting professionals have a rudimentary understanding of the 5, 7 and 15-year property classifications, few have a detailed understanding of this highly specialized niche. Most accountants are aware of cost segregation as an option to increase depreciation and reduce current federal taxes, but believe it is very expensive and is financially feasible only for large properties. The execution rate for cost segration is under 10% because of limited knowledge by many property owners and accountants. In addition, there are misconceptions regarding the cost of obtaining these studies and the size properties for which cost segregation studies are financially feasible. As awareness of the practice increases among real estate investors and accountants, the implementation rate is rapidly increasing.

SUMMARY

- If you own real estate and pay federal income taxes or expect to during the ownership period for the property, you will benefit from the results of a cost segregation study.
- Both large and small owners of income property or owner-occupied commercial property can benefit from a cost segregation study.
- Benefits of a cost segregation study are substantial, immediate and enduring.
- Existing properties built or purchased after 1986 offer significant savings in year-one of cost segregation, even without producing original cost documents. Capturing non-segregated depreciation from prior years is perfectly allowable by the IRS.
- By ignoring generous IRS guidelines when establishing depreciation schedules, over 90% of real estate investors are unintentionally overpaying federal income taxes. In addition, they are paying federal income taxes earlier than necessary.

SINCE 1993
2190 Dallas Highway · Marietta, Georgia · 30064
Fax: 770-427-4004 · info@costseg.com · 1(800)COST-SEG · **www.costseg.com**

ERNST & MORRIS
THE LEADER IN COST SEGREGATION