



1031 EXCHANGE

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Cost Segregation – Save Taxes and Increase Your Cash Flow

What is Cost Segregation?

Cost segregation is the IRS sanctioned process by which real property components are re-classified as personal property. Re-classifying real property to personal property creates larger depreciation deductions because personal property is depreciated over much shorter periods (5, 7 or 15 years) than real property (27.5 years for residential or 39 years for commercial). And, creating larger tax deductions reduces current taxable income and allows the taxpayer increased cash flow.

Does the IRS approve of Cost Segregation?

Cost segregation studies are accepted and approved by the IRS. There are various IRS rulings, regulations and court cases which provide the basis for cost segregation studies.

For more detailed information, see the below link to the IRS Cost Segregation Audit Techniques Guide revised in March of 2008. <http://www.irs.gov/businesses/article/0,,id=134180,00.html>

Who Can Utilize Cost Segregation and When Can It be Implemented?

Any taxpayer can use cost segregation for buildings acquired in prior tax years; when constructing a building; buying an existing one; or, in certain circumstances, years after disposing of one.

A taxpayer that uses cost segregation for a previously acquired structure must file IRS Form 3115, Change in Accounting Method.

How is a cost segregation study prepared?

Typically, the taxpayer engages an accountant and an engineer to analyze the components of the building structure to determine which components can be re-classified as personal property and re-allocated shorter depreciation periods. These professionals analyze architectural drawings, mechanical and electrical plans, and other blueprints to identify and segregate the structural and general building elements including electrical and mechanical components from those linked to personal property.

The following is an estimate of the range of building costs eligible for re-classification through a cost segregation study to personal property resulting in accelerated depreciation.

Apartment Buildings	21-36%
Auto Dealerships	26-39%
Banks	26-38%
Hotels	26-41%
Manufacturing Facilities	26-39%
Medical/Dental Facilities	25-40%
Office Buildings	22-37%
Restaurants	30-45%
Shopping Centers	21-37%
Warehouses	18-31%

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What are the benefits of Cost Segregation?

The primary benefit is greater depreciation deductions and increased cash flow.

For example, if a taxpayer acquires a small residential apartment complex for \$1.5 million and thereafter obtains a cost segregation study, which re-classifies 35% of the property as 5 year personal property, the taxpayer's depreciation deductions increase from \$54,545 each year to \$140,454 each year – an increase of 157%.¹

There are, however, other significant benefits:

- If a building component needs replacement at some point after the cost segregation, the taxpayer may take, as a deductible loss, the value of the component at the time of replacement.
- If real property is reclassified as 5-, 7- or 15-year personal property, it may qualify for bonus depreciation. Bonus depreciation allows an owner to depreciate 50% of the asset immediately.

Cost Segregation and tax deferred exchanges

If a taxpayer obtains a cost segregation study and thereafter exchanges the property, he must remember to be cognizant of the new real and personal property allocation to ensure that any replacement property acquired has the same proportion of real and personal property.

What is the cost to prepare a Cost Segregation Study?

Fees for a cost segregation study are based on the size and type of building and the anticipated time required

to complete the study and thus can vary substantially from project to project.

OREXCO's choice of vendor for cost segregation studies, Tax Strategies Group, LLC, will provide clients with a free analysis to determine whether the taxpayer will benefit from a study. Tax Strategies' estimate includes the projected increase in depreciation, showing the net present value to the client. Clients should expect to receive benefits between five and ten times the cost of the Study. Tax Strategies' free estimate allows taxpayers to examine and weigh the benefits of its services without risk or expense. Likewise, Tax Strategies' studies are backed by a policy of insurance issued through Lloyd's syndicates providing for payment of taxes or fines imposed as a result of a finding that the study is defective or unsupported.

Tax Strategies Group, LLC may be contacted at (877) 394-3300 and info@tax4cash.com. Further information about Tax Strategies Group, LLC can be obtained at their website, www.tax4cash.com.

OREXCO gratefully acknowledges the participation of Jim Davis, Esq. of Tax Strategies Group, LLC in the preparation of this article.

Choose OREXCO to handle your next exchange. For more information about OREXCO and its QI services, please go to www.orexco1031.com.

Taxpayers contemplating an exchange should always consult their tax or legal advisor.

¹ Depreciation deduction before cost segregation:

\$1.5 million residential real property – 27.5 year depreciation =

Depreciation deductions after cost segregation:

Re-classified as 65% real - \$975,000 – 27.5 years depreciation =

Re-classified as 35% personal - \$525,000 – 5 years depreciation =

\$54,545/annual depreciation

\$35,454/annual depreciation

\$105,000/annual depreciation

\$140,454/total annual depreciation