



# Financial Adviser

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## Cost Segregation is Worth a Look

Depreciation of a commercial building is one of the least beneficial deductions available to a business. Most nonresidential buildings are required to be depreciated over a punitive 39 years. This means a building costing \$1 million would only provide annual depreciation deductions of \$25,641. At a 35-percent tax rate, the current tax benefit of the depreciation is only \$8,974. Constructing or expanding a building is a risky and costly endeavor in both money and time, but the Internal Revenue Service (IRS) worsens the impact by requiring a long-term write-off of the cost.

What is often overlooked, or not considered, is cost segregation. Cost segregation of your building can provide substantial benefits by accelerating the depreciation deduction. Rather than deducting the full cost of your building over 39 years, a portion of your cost would be carved out and depreciated over a shorter life, which would result in larger depreciation deductions per year.

### What is Cost Segregation?

Cost segregation is a process by which there is an analysis of the construction and design of a building and segregation of the costs into different asset categories for federal tax purposes. These asset categories are:

- Land
- Building
- Tangible personal property
- Land improvements (landscaping, parking lots, sidewalks, etc.)

Land is a non-depreciable asset and would provide no current tax benefit and building costs are depreciated over the aforementioned 39 years. However, tangible personal property and land improvements are depreciated over shorter lives, usually 5 to 15 years and, therefore, are more beneficial.

Architects, engineers, contractors and/or other qualified company personnel competent in design, construction or estimation can perform a cost segregation study in conjunction with a tax adviser who is knowledgeable in the applicable tax laws.

When someone is performing a cost segregation study, they are looking to differentiate between structural components that relate to the operation or maintenance of the building versus other components of the project that are personal property, or are integral to a manufacturing process, that could be assigned shorter depreciable lives. For example, if the design of your building is to include structural elements that are required for or to support your

specific machinery, then those building costs could be depreciated over the same life of the machinery to which it relates.

Electrical service and lighting are other areas that should be investigated to determine if there are potential cost segregation benefits. Lighting costs that are beyond the general basic illumination for the building could be personal property. Furthermore, electrical systems that do not relate to the overall operation or maintenance of a building could be related to personal property and thus depreciated over a shorter life. Electrical systems and connections that are designed solely to power specific machinery could be depreciated over the same life of the machinery. Analyzing electrical systems is a very complex process and using experts in this area will enhance your cost segregation study significantly. Plumbing, ventilation and cooling components could likewise qualify as personal property integral to a manufacturing operation.

For example, the depreciation deductions associated with a \$1 million construction project that is segregated into \$400,000 of special foundations, electrical and plumbing fixtures, and lighting and ventilation required for the operation of machinery and qualifying for a seven-year life; \$30,000 of land improvements qualifying for a 15-year life; and the remaining \$570,000 with a 39-year life would result in present value tax savings of around \$65,000 (using a 6-percent discount rate) when compared to the value of depreciation deductions if the entire \$1 million building were depreciated using a 39-year life.

A cost segregation study is not only applicable to the construction of a new building, but also to purchases and renovations of existing facilities. You should review your company's fixed assets schedule to see if there are any facilities placed in service in previous years that could benefit from cost segregation. The IRS allows you to modify your depreciation lives for assets placed in service in prior years and recoup lost depreciation deductions.

### Is a Cost Segregation Study Right for You?

For the small-business owner, a cost segregation study could be expensive and the cost of the study should be evaluated against the benefits in tax savings. Your certified public accountant should be able to assist you in determining if a cost segregation study is practical for your business. \*

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