

Free CD!
[How to get started in Self Storage](#)

Home
Forum
Industry Links
Job Finder
Manager Locater
Properties for Sale
Articles
News
Laws/Trade Assoc.'s
Industry Partner News

Sign up for info

Your Email

[Sign up](#)

RSS/XML feed: [XML](#)

Articles

[< back](#)

Cost Segregation

Jul 11, 2006



Why are 90 percent of self-storage owners overpaying on their federal income taxes?

More than 90 percent of real estate investors unintentionally overpay on their federal income taxes, and usually years or decades earlier than necessary. This oversight typically occurs because the investor's accountant doesn't fully understand the concept of cost segregation.

Cost segregation, recently integrated into IRS guidelines, is a proven tax-savings tool used when establishing depreciation schedules over five, seven or 15 years, rather than the 39 years typically used for self-storage facilities. Savings for storage owners are significant, exceeding \$50,000 to \$1,000,000 in the first year. Cost segregation converts income taxed at 35 percent (ordinary income) to income taxed at 15 percent (capital gains). It also defers payment of income taxes, often for five to 10 years.

Effects of Higher Depreciation

There are two benefits of increasing depreciation:

1. Converting ordinary income into capital gains income.
2. Deferring income until a gain on the sale of the property is realized.

The conversion of ordinary income into capital gains income has to do with the technical nature of the allocation of the gain on the sale. Many, if not most, accountants initially believe it is simply a timing issue. However, when the mechanics of gain are discussed, they quickly realize increasing depreciation leads to paying taxes at the capital gains vs. the ordinary income rate. For this reason, if you recently sold a property, correcting a depreciation schedule makes a real difference.

For example, assume an investor sold a property in late 2005, obtained a cost-segregation study, and increased depreciation by \$100,000. The result is ordinary income taxes will be reduced by \$35,000 ($\$100,000 \times 35\%$), and capital gains taxes will be increased by \$15,000 ($\$100,000 \times 15\%$). This nets the owner \$20,000 in federal tax savings by simply correcting an error in the depreciation schedule after the property has already been sold.

Cost segregation clearly makes sense for properties with an improvement basis of at least \$500,000. In many cases, it makes sense for smaller properties. While accountants are becoming increasingly active in reviewing options for depreciating real estate the owner often needs to take the lead in proposing cost segregation as a mechanism to reduce and defer federal taxes.

- ADVERTISEMENT -



Property Owner Involvement

Many real estate investors proudly take the stance, "My federal tax return is too complicated. My accountant handles it," as if it's a rite of passage to have a complex return. Only about 2 percent to 5 percent of depreciation schedules in federal tax returns properly separate short-life property to minimize the owner's taxes.

While many parts of the federal return may be too difficult for an owner to understand and prepare, this is simple to understand: If you pay federal taxes and can use additional depreciation, you benefit from obtaining a cost segregation study. Those familiar with cost segregation often think it only makes sense for large properties (i.e., those worth more than \$10 million). For owners of properties with a cost basis of \$500,000, however, the year-one savings are typically \$3,200 to \$10,000. If the property was purchased or built some years ago, savings can increase dramatically in the first year-even without amending prior tax returns.

Getting Started

When deciding whether you can benefit from a cost-segregation study, ask yourself the following questions:

1. Do you pay federal income taxes?
2. Do you own investment real estate?
3. Can you use additional depreciation?

If you can use additional depreciation and are paying federal taxes, call a cost-segregation expert and request a preliminary analysis. There should be no fee for this consultation. The initial study will estimate the amount of five-, seven- and 15-year property that can likely be identified as well as the catch-up depreciation. This analysis will not involve a site inspection, nor will it be precise. However, it should be accurate enough to help you decide whether a cost segregation study is financially feasible.

Catch-up depreciation is that which has been under-reported since the date the property was placed in service. A real estate investor can "catch-up" under-reported depreciation by filing a Form 3115 with the current tax return. Moreover, you can file the form without including the tax returns for each under-reported year; only the current year is needed. According to the IRS, filing a Form 3115 is not a red flag for an audit.

Once you obtain the preliminary analysis, consult your accountant, since he will complete and sign your tax return. In many cases, it makes sense for the accountant, property owner and cost-segregation advisor to meet and discuss the options and issues. If you ultimately decide a cost-segregation study makes sense, investigate whether the extra depreciation should be used in a prior year, which would involve filing amended returns, or the current year.

To minimize federal income taxes, make a cost-segregation study a routine part of all future real estate investments.



Patrick O'Connor, a designated member of the Appraisal Institute, is president of O'Connor & Associates. The firm, in business since 1974, specializes in real estate appraisals, research, and state and federal tax reduction services nationwide. With offices in Houston, Dallas, Los Angeles and Newport Beach, the firm employs more than 130 people. Patrick O'Connor is frequently acknowledged by national publications as a respected source of information on real estate trends. Visit www.cutmyfederaltaxes.com.

[Patrick O'Connor, MAI and president of O'Connor & Associates](#)

SelfStorageGuide.com

[Home](#) [About Us](#) [Contact](#) [Looking for Storage?](#)

© 2006 SelfStorageGuide.com