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Cost Segregation and Estate Tax Reporting – *Tax Reduction for Heirs!*

By Ralph Consola, Principal

A family recently lost a loved one, the founder of a successful real estate management, brokerage, and investment firm. He started with a single small commercial property investment in the 1970's and, over time, grew it to a multi-property portfolio worth tens of millions of dollars.

The founder's CPA introduced the concept of cost segregation to him some 20 years ago, reducing his income taxes on every new real estate investment thereafter. Estate tax advisors worked with him to implement a wealth transfer plan to reduce the tax burden on the transfer of ownership in the properties to his beneficiaries. The family then continued the tax reduction strategy by engaging Marshall & Stevens to perform a cost segregation analysis for the benefit of the heirs at the same time as we were engaged to value the real estate investments for estate tax reporting purposes. The reduction in federal taxes owed by the heirs upon the change in control on the portfolio of properties was significant due to good tax strategy and implementation.

Cost Segregation is the application of the IRS' Modified Accelerated Cost Recovery System ("MACRS"), an alternative to straight line depreciation added to the tax code in 1987. Cost Segregation engineers inspect improved real estate to determine which electrical, plumbing, finish, and other components may be allocated a personal property tax life of 5, 7 or 15 years versus the real property tax life of 39.0 years (27.5 for multifamily). Cost segregation analyses require a deep understanding of a specific area of tax code, relevant caselaw, construction cost estimating, and valuation.

Below is an example of the actual benefits of a cost segregation analysis performed for the heirs to a real estate portfolio:

Developed Property Portfolio Valuation	
Value of Subject Properties:	$41.676 Million
Total Value of Land:	$14.330 Million
Building & Improvements:	$27.346 Million – *Depreciable Tax Basis*

Resulting Allocation of Tax Basis from Cost Segregation	
5-Year Property:	$ 3.053 Million
7-Year Property:	$ 0.002 Million
15-Year Property:	$ 0.540 Million
Personal Property Total:	**$ 3.595 Million**
39-Year Property Allocation:	$23.751 Million
Depreciable Tax Basis Total	$27.346 Million

Year	5-Year	7-Year	15-Year	39-Year	**Depreciation Expense WITH Cost Segregation**	Depreciation Expense without Cost Segregation	**Change in Depreciation Expense from Cost Segregation**	**After-Tax Change in Cash Flow from Cost Segregation**
1	610,574	358	27,000	304,483	**942,416**	350,576	591,840	177,552
2	976,919	614	51,300	608,966	**1,637,799**	701,151	936,648	280,994
3	586,151	439	46,170	608,966	**1,241,726**	701,151	540,575	162,172
4	351,691	313	41,553	608,966	**1,002,523**	701,151	301,372	90,412
5	351,691	224	37,400	608,966	**998,281**	701,151	297,130	89,139
6	175,845	224	33,658	608,966	**818,693**	701,151	117,542	35,263
6 Yrs	3,052,872	2,172	237,082	3,349,312	**6,641,438**	3,856,333	**2,785,105**	**835,532**
39 Yrs	*3,052,872*	*2,508*	*540,000*	*23,750,620*	*27,346,000*	*27,346,000*	*0*	*0*

In this example, by allocating the $3.595 Million of the building and improvements tax basis from 39-year straight line depreciation to shorter tax lives, as outlined above:

- The **increase in depreciation expense** for the first six years of "new ownership" is **$2.785 Million,** and

- The **estimated reduction in taxes** for the heirs is **$835,532**.

This example represents a portfolio of store front retail and office properties which yielded a relatively low allocation of tax basis to personal property, just 13% to shorter depreciable lives. We have performed cost segregation analyses for single properties and portfolios where the results are double or triple the percent of tax basis allocated to shorter lives.

Established in 1932, **Marshall & Stevens** is a recognized leader in business and asset valuation, serving investors and trusted advisors with estate and gift tax planning and reporting analyses.

For more information about cost segregation, real estate valuation, estate and gift tax reporting analyses, or other valuation topics, please contact one of the professionals listed below.

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