



CPAs & Business Advisors

17501 East 17th Street, Suite 100 • Tustin, CA 92780-7924 • www.hmccpa.com
(714) 505-9000 • Fax: (714) 505-9200 • E-Mail: cpas@hmccpa.com

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Defer Taxes, Improve Cash Flow With a Cost Segregation Study

With the right analysis and documentation, manufacturers are winning faster depreciation allowances on certain capital improvement projects, which defers tax liability in a way that improves cash flow. All it takes is a cost segregation study.

When a manufacturer buys, builds, or renovates a facility, a cost segregation study classifies the expenses as real property, which is depreciable over 39 years, or personal property, which can be depreciated in five, seven, or 15 years, depending on the asset.

Shorter Depreciable Lives

Structural assets are classified as real property, but nonstructural assets are categorized as personal property. These include not only the equipment but, in many cases, the costs of preparing a site to accommodate the equipment as well.

For example, if a heavy piece of equipment commands extra structural reinforcement, special wiring, ventilation, or plumbing, those improvements might be classified as nonstructural. The associated costs could include the labor, materials, and overhead that can be allocated to the modifications.

In many cases, exterior improvements such as landscaping, lighting, and parking lots also can be classified as “land improvements” qualifying for a 15-year depreciation schedule.

The accelerated depreciation enables a manufacturer to reduce its taxable income in the current year, which increases cash flow. The 30% bonus depreciation provision contained in the Job Creation and Worker Assistance Act of 2002 offers an even stronger incentive to take a close look at depreciation.

The act allows taxpayers who place qualifying property in service after Sept. 10, 2001, and before Sept. 11, 2004, to depreciate the assets by an extra 30% in the year they are placed in service. Qualifying assets include new assets with a recovery period of 20 years or less.

Document for Success

The Internal Revenue Service traditionally has rejected attempts to classify the costs of capital improvements in such a way, but some recent, high-profile court battles have given taxpayers the advantage.

The IRS since has demonstrated significant acquiescence, but only when the allocation of costs is backed by a well documented cost segregation study. That means the expertise of architectural and building professionals must be reflected in the study, in addition to accounting expertise.

The ideal time to perform a cost segregation study is before construction on a project begins, when the costs are easier to segregate and when the values of various assets are easier to



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establish. The study can be after the fact, but it's more difficult to complete and more difficult to defend to the IRS.

Claiming the Deduction

Even when a manufacturer has already filed a return declaring the full 39-year depreciation schedule for a particular project, the company can file an application in the current tax year to explain the missed deduction and reclaim it. The IRS will scrutinize the deductions carefully, but a well-documented cost segregation study is the key to making the deductions stick.

The savings that any particular manufacturer might discover will vary greatly depending on the value of assets. Preliminary studies, however, suggest manufacturers might see a reduction in tax liability of 20% to 35%.

If you are planning a purchase, renovation, or construction project, or if you've completed one in the past few years, we can help you analyze your investment to determine if you might benefit from a cost segregation study. If you've placed real property in service since Sept. 10, 2001, the savings could be considerable.