ISS INSIDE SELF-STORAGE

The Basics of Cost Segregation: Tax Benefits for Self-Storage Owners

Jerome H. Kootman
09/17/2009

The government has been steadily handing out money to the banks this year, so you may be asking, “Where is my piece of the pie? My rentals and revenue are down. I’ve been doing everything I can to manage expenses, carefully analyzing day-to-day operations, purchasing and marketing.” Or maybe you’re one of the lucky self-storage owners who haven’t been hit as hard by the recession.

Either way, recent allowances by the Internal Revenue Service aimed at helping small-business owners are being used by many self-storage owners to generate cash flow and improve their financial position.

The IRS recently changed the regulations to allow net operating losses (NOL) to be carried up to five years. This means that if you paid taxes in the last five years and are now operating at a tax loss, you can claim a refund on your previous years’ taxes.

How do you create a bigger NOL that will allow you to reclaim your previously paid tax dollars? The answer is cost segregation.

The IRS also reinstated 50 percent bonus depreciation for new construction projects started after Dec. 31, 2007, and placed in service before Jan. 1, 2010. Property with a recovery period of 20 years or less is eligible.

How do you create more property eligible for this bonus depreciation? Once again, the answer is cost segregation.

What It Is

Cost segregation is an engineering-based approach to identifying assets within a facility that can be reclassified into a much shorter depreciation class than the building itself. Non-residential properties (and everything in them) are generally depreciated using a straight-line method over 39 years. The cost-segregation specialist maximizes the inherent tax benefit by identifying, quantifying and segregating the personal property components of a facility, resulting in depreciable lives of five, seven and 15 years using accelerated depreciation.

This is not simply a matter of classifying equipment to a five- or seven-year recovery period. Items typically reclassified include land improvements, such as paving, curbing, site lighting, storm drainage, fencing, and landscaping, and personal property including signage, security systems, certain floor coverings and special climate-control systems. The list is extensive.

The accompanying table illustrates the financial benefits of performing a cost-segregation study for a sample $5 million self-storage facility for which you could reclassify 30 percent of the cost basis to a shorter life.

Year	Depreciation Before	Depreciation After	Change In Depreciation
1	$69,550	$183,685	$114,135
2	$128,205	$322,244	$194,039
3	$128,205	$260,594	$132,389
4	$128,205	$220,524	$92,319
5	$128,205	$212,054	$83,849
Total First 5 Years	$582,370	$1,199,101	$616,731
Tax Savings Over First Five Years = $218,146			
Total Net Present Value Tax Savings = $286,171			

The best time for a study is when a facility is constructed or acquired, but it’s also possible to obtain these benefits for properties that have been in your portfolio for up to 15 years. A retroactive study can be performed without the problems associated with amending prior year tax returns or IRS approval. You can claim the difference between the allowed depreciation and what you actually claimed in prior years all on your current tax return, which would result in big tax savings for you.

How It Works

A cost-segregation specialist uses an engineering-based approach as specified by the IRS. His job is to examine architectural and engineering drawings, cost data and other project specifications for potential asset reclassification. He can use his expertise in construction-cost estimating to overcome the lack of available information if cost data is not available.

The government is doing its part to help owners maximize the benefits of real estate investing. Recent IRS pronouncements have enhanced this tax strategy and made cost-segregation studies an even more beneficial method for increasing project cash flow and profitability.

The IRS also published a 115-page Cost Segregation Audit Techniques Guide, developed to provide its agents with a fundamental understanding of cost segregation. Why? Because property owners throughout all industries are using it, and the IRS wants agents to be familiar with the process.

The following questions will help you determine if your facility is a candidate for a cost-segregation study:

- Is the cost of the facility (excluding land) at least $1 million?
- Have you purchased, constructed or renovated any facility in the past 15 years?
- Do you plan on retaining this facility for at least the next few years?
- Do you have net income that is currently taxed?

If you can answer “yes” to these questions, cost segregation will increase your cash flow and return on investment.