

## **Look-Back Studies: A commonly overlooked application for cost segregation**

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Properties already in service are often overlooked when it comes to cost segregation, but this is a big mistake. The IRS permits taxpayers to use a cost segregation study (CSS) to adjust depreciation on properties placed in service as far back as January 1, 1987.

### **The Look-Back Study**

A CSS performed on a property already in service, for which a tax return has been filed, is known as a look-back study. This analysis is used to identify costs that were incorrectly classified as 27.5, 31.5, or 39 year property and reallocate them to the appropriate 5, 7, or 15 year recovery periods. Upon completion, the taxpayer is allowed to make an adjustment under IRC Sect. 481(a) to catch up on depreciation. The catch up, which is often quite significant, is equal to the difference between depreciation expense taken and depreciation expense that could have been taken if a CSS had been performed on day one. Believe it or not, this change can be made without filing any amended returns. The taxpayer simply attaches files Form 3115 (Change in Accounting Method), to its tax return for the year of the change.

It is not uncommon to have a look-back study conducted on a property that was placed in service as far back as 10 -12 years ago, but this is typically about as far as you'll want to go. Of course the facts and circumstances must be carefully reviewed as it is not always prudent to go back even that far. Conversely, it might make sense to go back even further.

### **Example (CSS performed for the 2006 tax year)**

- \$5M office building
- Placed in service in March of 2000 (100% treated as 39-year property)
- CSS reallocated \$400,000 (8%) to 5-year and \$550,000 (11%) to 15-year
- Additional 2006 depreciation = \$508,493\*
- Additional 2006 year tax deferral = \$203,397\*
- 10-year NPV = \$221,638\*

*\* The depreciation and NPV (Net Present Value) benefits were calculated using a 40% tax rate and a 6% discount rate.*

### **Bonus Depreciation**

Do you remember bonus depreciation? This incredible tax benefit was originally introduced as part of the Job Creation and Workers Assistance Act of 2002. Bonus depreciation allowed taxpayers to depreciate 30% or 50% of qualifying assets, with a recovery period of 20 years or less, in the first year. For example, if you had \$500,000 of 5-year property and qualified for the 50% bonus level you would have deducted \$250,000 in the year placed in service as bonus depreciation and then depreciated the remaining \$250,000 over five years.

You may be thinking that bonus depreciation ended on December 31, 2004; so why bring it up? Although this is technically true, bonus depreciation is still available via a look-back study for taxpayers who did not specifically elect not to use bonus

depreciation when they filed their tax return. If you meet the requirements for bonus depreciation then you can take this deduction as part of your Sect. 481(a) adjustment discussed above.

### **Closing Thought**

Your tax advisor, working in conjunction with a cost segregation consulting engineer, will be able to help determine the appropriate strategies to take advantage of this procedure. Since “look-back” studies often identify significant amounts of reclassified assets as well as very large 481(a) adjustments, there is a somewhat higher probability that the study may be subjected to IRS scrutiny. This further underscores the advantage of using a qualified cost segregation advisor with experience performing look-back studies.

*Please contact your Berry Dunn Tax Advisor for additional information on cost segregation studies at [info@bdmp.com](mailto:info@bdmp.com).*