

THE NEUMAN GROUP — INVESTOR EDUCATION

Does Cost Segregation Raise Your Audit Risk?

The honest answer for high-income professionals, with every source cited.

One-line version: a cost segregation study by itself does **not** put a target on your back — the IRS expects them and publishes its own manual for reviewing them. What raises the odds of a look is a return that suddenly looks very different from other people in your profession and income bracket — and losses used in ways the passive-loss rules do not allow.

1. The Short Answer

Cost segregation is a normal, IRS-accepted tax strategy. The IRS publishes its own **Cost Segregation Audit Techniques Guide (Publication 5653)** telling examiners exactly how to review these studies — the agency expects to see them. The study itself is not a red flag. A professionally prepared, **engineering-based study actually lowers your audit exposure**, because it is precisely the documentation an examiner asks for first. Most problems arise from sloppy or undocumented allocations, not from large, justifiable deductions.

2. How the IRS Decides Who Gets Looked At

Nearly every return is scored by a computer system called the **DIF score** (Discriminant Information Function). It compares your return to other taxpayers like you — same kind of work, same income bracket. The further your deductions, losses, and effective tax rate drift from what is statistically normal for your peer group, the higher your score, and the more likely a human pulls the return for review. A high score is **not an accusation** — legitimate deductions belong on the return; documentation simply must back up every line.

3. The High-Earner Scenario, Concretely

Take an attorney with strong practice income whose tax bill suddenly drops far below what other attorneys at the same income level pay, because a cost segregation study generated a large first-year depreciation loss. That return now **deviates from its peer group** — and yes, that raises the DIF score and modestly raises the chance of a look. Large rental depreciation losses stacked against large professional income is a known stand-out combination: for example, **\$80,000 of rental depreciation losses against \$400,000 of professional income** tends to stand out for review. But more likely to be looked at is not more likely to owe money — if the study is engineering-based and the loss was legally usable, an audit is a document request, not a penalty.

4. The Real Trap: The Passive-Loss Rules

For a full-time professional, the bigger audit question is usually not was the study real, but **were you allowed to use those losses against your practice income at all?**

- Rental losses are normally **passive**. Passive losses generally cannot offset wages or professional-practice income.
- Main exceptions: qualifying as a **Real Estate Professional** (very difficult with a full-time practice — 750+ hours and more time in real estate than in your profession), or the **short-term-rental exception** with genuine material participation.

- The IRS **frequently challenges** Real Estate Professional status and material-participation claims from people with demanding full-time careers — this, not the study, is where high earners actually lose audits.
- Schedule E losses above roughly **\$25,000**, especially combined with the short-term-rental approach, draw extra scrutiny.

5. What Raises Risk vs. What Does Not

Situation	Audit-risk effect
Engineering-based study from a reputable firm, losses used within the passive rules	Low
The cost segregation study itself, done properly	Not a flag
Effective tax rate far below your professional peer group	Raises DIF score
Large depreciation losses offsetting large W-2 / practice income	Stands out
DIY or spreadsheet-only study, no engineering report	The real danger
Claiming Real Estate Professional status with a full-time career	Frequently challenged
Extreme allocations (40-50% into 5/7/15-yr property; normal is roughly 20-35%)	Aggressive

6. The Actual Odds, In Numbers

Recent IRS examination data puts the baseline odds of an individual audit at about **0.4 percent, roughly 1 in 250 returns**. The odds climb with income:

Income level	Chance of audit
Most taxpayers (under about \$500,000)	~0.4% (1 in 250)
\$500,000 - \$1 million	~0.6%
\$1 million - \$5 million	~1.1% (1 in 90)
\$5 million - \$10 million	~3.1%
Over \$10 million	~4%+ and rising

Good study vs. bad study, the honest part: no official statistic exists for audit odds with an engineering study versus a do-it-yourself one, because the IRS computer that selects returns never sees your report, only your numbers. Study quality mostly changes **what happens if you are picked**.

Engineering-based study: the most common audit outcome is full acceptance or minor adjustments to a few components. Full disallowance is rare.

DIY or non-engineering study: full disallowance is common, meaning deductions thrown out entirely, with back taxes, interest, and potential accuracy penalties. The extreme allocations these studies tend to produce are exactly the numbers that raise selection odds in the first place.

Plain version: odds of being picked = your income and how unusual your return looks. Odds of surviving the pick = the quality of the report.

7. How to Stay Protected

- **Use an engineering-based study** from an established firm and keep the full report — it is the first thing an examiner requests, and it is your armor.
- **Confirm the losses are usable** before filing: passive-activity status, Real Estate Professional hours, or the short-term-rental material-participation test — documented with contemporaneous time logs.
- **Prefer Form 3115** (change of accounting method with a catch-up adjustment) over amending old returns when claiming missed depreciation — amended returns get slightly more eyes.
- **Have your CPA sign off** on how the deduction interacts with the rest of the return. The study firm handles the building; the CPA handles the rules above.

SOURCES

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