

Owners turning to cost segregation for tax savings

Real Estate Weekly (excerpt)

In these times with landlords focusing on reducing expenses and hitting the wall with trying to raise rents in a market of minimal inflation and high vacancy, owners and investors are turning to cost segregation to generate tax savings.

If more than \$1 million is spent for a building, new construction or renovation, a cost segregation study could provide the owner with a significant tax benefit. This also applies to buildings that have been purchased since 1987.

Cost segregation is essentially a depreciation, tax deferral tool and for certain property types the net present value tax savings can be substantial. One must remember that depreciation is the most important factor that affects a project's after-tax cash flow.

Over the years, the federal government has adjusted not only depreciation recovery periods but also the convention (straight-line, 150% declining balance, 200% declining balance, etc.). If examined on a present value basis as a percentage of original cost, today's non-residential recovery period of 39 years is the lowest since 1953. However, the IRS now permits the segregation of construction costs into shorter recovery periods. The resulting "blended" depreciation recovery period is a desirable, much larger depreciation deduction within the early years of the hold. And, the greater the tax rate of the taxpayer (owner), the greater the tax benefit.

The amount of savings depends on the building type, use, its depreciable basis, and the tax rate of the taxpayer, and the recovery period. Most owners depreciate their buildings over 39 years if it is non-residential or 27.5 years if it is residential real estate. Typically, the net present value savings can range from 2% to 5%. For a building worth \$5 million that amounts to \$100,000 to \$250,000.

Certain buildings are better candidates than others. For instance, buildings with extensive site work improvements, process or manufacturing related systems, furnishings or appliances, etc. are all good candidates. This would include warehouses and distribution facilities, laboratory and biomedical research and development facilities, manufacturing facilities, multi-family buildings, offices, shopping centers, etc. Although tenant improvement work is generally depreciated over 39 years, most law offices have a preponderance of millwork, built-ins, specialty lighting, etc. which would qualify for a shorter recovery period.

Based on recent IRS court rulings, now all site related improvements such as paving, curbing, utilities, lighting, etc. can be depreciated over 15 years instead of 27.5 or 39 years. If we take the position that the taxpayer is in the highest income bracket and subject to New York State tax as well, for every \$1 million of site related improvements that are re-classified, the taxpayer will save \$100,000.

Using the same parameters and re-classifying \$1 million from 27.5 years to a 7-year recovery period would provide \$230,000 of present value tax benefits. Now, most residential appliances, kitchen cabinets, carpeting, millwork, signage, telecommunications systems, etc. can qualify for a 7- or 5-year recovery period.

Cost segregation studies apportion the costs (both direct and indirect) of specific components of the building a site to certain federal tax depreciable recovery periods. To optimize the reclassification from longer lives to shorter lives, an analysis of a property is required. This is accomplished by preparing a detailed cost estimate of pertinent components and systems, and reconciling such costs with the tax documents. **Preparing a cost segregation study requires a skill and understanding of IRS and tax court case law complemented by engineering and cost estimating skills.**

Cost segregation has IRS backing and support. The IRS has published "how to" bulletins and provided examples. The IRS has made it simple, too. Re-filing the tax returns is not required, just the submittal of IRS Form 3115 requesting a change in accounting procedures.

Recent IRS and Tax Court Rulings get even better. The IRS also permits the taxpayer to receive "catch-up" depreciation, a tax benefit "refund." This is the difference between the depreciation taken thus far and the depreciation that could have been taken once the depreciation was re-figured using cost segregation techniques. Now, this "catch-up" depreciation can be taken within a single tax year. Up until March 2002, it had to be taken over a four-year period. Depending on when the property was acquired, this single year tax benefit could be a windfall.

If you plan to own the asset for at least four years, inquire about cost segregation opportunities. Cost segregation is straightforward, it is not "risky" or audit triggering, follows IRS guidelines, and the money saved can be substantial. Why pay more in taxes than you have to?