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# Cost segregation studies provide significant tax benefit

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Construction Cost Recovery

I do not need to tell anyone how hard it has become to generate acceptable returns in this "low cap rate" market. Unfortunately for buyers, the rise in the cost of financing has not translated into a meaningful reduction in the cap rate.

The cycle is vicious: the lower the cap rate, the higher the price; an improving job market leads to higher rents; the higher the rents coupled with an abundance of capital leads to new construction and then unfortunately, lower rents. However, owners and buyers have the opportunity to increase the After Tax IRR and Cash on Cash through cost segregation. (More commonly referred to as "cost seg".) A cost seg can typically add 100 bps to an internal rate of return and 300 bps to a cash on cash return. That is a meaningful increase that can allow a buyer to be more competitive or supply an existing owner with additional cash for an expansion or distribution to its partners. During the due diligence phase is the time to start preparing for your cost seg. "By bundling the property condition assessment and cost segregation study during the due diligence phase, the buyer will save additional capital by eliminating the redundancy of these two complementary services" says Robert Barone, RA, principal of the IVI Companies. What is cost seg and its benefits? Cost segregation is essentially an analysis of all construction improvements from a tax perspective. Classifying certain assets to their correct "accelerated" categories can help defer taxes. While often overlooked, it is important to remember that depreciation is the most crucial factor that affects a project's after-tax cash flow. 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 $5 million building 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, multifamily 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 reclassified, the taxpayer will save $142,000. Using the same parameters and re-classifying $1 million from 27.5 years to a 7-year recovery period would provide $260,000 of present value tax benefits.

Today most residential appliances, kitchen cabinets, carpeting, millwork, signage, telecommunications systems, etc. can qualify for a 7 or 5-year recovery period.

American Jobs Creation Act 2004: Over the years, the federal government has tweaked the code to stimulate economic activity. For instance, under the American Jobs Creation Act of 2004 (AJCA), qualified leasehold improvements are depreciated over 15 years instead of 39. This provision will sunset by 12/31/06. Hence . . . don't miss out.

For example, a taxpayer who paid for the improvements can receive a significant tax benefit from using accelerated depreciation. For example, let's suppose that there is 50,000 s/f of tenant improvement work constructed at a cost (both direct and indirect) of $35 per s/f for $1.75 million. Using the previous 39 year recovery period, this would provide a present value tax benefit of $140,000 over 10 years using a combined federal, and state tax rate of 43%. However, with the new AJCA rules in effect, the present value tax benefit would be $358,000, or an impressive increase of $218,000 in after tax cash flow.

The key to leveraging the benefit of the AJCA is that the property must meet the criterion of qualified leasehold improvement(s). Qualified leasehold improvement property is any improvement to an interior portion of nonresidential real property if the following requirements are satisfied:

The improvement is made under or pursuant to a lease by the lessee, sublessee, or lessor (a commitment to enter into a lease is treated as a lease for this purpose). The lease is not between related persons; the building (or portion that the improvement is made to) is occupied by the lessee or sublessee; the improvement is section 1250 property (i.e. structural component); and the improvement is placed into service more than 3 years after the date that the building was first placed into service (Code Sec. 168 (k)(3); Temporary Reg. 1.168(k)-1T(c)).

What Does a Study Entail?

Cost segregation studies apportion the costs (both direct and indirect) of specific components of the building and 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.

IRS Supports Cost Segregation

Cost segregation has IRS backing and support. Recent IRS and Tax Court rulings get even better. The IRS also permits the taxpayer to receive "catch-up" depreciation, a tax "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. This "catch-up" depreciation can be taken within a single tax year. Depending on when the property was acquired, this single year tax benefit could be a windfall. Re-filing the tax returns is not required, just the submittal of IRS Form 3115 requesting a change in accounting procedures.

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?

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