

# Real Estate Journal

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## CSS, an IRS approved process to reduce taxes

**md** Mark de Stefanis



Construction  
Cost  
Recover, Inc.

While many have closed the books on 2005, savvy real estate owners can still generate additional returns through the use of Cost Segregation. A Cost Segregation Study (CSS), commonly referred to as Cost Seg Study, the CSS is an IRS-approved process that can reduce taxes and increase cash flow and can be applied on a retroactive basis or for recently acquired assets.

Here's how it works: All costs associated with the acquisition or construction of a building are scrutinized. Those costs are classified as real or personal property. Certain elements

of improved real and personal property are then depreciated on an accelerated basis. The outcome of this process is often tax savings totaling in the hundreds of thousands of dollars. If you think that's good news, consider this: the increase in annual after-tax cash flow through accelerated depreciation can be retroactively applied to your portfolio of assets all the way back to 1987. The key to success is an engineering-based approach that includes multiple disciplines for maximum results. The IRS specifically identifies the appropriate CSS techniques through their field service guides and audit procedure manual as a construction based approach that requires the knowledge of an engineer, architect, or other construction professional in conjunction with iden-

tify specific improvements. The construction professionals' position must be complemented by a professional with knowledge of the tax system to ensure that the correct categorizing of the improvements is complete. In short, the IRC looks to how buildings are constructed in their determination of whether an item is either real or personal property. Understanding accelerated depreciation: You probably know that real estate improvements are typically depreciated using a straight-line method that runs over a 27.5-year period for residential properties and a 39-year period for non-residential properties. What you may not know is that the tax code, in conjunction with relative procedures and rulings allow certain tangible building components and improvements,

as well as a wide range of site work costs, to be depreciated over a much shorter period – 15, seven, or even five years. That's where the CSS comes in. The CSS is a strategic weapon in the real estate owner's tax saving arsenal because it identifies these shorter-lived assets. Instead of lumping improvement costs into the total price of the facility and depreciating the sum over a period of two or more decades, these costs are reclassified into a shorter depreciation schedule. When you compare a five, seven or 15-year depreciation cycle to a 27.5 or 39-year depreciation cycle, the potential near-term cash flow increases are evident. Land improvements classified under Revenue Procedure 87-56 are just one example. Improvements like paving, lighting, curbs and storm

water drainage are considered 15-year property. The Net Present Value (NPV) of reallocating these costs and accelerating the depreciation of these elements alone can be significant. Realizing the potential cost savings: How significant? Of course, the actual amount of the real savings and financial benefits vary. The type of property, its age and specific construction components are key considerations. That said, most facilities can derive some benefit. On average, real estate owners can increase an after tax IRR by 100 basis points or as much as 350 basis points on a cash-on-cash basis. Now that's big in a market of low cap rates! Let's say you purchased a property for \$3 million and reclassified 20% of the improvements from standard long-term categories to shorter-lived categories, the financial benefits would be substantial. In the first year alone, the CSS would increase the after tax cash flow by more than \$19,000 using a 43% effective tax rate.

This is more than double the fee for the actual study. Over a full term hold, the additional cash flow is in excess of \$89,000.

Furthermore, during due diligence it is not uncommon for the buyer to obtain a building inspection in accordance with the ASTM

E 2018-01 entitled Standard Guide for Property Condition Assessments (PCA). This report format is typical for lender and owner requirements and identifies various building systems, their construction, configuration, functional obsolescence and deferred maintenance. The information gathered by the building inspector can be used to support the findings outlined within a CSS, (Cost Segregation Study). By utilizing a firm that is qualified to a complete both a CSS and a PCA will translate into additional cost savings to the owner.

Prime CSS properties : Property owners could expect an average of 15 to 30 percent of project-related costs to be reclassified into shorter-lived categories. The more specific function-dedicated a property is, the greater the potential benefit. Manufacturing facilities, hotels and resorts, and corporate headquarters, as well as high-end tenant improvements, are CSS candidates. Properties with extensive site preparation work and personal property, such as big-box retailers, warehousing and distribution centers, self-storage facilities, and multifamily buildings are also excellent CSS candidates.

A CSS can even help jus-

tify a lower property valuation basis for real estate owners looking to reduce tax burdens. When a CSS is completed before the closing date, the purchaser has the opportunity to apportion the purchase price between real and personal property. That ensures the right amount of real property is allocated to its appropriate tax role. Often, these savings alone can pay for the cost of preparing a study.

Did you construct, acquire, renovate, or improve your property after 1986? Is it currently under construction? Or is it in the property planning stage? Have you owned or do you expect to own the property for at least four years? Does the property have positive EBT? Or could increased depreciation deductions reduce current tax liabilities?

Is the value of the property at least \$1 million? If you answered "yes" to these questions, then a CSS will undoubtedly save you money. An engineering-based approach depending on a review of contractor and sub-contractor payment requisitions to identify reclassification opportunities is not enough to satisfy IRS scrutiny. The IRS requires an engineering-based approach. That means a convergence of professional skills, includ-

ing engineering, architectural, program management, accounting and tax law.

Successful CSS preparation requires a detailed analysis of the direct and indirect construction, improvement and renovation costs, followed by an examination of available drawings and specifications. CSS preparation also entails a physical inspection to observe and identify component utilization. A comprehensive CSS mandates an expert understanding of specific building, mechanical and electrical systems, and the processes characteristic of certain type of assets. Finally, successful CSS preparation demands detailed knowledge of the tax code as it applies to the cost segregation process. Gaining the maximum financial benefits from CSS – and passing muster with government auditors – means working with a firm that has experience navigating the labyrinth of rules, regulations and opportunities presented by accelerated depreciation strategies. The bottom line is cost savings that go far beyond the investment in the study.

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**Mark de Stefanis is the President of Construction Cost Recovery, Inc. New York, N.Y.**

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