



nerenj

Building owners save in taxes with IRS depreciation study

December 11, 2008 - Financial Digest

New England commercial real estate owners take note! Cost segregation studies are becoming one of the hottest tax planning strategies in commercial real estate. The study offers a tremendous opportunity to increase cash flow and defer tax payments until later years.

A Cost Segregation Study (CSS) is an engineering based study that allows a commercial building owner to accelerate a substantial amount of the depreciation deductions on a building by identifying construction or acquisition costs that can be allocated to a shorter recovery period. The basic idea is to move costs that would ordinarily be depreciated over 27.5 to 39 years to being depreciated over 5 to 7 years using the IRS approved, engineering based study as proof that the cost should be depreciated over a shorter life.

Let's look at some situations where this study is appropriate and some local examples of how commercial building owners in N.E. have benefited from such as study.

Initial Construction

Generally speaking, this is the easiest type of study to perform because the engineers get involved right from the beginning and have access to the architectural drawings and building invoices. For example, a 4 story Boston office building completed at a total construction cost of \$9.6 million. Without the help of an expert CPA and engineer, the building owner would be depreciating the \$9.6 million of cost over 39 years. With a cost segregation study, the engineers come in and examine all the construction invoices and design documents. The engineers do an on-site study where they identify, measure, quantify and photograph the existence of all the assets within the building that qualify for accelerated depreciation.

End Result: By performing the study, the engineers were able to allocate \$1.95 million or 20% of the assets to shorter recovery periods and save the property owner over \$427,000 in taxes calculated using the net present value method.

Property Acquisition

The CSS can also be performed when a commercial property owner acquires a property. Generally speaking, there are two types of these studies:

- *Studies that are performed around the period of acquisition

- *Studies that are performed after acquisition even if the acquisition or construction was several years ago (called a "look-back" study)

For example, a local regional mall located in suburban N.E. was purchased by a real estate investment company. The 2 story mall was purchased for \$25.6 million. Without a cost segregation study, the acquisition cost would be depreciated over 39 years. Upon acquiring the property, the

new owners had an engineering based CSS performed. Using whatever initial construction data that was available from the prior owner and by performing a detailed on-site evaluation and identification process that included photographing all the assets, the engineers were able to determine which assets were eligible for accelerated depreciation.

End Result: A total of \$9.8 million of assets (38% of the total cost) was determined to qualify for either 5 year or 15 year depreciation resulting in a net present value tax savings of \$1.5 million over the first 10 years of the property ownership and \$250,000 of tax savings in the first year.

When performing a "look-back" study, often none of the construction information is available. A look-back study typically relies on the engineer's on-site evaluation and identification of qualified assets.

However, a property owner doing a "look-back" study can often receive a terrific amount of tax savings in the first year because according to Internal Revenue Code Section 418(a), the property owner is allowed to make an adjustment to catch up on depreciation. The catch up is equal to the difference between what was depreciated and what could have been depreciation had a Cost Segregation Study been performed on day one. Let's look at an example:

A small suburban New England office building was purchased by its owners in 2000 at a cost of \$10 million. At this time, the owner's accountant began depreciating the property over 39 years. The CSS was performed in 2005. The study identified \$800,000 of assets that could be reallocated to a 5 year recovery period.

End Result: In 2005, the property owner was allowed a catch up of more than \$680,000 of depreciation which resulted in a \$238,000 tax savings under Internal Revenue Code Section 481(a).

Additional Applications

What types of properties can benefit from a CSS? N.E. examples include office buildings, shopping malls, strip shopping centers, apartment buildings, large leasehold fit-outs, auto dealerships, free standing out parcel buildings used for large retail stores or chain fast food restaurants, hotels and resorts, distribution warehouses, manufacturing facilities and industrial buildings. Any commercial property owner looking to reduce their tax burden should consider this powerful strategy.

Ted Lanzaro, CPA, runs Lanzaro CPA, LLC, Shelton, Conn.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540