How Cost Segregation Offers Substantial Tax Benefits to Real Estate Owners & Investors in Real Estate

by David Grant

With the advent of the Internal Revenue Code of 1986, real estate owners and investors have been searching for ways to increase the tax benefits from owning or investing in real estate. A Cost Segregation Study will accelerate tax depreciation, yielding a current tax benefit. In general, the more elaborate and costly the property, the greater the tax benefit. Both commercial and residential property can reap the benefits of a Cost Segregation Study. If learning how to reduce taxes is of interest to you, this may be the most important article you have read in a long time.

FOUR FUNDAMENTAL QUESTIONS

- Can you or someone you know benefit from accelerating tax depreciation on their real estate holdings? (*i.e.* will additional depreciation shelter current tax liabilities?)
- Have you or someone you know purchased, constructed, or expanded their real estate holdings any time after 1986?
- Is the cost of the building at least $1,000,000?
- Do you, your company, or your client expect to retain their real estate holding(s) for at least the next three or four years?

If you answered yes to these fundamental questions, then you, your company, or your client's company qualify for a unique asset reclassification strategy known as a Cost Segregation Study (CSS).

ABOUT THE AUTHOR

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Over the last few years, we have found that many individuals and companies that owned real estate were missing out on current income tax savings by underdepreciating their real estate assets. A CSS will accelerate tax depreciation deductions, enabling individuals and companies that own real estate to lower their current income tax liability, thereby increasing current cash flow.

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HOW MUCH CAN BE SAVED?

CSSs have generated millions of dollars in current federal and state income tax savings to owners of real estate. However, given the complicated nature of the study, it requires a tax expert with an intimate knowledge of the IRS code, the relevant tax cases, and a network of resources to maximize the benefits. To date, only a relatively small number of CPA firms provide this service to their real estate clients.

The amount of the benefits from performing a CSS will vary depending on a). the type of property; b). the cost of the property; and c). the year it was placed in service.

While certain properties get a bigger bang for the buck than others, we have found that almost every type of real estate can benefit to some degree from a CSS. This is due to the long-lived property categories of most real estate holdings, which contain at least some amount of shorter-lived personal property. By segregating the shorter-lived personal property from the long-lived property category, we can greatly accelerate depreciation deductions. The greater the depreciation deductions today, the greater the present tax savings. The greater the present tax savings the greater the present cash flow, which in turn can be used to underwrite current or future acquisitions.

Our experience in performing cost segregation studies for the real estate industry indicates that the savings can be as high as five percent of the asset cost. On a $5 million property, for example, a five percent benefit would generate $250,000 in tax savings. Savings of anywhere from $50,000 to $1 million, or more (depending on the type and size of facility) are routine.

WHAT TYPE OF PROPERTY BENEFITS THE MOST?

While almost every type of real estate can benefit from a CSS, our experience indicates that certain types of property yield the highest tax saving benefits from a CSS. Those properties include specialty-use buildings, such as medical facilities, manufacturing facilities, and high-end office buildings, to name a few. Warehouses and industrial properties tend to yield lower benefits, while residential garden apartments fall somewhere in the middle. We have found that even large tenant fit-outs can qualify for substantial benefits as well.

WHAT IS A COST SEGREGATION STUDY?

Almost anyone can identify and properly depreciate items such as office furniture and equipment over seven years for federal tax purposes. However, a high percentage of construction-related costs, sometimes as high as 40 percent, are too commonly lumped into the building component of the property and depreciated on a straight-line basis over 39 years. A CSS is the process of reviewing and identifying the costs a company incurs to acquire, construct, or expand its real estate holdings. It identifies the specific types of assets being placed in service and often leads to a cost allocation that assigns part of the cost to 15-year real property and seven- or five-year personal property. An analysis of costs can be conducted from either the detailed construction records - in the case where such records are available - or by using qualified appraisers, architects, or engineers to perform the cost allocation analysis. In both instances, a tax expert is also needed to identify the specific types of property that will qualify as shorter-lived assets.

HOW COST SEGREGATION WORKS

While personal property is usually depreciated over a five- to seven-year life, real property is typically depreciated over 39 years (commercial property) or 27.5 years (residential property). With a cost segregation study, owners of real estate can shelter large

sums of income now rather than later, by shifting certain property costs from a 39-year life to 15-year, seven-year and even a five-year life.

Construction-related soft costs have historically been lumped together as part of real property. However, by performing a cost segregation study, these soft costs can be allocated to various components of the property, many of which have shorter depreciable lives than the real property component. The result is a faster write-off of costs previously included as real property.

Cost segregation studies can be performed on purchased facilities as well as newly constructed facilities, not to mention major renovation of existing facilities. Studies can be performed for real estate holdings placed in service as far back as 1987, even if the year is "closed" for tax purposes. Recently issued IRS revenue procedures *(see IRS Revenue Procedure 99-49 described below)* permit companies that have claimed less than the allowable depreciation to claim the omitted amount over a four-year period on a going-forward basis. In addition, the segregated components continue to be depreciated over shorter lives going forward.

Savings derived from these studies flow directly to the bottom line in tax savings and cash flow.

IS THERE EXPOSURE TO A TAX AUDIT?

This is a question that we are asked quite frequently by individuals and other practitioners. Our experience indicates that a properly performed CSS does not create additional exposure to a tax audit. Depreciation is not a high priority area with the IRS. The benefits of a CSS come from the acceleration of tax deductions, not taking a tax deduction for something the taxpayer is not already entitled to. If the property is held for its entire depreciable life, the IRS will get all that it is entitled to. The benefit from a CSS comes from the time value of money generated by current tax savings that may eventually be paid back, albeit, 20 or so years later.

CSS AS AN ESTATE PLANNING TOOL

When property changes hands through an estate, the tax basis of the property will generally step-up (usually increase) to fair market value. This stepped-up basis begins a new depreciable life for the property. The property could have been 50 years old and fully depreciated prior to the death, however, the stepped-up basis now can be depreciated based on its fair market value. This is an ideal time for a cost segregation study.

HCA CASE LIGHTS THE WAY

The *Hospital Corporation of America* (HCA) case, concluded in 1997, constituted a major win for tax payers and owners of real estate. In this case, the court concluded that property qualifying as tangible personal property under former investment tax credit (ITC) rules would also qualify in the same manner for purposes of tax depreciation. Thus, we can look to the guidance under the former ITC rules when determining whether property is depreciated as real property (*i.e.*, 39-year recovery period) or personal property (*i.e.*, generally a five-year or seven-year recovery period).

In the HCA case, the taxpayer argued that several disputed items associated with facilities it built in the 1980s constituted tangible personal property (see definition below) that should be depreciated over a five-year recovery period (based on the applicable business asset guideline class appropriate for the taxpayer's business). The IRS countered that allowing these items to be depreciated over a different recovery period than the buildings to which they related, amounted to component depreciation (which was outlawed in 1986). The IRS also argued that the items in question were structural components of the buildings in which they were housed *(see definitions below)*. Furthermore, the IRS suggested to the court that the old ITC cases that predate the adoption of current depreciation methods in the 1980s, were of limited usefulness in determining what constitutes a structural component.

The court concluded that items such as kitchen hoods and exhaust systems and wiring for telephone and communications systems, to name a few, were tangible personal property rather than structural components of the building because the items were related to furnishing medical services rather than providing building services. We would expect that similar logic should apply to other industries and activities, particularly where a part of a building's features are for the specific use of the company's business operations.

DEFINITIONS

Tangible Personal Property — Under § 1.48-1(c), is defined as, "any tangible property *except* land and improvements thereto, such as buildings and other *inherently permanent* structures (including items which are *structural components* of such buildings or structures)."

Inherently Permanent — In *Whiteco Indus., Inc. vs. Commissioner*, T.C. (1975), the following factors

were considered in resolving whether property is inherently permanent and, thus, not tangible personal property:

1. Is the property capable of being moved, and has it in fact been moved?
2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances that tend to show the expected or intended length of affixation; *i.e.*, are there circumstances that show that the property may or will have to be moved?
4. How substantial a job is removal of the property and how time-consuming is it? Is it "readily removable?"
5. How much damage will the property sustain upon its removal?
6. What is the manner of affixation of the property to the land?

Additional Factors to be Considered:

Movability itself is not the controlling factor in deciding whether the property lacks permanence.

The fact that an item is not readily reusable in another location is evidence supporting the conclusion that it is to be treated as permanent in its present location.

Structural Components — § 1.48-1(e)(2), Income Tax Regs., explains the meaning of "structural components" by way of example, rather than by definition, as follows:

> The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings thereof such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery, the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs.

The opportunity for individuals and companies that own or have investments in sizable real estate portfolios to realize significant financial benefits through cost segregation is substantial, as are the savings. With tax laws and interpretations continually changing, the time to act is now.

Accordingly, an item constitutes a structural component of a building if the item relates to the operation and maintenance of the building. Sec. 1.48-1(e)(2), Income Tax Regs. The "sole justification" test set forth in section 1.48-1(e) (1), Income Tax Regs., excludes from the term "structural component" only machinery that is required to meet the temperature and humidity requirements of other machinery.

IRS Revenue Procedure (Rev. Proc.) 99-49 — Rev. Proc. 99-49 describes the requirements and procedures for a taxpayer to obtain an automatic consent to change methods of accounting. This Rev. Proc. allows taxpayers to retroactively change their method of accounting for depreciation and catch up the difference over a four-year period.

The Rev. Proc. describes the change as follows:

> "(a) This change applies to a taxpayer that wants to change from an impermissible method of accounting for depreciation or amortization under which the taxpayer did not claim the depreciation allowable, to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable.
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> (b) A change from a taxpayer's impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable is a change in method of accounting for which the consent of the Commissioner is required."

The Rev. Proc. also describes in detail the requirements and conditions needed to take advantage of this provision in the law. A competent tax accountant will need to follow the strict IRS requirements to effectuate the change in accounting.

EXAMPLES OF COST SEGREGATION

These case studies further illustrate the tax savings benefits of cost segregation:

- A company constructed a $11 million office building in 1988. During the first 10 years of operations, depreciation expense was originally calculated as $3,300,000. As a result of a cost segregation study performed in 1998, the company was able to increase its depreciation expense by over $1,600,000 during the next four years. This resulted in discounted present value tax savings and additional cash flow of more than $340,000 to the company.

- A $6,000,000 warehouse facility was put into service in 1997. As originally calculated, depreciation expense during the first four years of operations was approximately $650,000. After a cost segregation study was performed in 1999, the company was able to increase its depreciation expense during the same four-year period by $225,000. This resulted in tax savings and additional cash flow of over $100,000.

- A $8,500,000 nursing home was constructed in 1987. As originally calculated, depreciation expense during the first 11 years of operations was approximately $2,600,000. After a cost segregation study was performed in 1998, the company was able to deduct an additional $1,600,000 of depreciation spread over the next four years. This resulted in tax savings and additional cash flow of over $500,000 during the four-year period.

- An office building complex costing $48,000,000 was acquired in 1995. The owner made tenant improvements of $2 million to the facility over the ensuing two years. As originally calculated, the depreciation expense from 1998 through 2001 was $5,050,000. A cost segregation study that identified improvements such as millwork, wall coverings, kitchen plumbing, telecommunications wiring, and supplemental air conditioning, to name a few, increased depreciation expense during that four-year period by $2,300,000. This led to tax savings and additional cash flow of over $700,000 to the owner.

CONCLUSION

The opportunity for individuals and companies that own or have investments in sizable real estate portfolios to realize significant financial benefits through cost segregation is substantial, as are the savings. With tax laws and interpretations continually changing, the time to act is now. REI