



COST SEGREGATION

Increase the financial performance of your hotel.

BY JEROME H. KOOTMAN

Unlike property owners in other industries, hotel owners are also responsible for all aspects of operating a business including day-to-day operations, purchasing, marketing, and most importantly finance. As hoteliers, you are well aware that your business will not be considered a success — unless, at the end of the year, you have covered all expenses and have a sufficient amount of income left over for your partners and yourself.

DEPRECIATION DEDUCTIONS

One way to ensure that your business is profitable is to closely scrutinize your depreciation deductions. As you know from your financial experience as property owners, increased depreciation will decrease your taxable income and thus lower your income taxes.

Wouldn't it be nice if there were a way to increase your depreciation deductions?

Hotel owners are discovering that cost segregation studies can provide just that — an increase in your depreciation deductions.

COST SEGREGATION STUDIES

Cost segregation studies are an engineering-based approach to identifying assets within a building that can be reclassified into a shorter depreciation class than the building itself. Real estate properties such as hotels (and everything inside hotels except movable furniture and equipment) are generally depreciated using a straight-line method over 39 years. A cost segregation study maximizes the inherent tax benefit of real estate by identifying, quantifying and segregating the personal property components of

the building, resulting in depreciable lives of five, seven and 15 years using accelerated depreciation.

BENEFITS OF COST SEGREGATION:

- Accelerates depreciation expense
- Reduces corporate or individual income taxes
- Increase cash flow and provides investors with additional cash to reinvest in new projects
- Provides quicker return on investment (ROI)

RECLASSIFICATION OF PERSONAL PROPERTY

Cost segregation is not simply a matter of classifying furniture or equipment into a five-year recovery period as most hotel owners and accountants already routinely do. There are many additional items for which costs are available or it is not obvious that they can be classified into a quicker recovery period. Items typically reclassified include certain flooring, finish millwork, cabinetry, specialty electrical and plumbing, and land improvements such as asphalt paving, concrete sidewalks, site lighting and underground utilities. The list is extensive.

Cost segregation studies are typically beneficial to almost all types of real estate, however hotels are especially well suited for these studies due to large amounts of personal property items in the rooms. Hotels that include restaurants, pools, conference rooms or banquet halls contain an even higher percentage of personal property, which can be depreciated quicker and result in even greater tax savings.

The cost segregation study does not create depreciation; rather it allows you to front load the depreciation and decreases your taxable income over the first 15 years of ownership. You can then use this monetary savings to invest in other properties or expand your business. Eventually your annual depreciation will be lower than if you had not performed this study, but that typically does not occur until 15 years later. Think of it as an interest free loan from the government.

The table below illustrates the financial benefits of performing a cost segregation study for a sample \$5 million hotel building and reclassifying 22 percent of the

Cost Segregation Study for a \$5 million hotel building, reclassifying 22 percent of the building basis to a shorter life.

Year	Depreciation Before	Depreciation After	Change In Depreciation
1	\$69,550	\$203,894	\$134,344
2	\$128,205	\$346,995	\$218,790
3	\$128,205	\$262,420	\$134,215
4	\$128,205	\$210,015	\$81,810
5	\$128,205	\$204,770	\$76,565
First 5 Years	\$582,370	\$1,228,094	\$645,724
Net Present Value Tax Savings (First 5 Years):			\$230,086
Net Present Value Tax Savings (First 15 Years):			\$239,978

building basis to a shorter life.

Next, consider the acquisition of the same hotel and the following first year cash flow scenario. Assume 55 rooms with a revenue per available room (RevPAR) of \$75, a down payment of \$1.5 million [30 percent] and a 30-year mortgage at 6.9 percent. (See chart on right.)

The return on investment for this acquisition jumps from 7.93 to 11.51 percent in the first year due to additional depreciation of \$134,344.

How do I know when a cost segregation study is appropriate?

A study is typically economically feasible for hotels with a building cost basis greater than \$1 million and should be considered by any taxpayer who has:

- Recently acquired property
- Recently started or completed a construction project
- Acquired property within the last 15 years that did not have a study performed
- Received property from an estate that will have the basis stepped up

Cost segregation professionals make it very simple for you to determine if a property is a candidate for a study. Based on a brief discussion with you and/or your accountant, the cost segregation professional will then provide you with a free projection of benefits and projected depreciation schedule so that you can see how it will affect your tax return. Typically, this is provided at no cost to you. The cost segregation professional must also commit to a professional fee, which is based on the time required to perform the study, so you can compare the cost/benefit of performing the study before committing to anything. The IRS does not permit a contingent fee.

Can I perform a study for a property I've owned for several years?

The best time for a study is when property is acquired or constructed, but it is also possible to obtain these benefits for properties that you have owned for up to 15 years.

Acquisition of the \$5 million hotel building and the first year cash flow scenario. Assume 55 rooms with a RevPAR of \$75, a down payment of \$1.5 million (30 percent) and a 30-year mortgage at 6.9 percent.

	Before Cost Segregation	After Cost Segregation
Revenues	\$1,506,000	\$1,506,000
Less: Operating Expenses	(\$1,054,000)	(\$1,054,000)
Net Operating Income	\$452,000	\$452,000
Less: Debt Service (P&I)	(\$276,000)	(\$276,000)
Pre-Tax Cash Flow	\$176,000	\$176,000
Less: Depreciation	(\$69,550)	(\$203,894)
Add Back: Principal Payment on Debt	\$36,200	\$36,200
Taxable Income	\$142,650	\$8,306
Pre-Tax Cash Flow	\$176,000	\$176,000
Less: Taxes (at 40 percent)	(\$57,060)	(\$3,322)
After Tax Cash Flow	\$118,940	\$172,678
Return on Investment	7.93 percent	11.51 percent

A retroactive study can be performed without the problems associated with amending prior year tax returns or IRS approval. You can claim the difference between the allowed depreciation and what you actually claimed in prior years all on your current tax return, meaning big tax savings for your business.

What does the IRS think about cost segregation?

All of this sounds great, so you may be wondering why you haven't heard about cost segregation studies before now. The reality is that many accountants are just beginning to learn about cost segregation. Fortune 500 companies have been performing these studies for many years and the studies are just now becoming cost effective for smaller businesses with lower cost-basis properties. Costs to perform studies have decreased as the industry matured and recent IRS pronouncements have clarified the procedures to implement the studies. As a result, the lodging industry and accounting professionals are quickly learning about and implementing these studies.

The IRS recently published a 115-page Cost Segregation Audit Techniques Guide, which was developed to provide their agents with a fundamental understanding of cost segregation. Why? Because

more and more business owners are using it and the IRS wants its agents to be familiar with it.

The IRS has a specific set of requirements as to who is qualified to perform a study. As long as the study is properly conducted and documented, it does not raise the risk of an audit.

Now is the time to increase the financial performance of your hotel. You owe it to yourself to explore the possibilities of a cost segregation study and find out how you can lower your taxes and increase your cash flow. **ALB**

Jerome H. Kootman, CPA, is managing tax director for Cost Recovery Solutions LLC, a specialized engineering firm that provides cost segregation services. He can be reached at 732-548-3855 or e-mail jerry@CRScostseg.com.