

# Depreciation deductions can help with cash flow

By Jerome H. Kootman

HWN CONTRIBUTOR

**C**ash flow is one of the most critical measures of a hotel's performance. The poor economic conditions and resulting decrease in occupancy rates have only exacerbated the need to properly manage cash flow.

One way to ensure you are doing everything possible is to closely scrutinize your depreciation deductions. Increased depreciation will decrease your taxable income and thus lower your income taxes. This will immediately impact your bottom line by reducing or eliminating quarterly tax payments, freeing up cash for payroll, renovations or other critical expenditures.

You may already be operating at a tax loss. Luckily, the IRS recently changed the regulations to allow net operating losses (NOLs) to be carried back up to five years. This means that if you paid taxes in the last five years and are now operating at a tax loss, you can claim a refund on your previous year's taxes. How do you create a bigger NOL to allow you to get your previously paid tax dollars back? The answer is cost segregation.

Cost segregation studies are an engineering-based approach to identifying assets within a building that can be reclassified into a much shorter depreciation class than the building itself. Real estate properties such as hotels (and everything in them 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 your hotel by quantifying the personal property components of the building, resulting in depreciable lives of 5, 7 and 15 years using accelerated depreciation.

Benefits of cost segregation include:

- accelerates depreciation expense
- reduces corporate or individual income taxes
- increases cash flow and provides investors with additional cash to reinvest in new projects
- provides quicker return on investment

This is not simply a matter of classifying furniture or equipment to a 5-year recovery period as most hotel owners and accountants already routinely do. Items typically reclassified include specialty electrical and plumbing, certain flooring, finish millwork, cabinetry and land improvements such as asphalt paving, concrete sidewalks, site lighting and underground utilities.

Cost segregation studies are typically beneficial to almost all types of real estate, however, hotels are especially well suited for them due to the large amount 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 that can be depreciated quicker and result in even greater savings.

The following table illustrates the financial benefits of performing a cost segregation study for a sample \$5 million hotel building and reclassifying 22 percent of the 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 of \$75, a down payment of \$1.5 million

## \$5 million hotel with 22 percent reclassification

Year	Depreciation before	Depreciation after	Change in depreciation
1	\$69,550	\$199,249	\$129,699
2	\$128,200	\$339,496	\$211,296
3	\$128,200	\$257,946	\$129,746
4	\$128,200	\$207,616	\$79,416
5	\$128,200	\$203,766	\$75,566
<b>First 5 years:</b>	<b>\$582,350</b>	<b>\$1,208,073</b>	<b>\$625,723</b>
<b>Net present value tax savings (First 5 Years):</b>			<b>\$215,488</b>
<b>Net present value tax savings (first 15 years):</b>			<b>\$228,590</b>

[30 percent] and a 25-year mortgage at 6.3 percent.

The return on investment for this acquisition jumps from 7.21 percent to 10.67 percent in the first year, due to additional depreciation of \$129,699.

## 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

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. A retroactive study can be performed without the problems associated with amending prior year tax returns or IRS approval.

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## First year cash flow scenario

	Before cost segregation	After cost segregation
Revenue	\$ 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)	(278,000)	(278,000)
Pre-Tax cash flow	174,000	174,000
Less: depreciation	(69,550)	(199,249)
Add back: principal payment on debt	60,000	60,000
Taxable income	164,450	34,751
Pre-tax cash flow	174,000	174,000
Less: taxes (@40%)	(65,780)	(13,900)
<b>After tax cash flow</b>	<b>\$108,220</b>	<b>\$ 160,100</b>
<b>Return on investment</b>	<b>7.21%</b>	<b>10.67%</b>

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## Are you pricing effectively?


By Glenn Withiam

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**A**fter a long, consistent effort, the hotel industry finally gained some control over its rates in the last few years. Then the economy took its current nosedive, and pricing has become a challenge again. At the beginning of this recession, according to Smith Travel Research, the industry held on and resisted cutting prices. More recently, STR reports that prices in many markets have essentially crumbled as hotels attempt to woo a reduced number of travelers. In that regard, it's no secret that posting prices thither and yon on websites doesn't help matters. Your guests and also your competitors quickly know what you're currently charging, and the aggressive competitors will respond in kind.

To make matters worse, there's no real indication of an early recovery in the economy. We can only hope the green shoots that some analysts have seen are not simply more weeds growing. In its market forecast, PKF Consulting foresees a potential growth in real revenue per available room beginning in 2011. PKF also points out each market will recover at its own speed and in its own time. Some markets are not suffering as much as others.

With this dismal background, you may think I'm insane or insensitive to suggest being careful with rates. I've never had the responsibility of setting hotel rates, and I do not envy those who must do so. But I can share the results of a study recently released by a research team based at Cornell's School of Hotel Administration. The researchers, Cornell Professors Cathy Enz and Linda Canina, along with the president of STR, Mark Lomanno, analyzed the RevPAR effects of setting your



prices either below those of your competitors or above competitors. You can read this research study for yourself at no charge from the Center for Hospitality Research ([chr.cornell.edu](http://chr.cornell.edu)). The study, "Competitive Pricing in Uncertain Times," is an extension of earlier research on this topic.

This study is not a discussion of discounting. Instead, it compares hotels and their competitive sets with regard to rate, occupancy and RevPAR. The study ran for seven years, from the last recession in 2001 through 2003 and then during the fizzy economy of 2004 through 2007. It turned out that the economic background made no difference. Hotels that kept their rates below those of their close competitors made comparatively less money even though their occupancy was greater than that of their competitors. The opposite was true also. Hotels that maintained their prices even just a few percentage points above those of competitors saw lower occupancy than those competitors did but had a greater RevPAR.

None of this means a hotel shouldn't use its revenue management system by adjusting rates as needed. The point is to understand the results of a strategy of maintaining room rates lower than those of your competitors (or a price higher than that of your competitors). This is a matter of positioning, not one of discounting. Having said that, there's no question it's difficult to hold out for a price position above that of your competition and watch customers go elsewhere. At the same time, we know hotel guests build expectations about your future prices based on your current prices. If the economic recovery is as slow as some observers forecast, it may require another long, drawn-out effort to bring rates up once they are down.

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