Significant Savings

By Jerome H. Kootman

Cost segregation can increase cash flow and return on investment by maximizing the inherent tax benefit in a real estate asset, whether old or new, acquired or developed.

Commercial property owners are always looking for a way to increase cash flow and return on investment with their properties. Many think they are maximizing the financial levers that allow them to improve these parameters. Unfortunately, they often fail to consider the dramatic impact depreciation can have on their taxable income because their accountants typically handle this area.

In fact, many commercial property owners may be leaving significant savings on the table because they are not claiming the maximum allowable depreciation deduction when they and their accountants overlook the benefits of cost segregation studies. Thus, they should periodically review their depreciation schedules or consult with a specialist in this area.

Real estate assets (and everything in them) are generally depreciated using a straight-line method over 39 years (27.5 years for residential properties), whereas many components are in reality eligible to be depreciated over five, seven or 15 years. Specialized engineering firms that focus on cost segregation—with a blend of tax, engineering and construction knowledge—can typically reclassify between 15 and 40 percent of a building to these shorter recovery periods. By maximizing the relative value of these shorter recovery periods, an owner can front-load depreciation deductions and take advantage of them now.

"Many commercial property owners may be leaving significant savings on the table because they are not claiming the maximum allowable depreciation deduction."

Let's consider a typical office building and assume we can reclassify 19 percent of the building basis to a shorter recovery period. The following table illustrates the first-year depreciation and potential tax savings for a sample $5 million office building before and after a cost segregation study:

	Total Cost (Excluding Land)	Percent Reclassified	First Year Depreciation	Tax Savings
Before Cost Segregation	$5,000,000	N/A	$64,000	
After Cost Segregation	$5,000,000	19%	$193,000	
Increase			**$129,000**	
First Year Tax Savings (@35%)				$45,150
Total NPV Tax Savings (@35%)				$215,000

This is not simply a matter of classifying computer equipment or office furniture in a five- or seven-year recovery period. Items typically reclassified include certain flooring, finish millwork, specialty electrical and plumbing systems, and land improvements like asphalt paving, site lighting and underground utilities. The list is extensive.

Cost segregation is an engineering-based approach to identifying assets within a building that can be reclassified into a much shorter depreciation class than the building itself. The cost segregation specialist maximizes the inherent tax benefit by identifying, classifying and segregating the personal property components of the building—resulting in depreciable lives of five, seven and 15 years—using accelerated depreciation.

The good news is that the Internal Revenue Service is taking special pains to accommodate this opportunity. It recently published a 115-page *Cost Segregation Audit Techniques Guide* to provide its agents with a fundamental understanding of cost segregation. It does specify that "an underlying assumption is that the study is performed by 'qualified' individuals or firms, such as those employing personnel competent in design, construction, auditing and estimating procedures relating to building construction." For this reason, property owners should align themselves with a cost segregation firm to maximize their tax savings.

That specialist will examine architectural and engineering drawings for potential asset reclassification. They must perform a physical inspection and will examine cost data—including the contractor's application for payments, change orders, owner-incurred costs and disbursements—when available. Direct labor, material components and indirect costs are allocated based on analysis of drawings and specifications.

These studies are commonly performed for new construction or recent acquisitions, but they can also be applied retroactively to properties that have been in an owner's portfolio for the past 15 years. For older or acquired properties, cost segregation specialists can use construction cost estimating expertise to overcome the lack of available information.

Retroactive studies on properties owned for some time allow the owner to claim the difference between the allowed depreciation and what was actually claimed in prior years, all on their current tax return, providing a potential depreciation windfall. Better still, the IRS permits a retroactive study without the problems associated with amending prior-year tax returns or obtaining IRS approval. The only things required are a supportable study and the preparation of Form 3115, "Application for Change in Accounting Method," filed with the current tax return.

The benefits work equally well for REITs and tenant-in-common properties, with the tax savings and increased rate of return usually factored into models for promoting these investments. To determine if a cost segregation study is appropriate for your portfolio, ask yourself: Is the cost of any of my buildings (land excluded) at least $1 million? Have I purchased, constructed or renovated any property in the past 15 years? Do I plan on retaining these properties for at least the next few years? Do I have net income that is currently taxed?

If you can answer "yes" to these questions, then you should pursue cost segregation. It will increase both your cash flow and your return on investment.

Jerome H. Kootman is managing tax director for Cost Recovery Solutions L.L.C., a specialized engineering firm that provides cost segregation services. Visit the company at www.crscostseg.com.

Advertiser Index

COMPANY	PAGE	URL	TELEPHONE
Duke Realty Corp.	5	www.dukerealty.com	800-875-3366
Buchanan Street Partners	12	www.buchananstreet.com	800-675-1900
CoreNet Global	11	www.corenetglobal.org	800-726-8111
CoStar Group Inc.	9	www.costar.com/mlsproperty	[illegible]
DP Partners	19	www.partnerwithdp.com	800-470-0042
For 1031 L.L.C.	28	www.for1031.com	800-787-1031
GE Real Estate	2	www.gerealestate.com	888-GE-FIRST
Grubb & Ellis Co.	21	[illegible]	800-968-1599
GVA Advantis	23, 35	www.gvaadvantis.com	888-757-4744
Holliday Fenoglio Fowler L.P.	22	www.hfflp.com	713-852-3500
Hotel Investment Conference	27	www.hotelinvestmentconference.com	404-355-0880
J.J. Melody & Co.	33	www.jjmelody.com	713-787-1900
Panattoni Development Co.	13	www.panattoni.com	916-381-1561
SCI Real Estate Investments	18	www.sciacquisitions.com	877-724-1031
Starwood Capital Group L.L.C.	6-7	www.starwoodcapital.com	203-422-7731
U.S. Realty Advisors L.L.C.	24	www.usrealtyadvisors.com	212-581-4540
Yardi Systems Inc.	back cover	www.yardi.com	800-866-1144