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Is There a Pot of Gold Hidden in Your Walls?

by Ralph Consola, Principal

What would you say if someone offered you a dollar in exchange for a dime? You'd probably say it sounds too good to be true. What if your accountant said he had a service that would return $1 in tax savings for every 10 cents you spent on the service? It probably also sounds too good to be true, but it is true.

Cost Segregation

The service is called cost segregation and it can result in significant IRS-recognized tax savings for building owners. Cost segregation is a method for business owners to **retain cash and decrease dividend payout** requirements to real estate investment trusts (REITs).

Accountants have traditionally limited their assignment of short-term depreciation of building components for Federal Income Tax purposes to 3% to 5% of building costs found in the cabinets, carpets, phone systems, etc. Depending on the building's features and usage, cost segregation studies can often identify anywhere from 10% to 50% or more of a building's costs for short-term depreciation. This results in a reduction of taxes owed during the first four to eight years of building ownership. These savings drop right to your bottom line as cash!

Is there more than one power outlet in the offices? Is there a unique reception desk in the building? Have you supplied a kitchen for the tenants? How is the decorative paneling attached to the walls? How much was spent on decorative lighting in and around the building? Is there dedicated or increased cooling provided to accommodate data processing? Have you provided a redundant air system to support a clean room or kitchen? These are just a few of the items that cost segregation specialist may identify to improve the cash position of building owners.

Cost segregation studies should be initiated as early in the construction or acquisition process as possible to obtain maximum savings. Usually, if allowed just ten minutes with the architect before the building is designed, a cost segregation specialist can describe how to make a larger percentage of the building's components qualify for short-term depreciation, thereby increasing the tax savings to the building owner. Building components usually have a higher invoiced cost than can be substantiated from IRS-recognized cost estimating guides. With proof of the true costs, a cost segregation specialist can record the higher value in their report. If granted early access to the construction chief, a cost segregation specialist will usually request that costs for a short list of items be set aside for their documentation.

Performing a cost segregation study before the acquisition of a building allows for the identification of personal property from the building costs. The two costs can then be broken out in the sales agreement and the real property transfer tax basis can be reduced.

The IRS demands that cost segregation reports list the specifications of every component selected for accelerated depreciation. Cost segregation analyses on properties where building plans and cost documents do not exist can therefore only be performed by someone with construction or engineering experience. This experience provides these specialists with the knowledge to determine, without physically digging to get at them, the size, length, capacity, and other properties of the pipe, wiring, bracing, concrete, and other building components located underground, in the walls, in the ceiling and in the flooring.

And don't forget to consider the cash made available by one of these studies when analyzing how to finance an acquisition. Consider the following scenario: A 20-year loan for 75% of a $10 million value at an interest rate of 7.5% will require a monthly payment of $80,500. Although every situation is different, typical savings from a cost segregation study on most $10 million commercial and multifamily properties is at least $82,000 the first year. That means in the first year alone you have saved enough in taxes to make one mortgage payment, with additional savings available in future years.

Are you planning on leasing your building to others? Provide a construction allowance for tenant buildouts, charge more for the improved space, and depreciate the improvements yourself. Tenant improvements are where the bulk of cost segregation savings are found.

Cost segregation studies often produce results for properties that have been depreciating for as many as ten years. Using the results from the cost segregation analysis, your accountant can calculate what you should have paid in taxes had you depreciated the building using cost segregation, subtract what you already paid using straight-line depreciation, and come up with the amount overpaid. The IRS will return your overpayment in four equal payments over the next four years.

Once the cost segregation study is complete, the results are usually reorganized into two other useful reports: Asset Management, a fixed asset and deferred tax liability report prepared to make life easy for your accountant, and Property Tax. There are expenses in nearly every construction job that do not make the building more valuable, such as overtime incurred to get the building open on time, repair work, changed orders due to plan changes, and replanting trees from their original place to another location on the lot. Such expenses should not be included in your property tax basis. Proper documentation from the builder will allow the cost segregation specialist to track these costs.

A good cost segregation study will not trigger an IRS audit. Having said that, make sure your cost segregation specialist can and will defend his or her position to the IRS for three to five years after the analysis has been performed. A good cost segregation analysis is based on well-founded interpretations of the Internal Revenue Code Sections, applicable court cases, and revenue rulings.

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