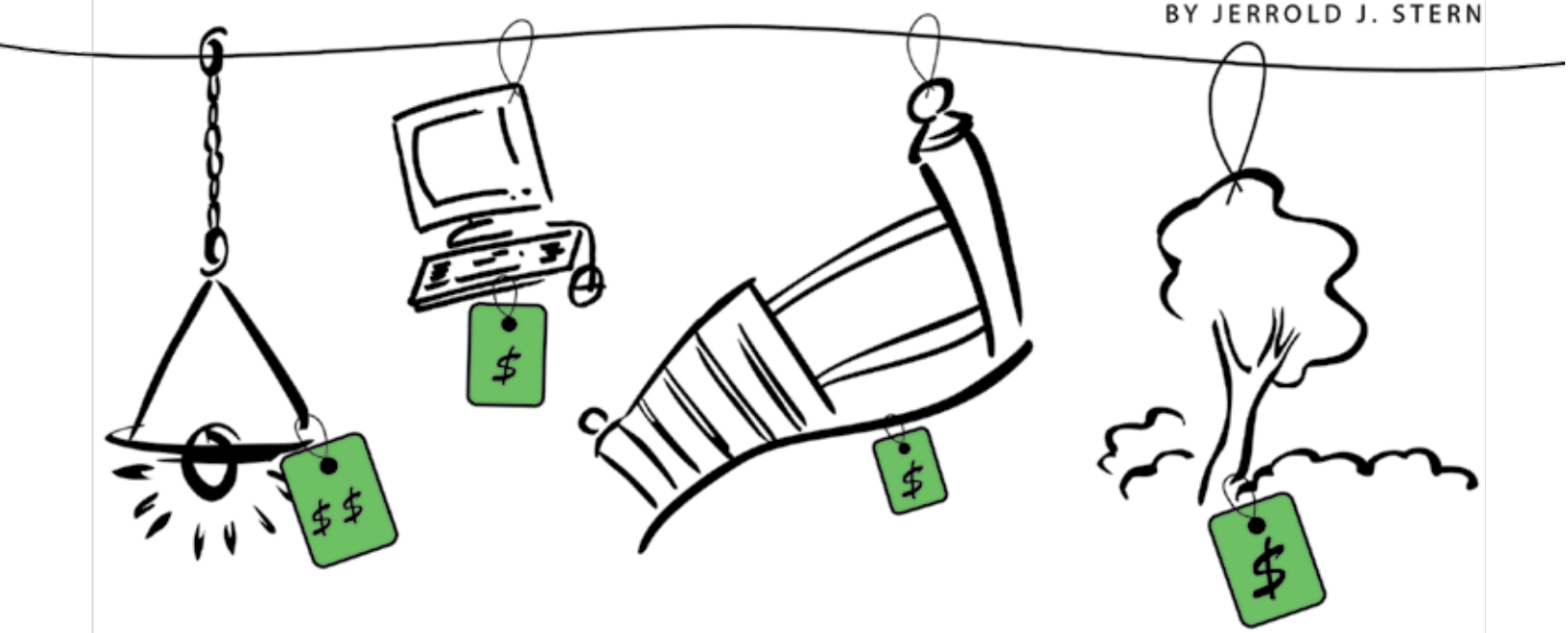
COST SEGREGATION YIELDS CASH FLOW

BY JERROLD J. STERN



Cost segregation techniques allow tax savings from depreciation deductions to be received earlier during a property's holding period. Early tax savings are valuable because of the time value of money.

Even better, cost segregation (cost seg) can provide a large immediate cash flow for currently owned properties acquired in prior years. Recent changes in the tax law and cost seg techniques make this immediate benefit possible.

Cost seg is an effective tool that real estate professionals can use to add value and cut costs for clients. The value (present value benefit) of cost seg can make a previously uneconomical investment in a new property viable by increasing its after-tax rate of return. Also, licensees can contact clients who purchased properties in the past to inform them of the immediate cash flow benefits from cost seg. That cash flow could enable the client to put a down payment on a new property.

Conceptual Example

Assume a retail shopping center is purchased for $3.9 million, exclusive of land (Table 1). Tax law allows the buildings to be depreciated over 39 years using straight-line depreciation ($3.9 million/39 years = $100,000 depreciation per year).

A firm specializing in cost seg is hired to prepare an analysis. The firm employs engineers and other experts to identify assets contained in the retail center that may be written off over periods much shorter than 39 years, such as fixtures,

built-ins, electrical, plumbing and land improvements. The analysis assumes that approximately 15 percent of the $3.9 million cost ($600,000) can be written off in five years, and approximately 13 percent ($500,000) can be written off in 15 years, leaving the balance of $2.8 million to be depreciated over 39 years.

The owner/investor is assumed to have a 35 percent marginal tax rate (the top federal corporate tax rate exclusive of state taxes). Taxpayers must have positive taxable income to benefit from cost seg.

The best approach is to perform a cost seg study when a property is first purchased. Tax savings (additional cash flow) in Years 1–5 amount to $43,795 per year. These savings result from depreciating $600,000 of building cost over five years and $500,000 over 15 years, rather than 39 years. In Years 16–39, tax savings are negative $9,872 per year, reflecting depreciation that has been moved from those years to Years 1–15.

Now assume the property had been purchased five years ago, and the cost seg study is being performed now, at the end of Year 5. Tax law allows all of the tax savings that could have been received in the years prior to the cost seg study to be received almost immediately after the study is completed and implemented for the Year 5 tax return (Table 1). In this example, $218,975 cash flow from tax savings is received when the Year 5 tax return is filed in Year 6. The cash flow represents 5.6 percent of the cost of the building ($218,975/$3.9 million).

Actual Experience with Cost Segregation

The example captures the essence of the benefits cost seg provides. Table 2 contains a representative list of properties and the immediate cash flow generated from cost seg studies. The first property in the table is an automotive dealership. Its cost (exclusive of land value) is $5 million. It was placed into service in 2004. A 2009 cost seg study led to $821,000 of extra depreciation available for deduction. The $821,000 is extra depreciation that would have been deducted from 2004–08 if cost seg had been employed. The $821,000 is analogous to the $625,641 toward the bottom of the analysis section of Table 1. The extra depreciation, all deducted on the 2008 tax return (filed in 2009), provided $287,350 immediate cash flow (tax savings). The $287,350 is analogous to the $218,975 in Table 1.

Table 3 provides a broader perspective on the applicability of cost seg. It is based on the collective experience of various firms specializing in cost seg consulting. The table indicates the potential amount of property cost for various property types that could be reclassified and written off over periods much shorter than the 39 years required for commercial real estate buildings (27.5 years for residential properties).

In the Table 1 example, approximately 28 percent of the retail center cost (15 percent plus 13 percent) is depreciated over Years 1–15. That percentage is analogous to the percentages shown in Table 3. Note that the 28 percent amount falls near the middle of the 10 to 40 percent range for retail properties in the table.

Virtually any type of income-producing real estate can benefit from cost seg (Tables 2 and 3). Other prime candidates for cost seg include fast food and quick service restaurants, department stores, medical services buildings and data centers.

According to Charles N. Sirro, principal of Cost Segregation Partners, "Cost segregation is still a wide open market with less than 10 percent (estimated) of all U.S.-based commercial properties having been formally processed under

Table 1. Conceptual Example

Assumptions		Percentage of cost					
Building cost	$3,900,000	100.0					
Cost subject to 5-year write-off	(600,000)	–15.4					
Cost subject to 15-year write-off	(500,000)	–12.8					
Cost subject to 39-year write-off	$2,800,000	71.8					
Marginal tax rate	35 percent						
Analysis	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6–15	Year 16–39
Depreciation without cost segregation							
$3.9 million/39 years	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Depreciation with cost segregation							
$600,000/5 years	120,000	120,000	120,000	120,000	120,000		
$500,000/15 years	33,333	33,333	33,333	33,333	33,333	33,333	
$3,130,000/39 years	71,795	71,795	71,795	71,795	71,795	71,795	71,795
Total depreciation with cost segregation	225,128	225,128	225,128	225,128	25,128	105,128	71,795
Depreciation increase (decrease) due to cost segregation	$125,128	$125,128	$125,128	$125,128	$125,128	$ 5,128	$ (28,205)
Tax savings (cost) at 35 percent due to cost segregation	$ 43,795	$ 43,795	$ 43,795	$ 43,795	$ 43,795	$ 1,795	$ (9,872)
Total depreciation from Years 1–5 deductible "immediately" in Year 6 if cost segregation study is performed in Year 5	$625,641						
Total tax savings from Years 1–5 available "immediately" in Year 6 if **cost segregation study is performed in Year 5**	**$218,975**			**Total tax savings** as a percentage of **building cost.**	$218,975 / **$3,900,000**	= 5.6 percent	

Source: Dr. Jerrold J. Stern

Table 2. Immediate Cash Flow for Actual Properties

Assumed Marginal Tax Rate	35 Percent				
Column 1	Column 2	Column 3	Column 4	Column 5	Column 6*
Industry	**Original cost**	**Date placed in service**	**Additional depreciation due to cost segregation**	**Immediate cash flow due to cost segregation**	**Col. 5 / Col. 2 (percent)**
1. Auto Dealership	$ 5,000,000	2004	$ 821,000	$ 287,350	5.7
2. Hotel	25,000,000	2003	3,900,000	1,365,000	5.5
3. Community bank	1,200,000	1998	199,000	69,650	5.8
4. Industrial facility	8,000,000	2002	1,250,000	437,500	5.5
5. Apartment complex	8,000,000	1999	862,000	301,700	3.8
6. Office Building	10,000,000	1998	1,340,000	469,000	4.7
7. Restaurant	1,300,000	2000	308,000	107,800	8.3
				Average	5.6

*Column 6 is the immediate cash flow (column 5) expressed as a percentage of original cost (column 2).
Source: Charles N. Sirro, Principal, Cost Segregation Partners, Scottsdale, Arizona

Table 3. Reclassification Potentials

	Type of Structure	Potential Reclassification Percentage
1	Apartment Buildings	15-40
2	Retail	10-40
3	Office Buildings	10-25
4	Hotels	20-40
5	Warehouses	8-12
6	Light Manufacturing	15-40
7	Heavy Manufacturing	25-70
8	Processing Plants	60-90
9	Nursing Homes	15-30
10	Restaurants	15-40

Source: CCIM Institute Cost Segregation Reference Manual

the IRS cost segregation audit guidelines. While the majority of the opportunities exist in the small-mid-cap market, there still remain Fortune 500 firms that have not 'cost-segregated' their commercial real estate holdings."

Assets Available for Cost Segregation

Simply put, assets that can be reclassified for cost seg include assets that are not required by local building code requirements to be part of the basic structure. Many of these assets are personal property that often get lumped together and depreciated with the structure for tax purposes when cost seg is not used.

Assets eligible for cost seg fall into primarily three tax law categories: five-year, seven-year, and 15-year depreciation period "recovery classes." Long-standing tax law, supplemented in a critical way by the *2005 IRS Cost Segregation Audit Techniques Guide*, provides specific guidance on assets that can be segregated.

Five- and Seven-Year Property

Examples of this type of property are furniture, fixtures, equipment, machinery, computer-related assets, carpeting, decorative finish carpentry and roofing, signage, installation expenses for five- and seven-year property, many types of leasehold improvements, and specialized assets for certain industries such as special doors, electrical connections and circuitry, fire-protection systems, HVAC (such as refrigeration units and equipment for climate-controlled rooms), nonsupport columns not permanently attached, emergency power generators, certain wall coverings, and equipment for storage and preparation of food and beverages.

15-Year Property

This category includes land improvements (such as grading, drainage, paving, curbs, parking lot, landscaping, fencing, tire stops), service stations and billboards.

Additional Value from Cost Segregation

Value added from cost seg can be even higher than indicated in the tables. Insurance and real estate taxes may be reduced when five-year and seven-year asset costs are segregated from the structure's cost. In addition to federal tax savings, state income tax savings can materially enhance cost seg benefits for properties outside of Texas. In most cases, the Texas Franchise Tax cannot be reduced by cost seg.

Cost Segregation Firms

Many firms specialize in preparing cost seg studies. These firms employ teams of experts in accounting, tax law, and, most importantly, construction engineering. The experts analyze detailed blueprints and building plans to segregate the cost of basic structural components from the cost of five-year, seven-year and 15-year assets.

Cost seg studies usually take two to six weeks to complete and are generally economically viable only for buildings costing more than $300,000 and having an anticipated holding period greater than two to three years. Fees charged range from $5,000 to $30,000 depending on the cost complexity and age of the assets. A fee quotation along with estimated tax savings are provided free by the firm. The initial information provided by prospective clients to a cost seg firm is typically easy to prepare. Once a cost seg study is completed, the client's tax accountant or attorney can implement it for tax return purposes.

Favorable court decisions as well as recent tax law revisions and IRS pronouncements have completely blessed cost seg.

Specialized cost seg firms can advise clients and their tax advisors on how to implement this tax strategy and provide significant cash-flow benefits.

Dr. Stern (stern@indiana.edu) is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University.

THE TAKEAWAY

Cost segregation can accelerate cash flow and generate sizeable immediate cash flow for currently-owned properties acquired in prior years. Cost segregation firms specialize in providing the necessary guidance to clients and their tax advisors.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

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