

## Real Estate Owners Enjoy Cash Flow and Tax Savings

For companies that have purchased, constructed or substantially renovated a building since 1987, a recently released Revenue Procedure, coupled with a landmark Tax Court case, provide new impetus to undergo a Cost Segregation study that could result in significant and immediate cash flow and tax savings.

While the enactment of the Tax Reform Act of 1986 eliminated the investment tax credit (ITC), it substantially altered the depreciation system for real and personal property by classifying assets into nearly 130 different categories, each with its own depreciable life. This pattern of depreciable lives is known as Modified Accelerated Cost Recovery System (MACR).

In the landmark Tax Court case Hospital Corporation of America, 109 TC 21 (1997), the court held that if the property would have qualified as tangible personal property under the repealed ITC that same property would also qualify as tangible personal property under MACRS. In addition, a 1998 IRS Revenue Procedure allows real estate owners to automatically go back to closed tax years and "catch up" the entire omitted depreciation, without amending tax returns.

A Cost Segregation Study will identify and price non-structural elements and exterior improvements, making it possible for property owners to maximize their depreciation deductions by reclassifying as much as possible of the related costs from building costs to personal property and exterior improvements. In addition, indirect construction costs such as construction period interest; general conditions, architecture and engineering fees are allocated on a pro-rata basis to the assets identified as non-structural. By maximizing their depreciation deductions, building owners increase their cash flow by paying less income tax during the early years of a building's depreciable life. As stated earlier, the owner is also eligible to play "catch up" for depreciation errors made in the prior years.

Under today's guidelines, a commercial building is depreciated for tax purposes over 39 years (27.5 years for residential real estate). Upon segregation of tangible personal property and exterior improvements from a building's cost, companies realize the benefits of deducting accelerated depreciation on assets otherwise lumped together with a building's cost. Depending on the type of industries, 20-50% of building cost can be segregated into 5, 7, or 15 years lives instead of a 39 years life.

Examples of tangible personal property include heating and ventilating systems; wall coverings; electrical and plumbing costs that relate directly to the processing equipment; flooring; moveable wall partitions and appliances. Examples of exterior improvements include sidewalks, drainage, parking lots, landscaping, roads site utilities, fencing and outdoor lighting.

The saving from an accelerated recovery can be quite significant. Take the example of a heavy manufacturer who purchased a new facility in 1992 for \$5 million, \$1 million of which was for equipment costs. The company had been depreciating the building cost of \$4 million over 31.5 years, and the \$1 million of equipment over seven years. A cost segregation study was performed, segregating 15 percent of the building cost to fifteen-year property and 15 percent to seven-year property. As a result of the segregation, the total taxes deferred over a four-year period exceeded \$300,000, while the cumulative present value on the taxes deferred at eight percent was approximately \$175,000 (assuming a combined federal and state effective tax rate of 48 percent).

Real estate investments best suited to undergo a cost segregation study include all post 1986 real estate construction, building acquisitions or improvements; new buildings under construction; the purchase of existing property; existing buildings undergoing renovation or expansion; and office leasehold improvements and "fit outs".

Other factors to be considered when deciding to undergo a cost segregation study include profitability of the entity or its shareholders, passive activity rules, early disposition, and tax related situations.

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**The above information is of a general nature and cannot be regarded as legal or tax advice. For additional information regarding cost segregation and their effects on your business, contact Anne Tahim, CPA at 714-772-4744.**