Tax-saving trick: Cost segregation studies allow owners to pocket more cash

IRS issues guidelines for a qualified study. By Nicole Crate, ASA

IRS GUIDELINES

In January 2005, the Internal Revenue Service (IRS) issued its revised "Cost Segregation Audit Technique Guide," for guidance purposes to assist IRS examiners, specialists who conduct studies and practitioners who hire specialists. It explains why cost segregation studies are performed, how they are prepared and what to look for when reviewing studies and hiring specialists (see www.irs.gov/businesses/article/0,id=134180,00.html). The guide outlined 13 key principal elements of a "qualified study," including:

- Preparation by an individual with expertise and experience;
- Detailed description of methodology;
- Use of appropriate documentation;
- Interviews conducted with appropriate parties;
- Use of common nomenclature;
- Use of standard numbering system;
- Explanation of legal analysis;
- Determination of unit costs and engineering "take-offs";
- Organization of assets into lists or groups;
- Reconciliation of total allocated costs to actual costs;
- Explanation of the treatment of indirect costs;
- Identification and listing of Sec. 1245 property; and
- Consideration of related aspects (i.e., change in accounting method and sample techniques).

Whether they choose to buy and hold properties or do renovations or new construction, multifamily owners and developers who retain ownership can benefit from a little-known secret and immediate tax savings, sometimes amounting to millions of dollars, by conducting a cost segregation study.

The time for a property owner to think about having a cost segregation study performed is at the point of purchase or during the early stages of construction. Taking the time to identify an opportunity will allow an owner to reap the benefits right away and smooths out the cost segregation process – benefiting the owner and the cost segregation specialist performing the study.

A cost segregation study is an engineering-based tax analysis that allows real estate owners to accelerate the depreciation of property assets, thereby reducing their federally taxable income. It can also be used for financial accounting, insurance and property tax purposes.

For income tax depreciation purposes, there are two major types of assets: Sec. 1250 real property and Sec. 1245 personal property. By taking advantage of certain rules in the tax law, property may be further segregated within these two sections by identifying five-year and seven-year personal property, 15-year land improvements, and 27.5-year residential and 39-year nonresidential real property.

For example, the following items would appear to be structural in nature: specialty lighting, supplemental HVAC, wiring for computer equipment, receptacles, kitchen appliances, chemical sprinkler systems dedicated to equipment, and supplemental plumbing. However, a significant portion of these items service dedicated components in buildings and can qualify for accelerated depreciation upon further inspection.

Multifamily properties suitable for cost segregation include:

- High-value properties such as seniors housing, garden apartment communities, luxury apartment communities, mixed-use with retail, mixed-use with office, college housing and high-rise communities in excess of $1 million. These can generate sizable savings from a study.
- Any property purchased for full basis (i.e., cash plus assumption of debt).
- Any development property.
- Any property acquired in a tax-free exchange (i.e., a Sec. 1031 exchange), provided the asset has substantial tax basis. Cost segregation studies can help identify the real and personal property basis in the new "like-kind" property that is exchanged for the existing property to help avoid the possibility of paying taxes on any excess property above the adjusted basis.
- Assets owned since 1987: Internal Revenue Service (IRS) Revenue Procedure 2004-11 allows property owners to retroactively catch up on missed depreciation on assets owned as far back as 1987 with a one-year

catch-up adjustment called a Sec. 481(a) adjustment. This creates a large tax deduction and generates additional cash flow from tax savings in the year the tax return is filed and the cost segregation study is performed.

In addition to depreciation and retroactive analyses, there are other uses for cost segregation studies in real estate. Purchase price allocations under new accounting rules (Financial Accounting Standards Board Statement No. 141) require the allocation of the purchase price by determining the fair market value of the underlying tangible and intangible assets. A component of this evaluation includes determining the depreciated replacement cost of the core and shell of the property (a natural derivative of the cost segregation study).

Bonus depreciation, resulting from the Jobs and Growth Tax Relief Reconciliation Act of 2003, allows real estate owners to take an additional 30 percent or 50 percent deduction (depending upon when the asset was placed in service) in the first year for newly constructed assets with less than a 20-year life or qualified leasehold improvements with a life of more than 20 years on a three-year-old building. Property qualifying for bonus depreciation must have been placed in service before May 6, 2005.

Private owners and developers receive immediate cash flow benefits through additional depreciation. There is virtually no reason why they would not want to have a cost segregation study performed. Real estate investment trusts (REITs) also stand to gain from cost segregation studies in one of two ways: First, they can significantly reduce their taxable income and its distribution requirement, thereby retaining additional cash flow. Second, a cost segregation study permits a REIT to pay dividends in the form of return of capital (untaxed until shareholders' shares are sold) instead of ordinary income if it chooses not to alter its distribution policy.

While many opportunity funds do not take advantage of cost segregation studies because they have plans to dispose of their assets in the near term or because they are owned by pension funds that will not benefit from the additional depreciation, the time value of money realized through a cost segregation study may still ultimately present some financial gain.

How does a cost segregation study work?

Cost segregation studies for existing properties can have a turnaround time of four to six weeks, depending on the size and complexity of the project. Newly constructed properties can start in the developmental stage on through to completion of construction and can last from one to two years.

The studies typically include, but are not limited to, the following:

- A site visit to verify the condition, functionality and existence of assets.
- Copies of as-built drawings, including a site survey with a legal description.
- A review of property-condition reports, purchase agreements and appraisals, which are used to corroborate evidence when original construction documents are not available.
- General contractor and subcontractor payment applications, generally referred to as AIA (American Institute of Architects) documents, as well as owner invoices for work performed or items purchased outside the contractor's scope.
- Depreciation schedules for property treatment verification on projects eligible for a Sec. 481(a) adjustment.
- Interviews with contractors, property managers, and building engineers to ascertain specific uses of property.

Upon completion of a thorough review of gathered data, functional and permanency tests, engineering quantity "take-offs" are conducted to determine assets that qualify as real and/or personal property as defined by the IRS. Quality deliverables include proper verbiage and references as dictated by the IRS Guide to Cost Segregation Techniques.

What do you gain?

Let's say that an owner purchased a 200,000-square-foot garden style apartment complex for $10 million in June 2005; the property has 300 units. A cost segregation study conducted in the year of purchase revealed $2.1 million of costs segregated into shorter tax lives (five-, seven- and 15-year property) and an increase of $1.2 million of depreciation in the first five years. For this study, five-year assets include items such as carpeting, laundry equipment and dedicated plumbing for laundry and dishwashers. Seven-year assets include furniture and fixtures in the management office, and 15-year assets include landscaping, paving, sidewalks and curbing, to name a few.

Assuming a 7% discount rate and 40% tax rate, the owner of this property would receive a net present value tax savings of $100,000 in the first year and $400,000 over the first five years based on the segregation of assets into shorter depreciation periods. The first-year net present value savings more than pays for the study, which can range from $12,000 to $14,000 for a facility of this size.

Multifamily owners and developers typically focus on cash flow, value and return on investment, but many are unaware of the opportunity to realize immediate tax savings with the help of a cost segregation study. By reducing taxable income and increasing cash flow, owners can leverage a qualified cost segregation study as a significant financial management tool that plays a key part in their tax, accounting and insurance planning. ■

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