



Cost segregation strategies
for commercial property



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A little known secret in the IRS tax code could mean big tax savings and improved cash flow for commercial real estate owners and investors.

Cost segregation is a tax strategy that allows owners and investors to accelerate the depreciation rate of their properties – allowing them to take larger tax deductions for construction-related costs over a shorter period, rather than spreading them out evenly over the standard 39 years for commercial properties and 27.5 years for residential rental properties.

As a result, property owners often experience improved up-front cash flow and minimized taxes; potential catch-up depreciation allowing for retroactive refunds; and maximum bank financing because of improved cash flow, said Don Gardner, vice president of national sales, at Core Solutions Group, in Birmingham, Michigan.

“Cost segregation is often overlooked because it is a niche strategy,” Gardner said. “It shouldn’t be ignored because of its complexity, though. Owners and investors typically experience substantial benefits from this tax strategy.”

Cost segregation strategy applies broadly to commercial real estate

For owners and investors to realize these benefits, they must first determine if their properties qualify for cost segregation studies, whereby all building components – from carpet and cabinetry, to roofs and electrical systems – are identified. Their values are then quantified and also potentially reclassified as personal property so they can be depreciated by five, seven or 15 years.

In actuality, most commercial properties – from apartment buildings and day care centers to office buildings and warehouses – qualify for cost segregation tax advantages. Properties with a cost basis of \$1 million or greater are the most ideal candidates for cost segregation because once the cost of any analysis is factored into the equation, their return on investment is typically better than buildings with lesser value.

Further, resorts, restaurants, residential rentals and assisted living facilities are a few of the property types that benefit most from cost segregation because of the high percentage of property components capable of being reclassified as personal property – thereby shortening their life and allowing the property to be depreciated at a faster rate.

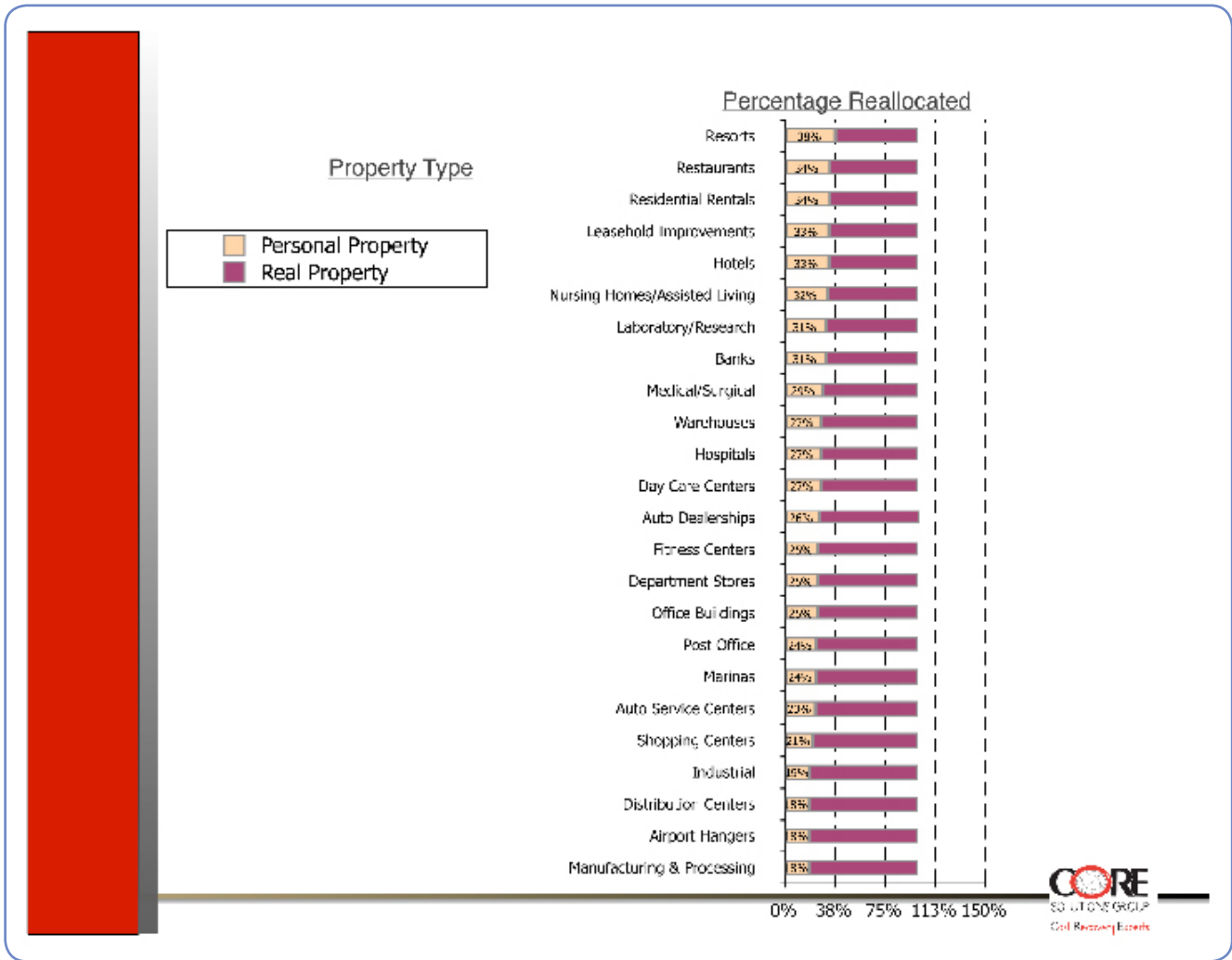
What qualifies for reclassification?

Items that can be reclassified in a cost segregation study include – but are not limited to – the following:

- Site improvements (landscaping/parking)
- Light fixtures
- Branch wiring
- Special plumbing
- Flooring
- Millwork
- Millwork window coverings
- Partition walls
- Cabinetry
- Furnishings
- Shelving
- Wall coverings

Source: Core Solutions Group

The graph below illustrates potential accelerated depreciation per property type



Building specifics aside, qualifying properties ultimately include: any building placed in service since January 1, 1987; existing buildings undergoing a renovation, remodeling, restoration or expansion; any building that experienced major leasehold improvements after January 1, 1987; inherited commercial and investment real properties; and any building undergoing preconstruction planning so building designs can be modified to increase shorter-life asset classification.

In some situations, however, cost segregation offers little to no benefit – for instance if much of a building’s depreciation has already occurred because it has been owned for numerous years and lacks recent renovations. Of course, exceptions always exist.

“Generally speaking, even if a building has been owned for ten years, a feasibility analysis isn’t out of the question,” Gardner said. “Any commercial property owner should consider the potential benefits of cost segregation and exploring a consultation.”

Studies reduce taxable income upfront, freeing up cash flow

That consultation could lead to substantially improved property cash flow and expense performance.

Gardner said properties that undergo cost segregation studies typically see significant increases in deductions within the first five years of doing the analysis because of accelerated depreciation. While each property is different, between 15 percent and 30 percent of a building's cost basis can be reclassified and accelerated at a faster rate for depreciation purposes, he said.

"Increased depreciation in a given year reduces owners' net income, which reduces their tax liability – thereby saving them money," Gardner said.

For instance, for every \$1,000,000 of cost shifting from a 39-year property to a five-year property, the net present value of the tax benefit is \$160,000 – assuming a tax rate of 35 percent and a 5 percent return on investment.

Assuming the same tax rate and return, for every \$1,000,000 of cost shifting from a 39-year property to a 15-year property, the net present value of the tax benefit is approximately \$100,600.

Gardner cited some recent examples of clients that experienced tremendous savings from their cost segregation studies: A nearly \$18 million apartment complex – comprised of 12 complexes – saw five-year tax savings of approximately \$1.6 million; a nearly \$5.2 million high-end office building experienced five-year tax savings of almost \$626,000; and a nearly \$1.7 million hotel encountered five-year tax savings of just over \$812,000.

Such savings allow owners and investors to appropriate that money elsewhere, like future investment or business expansion, rather than using the money to merely pay taxes, Gardner said.

"Because accelerated depreciation is a non-cash expense, it doesn't impact cash flow," he said. "This frees up money for future investments or green initiatives, or even allows property owners to expense demolition or remodeling as opposed to capitalizing such projects."

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A case study in tax saving from CB Richard Ellis

Eli Varol, managing director for cost segregation at CB Richard Ellis in Chicago, said cost segregation is a viable option for owners and investors because of the potentially significant tax benefits in the form of deferred corporate income tax obligations.

“The tax considerations are significant and can make the difference between a property’s cash flowing and not flowing,” he said.

He illustrated the benefits of cost segregation by providing the following case study, whereby a client elected to do a cost segregation analysis.

Challenge

In 2006, an institutional investor acquired a portfolio of Class A office buildings in the Houston, Texas metro area. The buildings cover over 2,500,000 square feet with more than 400 individual tenant spaces. \$250,000,000 of the purchase price was allocated to real property. The CBRE Cost Segregation team was engaged to analyze the property.

Solution

A team of five engineers conducted the site inspections and coordinated with the property managers to schedule times to walk through each tenant space. They identified components in each tenant space that qualified for accelerated depreciations (five-year tax life). This included office equipment power distribution, break room electrical and plumbing service, cabinetry, removable floor coverings and demountable partitions. They assembled a detailed report for each building, broken down by tenant space, listing out all their takeoffs and estimates and referenced back to estimating sources such as RS Means and Marshall & Swift.

Results

Before Cost Segregation:		After Cost Segregation:	
5-Yr Property:	\$0	5-Yr Property:	\$27,000,000
7-Yr Property:	\$0	7-Yr Property:	\$2,200,000
15-Yr Property:	\$0	15-Yr Property:	\$2,700,000
39-Yr Property:	\$250,000,000	39-Yr Property:	\$217,500,000

Benefit

A present value benefit of \$6,982,000 in deferred tax payments was generated, all of which was available to the client in the first six years.

Detailed building audit reduces chance of IRS audit down the road

With great rewards comes great scrutiny, though. Cost segregation studies cannot be carelessly thrown together to achieve tax advantages. While the IRS has generated a legal memorandum supporting these studies, it necessitates they include detailed engineering analysis and documentation. Well-supported information lessens the chance for an audit.

“Lack of engineering expertise will not withstand IRS scrutiny,” Gardner said. “Also, engineering expertise, coupled with tax law guidance, will reduce the likelihood of valuable tax benefits being left on the table.”

As a result, professional firms with accountants, engineers and architects are usually solicited to do the studies, which involve inspecting the facility to determine the nature of the project and its intended use; photographing specific property items for reference; and reviewing construction drawings, site surveys, contracts, bid documents, contractor invoices and other construction documentation.

Upon completing such research, the solicited firm makes its assessment on potential reclassifications; drafts a report based on those assessments; and then passes the report on to the client or client’s accountant, who then incorporates the information into the property’s fixed asset schedule for tax reporting purposes.

“The process is not too arduous for the stakeholders — particularly for those that keep good records or elect to do a cost segregation study during the actual construction phase when pricing information for construction costs or building components is easily at their disposal,” Gardner said. “Ultimately, the burden falls upon the cost segregation team, which is why owners should have a good one in place.”

He said owners should look for cost segregation firms that have a lot of experience doing such analyses, as well as employees with construction, architectural and engineering backgrounds along with a thorough understanding of the tax laws as they relate to depreciation of real estate. He also advised hiring firms that provide free estimates of the net cash/savings benefit from cost segregation studies.

“Cost segregation comes with a lot of IRS requirements,” Gardner said. “Having a team that can navigate those rules, as well as adequately audit the property, is crucial to generating positive results.”

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Positively worth considering

Ultimately, the positive results stemming from cost segregation studies can't be ignored. The dramatic reduction in taxable income, increased cash flow for investment opportunities and business expansion, and property tax savings are all advantages that would benefit any commercial real estate owner or investor – not just the largest entities.

Building owners can jumpstart the process by inquiring with their accountants about such analyses and enlisting the counsel of cost segregation experts to determine whether they should move forward in the process.

“Owners looking to improve their cash flow need to leverage these tax advantages granted by the IRS,” Gardner said. “They should continue to educate themselves about these advantages and the process to enhance their business.”

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