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Increasing After-Tax Cash Flow Through Cost Segregation

by Ed Hanley ** MAY 9, 2002

Everyone is looking for an edge in the current leasing environment. Anything that makes the current market more palatable is welcome. One area that landlords and tenants are increasingly pursuing is accelerating the depreciation of improvements.

In the late 1980s, the tax law changed the treatment of leasehold improvements and required depreciation over the longest possible depreciable life for real estate (now 39 years). Before that change, the improvements were written-off over the term of the tenant's lease.

There have been some recent favorable pronouncements by the IRS that allow taxpayers to segregate leasehold improvements that may be depreciated over a shorter life (such as 5 or 7 years) from those that are depreciated as real property. For the landlord, the present value of the increased tax deductions can greatly improve the after-tax cash flow from the property. (See graphic).

The process of carving assets with shorter lives out of the overall project is called cost Segregation.

Cost segregation requires the combined skills and knowledge of a tax professional and an engineer. These professionals analyze each aspect of the entire project to identify the improvements that may be depreciated over shorter lives.

Here's an example where cost segregation leads to great tax savings. A company had made \$4 million in leasehold improvements back in 1997 and was depreciating those improvements over 39 years. The improvements related to HVAC and other specialized build-out. In early 2002, the company's read about cost segregation in an industry newsletter and contacted his accountant. By aggressively pursuing cost segregation, this company will accelerate over \$2 million of deductions into his 2001 – 2005 tax years – deductions that otherwise would have taken over the next 30+ years.

Net Present Value of Segregating Construction Cost in a Tax-Efficient Manner

Analysis

	Gross Tax Savings over 10 Year Period				
	<u>Percentage Segregated as Personal Property</u>				
	10%	15%	20%	25%	30%
Project Costs Incurred					
250,000	7,994	11,990	15,987	19,984	45,481
500,000	15,987	23,981	31,974	39,968	90,962
1,000,000	31,974	47,962	63,949	79,936	181,923
2,500,000	79,936	119,904	159,872	199,840	454,808
5,000,000	159,872	239,808	319,744	399,679	909,615

	Net Present Value Using an 8% Discount Rate				
	Percentage Segregated as Personal Property				
	10%	15%	20%	25%	30%
Project Costs Incurred					
250,000	6,629	9,944	13,258	16,573	36,845
500,000	13,258	19,887	26,517	33,146	73,690
1,000,000	26,517	39,775	53,033	66,292	147,380
2,500,000	66,292	99,437	132,583	165,729	368,449
5,000,000	132,583	198,875	265,166	331,458	736,899

Cost segregation works especially well with computer and telecommunications related build-out, utilities upgrades, signage, landscaping and parking lots. If 20% of the costs incurred on a \$2.5 million project are re-characterized as personal property, the ten-year present-value savings may be \$130,000 using an 8% discount rate. On a smaller scale, a tenant build-out that costs \$500,000 and identifies 20% of the improvements as personal property has a present-value savings of \$25,000.

The IRS has conceded that the costs of projects may be segregated along functional lines using the principles that apply for the Investment Tax Credit. As noted, the present value of the increased deductions from depreciation can help increase the building owner's after-tax rate of return. In the current leasing environment, cost segregation may help turn lemons into lemonade.

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