

Cost Segregation & Qualified Leasehold Improvements

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Cost segregation has received a considerable amount of attention over the past few years and rightfully so. This valuable tax planning strategy, which is routinely used by commercial real estate owners and tenants, can have a significant and immediate impact on cash flow.

The growing awareness of cost segregation has been fueled in recent years by the passing of a number of laws. These laws have added even greater value to this already effective strategy. The most recent being the Tax Relief and Health Care Act of 2006, which retroactively extended the deadline for Qualified Leasehold Improvements (QLI) from December 31, 2005 to December 31, 2007. This means those of you who placed QLIs into service during the past 13 months can take advantage of the special depreciation allowance. This benefit, which comes just in time for the rapidly approaching tax deadlines, can be best achieved with a cost segregation study.

Cost Segregation

Cost segregation is an IRS approved procedure which is used to accelerate depreciation deductions on commercial real estate assets. The analysis, which is known as a cost segregation study, involves a thorough review of relevant information such as cost data, building plans, rent rolls, and lease agreements, as well as an on-site inspection of the property by a qualified professional, preferably an engineer. Following the site visit, the engineer(s) will produce a detailed breakdown of costs and properly allocate them to the appropriate recovery periods (5, 7, 15, 27.5/39-year, etc.) depending on the facts and circumstances of the project. Soft costs such as architectural and engineering fees, and builder's overhead and profit are then allocated proportionately according to findings of the study. A quality engineered-based study will address all depreciable costs, not just those that qualify for a shorter recovery period.

The driving force behind cost segregation is the time value of money. A cost segregation study allows the taxpayer to accelerate depreciation deductions, which in turn reduces taxable income during the early years of ownership (years 1 – 15). Deferring taxes improves cash flow which allows the taxpayer to utilize their funds to pursue additional opportunities. Those who are not depreciating assets over the shortest allowable recovery periods are simply leaving money on the table; for all intents and purposes providing the IRS with an interest-free loan.

Qualified Leasehold Improvements

QLIs were originally introduced as part of the Job Creation and Worker Assistance Act of 2002. This act provided special tax treatment for qualifying improvements. Although the specific treatment (discussed below) has since been modified, the definition of qualified improvement has remained the same.

Generally, a QLI is any improvement to an interior portion of a building that is nonresidential real property, provided all of the following requirements are met.

1. The improvement is made under or pursuant to a lease by the lessee (or any sublessee) or the lessor of that part of the building. Note that a binding commitment between related persons is not treated as a lease.
2. That part of the building is to be occupied exclusively by the lessee (or any sublessee) of that part.

3. The improvement is placed in service more than 3 years after the date the building was first placed in service. Note that this is referring to when the building was first placed in service, not when the current owner purchased the building.

However, a QLI does not include any improvement for which the expenditure is attributable to any of the following.

1. The enlargement of the building.
2. Any elevator or escalator.
3. Any structural component benefiting a common area.
4. The internal structural framework of the building.

When first introduced by the 2002 Act QLIs could be treated the same way as costs that were eligible for bonus depreciation with the remaining balance depreciated over 39-years. This applied to improvements placed in service between Sept 11, 2001 and December 31, 2004. The treatment was then modified by the American Jobs Creation Act of 2004 (which also introduced Qualified Restaurant Improvements – not covered in this article) providing that QLIs placed in service between October 22, 2004 and December 31, 2005 should be depreciated over 15-years, using a straight-line method. Although this is not as beneficial as the bonus allowance it is far better than the usual 39-year recovery period. The Tax Relief and Health Care Act of 2006 retroactively extended the deadline set by the 2004 act from December 31, 2005 to December 31, 2007. Therefore any QLIs placed in service since October 22, 2004 are depreciated using a 15-year recovery period and a straight line method.

The best way to identify QLIs is with a cost segregation study. A quality study will properly identify all expenditures eligible for the special 15-year treatment as well as all costs that qualify for the even more beneficial 5 or 7-year recovery periods.

Closing Thoughts

Don't leave money on the table. If you own commercial real estate and are not using cost segregation as a part of your overall tax planning strategy you should strongly consider doing so. If you think you are eligible for QLIs talk to your CPA and/or cost segregation consultant. There is a reason why cost segregation has gotten so much attention lately. Simply put – the financial benefits can be huge.

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For more information about cost segregation and Bedford Capital Consulting, or to contact a representative in your area please visit www.bedfordcap.com. Alternatively, you can call Bedford's national headquarters at (800) 257-8962.

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