

# Real Estate Journal

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## An introduction to practical applications for cost segregation studies

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OK, so we've all read about the tremendous cash flow benefits associated with cost segregation studies (CSS). It's easy to see why this has become one of the hottest tax planning strategies in commercial real estate. I mean seriously, who doesn't want to defer tax payments? However, most are still unaware of how many practical applications there are for this valuable tax planning tool.

### Brief overview

A CSS allows a taxpayer to accelerate substantial depreciation deductions by identifying costs that can be allocated to shorter recovery periods; primarily 5, 7, and/or 15-year as opposed to 27.5 or 39-year. In doing so, the taxpayer can defer substantial tax payments and greatly improve cash flow. It should be noted that a CSS does not create new tax deductions it simply pushes deductions into the early years of ownership. This front-loading of deductions allows the taxpayer to take advantage of the time value of money. Simply put, using an arbitrary amount of \$20,000, would you rather receive \$20,000 over the next five years or wait 40 years to get the

same \$20,000? The answer for most is easy, give it to me as soon as possible.

While property owners and their tax advisors routinely utilize cost seg following completion of a new building or acquisition of an existing building, there are many additional applications of this practice that apply to the various stages of real estate ownership and development.

### Design/construction

New construction projects are often the first to get considered for a CSS. Typically the request for proposal comes after the building has been constructed and is ready to be placed in service. While substantial benefits can be generated by performing a study after construction, greater benefits can often be achieved if the cost seg consultant is involved during design. For example, manner of affixation may determine whether an item will qualify for allocation into a 5 or 39-year recovery period.

### Acquisitions

A good time for a CSS is immediately following acquisition. This allows the new owner to schedule all depreciable assets into the correct recovery periods. For larger transac-

tions however, you may want to have a CSS performed *prior* to conveyance of the property. In states where real estate transfer tax is high and personal property tax is either low or non-existent, it makes sense to evaluate the classification of real vs. personal property as part of the purchase agreement.

### Currently owned properties

Properties already in service are often overlooked when it comes to cost seg. This is a big mistake. The IRS allows taxpayers to use these studies to adjust depreciation on properties placed in service as far back as Jan. 1, 1987. The real kicker is that this can be done without filing an amended return. A "look-back" study is performed to determine which costs qualify for shorter recovery periods. Upon completion, the taxpayer makes an adjustment under Sect. 481(a) on Form 3115 (change in accounting method) to catch up on depreciation. The catch up, which can be taken entirely in the current tax year, equals the difference between what was depreciated and what could have been depreciated if a CSS was performed from day one. The benefits can be dramatic.

### Abandonment/redevelopment

A CSS can be used to maximize write offs prior to planned demolition. Whether you have a tenant moving out and are refitting the space or you're giving your property a face-lift having a CSS performed in advance can be very beneficial. Unless you have specifically identified the assets slated for demolition you may have some problems with Uncle Sam. Using a CSS to identify the tangible personal property will allow the owner to write them off upon disposition. The IRS will not allow you to write off arbitrary amounts based on cost per s/f, or tenant allowance.

### Leasehold improvements

Building owners are not the only ones who should consider a CSS. Tenants who have incurred expenses for fit-up can also benefit. Recent tax law has provided a boost for landlords and tenants allowing them to accelerate even more depreciation. Again, certain requirements must be met and the CSS will clearly address any areas of concern.

A detailed review of the individual applications will be provided on a monthly basis in the *Financial Digest* section. More on using a CSS with abandonment/redevelopment will be discussed in next month's *Financial Digest*.

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