

# Real Estate Journal

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## Practical applications for cost segregation studies: Using a CSS during design and construction



Although there are many applications for cost segregation, new construction projects are often the first to be considered. Generally speaking, it's good to have a cost segregation study (CSS) performed as soon as a property is placed into service. This allows the taxpayer to take full advantage of accelerated depreciation deductions from day one.

Typically, the request to perform the CSS is made after the building is completed and placed into 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 from the beginning — during the design phase. Unfortunately, many owners and their tax advisors are unaware of this valuable opportunity. Further, many cost segregation providers are still unfamiliar with this application, or they simply lack the engineering and construction expertise to address it.

### Design Phase

Getting your cost segregation consultant involved during the design phase can be very beneficial, especially on larger or more specialized projects. Early involvement allows



the cost seg consultant an opportunity to understand the project and make valuable suggestions before it's too late. While some issues can be addressed during construction, it is better to know ahead of time to avoid unnecessary change orders. Ideally, you'll want to make this introduction after the conceptual drawings are finished, but before the project goes out to bid. This will also provide an opportunity to request the bids in a format that is more conducive to performing the study.

The recommendations made during design will mostly deal with the types of materials being used and manner of affixation. Both are important things to consider from a tax perspective. Small changes to design or types of materials can generate large tax benefits. One classic example is whether to use paint or some form of removable wall covering. Paint is depreciated using a 39-year recovery period, while removable wall coverings can be depreciated over five or seven years. Some additional design elements to consider include wall partitions, floor coverings, lighting, and canopies, to name a few.

The design phase also provides an opportunity to check how drawings are labeled. The intended use of an asset is a key consideration in determining whether it will qualify for a shorter recovery period. Detailed labeling can help provide a more defensible position with regard to intended use. Lighting is a great example of this. Labeling the panel schedule of the blueprints to separately identify base building and accent lighting provides a clear distinction with regard to use. Base building lighting is a 39-year item in the eyes of the IRS, but accent lighting can be depreciated over five or seven years. This is especially important in properties that have a high percentage of special use assets, such as medical facilities, auto dealerships, restaurants, and manufacturing facilities, to name a few.

### Construction Phase

There are two important elements of the construction phase from a cost segregation perspective. First is the ability to make last minute suggestions with regard to materials and installation. Change orders may affect the initial design and therefore need to be reviewed. Second is the documentation process. Building a defensible position for the classification of assets is the cornerstone of a good CSS. Solid photographic and/or video documentation is a key part of this process. Involvement during construction allows the cost seg consultant to document aspects of the property that will not be visible once

construction is complete. It also provides an opportunity to document manner of affixation. This is important because of the permanence and adaptive reuse tests used by the IRS.

### Closing Thoughts

Getting a cost segregation consultant involved early can provide real value, but it can also create some challenges. It is important that the cost seg provider be familiar with the entire design and construction process so they don't get in the way. The last thing the design and construction teams want is someone to slow down their progress.

Although it can be tempting, don't assume that the architect or contractor can properly allocate costs or prepare a defensible CSS. Most architects and general contractors do not have any knowledge of the tax regulations and will not be willing to defend the taxpayer in the event of an IRS audit. Spend the extra dollars to get a real CSS.

The bottom line is that by getting your cost segregation consultant involved early on you may be able to recognize significant tax benefits. A good cost seg consultant will be able to identify opportunities and provide recommendations on how to achieve the most favorable tax treatment.

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