

# Real Estate Journal

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## Practical applications for cost segregation studies: Using a CSS with leasehold/tenant improvements


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Did you know that you can use a cost segregation study (CSS) with leasehold/tenant improvements? This is an excellent strategy for tenants as well as landlords who make contributions towards their tenant's improvements.

A CSS performed on leasehold improvements, sometimes called a tenant improvement study, works the same way as a normal CSS. A cost segregation consultant performs an analysis to determine which costs can be allocated to a five or seven-year recovery period as apposed to a 39-year recovery period. You read that correctly, I said 39 years. The IRS does not permit taxpayers to depreciate costs for improvements over the term of their lease. However, it is important to note that lease language can make a difference.

The key to a tenant improvement study is in knowing who owns the assets and therefore will be depreciating them. This is easy to determine when either the tenant or landlord pays for all of the improvements, but when the costs are shared and there is a landlord contribution things get a bit more

complicated.

### Landlord's Perspective

Although CSSs are routinely used by landlords these days, the studies typically do not provide detailed cost breakdowns for each tenant. In most cases the studies performed focus only on the base building and common areas. Although the benefits of a simple base building study can be significant, you may be leaving a lot of money on the table when it comes to the tenant improvements. Landlords who make contributions to their tenants for fit-up capitalize these costs, depreciating the majority of them over 39 years. When a tenant leaves, their space is frequently gutted and built-out for the next occupant. Often overlooked are the immediate write-offs that are available when you know the value of the materials that were retired during the renovation. These costs can be written off in the year of retirement, if properly identified prior to the renovation. A detailed study can be used to accurately identify and segregate all of the landlord's costs, by tenant. If you have not had a CSS performed on your property, you may want to do so before any more tenants leave.

### Tenant's Perspective

Equally important is how tenants capitalize improvements. In many cases the leased space is provided as an empty shell. Using cost segregation to properly classify assets either immediately

following construction or via a look-back study can greatly enhance a tenant's cash flow by accelerating depreciation deductions. In the case of a remodel or alteration of your existing space during the lease term, the data obtained from a cost segregation study can also be used to support write-offs for assets that are retired during the renovation. Remember, the study must be done before the renovations in order to establish a defensible position.

### Lease Language

Lease language can be very important when it comes to depreciation and writing-off retired tenant improvements. Knowing who owns what is very helpful. Therefore, special attention should be given to the allocation of any contribution. Lease language can be used to designate specific assets and/or cost to either the tenant or the landlord. Your cost segregation consultant should be able to give you advice as to how to specifically earmark certain assets.

### Qualified Leasehold Improvements

Taxpayers who made improvements to existing properties between October 22, 2004 and December 31, 2005 may receive special consideration from the IRS. Qualified leasehold improvements made during this time, on properties that were three years old or older, can be depreciated using a 15-year recovery period instead of the standard 39-years. It is important to note

that not all improvements qualify for this benefit. The costs of structural improvements for example are still considered 39-year assets. A cost segregation study will properly identify the assets eligible for this special 15-year treatment as well as all costs that qualify for the even more beneficial five or seven-year recovery periods.

Although there are talks of extending this benefit, nothing is official with the exception of the Liberty Zone and the Gulf Opportunity Zone (GO Zone). In the Liberty Zone the window is still open until December 31. In the GO Zone there is a 50% bonus depreciation allowance for leasehold improvements made through December 31, 2008.

### Closing Thought

Cost segregation is truly a multidisciplinary service. Not only does it require engineering, construction, and tax expertise, but familiarity with issues such as lease language is also important. When selecting a cost segregation consultant, like any professional service provider, be sure to check their credentials. The IRS specifically states, in the Cost Segregation Audit Techniques Guide, that "a quality study will identify the preparer and always references his/her credentials, experience, and expertise in the cost segregation area."

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