



building with a lower-level parking garage located on a 5.8 acre site. The total gross building area is approximately 136,000 s/f. The tax basis is \$24,271,276 net of land and does not include furniture, fixtures and equipment. The property was newly constructed by the current owners and placed in service in June 2006. The cost segregation study was conducted shortly after the building was placed in service.

### Tenant Improvements

Although cost segregation is routinely utilized by building owners these days, most studies typically overlook the importance of detailed cost breakdowns for each tenant. In most cases the study will not separate or group the costs by individual tenant, but rather put all costs into a single table. Although the initial benefits of the study should be the same either way, the future benefits associated with the two approaches will not be. A study that groups costs by tenant can be a powerful asset management tool throughout the life of the property.

Grouping costs by tenant is important because it creates a defensible position to support future write-offs. It also provides for a cleaner depreciation schedule as tenants move in and out and renovations are made. Let me explain.

Landlords who make contributions towards tenant improvements capitalize these costs and depreciate them, mostly over 39-years in the absence of a CSS. When a tenant leaves, their former space is often gutted or renovated significantly for the new occupant. If the landlord has a detailed breakdown of costs for the space being renovated, before any of the work is done, then they will know what materials are being removed and retired from service. The undepreciated values of these materials can be written-off in the current tax year. However, when there is no detailed record, the landlord is forced to carry assets that no longer exist (ghost assets) on their depreciation schedule for the remainder of the depreciable lives. This is no small amount of money. Think about some of the space you

Case Study A: Post CSS Allocation			
Personal Property	5-year	\$7,337,377	7.3%
Personal Property	7-year	\$863,053	0.9%
Real Property	39-year	\$91,799,571	91.8%
Total Depreciable		\$100,000,000	100%

Case Study A: Financial Impact	
Additional Depreciation (year 1) =	\$1,400,000 +
Additional Depreciation (years 1-5) =	\$6,400,000 +
10-year NPV =	\$2,260,000 +
40-year NPV =	\$1,600,000 +
<i>NPV calculated using a 40% tax rate and 6% discounted rate.</i>	

Case Study B: Post CSS Allocation			
Personal Property	5-year	\$3,807,249	15.68%
Land Improvements	15-year	\$1,323,704	5.45%
Real Property	39-year	\$19,140,324	78.86%
Total Depreciable		\$100,000,000	100%

Case Study B: Financial Impact	
Additional Depreciation (year 1) =	\$756,000 +
Additional Depreciation (years 1-5) =	\$3,480,000 +
10-year NPV =	\$930,000 +
40-year NPV =	\$1,270,000 +
<i>NPV calculated using a 40% tax rate and 6% discounted rate.</i>	

have recently renovated.

The best time for a CSS is immediately following acquisition or construction. Ideally, you will have a study performed on the property when it's placed in service. Therefore, any changes you make in the future, including tenant improvements, can be properly addressed from a tax and depreciation perspective. Materials removed from the property can be written-off and you will no longer have to continue depreciating assets that are now in the dumpster.

While we're discussing tenant improvements there is an important update that you should all know about and it's great news. Qualified Leasehold Improvements (QLIs) are back. The Tax Relief and Health Care Act of 2006 retroactively extended the deadline for this special treatment from December 31, 2005 to December 31, 2007. This provision allows taxpayers to depreciate "qualifying" improvements using a 15-year straight line recovery period instead of the

standard 39-year period, which can significantly improve cash flow. Note that there is still a significant opportunity to identify 5 and 7-year assets as well.

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:

Impact of QLIs	
\$100,000 allocated to	
15-year SL vs. 39-year SL	
10-year NPV savings =	\$11,939
40-year NPV savings =	\$10,845
<i>NPV calculated using a 40% tax rate and 6% discounted rate.</i>	

- 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. A binding commitment between related persons is not treated as a lease.
- That part of the building is to be occupied exclusively by the lessee (or any sublessee) of that part.
- The improvement is placed in

service more than 3 years after the date the building was first placed in service. This is 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: The enlargement of the building; any elevator or escalator; any structural component benefiting a common area or the internal structural framework of the building.

If you are planning improvements for a tenant this year, which you'll be paying for, keep the cut off date of December 31, 2007 in mind. The difference between placing the improvements in service on December 31st of 2007 verses January 1st of 2008 can be very substantial. I met with a prospective client recently who will realize approximately \$200,000 in additional net present value savings on a \$2.5 million tenant improvement if they can make the December 31st deadline.

Not all CSS are the same. Very few providers will take the time to fully explain the options and additional benefits. This may be due to a lack of understanding or because they simply want to submit the most competitive bid possible. A CSS that separately groups improvements by tenant will generally require more work and therefore cost more. The additional cost is often minimal, but in an industry that's getting more and more competitive, less experienced providers are doing whatever they can to keep prices down and profit margins up. An experienced provider will explain the options and help an owner make a decision based on needs and total value, not simply on price. We all know that the old saying is true—you get what you pay for.

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