

## Is there a pot of gold hidden in your walls?

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What would you say if someone offered you a dollar in exchange for a dime? Sounds too good to be true - we know. What if your accountant said he had a service that would return \$1 in tax savings for every ten cents you spent on a service? We know smart business owners would say, "Sign me up!" The service is called cost segregation and it brings great IRS-recognized tax savings to building owners interested in retaining cash and decreased dividend payout requirements to real estate investment trusts (REITs).

Accountants have traditionally limited their assignment of short-term depreciation of building components for Federal Income Tax purposes to the 3-5% of building costs found in furniture and fixtures. A cost segregation analysis maximizes a building's tax benefits by identifying, classifying, and segregating a larger percentage of a building's assets for accelerated depreciation. Depending on the building's features and usage, cost segregation studies can often identify anywhere from 10% to 50% or more a building's components for short-term depreciation. These savings drop right to your bottom line.

Is there more than one power outlet in any of your offices? Are your walls penetrating the drop ceiling tiles? Is there a one-of-a-kind reception desk in the building? Have you supplied a kitchen for your multi-family or corporate tenants? How is the conference room paneling attached to the wall? Do you have decorative lighting in and around the building? Is there dedicated cooling to accommodate your data processing room? Do you have a redundant air system to support a clean room or kitchen? These are just a few of the items that cost segregation specialist may identify to save you money. Based upon the Modified Accelerated Cost Recovery System (MACRS), cost segregation professionals assign the appropriate classification and tax life for each component of a building. The most common tax lives allowed by MACRS are 5, 7 and 15 years rather than 39.5 years (27.5 years for multi-family).

Cost segregation studies should be initiated as early in the construction or acquisition process as possible to obtain maximum savings. Consider these three points:

- If allowed just 10 minutes with the architect before the building is designed, we can describe how to make a larger percentage of the building's components qualify for short-term depreciation thereby increasing the tax savings to the building owner.
- If granted early access to the construction chief, we will request that unimposing five to ten items' costs are set aside for our use. Building components usually have a higher invoiced cost than can be substantiated from cost estimating guides. With proof of the true costs, we can report the higher value in our report. As the building process progresses, these costs documents get lumped into bigger line items and are harder to segregate.
- Performing a cost segregation study before the acquisition of a building allows for the identification of personal property from the building costs. The two costs can then be broken out in the sales agreement and the real property transfer tax basis can be reduced.

Also, don't forget to consider the potential depreciation savings when analyzing an acquisition. Consider the following scenario: A 20-year loan for 75% of a \$10 million value at an interest rate of 7.5% will yield you a monthly payment of \$80,500. Although every situation is different, typical savings from a cost segregation study on most \$10 million commercial and multi-family property is at least \$82,000 the first year. That means in the first year alone you have saved enough in taxes to make one mortgage payment.

If you plan on leasing your building to others, you need to provide a construction allowance for tenant build-outs, charge the tenant more rent for the improved space, and capture the Federal tax depreciation benefit from the improvements through a cost segregation analysis.

Cost segregation studies often times do produce results for properties that have been depreciated for as many as ten years. We can file an IRS Form 3115, Change of Accounting Method, and a Section 481 Adjustment to adjust the property's Federal tax position from the straight-line 39.5-year depreciation (27.5 years for multi-family) to the new accelerated depreciation mapped out in a cost segregation study. Short-term depreciable items are then put through a correction schedule and the overpayment in tax is returned to the property owner in equal increments over the next four years.

Once the cost segregation study is complete, the results are effortlessly reorganized into three other useful reports: 1) Property tax, 2) Fixed asset and deferred tax liability/asset management, and 3) Insurable value. Imagine finding out that your property value is lower than what the assessor has recorded and that you have been overpaying your property taxes. You can file for a restatement and if applicable, a refund. At the same time, you can make sure you have insured your facility for as much as you actually need (Parking lots and sidewalks don't burn so why would you include them in your fire insurance policy).

A good cost segregation study will not trigger an IRS audit. Having said that, make sure your provider can defend his position for why he selected each component for accelerated depreciation and, if necessary, can and will prove his position to the IRS three-to-five years after the cost segregation study has been performed. A good cost segregation analysis is based on well-founded interpretations of the Internal Revenue Code Sections, applicable court cases, and revenue rulings.