

INSIDER'S OUTLOOK

The value of cost segregation for owners, managers

By ISRAEL SEGAL, PRESIDENT,
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Building owners and managers can significantly reduce their taxes through a process called cost segregation. In fact, cost segregation has become one of the most vital aspects of real estate financing with tax consequences that can significantly add to a facility's bottom line.

According to federal tax laws, cost segregation consists of identifying personal property assets that are grouped with real property assets, then separating personal assets for tax reporting purposes.

In order to do this, one must hire an experienced engineer who should have a well-rounded understanding of construction finance, to produce a cost segregation analysis that identifies and classifies personal property assets so that depreciation time is dramatically truncated thus reducing one's tax obligations.

What is personal property? It consists of a building's non-structural elements, exterior land improvements, and indirect construction costs.

The engineer that one retains will examine all blueprints as well as architectural drawings, electrical plans, and isolate structural and mechanical components from those that are considered personal property. The cost segregation report will also identify architectural and engineering fees that can be segregated.

The report will identify "soft costs," such as architectural and engineering fees, that are components of the building. In addition a well documented and thorough cost segregation analysis will do the following:

Maximize tax savings by adjusting the timing of deductions.

Create an audit trail to help resolve IRS inquiries.

Take advantage of retroactive benefits. Building owners and managers can

capture immediate retroactive savings on property added since 1987. The rules have been amended so that you can now take the full amount of an adjustment in the year the cost segregation is completed.

Provide significant opportunities to reduce real estate tax liabilities.

And, under certain circumstances, permit building owners and managers to qualify for a special 30% bonus depreciation allowed by the Job Creation and Worker Assistance Act of 2002 or a 50% bonus depreciation allowed under the Jobs and Growth Tax Relief Reconciliation Act of 2003.

The cost segregation study will identify building costs that would normally be depreciated over a 27.5 to 39-year period, then reclassify those costs, resulting in an accelerated method of depreciation. Such non-structural costs for such items as carpeting, wall coverings, some aspects of an electrical system, decorative lighting, indoor and outdoor plants, sidewalks, and landscaping, can all be depreciated during the much shorter periods of five, seven or fifteen years.

The larger tax deductions will result in increased cash flow and a lower cost of capital, especially during the first few years following an expansion project, renovation, or purchase. A cost segregation study can significantly help identify opportunities for such periods of accelerated depreciation.

In order for building owners and managers to take full advantage of cost segregation opportunities, buildings must have been purchased, constructed, renovated, or expanded after 1987.

While cost segregation is cost effective for such new buildings, a well done study can uncover tax deductions for buildings that pre date 1987. In addition, buildings that are best suited for cost segregation should have a cost basis that

is greater than \$500,000.

In addition to providing tax relief, cost segregation can benefit building owners and managers in the following ways:

Maximizing tax savings by adjusting the timing of deductions. When an asset's life is shortened, depreciation expense is accelerated and tax payments are decreased during the early stages of a property's life. This, in turn, releases cash for investment opportunities or current operating needs.

Creating an audit trail. Improper documentation of cost and asset classifications can lead to an unfavorable audit adjustment. A properly documented cost segregation helps resolve IRS inquiries at the earliest stages.

Playing Catch-Up: Since 1996, taxpayers can capture immediate retroactive savings on property added since 1987. Previous rules, which provided a four-year catch-up period for retroactive savings, have been amended to allow taxpayers to take the entire amount of the adjustment in the year the cost segregation is completed. This opportunity to recapture unrecognized depreciation in one year presents an opportunity to perform retroactive cost segregation analyses on older properties to increase cash flow in the current year.

Additional tax benefits. Cost segregation can also reveal opportunities to reduce real estate tax liabilities and identify certain sales and use tax savings opportunities.

Under certain circumstances, segregated assets may qualify for a special 30% bonus depreciation allowed by the Job Creation and Worker Assistance Act of 2002 or a 50% bonus depreciation allowed under the Jobs and Growth Tax Relief Reconciliation Act of 2003.

An example of Cost Segregation: Suppose an individual purchases a building for \$10,000,000 while the

land is owned by another entity. If the purchaser does not use cost segregation, then straight-line depreciation over 39 years must be used.

If, however, an engineer is retained and produces a report that shows that of the total purchase price, \$9,000,000 should be for the building and \$800,000 for a parking lot, and \$50,000 for landscaping and shrubbery, the facility owner could save more than \$100,000 assuming a tax rate of 35% and 5% discount rate.

There is an another example of the tax savings that can result from cost segregation. Suppose a cost segregation analysis shows that a building's siding had an initial value of \$200,000. Five years later, it has a value of \$150,000 and must be replaced. The facility owner could deduct \$150,000 as a loss. Without a cost segregation study, the owner would be not able to take the deduction because the siding's tax basis and the cost basis of the building would not have been itemized as separate entities.

Altogether, a cost segregation study is an essential fiduciary component when one does any of the following: building a new facility; acquiring an existing building, renovating an existing facility, or expanding a facility.

And the following kinds of buildings are the most appropriate for cost segregation analysis: apartment complexes; automobile dealerships; distribution centers; fast food restaurants; food processing facilities; hotels/motels; manufacturing plants; medical centers; nursing homes; office buildings; retail chains/franchises; shopping malls; and supermarkets

Building owners and managers who do not hire the appropriate experts to conduct a cost segregation analysis will fail to take advantage of significant tax benefits. ■

Insight on the ideal conditions for acquiring raw land

By H. ROSS FORD III, PRESIDENT AND
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The recent credit crunch and related financial industry turmoil has dramatically limited financing options for real estate acquisitions, causing many to step back from a market that had been moving at a feverish pace only nine months ago. This widespread reversal in momentum has created ideal conditions for those considering the acquisition of raw land. Historically, great wealth has been accumulated by individuals who understood the concept of buying and holding raw land, and this may be one of the best times to buy land since the early 1990s.

The ready availability of capital from Wall Street lenders and the commercial mortgage-backed securities market created a significant run-up in land prices during the past several years. Developers worked overtime to put new products onto the market while purchasing land lots for future development.

However, the dramatic pull-back in

the credit markets has made it extraordinarily difficult for buyers to obtain financing. Not surprisingly, there is a historic property inventory backlog, and while demand exists, it is constrained by credit woes. The resulting slowdown in development across the country has prompted significant decreases in sales prices.

In some markets, particularly in Florida, California, Nevada and other West Coast states, homebuilders had amassed large amounts of undeveloped land on which they had planned to construct new homes. This type of scenario makes now an excellent time to acquire raw land because builders are looking to move existing inventory off their books. They bought the land at a time when the residential sector was thriving and prices were rising. Many homebuilders now own a great deal of land that is dropping in value, and, increasingly, they are seeking to dispose of this land, even if it means absorbing a loss.

As the real estate market became

overheated during the past several years, many savvy investors withdrew to the sidelines, waiting for value to return to the market. These investors, recognizing that acquisition conditions are becoming ever more favorable, are beginning to increase their activity. This trend is likely to continue as the economy moves beyond the credit crisis and through this period of disruption.

Investors should see plenty of opportunities to acquire land over the next 18 to 24 months. Most market watchers do not expect the glut of homes on the market to begin to clear up until at least midyear 2009, meaning that raw land will be available at an even greater value. Now may well be the ideal time for acquisitions — before the economy turns around and before interest rates become less favorable. Holding raw land as an investment also offers buyers some downside protection at a time of stock market volatility. A well-researched investment in land can provide numerous benefits to investors and make raw

land one of the most sound investment strategies available today.

Land investors must have a mid-to-long-term view, holding the parcel until the next real estate cycle comes around and offers the opportunity to sell. Correctly identified and evaluated in the path of growth, land can sometimes more than double in value in five years. In fact, many land buyers do not expect to see a return on their investment for as long as three to seven years. When the cycle turns, however, investors with large tracts of raw land will be perfectly positioned with valuable assets to sell at a time other investors are just beginning to search for investment opportunities.

Land parcels are now available at sharply discounted prices, with some sales representing a 50 percent loss for the seller. While opportunities to buy land remain, this may soon change. When prices fully stabilize, a flood of investors will be seeking to snap up land bargains, pushing prices higher, making today an ideal time to buy. ■