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Is There Money Hidden In The Walls Of Your Building?

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If you own or lease a commercial building and want to 'find' some money hidden in your walls through additional tax benefits, consider performing a Cost Segregation study on your building.

Many commercial building owners are taking advantage of this real estate tax strategy that in the past has primarily been used by Fortune 500 companies. This lucrative strategy can create significant and measurable tax benefits, and bring additional value to your building that you may not have realized was accessible to you.

What is a Cost Segregation Study?

Although Cost Segregation is a tax strategy that's been available for years, many real estate owners haven't heard of it. So...what exactly is a Cost Segregation Study?

A Cost Segregation Study is an in-depth analysis of the costs incurred to build, acquire or renovate a real estate holding. The primary goal of a Cost Segregation Study is to identify all construction-related costs that qualify for accelerated tax depreciation utilizing IRS guidelines.

Engineering based Cost Segregation studies allow commercial real estate owners to take what would otherwise be classified as real property (1250) for depreciation purposes and reclassify it as more rapidly depreciating personal property (1245). This reclassification results in substantial cash flow benefits in both current and future years through substantially shorter depreciable tax life and accelerated depreciation methods.

The IRS endorses the use of Cost Segregation studies where independent construction engineers study the property components, estimate costs and reclassify Real Property components (depreciated over 27.5 or 39 years) to Personal Property components (depreciated at 5 or 7 years) and Land Improvements (depreciated over 15 years). Typically, between 20% and 40% of a building currently being depreciated over 27.5 or 39 years qualifies for a faster recovery period.

The History of Cost Segregation

The legislation and procedures used in an engineering-based Cost Segregation study have been in existence since the enactment of the Investment Tax Credit (ITC) in 1962. When the act was repealed in 1986, most people assumed that Cost Segregation studies provided no further benefit under the new law. However, in a landmark 1997 tax court case, Hospital Corporation of America successfully defended the application of engineering-based Cost Segregation as a viable method to differentiate real and personal property under existing law.

Several recent rulings have been issued by the government to spur economic growth, which can have a major impact for building owners who have constructed, purchased or renovated a commercial property.

- During 2002, the IRS automatically consents to changes in the method of depreciation via Form 3115, filed with the return in the year the change is elected. (Rev. Procedure 2002-09)

- **What this means to you:** The IRS made it easy to change your method of depreciation to account for a Cost Segregation study, without the headache of an amended return.
- Following the 9/11 tragedies, the government allowed taxpayers to catch up on all deductions from previous years for items reclassified into the shorter tax lives as a result of a Cost Segregation study. (Rev. Procedure 2002-19)

What this means to you: Prior to 9/11 ruling, the beneficial adjustment had to be spread out across four years, but can now be expensed entirely in the year of the change, reported as a reduction to the current year taxable income.

- In 2004, the IRS reversed the two-year waiting period required to change the method of calculation for depreciation on a commercial property. (Rev. Procedure 2004-11)
- What this means to you:** You can change your method of depreciation in any year. Previously, if you purchased a property and elected to depreciate it over 30 years, you had to wait two years before changing depreciation methods and utilize a Cost Segregation study to take advantage of the shorter-lived personal property asset classes.
- The 2008 Economic Stimulus Package. The Economic Stimulus Package of 2008 introduced by Congress not only generated rebates for individual tax payers for 2008, but also created additional tax incentives for commercial businesses. New bonus depreciation was introduced as a way to help increase cash flow and stimulate the economy for certain classifications of commercial properties.
 - The 2008 Emergency Stabilization Act. This Act, passed in October of 2008, extends the 15-year depreciation schedule for improvements made to restaurants through 2009, and includes new restaurant construction in 2009. The National Restaurant Association's research shows that for a \$700,000 construction project, a typical restaurant would save nearly \$7,000 a year in tax payments using accelerated depreciation.

A Cost Segregation Example:

Example: A cost segregation study is performed on a building currently valued at \$2 million (this amount excludes the land). 100% of the building is currently being depreciated as Real Property with a 39 year depreciation schedule. When the Cost Segregation study is performed, the study reclassifies 30% of the building into short life assets.

<u>Before the Cost Segregation Study</u>	<u>After the Cost Segregation Study</u>
39 year property \$2,000,000	39 year property \$1,400,000 5 year property \$ 600,000

<u>Year One Depreciation - Before The Study</u>	<u>Year One Depreciation - After the Study</u>
\$2,000,000 / 39 years \$51,282	\$600,000 / 5 years (200% Declining Balance) = \$240,000 (\$600K / 5) * 2

**Total Year One Depreciation:
\$35,897 + \$240,000 = \$275,897**

Difference in Year 1 Depreciation

	No Cost Segregation	With Cost Segregation
Total Depreciation	\$51,282	\$275,897
Tax Benefit	\$20,513	\$110,359

Additional Year 1 Tax Benefit Gained Through Cost Segregation = \$89,846

Who Qualifies?

Many owners and tenants are eligible to take advantage of this tax benefit. The age of the building isn't important, but the building in-service date is. The property has to have been put in service by the current owner after December 31, 1986 or if a tenant, have been leased after that date.

If you own a building owner:

To qualify for a Cost Segregation Study, the company has to be a for-profit entity and the building's basis has to be valued at \$1,000,000 or more (excluding the land).

If you lease a (portion of a) building:

To qualify for a Cost Segregation Study, the tenant / lessee has to be a for-profit entity and the lease hold improvements basis should be valued at \$500,000 or more.

No-Cost Evaluation Of Your Property

One great feature of a Cost Segregation Study is that Capital Recovery Corporation will conduct a no-cost evaluation of a property to demonstrate the potential tax benefits to the property owner. This no-cost evaluation takes the worry out of spending money on something that you're unsure is going to benefit your business or reduce your personal taxes.

When is a good time to do a Cost Segregation Study?

A study can be conducted on any building put into service since 1987, but the best time to conduct a study is the year it is put in service. This allows the owner to begin accelerating their depreciation the year the building was purchased, and the additional benefit can be put to good use in purchasing equipment, renovating the facility, or even helping a new business improve their cash flow position through the crucial first five years.

Is a REIT a good candidate for a Cost Segregation Study?

A REIT can gain from a Cost Segregation Study in two ways: it can significantly reduce taxable income and its distribution requirement, and a study permits the REIT to pay dividends in the form of return of capital (untaxed until the shareholders shares are sold) instead of ordinary income.

So if you want to 'find' some money hidden in your walls this year or have questions about Cost Segregation, email Andy Meisner at andy@capitalgroup.com or call him at 888-861-3331.

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