



Hustle and Flow

Speeding up tax depreciation on borrowers' properties may make their cash flow more attractive to lenders

WITH THE CONTINUING CREDIT CRUNCH, increasing property foreclosures and tighter mortgage-underwriting standards than in recent years, commercial mortgage brokers often must help their clients find creative ways to meet lenders' requirements and prequalify for loans. One common area of concern for commercial mortgage lenders is borrowers' cash flow — or lack thereof.

Brokers can help their clients understand how to increase their property's cash flow — and therefore, their chances of getting a loan — through a cost-segregation study.

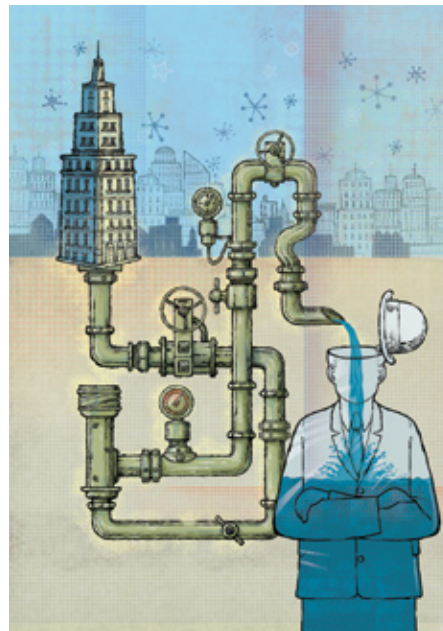
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When borrowers have access to substantial cash flow from the start of the transaction, lenders often feel more confident that they are bankable and can repay the debt. As such, clients' cash flow is one area to which commercial mortgage brokers should pay particular attention when prequalifying potential borrowers.

When lenders evaluate potential loans for approval, tax depreciation typically is not part of the equation. But by employing a cost-segregation study, which speeds up tax depreciation on borrowers' property, borrowers can face a better net cash-flow position. This can make a deal more fruitful for lenders and borrowers alike.

Cost segregation is a multidisciplinary approach that involves tax and engineering expertise. It identifies hidden assets often buried inside commercial real estate projects. Many times, these assets can be written off over a much shorter tax life than the building itself.

In the hospitality industry, for example, most assets fall into the personal-property classification and have five-year depreciations, and land improvements have



a 15-year tax-life period. The balance of the core real estate for a hotel, excluding land, typically is depreciated over a standard 39-year period.

Examples of often-overlooked assets that can be carved out in a cost-segregation study include, but are not limited to, exterior irrigation systems, curbing and sidewalks, site lighting, interior decorative lighting, process mechanical systems dedicated to equipment, water lines to equipment, fire systems for kitchen equipment, exhaust hoods for process equipment, etc.

Understanding details

The core competency of this specialized service came about in a 1997 U.S. Tax Court case, *Hospital Corporation of America vs. Commissioner*, won in large part by the taxpayer. The case provided guidance to taxpayers and certified public

accountants (CPAs) to help them determine what is considered real property versus personal property.

Many CPA firms do not have all the necessary expertise in-house to conduct a cost-segregation study properly, and the engineering portion is just as critical in determining and valuing assets that qualify for the shorter write-off periods. Taxpayers need the guidance of the right tax and engineering professionals to employ these techniques properly and to pass muster with the Internal Revenue Service (IRS) if the study or taxpayer faces an audit later.

If a property-owner hasn't previously used a cost-segregation study, the IRS allows taxpayers to go back and "catch up" on depreciation and take that difference in the current tax year. This is known as an Internal Revenue Code Section No. 481(a) adjustment, which would be an additional depreciation deduction.

Taxpayers do not have to amend any prior years' income-tax returns to do this. There is a one-time filing obligation via IRS Form No. 3115 that they must complete before filing the current year's income-tax return, but it

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is an automatic accounting-method change that does not require IRS preapproval.

Technically speaking, in evaluating their ability to “go back in time,” taxpayers can look at any commercial real estate they purchased and for which they did not use cost segregation as far back as Jan. 1, 1987. Considering the time and the cost to perform such a study, properties that have been in service in the past 10 years likely are the best candidates.

Study examples

To convey the benefits of cost-segregation studies properly, consider the following examples.

- **New hotel construction:** Consider a project where total costs to construct are about \$10 million. Without cost segregation employed, the hotel-owner would receive benefits in the form of depreciation write-offs equally in the next 39 years. The tax-depreciation expense on average would be about \$250,000 annually. In the first five years, the customer would accumulate about \$1.25 million. Employing a cost-segregation study, however, the hotel-owner could yield

depreciation benefits of about \$3.1 million in the first five years. This upswing in tax write-offs in the first five years would be about \$1.85 million. With a combined 40-percent federal and state income-tax rate, the taxes deferred in the first five years amount to about \$740,000. The first year alone could yield a net increase in tax depreciation of about \$350,000.

- **Multifamily apartment complex:** A standard apartment complex purchased in 2002 for \$12 million, exclusive of land, can allocate about 24 percent of the depreciable cost between five- and 15-year depreciable lives. For the property-owner, this means a cash-flow infusion of about \$1.4 million to catch up as an additional depreciation item in the current year’s tax return. In terms of tax deferral, a 40-percent combined tax rate may yield a tax-deferred benefit of \$560,000.
- **Retail shopping center:** For a retail strip center acquired in 2005 for \$15 million, exclusive of land, a cost-segregation analysis could allocate an average 22 percent of the depreciable cost between five- and 15-year depreciable lives. The first-year impact to the property-owner is a cash

infusion of almost \$1.3 million in the current tax year alone. This would be a tax-depreciation deduction beyond what the owner was expecting under the conventional 39-year tax classification. The tax deferral at 40-percent combined rate may yield a tax-deferred benefit of \$520,000.

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Employing a cost-segregation study can benefit all parties in a commercial mortgage transaction. Granted, certain tax situations may limit some property-owners from gaining cost segregation’s full benefits because of profitability, passive loss rules or other issues.

The key ingredient for mortgage brokers is that the acceleration of cash flow can show the lender that borrowers are more liquid than before and have an enhanced cash-flow position. ●

Note: Nothing in this article should be construed as the dispensing of tax advice. Mortgage brokers and their clients should seek advice from their certified public accountant or financial adviser for information specific to their individual situation.