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OPINION

Restaurant, franchise owners enjoy cash flow and tax savings from IRS windfall

By Grant Keppel, CPA

For individuals or companies that have purchased, constructed or substantially renovated a building since 1987, a recently released revenue procedure, coupled with a landmark tax court case, provides new impetus for undergoing a cost segregation study that could result in significant and immediate cash flow and tax savings.

While the enactment of the Tax Reform Act of 1986 eliminated the Investment Tax Credit, it substantially altered the depreciation system for real and personal property by classifying assets into nearly 130 different categories, each with its own depreciable life. That pattern of depreciable lives is known as the Modified Accelerated Cost Recovery System.

In the landmark Tax Court case Hospital Corp. of America, 109 TC 21 (1997), the court held that if the property would have qualified as tangible personal property under the repealed ITC, that same property would also qualify as tangible personal property under MACRS. In addition, a 1998 IRS revenue procedure allows real-estate owners to go back automatically to closed tax years and "catch up" the entire omitted depreciation, without amending tax returns.

A cost segregation study will identify and price nonstructural elements and exterior improvements, making it possible for property owners to maximize their depreciation deductions by reclassifying as much as possible of the related costs from building costs to personal property and exterior improvements. In addition, indirect construction costs, such as construction period interest, general conditions, and architecture and engineering fees are allocated on a pro-rata basis to the assets identified as nonstructural. By maximizing the depreciation deductions, building owners will increase their cash flow by paying less income tax during the early years of the depreciable life of a building. As stated earlier, the owner is also eligible to play "catch up" for depreciation errors made in prior years.

Under today's guidelines, a commercial building is depreciated for tax purposes over 39 years and residential real estate for 27 1/2 years. Upon segregation of tangible personal property and exterior improvements from a building's cost, companies realize the benefits of deducting accelerated depreciation on assets otherwise lumped together with a building's cost. Generally, for the restaurant and fast-food industry, 25 to 55 percent of building costs can be segregated into five, seven or 15-year lives instead of a 39-year life.

Examples of tangible personal property include process heating and ventilating systems, a grease trap, a fire system, flooring, movable wall partitions and appliances. Examples of exterior improvements include sidewalks, drainage, parking lots, landscaping, roads, site utilities, fencing and outdoor lighting.

The savings from an accelerated recovery can be quite significant. An example is a fast-food restaurant chain that constructed 10 new restaurants from 1992 to 1994 with an average cost per store of $600,000, excluding the equipment package. The company had been depreciating each building over 31 1/2 and 39 years. A cost segregation study was performed, segregating 20 percent of the building cost to the 15-year property and 25 percent to the five-year property. As a result of the segregation for the 10 buildings, the total taxes deferred over the cumulative four-year period exceeded $700,000, while the cumulative present value on the taxes deferred at 8 percent was approximately $400,000, assuming a combined federal and state effective tax rate of 46 percent.

Real-estate investments best suited to undergo a cost segregation study include all post-1986 real-estate construction, building acquisitions or improvements, new buildings under construction, the purchase of existing property, existing buildings undergoing renovation or expansion, and office leasehold improvements and "fit-outs."

Other factors to be considered when you are deciding to undergo a cost segregation study include the profitability of the entity or its shareholders, passive activity rules, early disposition and other tax-related situations.

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