Allocate Construction Costs To Improve Cash Flow

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Typically, the parties in a real estate transaction do not get an appraiser involved until the end or near the end of the transaction. This may be a mistake. By bringing in a skilled, qualified appraiser to look at all parts of a transaction from the beginning, you may identify opportunities for significant tax benefits that would otherwise go unnoticed.

If you are involved in construction, or in the acquisition or financing of a new facility, you should be aware that allocating costs between real and personal property is an important tool for securing the most favorable depreciation rates, which in turn are an essential financing and planning tool in today's market. The key to achieving these significant tax savings lies in properly segregating construction-related costs according to their federal tax lives.

Tax Benefits of Cost Segregation

Since Congress passed the Tax Reform Act of 1986, depreciable property has generally been depreciated under the Modified Accelerated Cost Recovery System, or MACRS. For many types of business assets, such as manufacturing equipment, office furniture and fixtures, and computer systems, almost anyone can determine the cost of an asset, and use the appropriate tables to determine the depreciation amount over its statutory tax life for federal tax purposes. But construction-related costs on a building project, which typically account for 80 to 90 percent of the overall project cost, are usually lumped together as "Realty," which has a depreciable life of 39 years.

To achieve the maximum write-off of a newly constructed or newly acquired facility, an alert builder/investor will commission a cost segregation study, whose purpose is to identify all related costs that qualify for a shorter federal tax life. The taxpayer can often reduce tax lives of many assets from 39 years (using a straight-line depreciation) to 15, 7, and even 5 years (using accelerated methods).

This shifting of the asset's tax lives can have a significant favorable impact on a business or corporation's federal tax liability. Take, for example, a 100,000-square-foot light manufacturing facility with construction costs totaling $3 million. With cost segregation, approximately 15 percent of the total construction cost would typically be classified as seven-year property and another 10 percent in a fifteen-year property. In the first year, an additional depreciation of $69,670 results in a tax saving of $23,688, assuming a 35-percent corporate tax rate; the net present value of the tax saving, at a 5-percent return over 39 years, comes to $91,550. (Interested readers may contact the author for a table describing a preliminary depreciation and present-worth analysis for typical new-construction

projects.)

Even greater savings may be realized on higher-cost, specialized construction projects, such as heavy manufacturing or metal stamping plants, or high-tech environments such as research labs, chemical processing plants, or pharmaceutical manufacturing facilities. For example, a modern high-tech pharmaceutical processing plant can cost anywhere from $15 million to $60 million to build; the tax saving resulting from an accelerated depreciation under MACRS may be as much as 75 times the amount given in the previous example. The table below summarizes the typical percentages of total construction cost that may qualify for accelerated depreciation on under MACRS, for various types of construction.

MACRS short-lived property in construction projects

Type of facility	% of construction cost qualifying for accelerated depreciation (average)
Retail or office building	10 to 20
Hotel	10 to 40
Building used as bank	15 to 35
Research	25 to 70
Manufacturing	15 to 85

Improvements to the land surrounding the building, such as paving, site utilities, landscaping, and site electricity, qualify as 15-year-life property. Which personal property items will qualify for five- or seven-year lives depends upon the nature of the business. Some of these are easily defined, since they relate either to equipment or operations within the facility. Others may be decorative in nature. Examples of personal property directly related to operations include process equipment; support foundations and framing; process-related electricity, plumbing, and HVAC; and, in some cases, land-improvement costs related to the processing. Also significant are the "soft costs" associated with the hard-cost construction components, such as architectural services, construction period interest, material testing, and various fees, which should also be allocated but are often overlooked in practice.

Will Your Project Benefit?

The simple answer is, "Yes"; almost any real estate owner can potentially realize tax-related economic benefits from the approach described here. The first step in finding out if your project may benefit is to have your situation reviewed by a qualified valuation consultant with expertise in this somewhat specialized technique. This will determine whether your equipment and other assets meet the criteria for a MACRS component segregation. If so, your consultant can then implement a detailed cost segregation study that will explore all possible classifications of your construction costs and segregate the asset costs properly between the various lives.

One word of caution, however. As with any accounting decision, it often pays to be aggressive, but the taxpayer must be prepared to defend his position—particularly today, when an aggressive taxpayer can expect to have his accounting decisions scrutinized very closely by the Internal Revenue Service. It is essential therefore to have a professional valuation consultant with specific skills and experience in allocating statutory tax lives of construction components, and who is capable of defending these allocations effectively. Your consultant should also be knowledgeable and up-to-date on the latest case law that may affect precisely what assets do and do not qualify for short-life property. With these precautions, many developers may find they can significantly improve their cash flow, and use the funds regained to help finance current expansion and future developments.

William F. Schoenhut, Jr., MAI, has derived millions of dollars in tax benefits for corporate giants such as Phillip Morris and General Electric as well as for REALTORS®, developers, REITs, investment banks, and other real estate investors. He is a Senior Vice President in the Philadelphia office of the national valuation and financial consulting firm of Marshall & Stevens, Inc. To learn more about the benefits of cost segregation, interested readers may contact Mr. Schoenhut at 800-797-0065.