

How Can an Investment in Real Estate Lower My Taxes?

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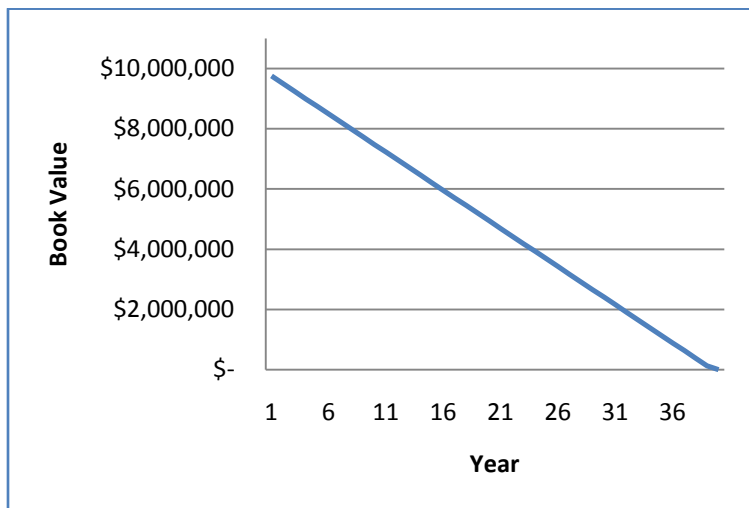
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All buyers of investment or corporate real estate should know about a powerful tax deferral strategy that reduces income taxes in the early years of an investment. The strategy can be employed whether a building is purchased or constructed and is inexpensive relative to the potential tax savings. Brokers, general construction contractors, construction project managers, and architects should also be aware of this strategy, since it might make the difference in a client's decision whether or not to undertake a project.

This strategy is known as cost segregation. It defers taxes by increasing depreciation.

In order to see how cost segregation reduces real estate taxes, we begin with how a property is depreciated in the absence of a cost segregation study. In this case, the recovery period depends on whether the building is residential or non-residential and when it was placed in service. The depreciation method is straight-line. The depreciation period for non-residential buildings placed in service after May 13, 1993 is 39.5 years. This means that, for this type of building with a construction cost of \$10 million, annual depreciation would be ($\$10 \text{ million} \div 39.5 \text{ years} =$) \$253,165. The resulting book value of the building at the end of each year is presented in Figure 1.

Figure 1: Book Value Using Straight-Line Depreciation Over 39.5 Years



Since taxable income is total income minus expenses and since one of these expenses is depreciation, increasing depreciation decreases taxable income. Cost segregation can take the income statement in Figure 2, with its high taxable income, and convert it into the one in Figure 3.

Figure 2: Income Statement without Cost Segregation

Total Income	\$ 1,000,000
Other Expenses	300,000
Depreciation Expense	<u>253,165</u>
Taxable Income	<u>\$ 446,835</u>

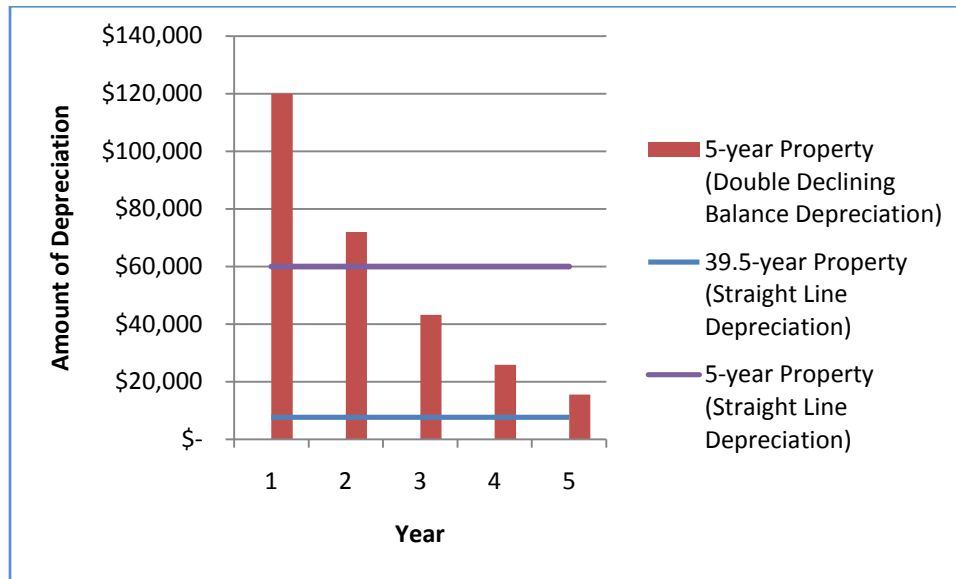
Figure 3: Income Statement with Cost Segregation

Total Income	\$ 1,000,000
Other Expenses	300,000
Depreciation Expense	<u>689,548</u>
Taxable Income	<u>\$ 10,452</u>

There are two ways in which cost segregation reduces taxes related to real estate. First, several components of the building are re-classified as 15-year, 7-year, or 5-year property. Second, it employs a type of accelerated depreciation known as the declining balance method.

Unlike the straight-line method of depreciation, the declining balance method uses a constant rate of depreciation instead of a constant amount. The initial rate of depreciation is applied to the remaining book value at the end of each year instead of the original cost of the asset. By itself, this method actually results in less depreciation than the straight-line method. For tax purposes, however, 5 and 7-year assets are depreciated at twice the straight-line rate (200%, or double declining balance) and 15-year assets are depreciated at 150% of the straight-line rate. If we shift 3% of our \$10 million property from 39.5-year property to 5-year property, the amount of depreciation that we can take on this portion of the property in the first five years increases dramatically. The rate of depreciation for the first year using the straight-line method is $(1 \div 5 =) 20\%$. By doubling this, we get an annual depreciation rate of 40%. As shown in Figure 4, the shift from 39.5-year property to 5-year property increases annual depreciation from \$7,595 to \$60,000 and the use of the double declining balance method increases the first-year depreciation to \$120,000.

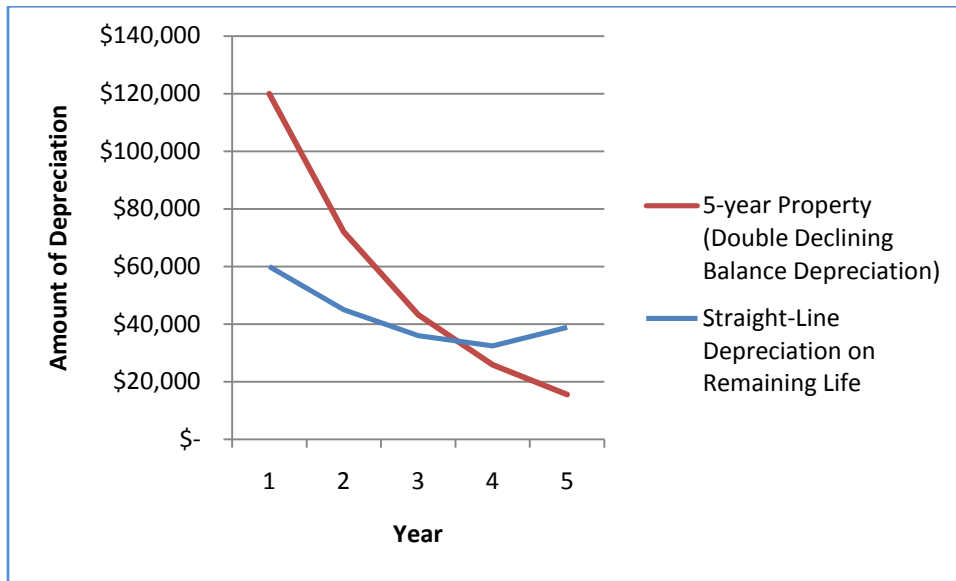
Figure 4: Effect of Shifting 3% of Cost from 39.5-year to 5-year Property



We're still not quite finished with our depreciation, however. At the end of 5 years, using the basic declining balance method, we have only depreciated our \$300,000 in 5-year property by \$276,672. Conversely, if we had used the straight-line method, we would have fully depreciated the property by this point. In order for this to happen, the straight-line method must result in higher depreciation than the double declining balance method at some point. In order to fully depreciate these assets, we have to switch from the double declining method to the straight-line method when the straight-line method results in higher depreciation.

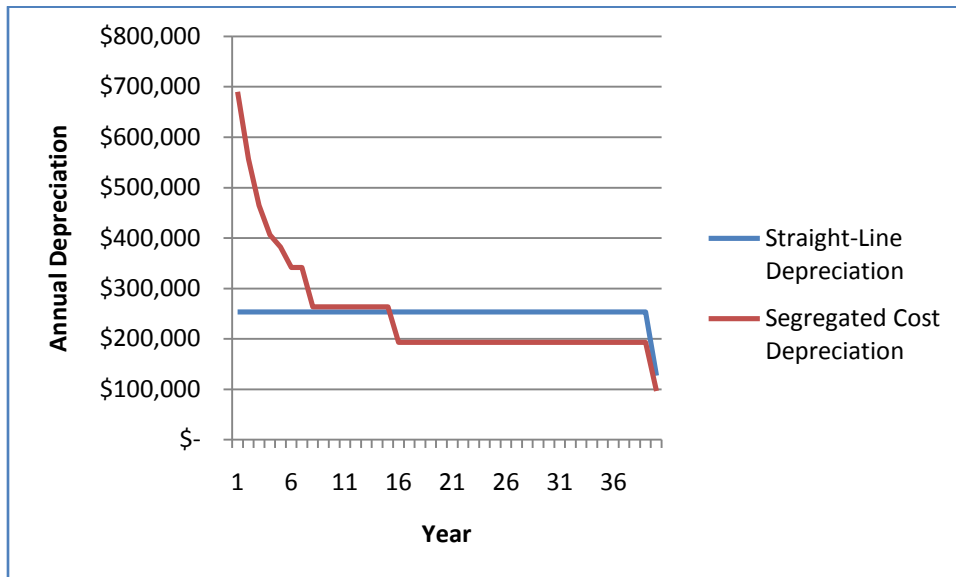
Figure 4 demonstrates the amount of depreciation if the straight-line method was used beginning in year 1, but we won't be switching to the straight-line method until a later year. Consequently, we have to calculate what the remaining book value divided by the remaining life will be for these assets for each year so that we can see when to switch to the straight-line method. Figure 5 shows us that switching to the straight-line method results in higher depreciation beginning in year 4.

Figure 5: Comparison of DDB and Straight-Line Depreciation by Year



We have now completed our depreciation schedule for the 5-year property. The next step is to complete the same process for the 7-year and 15-year property (using 150% declining balance instead of 200% for the 15-year property). Assuming that we classify 9% of the project as 7-year property and 12% as 15-year property, we arrive at a total first-year depreciation using the cost segregation method of \$689,548 compared to only \$253,165 using the straight-line method. The difference in the methods by year is presented in Figure 6.

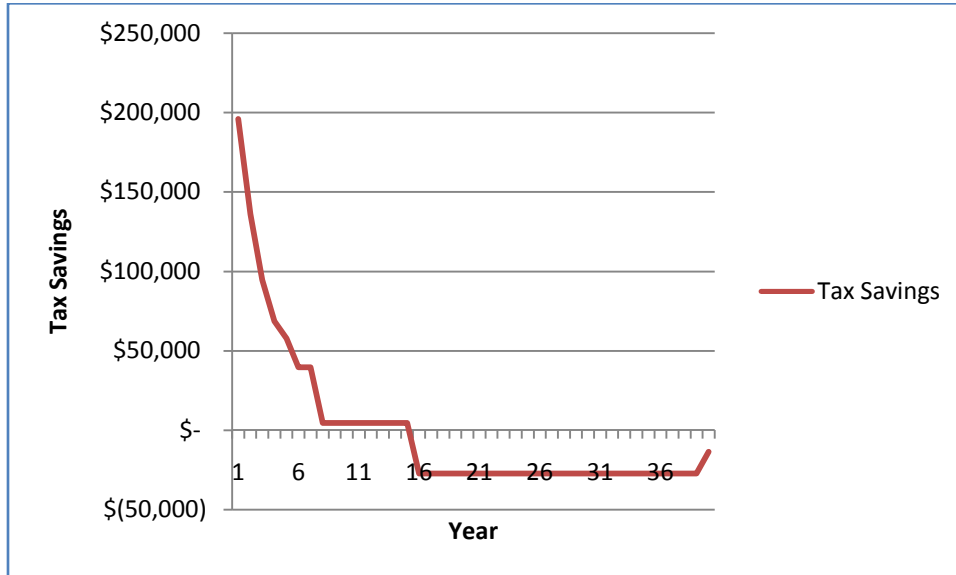
Figure 6: Comparison of Straight-Line and Segregated Cost Depreciation



As you can see, the depreciation using cost segregation is much higher in the first 7 years and continues to be higher than the straight-line method for the first 15 years.

Now we are in a position to figure out how cost segregation will affect taxes. For the purposes of this analysis, we will use a marginal federal tax rate of 35% and the Pennsylvania state tax rate of 9.9%. Based on these rates, the total tax savings each year are presented in Figure 7.

Figure 7: Total Tax Savings by Year Using Cost Segregation

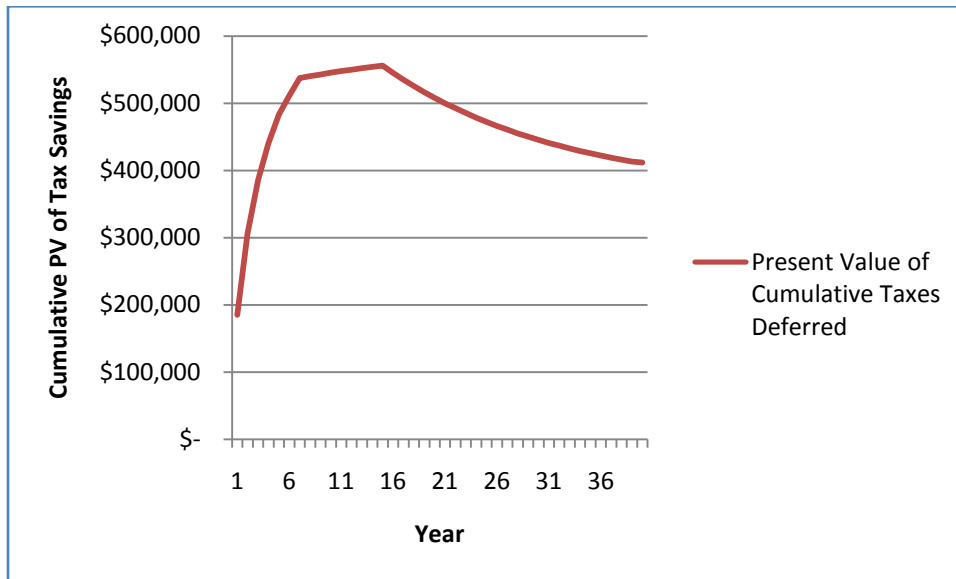


This indicates that the tax savings will continue through year 15, after which more taxes will actually be owed on the property than under the straight-line method. In fact, the total amount of taxes owed using either method if the property is held for 39.5 years or more are identical. This is why cost segregation is a tax deferral, instead of a tax avoidance, strategy. In order to illustrate the benefits of a tax deferral strategy, we have to introduce one final concept: the time value of money.

The time value of money is the idea that money received earlier is more valuable than the same amount of money received in the distant future. It is a universal feature of economics and accounts for interest on loans and bonds. The current value of an amount of money to be received in the future is known as its present value. In order to quantify the advantages of paying less in taxes now but more in the future, we have to apply a discount rate. In this case, we will use a discount rate of 6%.

We're now in a position to calculate tax savings by year. However, we know that the tax savings will be negative after year 15. What we are most interested in is the total tax savings over the life of the investment, or the cumulative savings by year. For this reason, we'll use the sum of the present values of the tax savings for each year. These are presented in Figure 8.

Figure 8: Present Value of Cumulative Taxes Deferred



We can see that the tax savings increase rapidly through year 7, then level out in year 15 before declining to just over \$400,000 at the end of the depreciation period. Since most investment real estate is held for less than 39.5 years, this is a valuable tool in planning an exit strategy. Of course, we might have to pay additional capital gains taxes upon disposition, but these are more than offset by the tax savings in every year after year 1.

All of these benefits begin with a cost segregation study. In order to reap the full benefits of the study and minimize challenges by the Internal Revenue Service, the study should be performed by a firm that has expertise in both construction costs and all of the accounting rules related to depreciation. Ideally, the study should be performed by a firm with both construction engineers and certified public accountants on staff. So the next time that you buy or build, be sure to look into a cost segregation study.