

Apartment Owners Find Tax Relief through Cost Segregation

By Patrick O'Connor, MAI

Apartment owners can face staggering expenses to maintain their properties. The upkeep of even a modest community could involve grounds keeping, unit renovation and replacements, such as parking lot asphalt and fencing. Another steep expense is federal income tax---and in some areas, an additional state tax on income. However, through an innovative study known as cost segregation, owners can use depreciation of property components to help lower federal taxes.

Today, more apartment investors are taking a close look at every possible avenue to lower costs. That's a frustrating task in the apartment business. One historically underused technique for saving money (in this case, saving taxes) is accurately reflecting all depreciable items on tax returns.

Those items are not limited to copiers, automobiles and heavy equipment. The list extends to a wide range of buildings and improvements. In fact, the Internal Revenue Service (IRS) recognizes 130 items that depreciate over much shorter time periods than the standard depreciation of 27.5 years for an apartment community. Many of those items, such as parking surfaces, landscaping and even certain wall coverings, are present in large proportions on typical apartment properties. A cost-segregation analysis, when reflected on depreciation schedules, reduces taxable income now and also defers taxes on capital gain amounts until the community is sold. At that time, the recapture of taxes on the extra depreciation taken can occur at a much lower rate than the 35 percent max tax avoided with the extra losses.

Don't forget the time value of money by deferring that inevitable tax by a few years. In light of the 130 IRS-identified "short life" items, this conservative tax-planning tool can help apartment owners allocate more costs to five-year, seven-year, 15-year and 27.5-year improvements versus the land value on rental properties.

Apartment communities, according to IRS rules, depreciate over the course of 27.5 years. This is 10 years less than the depreciation estimated for office, retail and industrial properties; this equals quicker savings for apartment owners. The IRS categorizes items found in every apartment, such as carpet, linoleum, window treatments and appliances, as five-year items, meaning that they are typically replaced after five years of use.

Comparing the Numbers

The following example comparison assumes a total cost basis of \$1.82 million less a land basis of \$172,000, for a total improvement basis of \$1.65 million. It depicts how depreciation using the cost segregation method increased this owner's depreciation by \$223,715 over five years, with nearly \$45,000 more in the first year. Using a 35 percent federal tax rate, this represents a savings of \$78,000 in taxes.

Wide Range of Applications

Whether an owner has recently purchased the community, owned it for a while, or has placed it on the market, a cost segregation analysis can help at any stage of ownership by reducing federal income taxes and showing future depreciation. The optimum time to do this is preferably as soon as ownership is taken, whether the property was bought or built. Any commercial property built after Dec. 31, 1986, is eligible, and there are "catch-up provisions" to accommodate higher savings in the first year in a cost segregation study completed for communities owned for several years.

Communities of all sizes can benefit, from small properties of fewer than 10 apartments to developments that span several city blocks. If the property has an assessed value of at least \$200,000, the cost segregation evaluation can almost always produce substantial federal income tax savings.

Preparing for a Study

A small amount of an owner's time is necessary when working with a consulting firm that specializes in cost segregation. And it is advisable for the owner's CPA or tax accountant to

collaborate with the consultant to ensure the most advantageous application for the particular financial circumstances.

The original purchase price of the apartment community is the cost basis; owners receive savings on their initial investment as well as on improvements. With research that is both quantitative, such as square footage of asphalt and pavement or quantities of wall or window coverings, and qualitative, such as judgment of remaining life, the consultant will conduct a specialized analysis and calculation before issuing a report. This report becomes the backup documentation for federal income tax returns.

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