

TAX SAVING STRATEGIES TO LOWER FACILITY COSTS

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While the investment in new property is a significant cost to corporations, opportunities to get tax relief exist for both investing in new leasehold improvements and when building new facilities.



New Tax Saving Provisions For Leasehold Tenant Improvements

Some tax savings are on the way for those who invest in leasehold tenant improvements in the coming years. Congress recently passed and President Bush signed a revised economic stimulus package that allows businesses to take a 30% tax deduction in the first year on the cost of leasehold tenant improvement projects that are undertaken in the next three years.

The bill, known as the Job Creation and Worker Assistance Act of 2002 HR 3090 provides that 30% of the costs of leasehold improvements made between 9/11/01 and 9/11/04 may be deducted in the year the improvements are placed in service.

The remaining 70% will be recovered over the remaining 38 years on the property. Notably, however, the so-called "close-out" provisions of current law will continue to apply. Thus, if a lease terminates before the 38-year period has elapsed, any remaining balance in the depreciation account may be deducted in the year the property is taken out of service. A transition rule will permit the 30% deduction for property placed in service between 9/12/04 and 1/1/05, so long as a binding contract was in place for the property as of 9/11/04.

The remaining provisions in the legislation relate to extensions of unemployment benefits, extension of expired and expiring provisions, net operating losses of corporations and various incentives for real estate development and jobs creation in lower Manhattan pursuant to the 9/11 tragedy.



Cost Segregation of New Facility Construction Can Create Big Tax Savings

One very significant potential tax savings for corporations building new facilities arises from the fact that owners of new construction get better tax treatment for personal and "site improvement" property than real property construction costs. The IRS allows that personal and site improvement property assets may be depreciated over a 7 or 15-year period whereas construction costs generally are depreciated over 39 years. Because Uncle Sam allows accelerated depreciation of trade fixtures and personal property, the legitimate reclassification of some building to personal property items will accelerate their depreciation and create significant tax savings.

The potential benefit of reclassifying construction can be huge. On a net present value basis, the benefit of reclassifying \$100 of property construction costs to either the 7-year or 15-year class is approximately \$17 and \$10 respectively. Utilizing state sales tax incentives that can provide significant additional savings at the point of purchase can also make additional savings.

While many owners and their accountants will allocate some asset costs to personal property, many legitimate deductions are overlooked due to a limited access to, or lack of familiarity with, either the construction cost documentation or the construction scope itself. This is why it is important to bring in professional help specializing in this area.

Cost Segregation Example

Example – Accelerated depreciation
New freestanding building
Site and building improvements total \$6 million

For simplicity, assume that the analysis identifies \$2 million in costs, which the owner's accountant agrees should be segregated as follows:

15 Year Category	\$ 1,400,000
7 Year Category	\$ 600,000

A schedule of the owner's tax deductions for the first five years is shown below:

<u>Year of Deduction</u>	<u>Deduction For 15-Year Assets</u>	<u>Deduction For 7-Year Assets</u>	<u>Total Accelerated Tax Deductions</u>		<u>Basic 39 Yr. Straight-line</u>
1	\$122,500	\$150,000	\$272,500	vs	\$51,280
2	\$127,820	\$128,580	\$256,400	vs	\$51,280
3	\$114,940	\$91,860	\$206,800	vs	\$51,280
4	\$103,460	\$65,580	\$169,040	vs	\$51,280
5	\$93,100	\$52,500	\$145,600	vs	\$51,280

Assumptions

15 year costs identified:	\$1,400,000
7-year costs identified:	\$600,000
Assume mid-quarter convention;	Assets placed in service in 1st quarter

The impact of accelerated depreciation is illustrated by comparing the final two columns. Total accelerated deductions are very significant in years 1 – 5, being "front-end loaded" for maximum benefit in the early years. As a comparison, the yearly deductions on a 39-year schedule would be \$51,280 per year for the entire 39-year recovery period.

In a recent real world example, a local electronics manufacturer will receive \$400,000 - \$500,000 in net present value savings through acceleration depreciation (large deductions in the first few years versus small deductions spread out evenly over 39 years) utilizing this method of reclassification of assets. They will also likely receive 80% – 90% sales tax relief totaling approximately \$800,000 in up front tax savings through the High Tech Sales Tax Deferral. This is a deferral only if they cease R&D operations; otherwise the tax obligation goes away.

If your company is considering a significant leasehold investment, or the construction of a new facility, be sure to discuss with your tax advisor these strategies.

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