

A Better Cash Flow

A Better Cash Flow Using Your Real Estate

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With the real estate markets improving in all areas in our country as both rental and occupancy rates have begun to increase, the economics of new construction are now becoming justified. Industrial plants around the country are producing at approximately 85% or better capacity, indicating a demand for new facilities. With new construction comes the need for obtaining maximum depreciation through cost allocation, the benefits of allocating cost between real and personal property become very relevant in today's market. By properly segregating construction related cost to their federal tax lives, both the real estate developer and corporate real estate executive may be able to improve the cash flow for their business, and in return, use the tax savings to pay for the cost of current and future expansions.

Identifying and depreciating the cost of manufacturing equipment, office furniture and fixtures, and computer equipment, property over five to seven years for federal tax purposes can be done by almost anyone. On the other-hand, construction related costs in a project may account for 80% to 90% of the overall project cost and are lumped together as realty, which has a depreciable life of 39-years.

In order to achieve maximum write-off of a newly constructed (or acquired) facility, a cost segregation study should be made to identify all related cost that qualify for a shorter federal tax-life. The end result is the reducing tax lives of 39-years (using a straight-line depreciation) to five, seven, and fifteen years, (using accelerated methods). The shifting of the asset's tax lives has a significant impact on a business or corporation's federal tax liability. For example, for a typical 100,000 square foot light manufacturing facility with construction cost totaling 3 Million dollars, it is reasonable to expect to have approximately 15% of the total construction cost in a seven year property and 10% of the total construction cost in a fifteen year property. The potential tax savings to an owner are reflected in Exhibit A. In the first year, there is an additional depreciation of \$69,670. The first years' tax saving is \$23,688, assuming a 35% corporate tax rate. The net present value of the tax saving at a 5% return over 39-years equals \$91,550.

While this example is for a typical light manufacturing facility, the real advantages become very apparent in heavy manufacturing or in the high-tech environment such as experimentation in research, chemical processing, metal stamping, pharmaceutical, and pharmaceutical manufacturing facilities. The savings that may be expected in these type projects are substantial, as the overall costs are much higher because of the specialized construction features. For example, the construction of a modern high-tech pharmaceutical processing plant can range anywhere from 15 to 60 Million dollars and the tax saving resulting from an accelerate depreciation under MACRS (Modification Cost Recovery System) can range anywhere from 25 to 75 times on the previous example. In exhibit B we have summarized the typical percentages of total construction cost, which may qualify for accelerate depreciation on under MACRS.

The land improvements that are fifteen year life property are those improvements on the land surrounding the building. Examples of such improvements are paving, site utilities, landscaping, and site electricity. Personal property are items, which qualify for either five or seven year lives, depends upon the nature of the business. These costs are easily defined, since they relate to either the equipment or operations that are within the facility or they may be items that are decorative to nature. Personal property examples that are related directly to the process equipment, are such items as: support foundations and framing, process relating and electricity, plumbing and HVAC. Also, in some cases, it includes land improvement cost related to the processing. In addition, an allocation of soft costs must be made to all hard costs of construction components. Soft cost includes such items as architectural services, construction period interest, material testing, and various fees. The allocation of these items is often overlooked.

While segregating the cost properly between the various lives is part art and science, a word of caution is needed. Although it pays to be aggressive, one must also be able to defend those allocations. With the federal government having emphasis on reducing the federal budget, the Internal Revenue Service is looking closely over all aggressive tax payers.

Marshall & Stevens, having been in business for 70 years, is skilled and knowledgeable on the allocation of the tax lives of components. We are also capable of defending these allocations. Our professional consultants are knowledgeable in the case law which deals precisely with short life property. Our company stands ready to assist you in classifying and exploring all possible classifications of the construction cost as to short lived lives. In this way, we may assist you in improving your cash flow to use for current expansion and future developments.

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