



Front Office

by Israel Segal

Cost segregation for hotels and motels can save owners money

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Hotels and motels can significantly reduce their taxes through a process called “cost segregation”. In fact, cost segregation has become one of the most vital aspects of hotel/motel financing with tax consequences that can significantly add to a facility’s bottom line. According to federal tax laws, cost segregation consists of identifying personal property assets that are grouped with real property assets, then separating personal assets for tax reporting purposes. In order to do this, one must hire an experienced engineer who should have a well-rounded understanding of construction finance to produce a cost segregation analysis that identifies and classifies personal property assets so that depreciation time is dramatically truncated, thus reducing one’s tax obligations.

What is personal property? It consists of a building’s non-structural elements, exterior land improvements, and indirect construction costs.

How cost segregation works

The engineer that the hotel owner retains will examine all blueprints as well as architectural drawings, and electrical plans, and isolate structural and mechanical components from those that are considered personal property. The cost segregation report will also identify architectural and engineering fees that can be segregated.

The cost segregation study will identify building costs that would normally be depreciated over a 27.5 to 39-year period, then reclassify those costs, resulting in an accelerated method of depreciation. Non-structural costs for such items as carpeting, wall coverings, some aspects of an electrical system, decorative lighting, indoor and outdoor plants, sidewalks, and landscaping can all be depreciated during the much shorter periods of five, seven or fifteen years.

The larger tax deductions will result in increased cash flow and a lower cost of capital, especially during the first few years following an expansion project, renovation, or purchase. A cost segregation study can significantly help identify opportunities for such periods of accelerated depreciation.

In order for hotels and motels to take full advantage of cost segregation opportunities, buildings must have been purchased, constructed, renovated, or expanded after 1987. While cost segregation is cost effective for such new buildings, a well done study can uncover tax deductions for buildings that pre-date 1987. In addition, buildings that are best suited for cost segregation should have a cost basis that is greater than \$500,000.

Cost segregation benefits

In addition to providing tax relief, cost segregation can benefit the owners and operators of hotels and motels in the following ways:

1. *Maximizing tax savings* by adjusting the timing of deductions. When an asset’s life is shortened, depreciation expense is accelerated and tax payments are decreased during the early stages of a property’s life. This, in turn, releases cash for investment opportunities or current operating needs.
2. *Creating an audit trail.* Improper documentation of cost and asset classifications can lead to an unfavorable audit adjustment. Properly documented cost segregation helps resolve IRS inquiries at the earliest stages.
3. *Playing Catch-Up:* Since 1996, taxpayers can capture immediate retroactive savings on property added since 1987. Previous rules, which provided a four-year catch-up period for retroactive savings, have been amended to allow taxpayers to take the entire amount of the adjustment in the year the cost segregation is completed. This opportunity to

recapture unrecognized depreciation in one year presents an opportunity to perform retroactive cost segregation analyses on older properties to increase cash flow in the current year.

4. *Additional tax benefits.* Cost segregation can also reveal opportunities to reduce real estate tax liabilities and identify certain sales and use tax savings opportunities.

Under certain circumstances, the Economic Stimulus Act (ESA) of 2008 allows depreciation of 50% of purchase cost. It also increased the Sec. 179 expensing limit to \$250,000.

Examples of cost segregation

Suppose an individual purchases a hotel/motel for \$10,000,000 while the land is owned by another entity. If the purchaser does not use cost segregation, then straight-line depreciation over 39 years must be used. If, however, an engineer is retained and produces a report that shows that of the total purchase price, \$9,000,000 should be for the building and \$800,000 for a parking lot, and \$50,000 for landscaping and shrubbery, the hotel owner could save more than \$100,000 assuming a tax rate of 35% and 5% discount rate.

Here is an example of the tax savings that can result from cost segregation. Suppose a cost segregation analysis shows that a building's siding had an initial value of \$200,000. Five years later, it has a value of \$150,000 and must be replaced. The hotel/motel owner could deduct \$150,000 as a loss. Without a cost segregation study, the owner would be not able to take the deduction because the siding's tax basis and the cost basis of the building would not have been itemized as separate entities.

Conclusion

Altogether, a cost segregation study is an essential fiduciary component when one does any of the following:

- Building a new hotel/motel,
- Acquiring an existing building,
- Renovating an existing hotel/motel, or
- Expanding a hotel/motel.

Owners and operators of hotels and motels who do not hire the appropriate experts to conduct a cost segregation analysis will fail to take advantage of significant tax benefits. ✧

(Israel Segal is president of VFR Finance, where he regularly performs cost segregation studies that identify and reclassify personal property assets so that depreciation time is significantly shortened for tax purposes, thus reducing one's tax obligations. VFR Finance specializes in all aspects of hotel/motel financing. The firm's website is www.vfrcs.com. For further information, please write info@vfrcs.com.)