

A Less-Taxing Way to Own Business Space

A sophisticated, IRS-allowable accounting practice and special tax incentives provided by the 2003 tax act have opened the door to a more affordable way to own office or industrial space.

The traditional way for most small to mid-sized business to acquire needed office or industrial space is leasing. Larger companies have the buying power to purchase business property, in order to better control their occupancy costs — but smaller companies have long been subject to rent increases caused by economic fluctuations over time.

In today's California real estate market, including here in the Silicon Valley, a second option is emerging. A growing number of developers and building owners are offering business condominiums, with office or industrial space that can be purchased on a much smaller scale than acquiring a complete building. Still, for many small businesses with modest cash reserves, making a down payment on the purchase of business space may seem beyond their reach.

Thanks to a little-known accounting practice called cost segregation, which has been accepted in the past by the IRS — together with outstanding tax benefits offered by the 2003 Jobs and Growth Tax Relief Reconciliation Act — any business owner can now consider the possibility of owning, rather than leasing, business space.

Let's take a closer look at cost segregation and several special, short-lived tax incentives, and see what they can mean for small to mid-sized companies.

Accelerated Depreciation

Commercial real estate has traditionally been depreciated over 39 years using straight-line depreciation. This is because a commercial building was presumed to have a useful life of approximately 40 years. Needless to say, this 39-year depreciation period significantly reduces any deductions that can be used to offset the substantial investment required. Cost segregation is a practice of identifying and segregating the depreciation of building components that support personal property or are related to business activity rather than the building itself, so that these components can be depreciated over a tax life much shorter than 39 years.

In a cost segregation study, capital expenditures or investment costs are broken down in exacting detail, accelerating the depreciation of building components over five, seven, 15, or 39 years. This can potentially save even the smallest businesses thousands of dollars in after-tax income annually.

Essentially, cost segregation recognizes that while a building may well stay standing and be functional for 40 years, certain components used in that building — from landscaping to lighting fixtures — may have been installed to support business activity or to create the appropriate ambiance rather than to make the building habitable and functional. As a result, cost segregation breaks out a wide range of building components that are eligible for faster depreciation, compared to the standard 39-year straight-line accounting method for structural components. These favored assets include relatively well-recognized items such as carpeting, cabinets, and wall coverings, along with lesser-known qualifying assets from paving and concrete, to interior partitions, electrical, plumbing, and HVAC components. The additional deductions can add up to tax savings that are quite substantial. "In a hypothetical one million dollar purchase of

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Accelerated Depreciation continued commercial real estate — where the value of the land might be \$300,000 — perhaps \$450,000 of the purchase might be integral to the structure itself," explains Ralph Borelli, president of Borelli Investment Company. "In this example, that would leave as much as \$250,000 to be depreciated over five, seven, or fifteen years. Accelerating the depreciation for that large a sum from 39 years to shorter time periods can put a lot of money back into the buyer's pocket." Cost segregation does not provide any additional

deductions when viewed over the 39-year life of the business space. The big benefit is that it potentially delivers increased deductions in the early years of ownership, when higher cash outflows are invested in the purchase of the commercial real estate. Various tax court decisions and IRS rulings have shown this practice to be acceptable when owners follow certain guidelines, making it a sound strategy for reducing taxes. As always, it is essential for any business to get the advice of tax counsel before making real estate investment or tax decisions.

The Cost Segregation Process

Conducting a cost segregation study requires the assistance of both an accounting firm or other tax professionals, as well as the help of an engineering consultant qualified to perform a detailed audit of a building's design, development, and construction. While a cost segregation study may be performed on older buildings, the typical process for evaluating a new construction project may include the following steps:

- Perform feasibility analysis and identify any tax issues that need to be resolved.
- Conduct on-site inspection of the commercial property and/or the particular space the business is interested in acquiring.
- Compile a list of all the expenses involved in the building's construction.
- Prepare a detailed listing of the fully installed cost of all site improvements and personal property.
- Carefully analyze the data and following IRS guidelines, calculate depreciation schedules for the various assets, as segregated.
- Provide full documentation, including necessary tax filings and reports.

If actual cost figures for the original construction of a given building are not available, experienced tax professionals working with engineers and other specialists can apply special costing methods used to determine what the replacement cost for a new building — including site improvements — would be. Then, an appropriate amount of money can be subtracted to allow for the asset's decrease in value over time.

"It's a sophisticated process, which requires the assistance of highly trained tax professionals and engineers," notes Borelli. "But performed correctly, cost segregation practices have been allowed by the IRS and tax courts in the past, and these practices certainly offer the potential for significant tax savings. It's worth a close look by any business property owner."

Benefits of Cost Segregation

There are a number of benefits available from cost segregation, according to Borelli, but by far the biggest is the potential savings in Federal income tax. In fact, the tax savings for a single year can be so substantial that the value exceeds the cost of a down payment. The net effect, after taxes, is that a small business person could actually be paid to purchase commercial real estate and enjoy all the advantages of ownership — with the down payment covered by the tax benefits, and the monthly loan payments approximating the lease payments that

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Benefits of Cost Segregation continued

would have been required. "For example, at our AirTech office condominiums near Mineta San Jose International Airport in San Jose, a 4,930 square foot office can be purchased for about \$1,095,000," says Borelli. "Using cost segregation along with currently available tax benefits, this could result in a first-year depreciation of from \$120,000 to \$150,000. If one assumes that the down payment would be about \$109,500 using SBA financing — which only requires ten percent down — the after-tax savings could substantially cover a large portion of the down payment. With the federal and state governments making the down payment for the business owner, it's hard to imagine why any owner would not want to buy."

Other potential benefits from cost segregation fall into a number of categories:

- Sales and use taxes — Cost segregation can help a business owner "back out" sales or use taxes that did not need to be paid on certain building components.
- Property taxes — The base for calculating property taxes can be reduced.
- Insurance — premiums can be reduced by segregating non-insurable property from the rest.

"The key is finding someone who understands cost segregation and can point a business owner in the right direction," Borelli notes. "We've been applying these practices for a number of years and have a pretty good handle on its proper usage."

Other Limited-Time Tax Advantages

Beyond cost segregation, the 2003 Jobs and Growth Tax Act provides several other potential incentives for small to mid-sized business owners to invest in commercial real estate "now". These include the IRS's Section 179 deduction and special depreciation allowance (bonus depreciation).

Section 179 deductions allow business owners to deduct up to \$100,000 from profits for a business asset in the first year that it's placed into service. This asset can be a large piece of equipment for a business, or it can be business space when it is purchased rather than leased.

The deduction can only be used to offset taxable income generated by a business in the year in which the company acquires the business space or other asset. It is not applicable if a business shows a loss. The current \$100,000 cap per asset placed into service will be reduced to only \$25,000 after 2005, providing a real incentive to act for business owners who may be considering purchasing space in the near future. As with any IRS offering, there are a number caveats that need to be carefully reviewed. For instance,

if a company's business use of a favored Section 179 asset drops below 50 percent during the asset's life, some or all of the deduction might have to be recaptured. Again, it is essential to consult with a knowledgeable tax professional before moving ahead with any of these deductions.

Another tax break is bonus first-year depreciation, or as the IRS refers to it, the special depreciation allowance. Under certain circumstances, a building or business condominium space may qualify for bonus depreciation of 50 percent for any asset with a recovery period of 20 years or less. This special incentive that was built into the 2003 Jobs and Growth Tax Act is set to expire on December 31, 2004, unless Congress grants an extension.

A close examination of the following Lease vs. Buy Analysis, prepared for Borelli Investment Company by Bridge Bank, illustrates how quickly these benefits can add up-putting substantial money back into the pocket of savvy business owners.

Lease

Monthly Costs	\$10,008
Adjusted Monthly Costs	\$10,008
Equity at Ten Years	\$0

Monthly Lease Rate	\$9,860
Lease Rate per Sq. Ft.	\$2.00
Property Size (sq ft)	4,930

Initial Costs:	
Security/Rent Deposit	\$19,720
Total Initial Costs	\$19,720

Monthly Costs:	per sq ft	
Lease Payments	\$2.00	\$9,860
Operating Costs	0.03	148
Association Fees	0.00	0
Total Monthly Costs	\$2.03	\$10,008

Ownership Benefits:	
Annual appreciation (2%)	\$0
Annual depreciation (40% Tax Bracket)	0
Total Ownership Benefits	0
Total Ownership Benefits Per Month	\$0

TOTAL ADJUSTED MONTHLY COSTS	\$10,008
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Buy

Monthly Costs	\$9,454
Adjusted Monthly Costs	\$1,718
Equity at Ten Years	\$588,199

Purchase Price	\$1,095,000
Price per Sq. Ft.	\$222
Property Size (sq ft)	4,930

Initial Costs:	
Down Payment (10%)	\$109,500
SBA Guarantee Fee	25,869
Packaging Fee	1,000
Estimated appraisal, escrow, title	\$10,000
Total Initial Costs	\$146,369

Monthly Costs:	per sq ft	
Loan Payments	\$1.26	\$6,200
Operating Costs	0.44	2,169
Association Fees	0.22	1085
Total Monthly Costs	\$1.92	\$9,454

Ownership Benefits:	
Annual appreciation (2%)	\$21,900
1st Year Fed. Deprec. ** (40% Tax Bracket)	70,926
Total Ownership Benefits	92,826
Total Ownership Benefits Per Month	\$7,735

TOTAL ADJUSTED MONTHLY COSTS	\$1,718
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Property Value and Owner's Equity							
	Value	Loan Balance	Equity		Value	Loan Balance	Equity
Year 5:	\$1,208,968	\$883,064	\$325,905	Year 15:	\$1,473,726	\$564,807	\$908,919
Year 10:	\$1,334,799	\$746,600	\$588,199	Year 20:	\$1,627,112	\$322,627	\$1,304,486

90% SBA Financing				
Financing Package	Loan Size	Term	Rate	Type
SBA 7(a) Loan	\$985,500	25 Years	5.75%	Variable

- This analysis assumes that the buyer is in a 40% annual income tax bracket and an annual property appreciation rate of 2%.
- Owner's equity calculation assumes a constant loan rate of 5.75%, 7(a) loan rate is subject to changes in the WSJ Prime rate.
- Please consult your accountant and real estate professional regarding your actual depreciation and appreciation benefits.
- ** 1st Year Federal Depreciation (No Bonus) using Cost Segregation Study. Note: Depreciation will be lower after year 1.

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"Clearly, there has never been a better time to consider purchasing business space, rather than leasing it," declares Borelli. "Taken together, cost segregation and these tax benefits offer substantial monetary incentives that open the door to ownership for even small entrepreneurs and other businesses just getting started in the Silicon Valley."

It Pays to Own

Real estate has long been viewed as an important part of an investor's portfolio. Virtually every successful business owner owns a personal residence, with the possibility of vacation properties or other real estate investments as well. Yet many small business owners have been reluctant to invest in their business space. The right purchase can potentially add substantial value to a business as the property appreciates over time.

In today's business climate, cost segregation and special tax incentives have created the ideal time to buy. For more information, business owners are invited to contact Ralph Borelli, president of Borelli Investment Company, San Jose, by telephoning (408) 453-4700, or visiting www.borelli-inv.com.

Borelli Investment Company currently has business condominiums for sale at three locations:

AirTech Office Condominiums, a two-story garden office complex with over \$2.5 million in renovations, near the airport in San Jose. www.airtechofficecondos.com

Ringwood Business Center, with well-appointed offices and industrial units in International Business Park, in San Jose. www.ringwoodbusinesscenter.com

Berryessa Industrial Center, with two industrial/manufacturing spaces – furnished and unfurnished – remaining in north San Jose. www.berryessaic.com

All the spaces require only 10 percent down with Small Business Administration (SBA) financing for qualified buyers.

This white paper does not take into account every tax situation for all businesses or individuals. Not all tax laws have been considered – for example, passive loss and at-risk rules or alternative minimum tax (AMT) requirements could alter the tax benefits. Business owners should contact a tax advisor before making buying decisions.

