CASE STUDY

CLIENT SAVINGS: $715,000

LEASEHOLD IMPROVEMENTS: LOOKBACK STUDY

Engagement Overview:

In 2003 a high tech medical equipment company (lessee) entered into an agreement to lease space in a new office building. The lessor incurred all costs of construction of the building and the land improvements. The lessor also provided an allowance for the basic interior improvements. The lessee paid for a substantial amount of upgrades and specialty improvements, such as laboratories, testing facilities, upgraded finishes, multimedia, enhanced security systems and computer networking. The lessee's improvements totaled $10 million. The lease term is for 24 years, and the lessee placed the building in service in November 2004.

On its 2004 income tax returns the lessee classified $2 million of the costs as 5-year tangible personal property. The remaining costs are classified as 39-year real property.

Services:

The consultant conducted a "lookback" cost segregation study for the costs incurred by the lessee. The company conservatively estimated that $6 million of the costs should be classified as 5-year tangible personal property. The remaining costs were classified as 39-year real property.

Certain property that is placed in service in 2004 qualifies for 50% bonus depreciation. At that time, the primary criteria to qualify for bonus depreciation for lessees of nonresidential real property were as follows:

1. Property with a recovery period of 20 years or less and
2. Qualified leasehold improvements.

To meet the definition of qualified leasehold improvements, among other factors, the building to which the improvements are made must have been placed in service for at least three years before the improvements are placed in service. Because the building is new, none of the 39-year property qualifies for bonus depreciation.

All of the property classified as 5-year property meets the 20-year-or-less criterion. As a result, the lessee will not only benefit from the acceleration of depreciation deductions resulting from reclassifying cost from 39 to 5-year recovery periods, the lessee will also be allowed to deduct 50% of the costs classified as 5-year property in 2004. However, in this case the because the 5-year property is fully depreciated by the 2009 tax year, the benefit of 50% bonus depreciation over a 5-year recovery period has fully reversed.

Projected Client Savings:

Under IRS Procedures, the lessee is allowed to deduct all of the missed depreciation from prior years on its 2009 income tax return. As a result, after the study the lessee will be allowed to deduct an additional $3.5 million of depreciation expense for 2009. At a 40% US and state marginal income tax rate, the 2009 tax liability will be lowered by $1.4 million.

If the lessee vacates the building in 2023, under the terms of the lease, the net present value of the tax savings, calculated using a 7% cost of capital, will amount to approximately $715,000. If the lessee vacates the building early, the net present value savings will, of course, be reduced. If the building is vacated in 2013, the net present value savings will amount to approximately $315,000. If the building is vacated in 2018, the net present value savings will amount to approximately $600,000.