Business Owners Should Know These 5 Practices to Save on Building Ownership or Leasing

Executive Offices
Executive One Building
4835 Towne Centre
Suite 203, Saginaw, MI 48604
www.wolgast.com

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Business owners, whether you own or lease your building, there are savings opportunities that not enough businesses employ. Your building is likely the largest expense for your business, so taking advantage of the programs and practices listed below can help your bottom line.

1. **Incentives through Michigan Economic Development Corporation (MEDC)**

   The MEDC website, www.michiganbusiness.org, features 37 incentive programs to help support business expansion for Michigan businesses. Their programs cater to varying sized businesses trying to accomplish many different goals. You would need to visit the site to investigate which of the programs fit your needs best, however, we'd like to specifically introduce the SBA 504 Loan for those who aren't familiar with it. You may not know that for years small businesses in Michigan have had this option to make improvements to their business whether it be a new building, equipment, expansion, and to a lesser degree remodeling activities.

   This program works well for small businesses who are growing, but don't have a lot of working capital to expend on real estate, improvements or equipment. Being able to finance 80-90% of the cost couldn't be a better deal for these companies.

   For those business owners that qualify, they can obtain a loan for up to $5M for tangible purchases such as real estate, equipment or property improvements that lead to job creation. The program's benchmark is for every $65,000 loaned it will create or retain one job (www.sba.gov).

   The loan requirements include 10% down by the business owner, 40% low interest loan by the SBA's Certified Development Company (CDC), and then 50% from an approved financial institution. The CDC loan maturity terms are for 10 or 20 years for a fixed fee payment including current market rates for U.S. Treasury issues plus approximately 3% in fees. It is still a nominal rate spanning a longer term than the traditional bank loan.

   In dealing with our commercial construction clients who have considered the program, we have learned more about the SBA 504 and why some choose to use it or not. First of all, the SBA has other loan options that it offers, but the 504 was implemented to be a faster loan process taking only two weeks or less for approval. The paperwork and approval time is typically longer for their other loans, such as General Small Business Loans, Microloans, and Disaster Loans.

   Also, the SBA 504 is set up to offer a low interest rate and a fixed monthly fee for the duration of the loan, either 10 or 20 years. Whereas a traditional bank loan "resets" every 5 years and the interest rate usually increases at that time, so you'll likely pay more every five years.

   Finally, some banks are less willing to engage a 504 loan because there is significantly more paperwork involved than traditional commercial loans. So it's a good idea to check with your financial institution to determine whether they offer the 504 loan option. Some banks that are

otherwise not willing to engage the 504 will do so for well-established clients that they have a relationship with.

Other Economic Development Tools available by MEDC: Industrial Property Tax Abatement, Border County Incentives, Speculative Building Development Program, Tax Exemptions for Michigan Companies, Community Development Block Grant Revolving Loan Fund, Commercial Redevelopment Act, Agricultural Processing Renaissance Zones, Private Activity Bond Program to name a few.

2. How to Find Cash Hidden within Your Building

As the economy rebounds, businesses are becoming more profitable. At the same time, higher individual taxes are placing a financial burden on business owners. If you're looking for ways to reduce taxes and boost cash flow, consider a cost segregation study.

You may benefit from such a study if you plan to acquire, construct, or substantially improve a building, or if you've done so in recent years, as explained below by our colleague Andrew Rose, CPA of Rehmann Group. These studies apply tax accounting and engineering principles to identify building components that qualify for accelerated depreciation. Armed with a cost segregation study, you may be able to cut taxes by claiming additional depreciation expense or capturing missed depreciation deductions from previous years.

Here's how it works: commercial real property (excluding land) is depreciated over 39 years (27.5 years for residential rental real estate). Real property includes buildings as well as structural components, such as walls, windows, floors, ceilings, elevators, wiring, plumbing, and HVAC systems. Personal property – such as furniture, fixtures, computers, equipment, and machinery — is usually depreciable over five or seven years. Land improvements – such as parking lots, fences, sidewalks, landscaping, and outdoor lighting – are depreciable over 15 years.

It's not unusual for owners to allocate costs to real property that could properly have been allocated to shorter-lived personal property or land improvements and depreciated more quickly. A cost segregation study reveals opportunities to reallocate these costs, accelerating depreciation deductions and reducing taxes.

Virtually any business can benefit, but cost segregation studies are particularly valuable for manufacturers, hospitals, hotels, restaurants and other businesses with specialized buildings. Often, property that would otherwise be considered a structural component depreciable over 39 years may be classified as personal property if it's more closely related to a process or a particular piece of equipment than to the building itself.

A manufacturing facility, for example, might require reinforced flooring to support heavy equipment. Or a hospital may need special wiring or electrical systems to operate medical equipment safely. In many cases, the costs of these items are depreciable over five or seven years.

The actual benefits depend on the particular facts and circumstances, but for acquired, constructed or renovated buildings, a rough rule of thumb says you can enjoy net-present-value

tax savings as high as 23 cents for each dollar that's reclassified as personal property. If reclassified property qualifies for 50-percent "bonus depreciation," the savings can be even greater.

You can also use a cost segregation study to reallocate the costs of real estate investments in previous years. Generally, this requires you to file Form 3115 – *Application for Change in Accounting Method* – with the IRS. This allows you to take a "catch-up deduction" in the current year for assets that were under depreciated in prior years.

Cost segregation studies can yield significant rewards, but they're not for everyone. The tax savings may be limited, for example, if your income is insufficient, you're subject to passive loss limitations, or a property's purchase agreement contains a purchase price allocation. If you think a cost segregation study would help your business, have your advisors perform an initial evaluation to get an idea of the potential benefits.

Cost segregation example: Cost segregation studies offer significant tax savings, especially for businesses, such as manufacturers, with specialized facilities. Consider this example:

Wooly Widgets, a heavy manufacturing company, acquires an existing plant for $10 million on July 1, 2013. If the company were to allocate the entire purchase price to the building, its depreciation deductions would be roughly $256,000 per year ($177,000 in year 1, under IRS tables). Wooly obtains a cost segregation study, which concludes that 35 percent of the purchase price is properly allocable to 39-year property, 15 percent to 15-year property, 45 percent to seven-year property, and five percent to five-year property.

Based on IRS tables, and using the Wolverine's first-year depreciation deductions are as follows:

Asset class	**Cost**	**1st-year depreciation**
39 years	$3,500,000	$61,950
15 years	$1,500,000	$75,000
7 years	$4,500,000	$643,050
5 years	$500,000	$100,000
Total	**$10,000,000**	**$880,000**

In this example, a cost segregation study generated an additional $703,000 in depreciation deductions in the first year alone.

3. Lease Your Building from Yourself

For most business owners, the short-term benefits of leasing their building are attractive, but we're guessing that most owners would favor owning their building and having control of their business use at a fixed cost. For business owners who will likely stay in their location for 7 or more years[1], owning their building can be a great investment for their future while allowing

them to have a fixed expense until the building is paid off. As a contractor who specializes in both construction and leaseback services, we can educate owners on how to leverage programs, accounting processes, and legal structures to make it more lucrative to own your building.

Note: we are passing along the knowledge that there are building ownership options and programs available, however, we recommend and advise that you contact your CPA and/or attorney before taking the steps featured here.

Lease the Building from Yourself for a Tax Reduction: By forming an LLC to purchase your office, you'll be able to lease the building from your LLC, deduct the payment on your business taxes, and your LLC members would be taxed on their individual taxes as a pass-through. This would eliminate the tax for your building and LLC members would be taxed at a lesser rate for the building[2].

Accelerated Depreciation for More Tax Savings: Your building has a set period of time for useful life, by which the building depreciates each year. Accelerated Depreciation is an accounting process that allows you to depreciate the building more in the beginning of its useful life. Paying the larger amount in the beginning lowers your net income, which you are taxed upon. So having a lower net income in turn would lower your taxes. Good resources to better understand this process are http://crfb.org/blogs/tax-break-down-accelerated-depreciation and http://content.moneyinstructor.com/1509/calculatingdeprectiation.html .

Return on Your Investment: Probably the most enticing part of owning your own building is the opportunity to make a profit on the sale of it when you no longer need it. Another option would be to lease it to a new tenant when you retire and bring in ongoing income when you're retired from the business.

[1] Fitsmallbusiness.com http://fitsmallbusiness.com/buying-vs-leasing-commercial-real-estate/
[2] Beckner & Associates http://www.becknerassociates.com/Should%20I%20Own.htm
[3] Ernst & Morris (www.costseg.com/cost-seg.html).

4. Leaseback: Get a New Building While Keeping Capital in Your Business (Build to Suit)

When the time comes to move your business to its own brick and mortar (or another material) building, or expand to a bigger building, you have an option to keep your capital in your business rather than spend it on a loan to cover construction costs. This new building can be built to suit your operational needs rather than trying to fit your operation into an existing floor plan, and with limited risk to your business.

Leaseback is a construction delivery method that provides the best of both worlds to qualified business owners and even though it may sound too good to be true, it's legitimately a great, low risk option for owners to remain focused on their business while a building is created for their use. I'll explain more about how it works below.

By definition, leaseback is a construction delivery method whereby a developer builds, finances, and leases a facility back to a business owner, allowing him or her to keep capital in the

business. This method is perfect for newer, up-and-coming businesses or those that are established and experiencing rapid growth because there is little risk to the business and there is a lot of flexibility in defining the provisions with the developer.

How it Works: The developer reviews the business owner/lessee's business financials and determines that he or she is a qualified candidate to take on the risk of building a building. The building owner then enters into a contract for the lease, which is flexible in the terms of the duration of the lease, who will handle maintenance, and who will cover taxes and insurance payments among other things. The developer will then work with the business owner to find the most optimal location for the business. Then they both work with the architect to design a building suited to the business' use (i.e. square footage, floor plan, finishes). Once the floorplan is determined, the developer works with the general contractor to ensure that construction goes as planned, leaving the business owner time to focus on business without the interruption of making decisions because, let's face it, they likely have enough of their own work to do without overseeing construction activities.

Early in the design process, the developer will be able to determine the lease payment amount, so the business owner will know quickly what the leaseback will cost per month. Also, the terms are negotiated in the contract and the lessee has flexibility to negotiate many of the terms with the developer. Typically, the finishes chosen by the lessee have the most direct effect on the monthly rent of a leaseback. By working with the architect, developer and general contractor, a lessee can choose the interior look and feel that's in their budget.

You'll notice that there are numerous benefits and most of them have the underlying theme of risk aversion to business owners. Here are the key benefits:

- Lease payments are fully deductible as a business expense by the lessee
- Terms of the lease can be flexible to allow the lessee the option to renew the lease or purchase the building at any time during the lease
- No large cash investment is necessary, so leaseback saves capital and keeps debt off the balance sheet of the lessee
- The cost of land can be amortized in the lease payment thereby preserving cash by the lessee
- You can choose a prime location that you may otherwise not be able to afford
- There are no financial covenants on a lease, which gives the lessee greater control over its own business and operations
- Owners would be able to keep financing options open for future opportunities
- Rather than worrying about all the moving pieces of construction, you can focus on your business

5. Savings by Planning Construction during Industry Slow Times

There are savings benefits to designing, estimating and generally planning your building construction in the off season. All though spring, summer and fall are more ideal for construction activity, we have the capabilities to remodel and build new in the winter, but below we discuss further the savings you can experience by planning your construction project in late

fall or winter. Let me clarify that the following explanation works best when applied to new construction in Michigan and other cold winter states.

Even though some contractors have the ability to effectively construct in winter conditions, warmer weather is still more ideal to build. Consequently, there's typically less construction happening in the winter resulting in more supply and less demand. Therefore, if you can get your design completed and solicit sub-contractor bids at this time, there will likely be more flexibility to get a competitive price from a larger selection of sub-contracting companies. In the off season, the pool of sub-contractors is larger because they're only starting to fill their schedules for spring and summer. More bidders means more competition and competitive pricing. As we get closer to spring, schedules fill up and the result is either fewer bidders or bidders who aren't as motivated because they already have a decent work load, so they're busy and don't have time to investigate their best price. The same holds true, typically, with materials and suppliers.

As we discussed in our blog "Ample Time Gets Better Bids", when a sub-contractor has sufficient time to run their numbers, they provide an accurate and uninflated budget. Otherwise, if they don't have adequate time, then they're more likely to round up, or inflate their price. This isn't to penalize the customer, but to make sure that they cover their costs to perform the service, and with inadequate time it sometimes is an educated guess. Therefore, allowing more time will likely result in a more accurate price that will affect your bottom line.

We would advise that getting bids when the pool is large will result in getting the best value for your budget because the cream of the crop subcontractors will fill their schedules quickly and may not be available or motivated to bid competitively during the heat of construction season.

If you must start your planning in the spring or summer, contractors will still seek the best value, just as they do in the winter. However, we have now shared with you that your budget will likely be lower if you do your planning in the winter when the pool is bigger and there is more time for estimating. Take advantage of this cost saving measure and you'll be ready to break ground when the weather turns.

Wolgast takes on projects of all sizes and can provide tips for time and money savings, please contact us when you're ready to design and construct. Whether it is a restaurant, business office, medical office, retail, manufacturer operation or school, we are experts at building or remodeling most every type of commercial building.