nyrej

Time value of money: A founding principle of western finance - Part 3 of 4 - by Christie Ellis

January 07, 2020 - Upstate New York

This is part three of a four-part series. Part four will appear in the February 4th issue of the Upstate Section.

As tax time approaches, use this founding principle of western finance in your investing decisions. Why cost segregation matters.

A founding principle of western finance might sound like a bold claim, but don't take my word for it. What is this bedrock of finance? Time Value of Money (TVM). All you have to do is google "time value of money" and you'll see everyone from The Street, to Investopedia, to The Journal of Accountancy urging investors and their CPAs to understand and evaluate this important factor in their financial strategy and planning.

TVM refers to the principle of finance that money you possess today is worth more than money that you will possess at a later date. This idea is the basis for the entire finance and banking system. That loan rate on your building purchase? That interest amount you earn by keeping cash in a savings account or CD? Both reflect the value of the time either the lender gives you access to his cash, or the time that you give the bank access to yours.

Opportunity cost, inflation, and the uncertainty of the future are all reasons there is a time value to money. To see this principle at work, let's imagine for a moment that a friend asks you to loan him $10,000. He promises to pay you back in 10 years' time. As you're considering whether you will accept his request, you realize that currently, your $10,000 is earning you 5% a year - $5,000 over the 10 years, as you currently have it invested. You also consider that the current annual inflation rate is 2.1%; in 10 years, your $10,000 will only be worth $7,900. Next you think about your friend's ability to repay you. He could lose his job, suffer an expensive illness, or lose his life. Will he be able to repay you in 10 years? Finally, you already had plans for that $10,000. You intend to purchase new equipment and are confident it will earn your business an additional $3,500 per year, but you will not be able to afford the equipment if you loan these funds to your friend.

Given the loss of $42,100+ and the uncertainty you will incur if you agree to the loan, does the time value of your money feel important to consider?

Cost segregation is the time value of money in action. It accelerates the depreciation of items that can be reclassified as short life personal property (Section 1245) vs the longer depreciation schedules of real property (Section 1250). If you consider, and magnify the simplified example above, the savings identified through competent, detailed engineering-based cost segregation studies starts to become clear, and extremely valuable.

Imagine that as a business owner, you received a loan from your bank of $1 million for the build-out of your leased industrial space. You agree to an interest rate of 5.5%. Now also imagine that your business format is an LLC – so that your income is taxed at the personal tax rates of the members. In the first year of your study, you received increased depreciation of over $900,000, resulting in income taxes decreased by over $358,000, due to a 39.5% combined federal and state tax rate.

When you consider the value of a cost segregation study, what you are really considering is the time value of money to you, which, the finance community already agrees is the foundation of our financial system. Money held today, is more valuable than the same money received at a future date, full stop. The money you save today doesn’t suffer from lost opportunity cost, or rising inflation. You can invest money you possess and begin creating additional wealth with it. There is no future uncertainty to contend with. It is yours today to use in your business or your property as you choose.

When utilized in conjunction with other tax opportunities, the value of cost segregation is increased. Looking for a way to pass commercial real estate purchases to your heirs, without capital gains? 1031 Tax Exchanges + cost segregation is the way to go. Are you wanting to invest in Opportunity Zones, but are concerned about required spend in property refurbishment? Add cost segregation to your strategy and watch as the investment dollar requirements decrease due to lower property basis.

Cost segregation is a no brainer for all mid-range and long-term property investors, in for-profit holding structures. Renovations and buildouts exceeding $200,000 and purchases exceeding $450,000 should all be considered for study.

Over the past two articles we’ve discussed how to identify a quality, detailed engineering-based provider, as well as how to ensure all the members of your financial team are collaborating in a way most beneficial to you. Now that you understand the value of a study, you’re ready to reach out to a provider to make sure you receive the benefits of a study during this tax season. Cost segregation providers, like all income tax related services are now entering their busiest time of year. Don’t delay to reach out now, while the tax season is just starting.

Christie Ellis is the president at Cost Segregation Advisors, LLC, Hudson Valley, N.Y.