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Northmarq

Understanding the Benefits of Bonus Depreciation and Cost-Segregation Analysis for Car Wash Investments:

A Conversation with Jim Ceresnak, Alex Smith and Sean Lichterman

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Car washes provide a unique investment opportunity, particularly as relates to bonus depreciation and the tax advantages an investor can realize when purchasing these assets. Often a cost-segregation analysis can enhance the impact of these tax benefits even further.

Jim Ceresnak, vice president at Northmarq with a specialization in car wash properties, joined Alex Smith of Patapsco Corporate Services, also known as "The Car Wash CPA," and Sean Lichterman, a cost segregation specialist at Capstan Tax Strategies, to explore this topic further. Both Alex and Sean have been featured in CarWash.com as experts on these topics.

How impactful is the ability to take advantage of bonus depreciation on the broader market for net lease car wash properties?

Jim Ceresnak: The most motivated buyers for net lease car washes tend to be those driven by a tax need. This has been the case since the passing of the Tax Cuts and Jobs Act of 2017. We expect it to be the case again this year. Car washes have increased in popularity among net lease investors for many reasons over the past few years. But the tax advantages they offer have unquestionably been a major attraction. So, bonus depreciation has been significantly impactful in driving overall investment sales activity in this sector.

Why are car washes a unique asset class when it comes to cost segregation and bonus depreciation?

Alex Smith: Bonus depreciation allows investors to expense a larger portion of their investment in the year of purchase instead of spreading that depreciation over several decades. Car washes are a unique commercial property that are equipment- and mechanical-intensive, instead of being strictly a building with land.

Sean Lichterman: I agree. Car washes, in general, offer more opportunities for reclassification and larger deductions compared to other commercial asset classes due to their high proportion of short-life assets like conveyors, dryers, vacuum systems, paved parking, signage, water reclamation and other specialized equipment which can be depreciated over 5, 7 or 15 years. Where other commercial properties have an average reclassification of 20% to 30%, car washes possess a staggering 65% to 100% reclass capability, making this asset class highly sought after for their tax benefits in addition to being promising investment opportunities.

Additionally, a large degree of "self-service" or "tunnel" style car washes can be reclassified as 15-year property, and the entire building and equipment can be written off thanks to the Modified Accelerated Cost Recovery System (MACRS) and Audit Technique Guide (ATG).

Can you explain how cost segregation plays a role in optimizing tax benefits for investors in net lease car wash properties?

Sean Lichterman: Cost segregation plays a crucial role in optimizing tax benefits by breaking down the costs of a property into various components that can be depreciated at different rates. For investors in net lease car wash properties, this means accelerating the depreciation of certain assets, such as equipment and fixtures, which can lead to significant tax savings in the early years of ownership. By front-loading depreciation, investors can reduce their taxable income and increase cash flow, ultimately enhancing the return on investment.

When evaluating a car wash investment, how should the investor think about bonus depreciation, cost segregation and their impacts on overall returns?

Alex Smith: Bonus depreciation is a key tax strategy to accelerate depreciation of equipment over what the IRS defines as 3, 5, 7 and 10-year property. The goal is to allocate as much of the total purchase price of a car wash to the equipment and mechanical systems under these types of property, allowing investors to accelerate their depreciation in the immediate year of purchase, realizing a larger deduction for tax purposes. A larger deduction will offset taxable profit from the investment and carry forward indefinitely into future years depending on each investor's overall tax situation.

Sean Lichterman: Cost segregation studies help maximize depreciation benefits by identifying and reclassifying personal property and land improvements, which can be depreciated over shorter periods, like Alex mentioned, compared to the standard 39-year period for commercial real estate. For owners of net lease car wash properties, this accelerated depreciation means larger deductions in the early years, leading to substantial tax savings. Improved cash flow results from these tax savings allow owners to reinvest in their business or other opportunities.

Is there a way for property owners who missed out on previous years' depreciation to take advantage in the current year?

Sean Lichterman: As discussed, bonus depreciation plays a crucial role in enhancing the first-year deductions from a cost segregation analysis. Thanks in part to the Tax Cuts and Jobs Act of 2017, the current bonus depreciation model allows for 100% deductions on qualifying property with a useful life of less than 20 years, for properties placed in service between 2018 and 2022.

However, starting in 2023, this model began to phase out, reducing the bonus depreciation rate by 20% each year until it potentially expires, or new legislation is passed. For owners of net lease car wash properties, this means that if they purchased property between 2018 and 2022, they can still activate the 100% bonus depreciation in the current tax filing year.

This is where look-back studies, or retroactive studies, come into play. Owners can conduct a cost segregation study now to identify and reclassify eligible assets that qualify for accelerated depreciation. By doing so, they can catch up on the depreciation they missed in previous years, applying the 100% bonus depreciation to these reclassified assets. This strategy allows property owners to look back at their portfolios and enhance their deductions for further growth.

Do bonus depreciation rules apply to car wash property improvements as well?

Alex Smith: Yes. When an investor makes improvements to a car wash property, a cost segregation study can be utilized again to accelerate and enhance the depreciation of those improvements in the year they are made, instead of stretching that expense over 30 years or more. It's important to keep in mind the terms of an investor's sale-leaseback, which will often spell out investor-funded improvements. Likewise, any residual value of depreciable property may be further written down if it was taken out of service as part of an improvement and replacement, creating an additional depreciable expense. This can allow investors to project the cost of the improvements and strategize against future years' taxable events they may need to offset.

Are there any potential pitfalls that should be avoided when utilizing these tax incentives?

Alex Smith: It's important to understand that a cost segregation study will accelerate depreciation today, and once deducted, will not be available in future years. This requires long-term tax planning and candid conversations about future tax events and liquidity requirements, and their probability of occurring in order to appropriately plan for the future.

Because the implications of investing in net lease car washes vary by taxpayer, it is critical to discuss the desired goals and expected financials with your CPA to appropriately strategize the purchase. Additionally, a cost segregation study is necessary in order to maximize the value of the investment. Investors should partner with a cost segregation expert early in the process in order to arrive at accurate estimates of the anticipated derived tax impact.

What is the current status of legislation in Congress relating to bonus depreciation?

Jim Ceresnak: Earlier this year, there was excitement when the House of Representatives passed legislation that included a retroactive reinstatement of 100% bonus depreciation for 2023 and an extension of 100% bonus depreciation through 2025. However, that bill stalled in the Senate. As of this note's publication, bonus depreciation will stay at 60% for 2024 before dropping to 40% in 2025.

While an eventual modification to the bonus depreciation sunset schedule seems likely, given bonus depreciation's general popularity in Congress, any changes on this front remain unknown and meaningful legislation addressing this issue is unlikely to pass ahead of the November election. If bonus depreciation is eventually extended by Congress – whether this year or some other time in the future – it will significantly boost to demand for net lease car washes from the tax-motivated buyer pool.

TCJA Bonus Depreciation Schedule

Year Placed in Service	Bonus Depreciation Rate
2018-2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027 and Beyond	0% or TBD

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Case Study: Illustrating the Benefits of Bonus Depreciation and Cost Segregation

An investor buyes a $5.0 million car wash in 2024. Here, we illustrate the impact of bonus depreciation on the investor's overall return and tax liability.

The same investor conducts a cost segregation analysis to help maximize their ability to take advantage of bonus depreciation. Under the Modified Accelerated Cost Recovery System (MACRS), a cost segregation analysis can identify specific car washes as 15-year property compared to the typical 39-year for most commercial properties, and 100% of 5-year and 15-year assets are reclassified.

By using a cost segregation analysis, the investor can take advantage of $2.4 milion in bonus depreciation in 2024, equating to $888,000 in tax savings. This substantial deduction significantly reduces taxable income, thereby improving cash flow that can be reinvested into the property or other opportunties.

Impact of Bonus Depreciation

Purchase Price	$5,000,000
Allocated Value of Land	$1,000,000
Allocated Value of 3, 5, 7 and 10-Year Property (2024 Depreciation Limited to 60%)	$2,500,000
Allocated Value of Building and Improvments Including Parking Lot and Infrastructure (Depreciation limited to 39 Years)	$1,500,000
Year 1 Depreciation	$1,538,462

Cost Segregation Analysis

Assumptions (Tunnel Type/Conveyor Style Car Wash):

Purchase Price	$5,000,000
Land Value (Non-Depreciable)	$1,000,000
Depreciable Basis	$4,000,000

Analysis:

5-Year Property (Fixtures and Equipment)	$2,500,000
15-Year Property (Land Improvements)	$1,500,000
39-Year Property (Building Structure)	$0

Immediate 60% Bonus Depreciation on 5-Year and 15-Year Properties:

5-Year Property: $2,500,000 x 60% = $1,500,000	
15-Year Property: $1,500,000 x 60% = $900,000	
Total Bonus Depreciation	$2,400,000
After Tax Savings (37% Tax Bracket)	$888,000

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