



Cost Segregation

A Value-Added Service for Your Clients

Presented by:

Alan J. Smith— Ernst & Morris Consulting Group, Inc.

To:

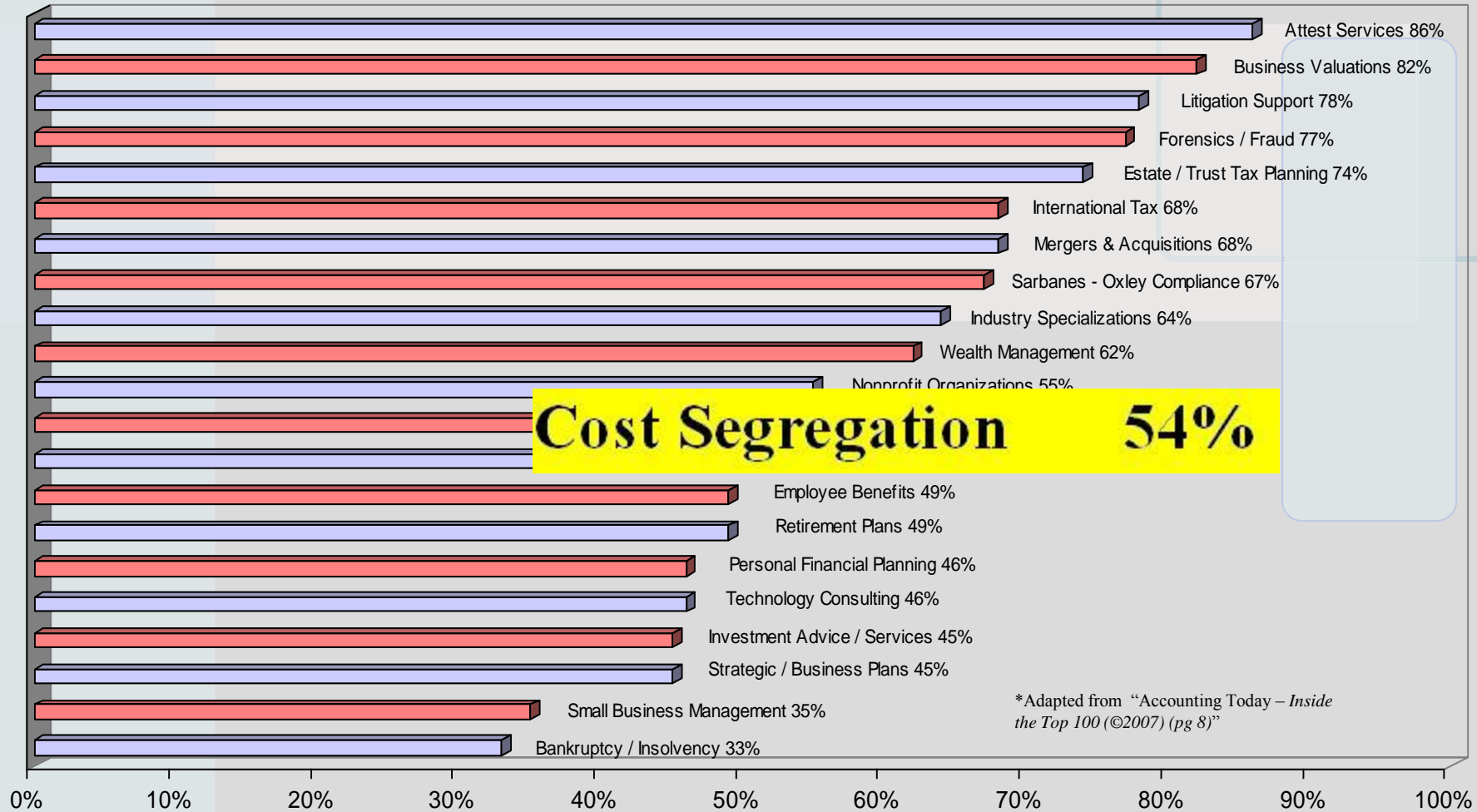
CPA Leadership Institute



THE LEADER IN COST SEGREGATION

Top Niche Services

(A Percentage of 78 Top Firms Reporting an Increase in that Type of Business)



*Adapted from "Accounting Today – Inside the Top 100 (©2007) (pg 8)"

Cost Segregation: a cash flow solution

Relevant History

- 1981** Established Recovery Periods for Most Business Property At 5 to 15 Years.
- 1984** Extended Recovery Periods to 19 Years (Tax Act).
- 1986** Extended Recovery Periods from 19 Years to 31.5 Years Straight-Line. (MACRS)
- 1993** Extended Recovery Period from 31.5 Years to 39 Years.
- 2002/
2008** Temporary 30% / 50% Bonus Depreciation (CO dated by 12/31/09).
- 2004/
2008** Qualified Leasehold & Certain Retail Improvements from 39 Years to 15 Years Straight-Line (effective 10/22/04 to 12/31/2009).



Tax savings by the square foot

Current Status

Property Class	Description	Method
39-Year	Nonresidential Real Property	Straight Line
27.5-Year	Residential Rental Property	Straight Line
15-Year	Land Improvements	150 DB
15-Year	Qualified Leasehold & Certain Retail Improvements (effective 10/22/04-1/09)	Straight Line
7-Year	Office Furniture, Fixtures, Equipment, Certain Personal Property	200 DB
5-Year	Cars, Trucks, Computer Related Equipment, Certain Personal Property	200 DB

Benefits are substantial, immediate, and enduring.

Past Precedent

-ACRS -> MACRS (1986)

-HCA – ITC still relevant

-IRS Revenue Rulings / Court Cases

-Whiteco Factors

Industry Directives

Audit Techniques Guide

- *Not Official Pronouncement of Law*
- *Not Official Position of IRS*
- *Primarily Used for Risk Analysis*
- *Promotes Consistency, Efficiency*
- *No Bright Line Test - Necessitates IRS Engineers*

Cost Segregation: a cash flow solution



Cost Segregation Study Types

Engineering Approach:

- *Complete Listing of All Project Costs*
- *On-site Inspection of Assets*
- *Official Documentation/Plan Review*
- *Cross-reference Take-off w/ Payment Records*
- *Proper Allocation of Indirect Costs*
- *Clear Segregation of Property into Asset Classes*

“the most methodical and accurate approach, relying on solid documentation and minimal estimation.”

(IRS Cost Segregation ATG Ch. 3)



Cost Segregation Study Types

Engineering Cost Estimation Approach:

- *Similar to Engineering Approach*
- *Estimated Costs Used in lieu of Actual Cost Data*
- *Used if Cost Records Not Available or for the Allocation of A Purchase Price*
- *Cost Estimations Must Be Referenced from Reliable Sources (e.g. Means or Marshall, etc.)*

Cost Segregation Study Types

Survey / Letter Approach:

- *Also an Estimation*
- *Costs Obtained from Contractors or Vendors*
- *Used in Engineering or Estimation Approach*

Cost Segregation Study Types

Residual Estimation Approach:

- *Only Short-life Asset Costs are Determined*
- *'Residual' Cost Assigned to 39 Year Property*

“Although this method is simpler and less time consuming than the engineering approaches, it can also be less accurate”

(IRS Cost Segregation ATG, Ch. 3)

Cost Segregation: a cash flow solution



Cost Segregation Study Types

Sampling or Modeling Approach:

- *Created Model or Template for Prototypes*
- *Study Performed on ‘Representative Sample’ Generalized to Property Population*

“to analyze multiple facilities that are nearly identical in construction, appearance, and use”

(IRS Audit Techniques Guide, Ch.3)

Cost Segregation Study Types

Desktop or 'Back of Napkin' Approach:

- *Little or No Documentation*
- *Usually Based on Estimated Percentages*
- *Does Not Withstand IRS Scrutiny*

Cost Segregation: a cash flow solution

Summary of IRS Report Guidelines

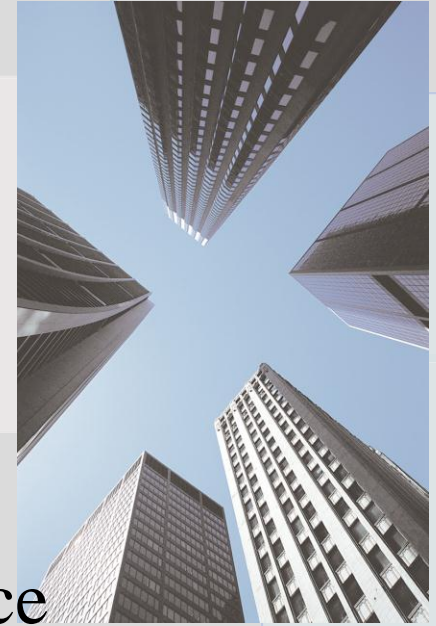
- Report Methodology
- Third-party, Engineering-based Studies
- On-site Verification of Assets
- Reliable, Documented Cost Sources
- Cross-referenced Documentation

“an underlying assumption is that the study is performed by "qualified" individuals or firms, such as those employing ...personnel competent in design, construction, auditing, and estimating procedures relating to building construction”

(IRS Cost Segregation ATG, Ch. 3)

Cost Segregation Opportunities

- New construction
- Purchase of existing property
- Renovations or expansions
- Leasehold improvements
- Existing property placed in service after 1986 (“look-backs”)
- Real property stepped-up through estate
- Treatment of 1031 Exchange Funds



Reduce Taxes, Improve Cash Flow

Cost Segregation Qualifications

- **Legal Entity Structure/Basis**

- Pass Through Entities

- Partnerships, LPs, LLPs

- LLCs

- S Corps

- Certain Trusts

- C-Corps

- REITs

- **Motivation of Taxpayer**

- Depreciation Recapture – Hold Property or Sell Eventually?

- **Net Passive Loss**

- **Alternative Minimum Tax (“AMT”)**



Tax savings by the square foot

Typical Percentages of Accelerated Property

Property Types

Typical % Eligible

Heavy Manufacturing/Processing	30-60%
Research & Development	30-60%
Car Dealerships	25-50%
Light Manufacturing	20-40%
MOB'S / MAB'S	20-40%
Golf Courses	20-40%
Offices	20-40%
Restaurants (Single or Multiple)	20-40%
Apartments	20-35%

Cost Segregation: a cash flow solution

Typical Percentages of Accelerated Property

Property Types	Typical % Eligible
-----------------------	---------------------------

Retail (Dept/Specialty Stores)	20-30%
Theaters	20-30%
Grocery Stores	20-30%
Hotels/Motels	20-30%
Senior Living/Assisted Living	15-25%
Strip or Regional Malls	5-30%
Tenant Improvements	5-50%
Warehouses	5-10%

Benefits are substantial, immediate, and enduring.

Data Requirements

New Construction, Leasehold Improvements and Renovation

1. Tax Depreciation Schedules (“look-back” only)
2. Site Survey (“look-back” only)
3. Capitalized Cost Supported By:
 - AIA Payment Application (form G702/G703)
 - Change Orders (including description & cost)
4. Project Budget Summarizing All Associated Costs
 - Indirect Costs Not Included in Pay Application
 - Cost Paid Directly to Subcontractors Outside General Contract
5. Complete Set of As-Built Construction Drawings is Required (after proposal approval)



Data Requirements

Purchase Price Allocation

1. Closing Statement
2. Recent Appraisal
3. Property Rent Roll as of Acquisition Date
4. Historical Information
 - Tax Depreciation Schedules or Fixed Asset Schedules (look-back only)
 - Inventories of Furniture, Fixtures, & Equipment
5. Land Value Allocated
6. Site Survey
7. Any Available Construction Drawings



Benefits are substantial, immediate, and enduring.

NPV Estimate Request Form

COST SEGREGATION STUDY - NPV ESTIMATE REQUEST



Date: _____ Accounting Firm: _____
 Individual: _____ Phone: _____

Proposal Information

Owner's Name / Entity: _____

Mailing Address: _____

Contact: _____ Phone: _____

Fax: _____ Email: _____

Property Information

Address: _____

Description: _____

Building Usage: _____ Building Square Footage: _____ Site Size or Acreage: _____

(e.g., apartments, dealership, office building, etc.) No. of Floors: _____ Tenants: Yes No

Contact: _____ Phone: _____

Fax: _____ Email: _____

Requested Due Date: _____ Is an Extension Possible? _____

Cost Segregation Proposal Data Requirements

New Construction: \$ _____ / _____
cost year placed in service

Leasehold Improvements

& Renovations: \$ _____ / _____
cost year completed

Acquisition: \$ _____ / _____
cost year of purchase

1031 Exchange: Yes No

754 Step-Up: Yes No

1. Tax Depreciation Schedules (look-back only)	1. Closing Statement
2. Site Survey (look-back only)	2. Recent Appraisal
3. Capitalized Cost Supported By: <ul style="list-style-type: none"> • AIA Payment Application (form G702/G703) • Change Orders (including description & cost) 	3. Property Rent Roll as of the Acquisition Date (multiple tenants only)
4. Project Budget Summarizing All Associated Costs <ul style="list-style-type: none"> • Indirect Costs Not Included in Pay Application (Architectural Fees, Engineering Fees, Surveying Fees, etc.) • Costs Paid Directly to Subcontractors Outside General Contract (Landscaping, Carpet, Phone System, etc.) 	4. Historical Information <ul style="list-style-type: none"> • Tax Depreciation Schedules or Fixed Assets • Schedule (look-back only) • Inventories of Furniture, Fixtures & Equipment
5. A Complete Set of As-Built Construction Drawings is Required Only After Proposal is Approved, Including: <ul style="list-style-type: none"> • Civil / Site Work • Structural • Architectural • Plumbing / HVAC / Electrical 	5. Land Value Allocated
	6. Site Survey
	7. Any Available Construction Drawings

Tax savings by the square foot

The Benefit



Each \$100,000 in assets reclassified from a 39-year recovery period to a five-year recovery period results in approximately \$22,000 in net-present-value savings, assuming an 8% discount rate and a 40% marginal tax rate.

Journal of Accountancy, Copyright 2005 by the AICPA



Reduce Taxes, Improve Cash Flow



The Benefit Applied

\$10 million retail shopping center, placed into service 10 years ago:

Original Depreciation Method: 39-year Straight Line

Reclassified Amount with Cost Segregation Study:

- 5-year Property- \$1 million
- 15-year Property- \$1.5 million

Adjustment Calculation and Resulting Tax Benefit:

Depreciation Reported Previously	\$2,564,100
Cost Segregation Study Depreciation	\$3,923,070
Section 481(a) Adjustment	<u>(\$1,358,970)</u>
Tax Rate	40%
Tax Benefit in Year of Study	\$543,588

The Bottom Line – by performing an engineering-based cost seg study, the building owner was able to increase the amount of depreciation expense, thus reducing the current year taxable income, resulting in an increase in cash flow of \$544k.



Tax savings by the square foot

Cost Segregation Study - Tax Benefit Summary

**1996 Purchase Price Allocation - Look back (Study Done in 2001)
Apartment Building & Improvements**

MACRS Classifications

Property	<u>27.5 YEAR</u>	<u>%</u>	<u>15 YEAR</u>	<u>%</u>	<u>5 YEAR</u>	<u>%</u>
Apartments Rochester, NY	\$12,950,000	70%	\$2,590,000	14%	\$2,960,000	16%
336 Units						
	<u>Total</u>	<u>1st YEAR NPV</u>	<u>NPV*</u>	<u>FEE</u>	<u>ROI**</u>	
	\$18,500,000	\$1,185,000	\$748,000	\$15,000	50 to 1	

*** Net Present Value assumes a 27.5 year holding period, an 8% discount rate and a 40% tax rate.**

****Computed Using the After Tax Fee**



Cost Segregation: a cash flow solution

Cost Segregation Study - Tax Benefit Summary

**New Construction
Free-Standing Restaurant**

MACRS Classifications

<u>Property</u>	<u>39 YEAR</u>	<u>%</u>	<u>15 YEAR</u>	<u>%</u>	<u>7/5 YEAR</u>	<u>%</u>
Restaurant Portland, OR 8,220 SF	\$836,901	57%	\$284,016	19%	\$345,991	24%
	<u>Total</u>		<u>NPV*</u>	<u>FEE</u>	<u>ROI**</u>	
	1,466,908		\$109,495	\$7,000	16 TO 1	

**** Net Present Value assumes a 39 year holding period, an 8% discount rate and a 40% tax rate.***

*****Computed Using the After Tax Fee***



Benefits are substantial, immediate, and enduring.

Cost Segregation Study - Tax Benefit Summary

**New Construction
Hotel Building and Land Improvements**

MACRS Classifications

<u>Property</u>	<u>39 YEAR</u>	<u>%</u>	<u>15 YEAR</u>	<u>%</u>	<u>7/5 YEAR</u>	<u>%</u>
Hotel Cocoa Beach, FL 150 Units	\$5,131,014	75%	\$860,795	13%	\$836,952	12%
	<u>Total</u>		<u>NPV*</u>	<u>FEE</u>	<u>ROI**</u>	
	\$6,828,761		\$285,517	\$10,000	29 TO 1	

****Net Present Value assumes a 39 year holding period, an 8% discount rate and a 40% tax rate.***

*****Computed Using the After Tax Fee***



Reduce Taxes, Improve Cash Flow

Cost Segregation Study - Tax Benefit Summary

New Construction & Renovation

Research & Development Facility with Land Improvements

MACRS Classifications

<u>Property</u>	<u>39 YEAR</u>	<u>%</u>	<u>15 YEAR</u>	<u>%</u>	<u>7/5 YEAR</u>	<u>%</u>
R & D Huntersville, NC 32,476 SF	\$4,895,447	69%	\$698,392	10%	\$1,505,850	21%
	<u>Total</u>		<u>NPV*</u>	<u>FEE</u>	<u>ROI**</u>	
	<u>\$7,099,689</u>		\$424,951	\$19,000	36 TO 1	

****Net Present Value assumes a 39 year holding period, an 8% discount rate and a 40% tax rate.***

*****Computed Using After Tax Fee***

Cost Segregation Study - Tax Benefit Summary

Purchase Price Allocation

Manufacturing Facility with Land Improvements

MACRS Classifications

<u>Property</u>	<u>39 YEAR</u>	<u>%</u>	<u>15 YEAR</u>	<u>%</u>	<u>7/5 YEAR</u>	<u>%</u>
Manufacturing Facility	\$4,895,447	59%	\$896,282	25%	\$567,353	16%
Mechanicsville, Virginia						
200,000 SF						
	<u>Total</u>		<u>NPV*</u>	<u>FEE</u>	<u>ROI**</u>	
	<u>\$3,529,475</u>		\$220,502	\$6,300	58 TO 1	

****Net Present Value assumes a 39 year holding period, an 8% discount rate and a 40% tax rate.***

*****Computed Using After Tax Fee***

Quality Study Procedure



1. Estimate
2. Proposal Letter
3. Document Collection
4. Cost Analysis
5. Engineering Analysis
6. Take Off
7. Site Visit
8. Reconciliation of Costs and Take Off
9. Work Papers
10. Final Report

Benefits are substantial, immediate, and enduring.

Audit Performance

1. What to Expect in an Audit

2. Audit Procedure

- IDR
- Audit Intent
- Review of CS Study
- Review of Tax Depreciation Schedule
- Interview with Preparer
- Site Visit
- Resolve Issues, Determine any Reconciliation

3. What to Expect from your CS Firm in an Audit



Benefits are substantial, immediate, and enduring.

Change In Accounting Method

- Generally it's:

“a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction.” (Reg §1.446-1(e)(2)(ii)(a))

Benefits are substantial, immediate, and enduring.

Change In Accounting Method



- According to Reg. 1.446-1 a change in depreciation method, period of recovery or convention is a change in accounting method.
- The regulation also recognizes that a 481a adjustment may result.
- See the Reg. 1.446-1, Example 9, for an illustration of how the reg applies to a cost seg study.

Benefits are substantial, immediate, and enduring.

Change In Accounting Method

Revenue Procedure 2002-9 provides basic rules for change in accounting method with respect to depreciation

- Took effect January 7, 2002

Main Provisions:

- Provides for automatic consent unless:

- Taxpayer under exam
- Appeals
- Federal Court

- To get automatic consent :

• File complete application in duplicate:

- One copy with timely (including extensions) tax return
- Signed copy to IRS National Office filed no later than due date of return & no earlier than beginning of tax year of change

- Appendix section 2 governs depreciation

Benefits are substantial, immediate, and enduring.

Change In Accounting Method

Revenue Procedure 2002-19

- Took effect March 14, 2002
- Clarifies the treatment of a 481a adjustment:
 - Positive adjustment is recognized over 4 years
 - Negative adjustment is recognized entirely in year of change

Benefits are substantial, immediate, and enduring.

Change In Accounting Method

Completing Form 3115

Form 3115

- Calculate 481a adjustment
- Fill in applicable sections of the form - see example
- Some attachments will be required to support:
 - Part II, question 12 a - d & question 13
 - Schedule E, question 4
 - Schedule E, question 5
 - Schedule E, question 7 a - e

Benefits are substantial, immediate, and enduring.

Change In Accounting Method

Completing Form 3115 (Continued)

- Required statement:

“Each item of property that is the subject of the application filed under section 2.01 of the appendix of Rev. Proc. 2002-9 as revised by Rev. Proc. 2004-11, for the year of change beginning January 1, 20____, and that is reclassified from nonresidential (or residential real property) to an asset class of Rev. Proc. 87-56, 1987-2 C.B. 674 (or Rev Proc 83-35, 1983-1 CB 745) that does not explicitly include section 1250 property, is section 1245 property for depreciation purposes.”

- 481a adjustment - be sure to include regular tax as well as AMT

Benefits are substantial, immediate, and enduring.



Change In Accounting Method

Completing Form 3115 (Continued)

- Attach one copy of form 3115 to the tax return
- File one copy of form 3115 (signed) with the IRS National Office
- Refer to the form 3115 instructions for filing address, currently:

Internal Revenue Service
Attention: CC:PA:LPD:DRU
Automatic Rulings Branch
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Benefits are substantial, immediate, and enduring.



1031 Exchanges & Cost Segregation

- ❑ 1031 allows deferral of gain in an exchange of like kind property
- ❑ Cost segregation allows taxpayers to accelerate depreciation deductions on property and thus defer tax
- ❑ Cost segregation studies can work in conjunction with 1031 exchanges
- ❑ Exchanged basis of replacement MACRS property is depreciated using the relinquished property's:
 - Remaining recovery period
 - Depreciation method
 - Convention

Benefits are substantial, immediate, and enduring.

1031 Exchanges & Cost Segregation

❑ If there is excess basis on an exchange, i.e., new building FMV exceeds FMV of old, the excess basis can be depreciated under an accelerated method through a cost segregation study.

❑ Recapture could result:

- Cost segregation studies result in reclassification of 1250 to 1245 property

- If replacement 1245 property does not equal relinquished 1245 property - recapture occurs at ordinary rates

Benefits are substantial, immediate, and enduring.

1031 Exchanges & Cost Segregation

- Recapture can also occur on 1250 property, but only the excess of additional depreciation over straight line depreciation is recaptured.
 - Usually land improvements generate additional depreciation subject to recapture because they are depreciated using 150%DB vs. SL

Benefits are substantial, immediate, and enduring.

Other Considerations

- Section 754 Step Up / Inherited Property
- Passive Loss Issues
- Net Operating Losses
- AMT Status

Benefits are substantial, immediate, and enduring.

Energy Policy Act of 2005 (EPAct)

- Incentivized areas:
 - Lighting
 - HVAC
 - Building envelope
- Available for New Construction and Existing Buildings
- Also available for:
 - Tenant owned lease-hold improvements
 - Rental Apartment Buildings 4 stories or above
 - Primary Designers of Government Buildings

CPA firms can Expand Service Offerings

Commercial Building Owners

- Retailers
- Industrial Buildings
- Warehouses
- Office Buildings

Primary Designers of Government Buildings

- Architects
- Engineers
- Lighting Designers
- Design & Build Firms

Credit/Grants

Specified Energy Property	Credit Termination Date	Applicable Percentage of Eligible Cost Basis
Geothermal Heat Pumps	Jan 1, 2017	10%
Fuel Cells	Jan 1, 2017	30% **
Microturbines	Jan 1, 2017	10% ***
Combined Heat & Power	Jan 1, 2017	10%
Large Wind	Jan 1, 2013	30%
Closed-Loop Biomass Facility	Jan 1, 2014	30%
Open-loop Biomass Facility	Jan 1, 2014	30%
Geothermal under IRC sec. 45	Jan 1, 2014	30%
Landfill Gas Facility	Jan 1, 2014	30%
Trash Facility	Jan 1, 2014	30%
Qualified Hydropower Facility	Jan 1, 2014	30%
Marine & Hydrokinetic	Jan 1, 2014	30%
Solar	Jan 1, 2017	30%
Geothermal under IRC sec. 48	Jan 1, 2017	10% *
Small Wind	Jan 1, 2017	30%

*Geothermal Property that meets the definitions of qualified property in both § 45 and § 48 is allowed either the 30% credit or the 10% credit but not both.

** For fuel cell property the maximum amount of the payment may not exceed an amount equal to \$1,500 for each 0.5 kilowatt of capacity.

*** For microturbine property the maximum amount of the payment may not exceed an amount equal to \$200 for each kilowatt of capacity.

Additional Benefits of Credits/Grants

- 5 year accelerated depreciation
- bonus depreciation
- additional depreciation for 50% of the credit/grant amount

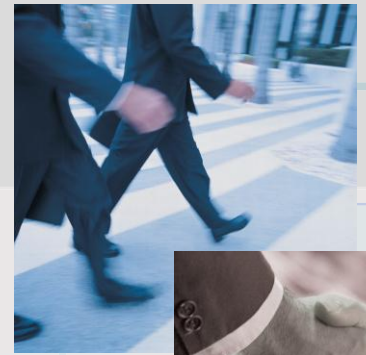
Grant in Lieu of Tax Credit

- Great for companies who don't pay taxes
- Forms have been released
- Applications now being Accepted
 - For projects placed in service after:
 - 1/1/2009
 - or projects started before:
 - 12/31/2010
- Applications accepted through 10/1/2011
- Marketing the Grant
 - Get the word out
 - Include Grant in Proposals

Geothermal Heat Pumps

- Tremendous Opportunity
 - Benefits
 - Energy Savings
 - 10% Grant/Tax Credit
 - 5 Year Depreciation
 - Bonus Depreciation
 - Depreciation of 50% of Grant/Tax Credit amount
 - Building will likely qualify for \$1.80/sq.ft. EPAct Tax Deduction

Questions and Answers



For Further Information Contact

Alan Smith – Director – Cost Segregation
Ernst & Morris Consulting Group, Inc.
2190 Dallas Highway
Marietta, Georgia 30064

Telephone: (770) 427-9677 x13 or
1-800-COST-SEG

Fax: (770) 427-4004

E-Mail: asmith@costseg.com

www.costseg.com

