CPE

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Cost Segregation: Why Your Clients Can Benefit From a Comprehensive Study

CPE Self-Study

Curriculum: Tax

Level: Basic

Designed For: Public practice, tax professionals

Objectives: To raise awareness about using cost segregation as a strategic tax deferral tool.

Key Topics: How cost segregation works, who qualifies, rules, methods, IRS requirements, what is involved, and effects of the 2008 Economic Stimulus Act.

Prerequisites: None

Advanced Preparation: None

Do you have clients who have constructed, purchased, expanded or remodeled any kind of commercial real estate? If so, cost segregation is a strategic tax deferral tool that allows companies and individuals to increase cash flow by accelerating depreciation deductions on their properties, and deferring federal and state income taxes.

How Cost Segregation Works

In general, it's easy to identify furniture, fixtures and equipment that are depreciated over five or seven years for tax purposes. However, a cost segregation study goes far beyond that by dissecting construction costs that are usually depreciated over 27.5 or 39 years. The primary goal of a cost segregation study is to identify all construction-related costs that can be depreciated over five, seven and 15 years. For example, 30–90 percent of the total electrical costs in most buildings can qualify as personal property (depreciated over five or seven years). Reducing the class life results in accelerated depreciation deductions, reduced income tax and real estate tax liabilities, and increased cash flow. A cost segregation study also provides an independent third-party analysis that will withstand Internal Revenue Service (IRS) review.

Figure 1 represents the percentages of project-related construction costs that could be reclassified from either 27.5- or 39-year real property to five-, seven-, or 15-year property utilizing an engineering-based cost segregation study.

Who Qualifies for a Cost Segregation Study?

Nearly any type of commercial property can benefit from a cost segregation study, including (but not limited to):

- office and industrial buildings,
- retail centers,
- restaurants,
- hotels,
- apartment complexes,
- manufacturing facilities,
- auto dealerships,
- medical facilities.

As a general rule, anyone who has purchased or constructed a facility since Jan. 1, 1987, with depreciable costs in excess of $750,000, or who has made interior improvements in excess of $400,000, will likely benefit from having a cost segregation study performed.

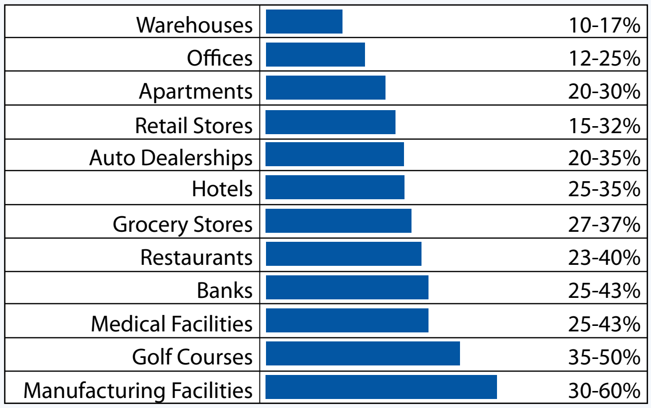
Because of depreciation recapture, cost segregation is generally not cost effective for taxpayers who plan on holding the property for three years or less. However, taxpayers who have the right type of exchange strategy in place can utilize this to defer any depreciation recapture, along with any gains, as long as they continue to perform cost segregation studies on their replacement properties. Additionally, taxpayers without enough taxable income will not be able to reap the benefits of the accelerated depreciation deductions that result from cost segregation.

Since cost segregation helps those with positive income, timing can be a very important element of the strategy. If a taxpayer is in a situation where he/she can make use of additional deductions, cost segregation studies should be employed as soon as possible to take advantage of the time value of money. However, there are still opportunities for taxpayers who never utilized cost segregation for past properties and those that weren't generating enough income to do so at the time the property was originally placed in service. The IRS allows taxpayers to essentially go back in time and retroactively correct depreciation through Revenue Procedure 2002-19. By performing a "look-back" cost segregation study, all missed depreciation deductions from prior years can be used to offset income in the current tax year through the filing of Form 3115 – *Application for Change in Accounting Method*.

FIGURE 1.

Average Cost Reallocation With a Cost Segregation Study Based on Property Type

Based on our experience for each property type, the following percentages of project-related construction costs could be reclassified from either 27.5- or 39-year real property to 5-, 7-, or 15-year property.



Example of Benefits for a Typical Office Building

Construction Costs: $4 Million

Facility Placed in Service: 5 Years Ago

Original Depreciation Method: 39-Year Life, Straight Line Method

Reclassified Amounts Resulting from Cost Segregation Study

5-year property - $480,000

15-year property - $800,000

Increased Deductions in the First Year and Resulting Tax Benefits	
Depreciation Deductions w/Study (through the current year)	$1,209,310
Depreciation Deductions w/o Study (through the current year)	568,440
Increased Deductions (through the current year)	640,870
Assumed Tax Rate	40%
Tax Benefit of Cost Segregation Study (through the current year)	256,348

How Does the 2008 Economic Stimulus Act Affect Cost Segregation?

There is even more great news for taxpayers who are embarking on a new construction project or were adding leasehold improvements in 2008 – the Economic Stimulus Act of 2008 was officially signed into law on Feb. 13, 2008, and with it, 50 percent bonus depreciation is back. In addition, §179 expensing has been enhanced for a limited time. As we learn more about these provisions, we can see how cost segregation can actually create eligibility here.

Under the new law, taxpayers qualify for a 50 percent first-year bonus depreciation on **certain types of property for the current tax year (see below)**. As it relates to any building construction expenditures, the majority of these benefits can only be identified through the use of a cost segregation study.

The act also substantially increases both the maximum amount of §179 that can be expensed along with the §179 phase-out threshold.

What are the Rules Behind Bonus Depreciation for Construction?

Congress has used bonus depreciation in the past to encourage business investment for brief periods of time. For example, bonus depreciation was available immediately after Sept. 11, 2001, as well as for certain property used in the New York Liberty Zone or the Gulf Opportunity Zone.

The rules behind bonus depreciation can be complex. For taxpayers constructing or remodeling buildings, much of the eligibility for additional tax deductions from bonus depreciation is based on when a binding contract was signed, when construction has started, when construction of certain components is completed, and when the building is placed in service. With the recent changes, taxpayers can claim an additional 50 percent first-year depreciation deduction on certain assets where construction started after Dec, 31, 2007 and is completed before Jan. 1, 2009. (Under certain circumstances, construction can be completed before Jan. 1, 2010.) It's important to note that the milestone for determining when construction has started is when 10 percent of the physical construction has been completed.

Once the date-based criteria are met, property must have a tax life of less than 20 years in order to be eligible for bonus depreciation. By identifying these components, cost segregation becomes the key driver for creating eligibility for bonus depreciation on newly constructed improvements.

To illustrate the benefits here, reclassifying $100,000 in constructed improvements from 39-year property to five-year property in 2008 would increase the first-year deduction to $60,000 versus a paltry $1,282 deduction had a cost segregation study not been performed. The result is almost a 47-fold increase in first-year deductions!

How Do the New Laws Affect Leasehold Improvements?

While the benefits to those constructing improvements are clearly substantial, landlords and tenants in the process of constructing interior leasehold improvements stand to reap even greater benefits from the new bonus depreciation rules since qualified leasehold improvements, which have a tax life of 39 years, are also eligible for bonus depreciation.

Qualified leasehold improvements do not include improvements that increase the length, width or height of a building. Qualified leasehold improvements also do not include any elevator or escalator, any structural component benefiting a common area or the internal structural framework of the building. Additionally, the leasehold improvement would have to be completed more than three years after the original construction completion date of the building and be made pursuant to a lease where the lessor and lessee are unrelated parties.

What are the New Thresholds for §179 Expensing?

In addition to bringing back bonus depreciation, the §179 limit is nearly doubled, so the maximum amount that businesses can write off under §179 goes from $128,000 to $250,000 during 2008. The Economic Stimulus Act of 2008 also raises the phase-out threshold from $510,000 to $800,000 for 2008. That means that once taxpayers have added more than $1,050,000 in qualifying property, they have no §179 deduction. No other changes were made to the existing rules applicable to §179.

The new law makes no changes to the general rules for the types of property that are eligible for expensing. Generally, the property must be tangible personal property, which is actively used in the taxpayer's business and for which a depreciation deduction would be allowed. The property must be used more than 50 percent for business and must be purchased during 2008. The existing exception for computer software also applies to the enhanced expensing amounts under the new law.

Since the cost of tangible personal property is eligible for this expensing provision, many owners will utilize these write-offs when purchasing equipment for their businesses. However, it's important to note that certain components within real estate can also qualify, since Section 179 property includes property with a tax life of five or seven years.

Similar to how a cost segregation study can quantify the components of real estate that may be eligible for bonus depreciation, a study can also be used to quantify the components that may be eligible for Section 179 expensing. Additionally, the enhanced expensing provisions are only applicable for the 2008 tax year.

Unlike bonus depreciation, however, these expensing provisions can be applicable to **both tangible personal property acquisitions and construction**.

What are the Most Common Methods Used in Conducting a Study?

The IRS Cost Segregation Audit Techniques Guide (available at www.irs.gov), issued in 2004, outlines the elements of a quality cost segregation study and provides direction to IRS field agents when reviewing a study. The guide outlines six different approaches, as follows.

Detailed Engineering Approach from Actual Cost Records. The detailed engineering approach from actual cost records, or "detailed cost approach," uses costs from contemporaneous construction and accounting records. In general, it is the most methodical and accurate approach, relying on solid documentation and minimal estimation. Construction-based documentation such as blueprints, specifications, contracts, job reports, change orders, payment requests, and invoices are used to determine unit costs. The use of actual cost records contributes to the overall accuracy of cost allocations, although issues may still arise as to the classification of specific assets. This approach is generally applied only to new construction, where detailed cost records are available. For used or acquired property and for new projects where original construction documents are not available, an alternative approach may be more appropriate.

Detailed Engineering Cost Estimate Approach. The detailed estimate approach is similar to the detailed cost approach. The difference is that the detailed estimate approach estimates costs, rather than using actual costs. This approach is used when cost records are not available or for an acquisition when the purchase price must be allocated.

Survey or Letter Approach. The survey or letter approach is an alternative method for estimating costs. In this approach, contractors and subcontractors are contacted via a survey or letter to provide information on the cost of specific assets that they installed on a particular project. These costs are then used in one of the engineering approaches or in the residual estimation approach.

Residual Estimation Approach. The residual estimation approach is an abbreviated method in which only short-lived asset costs (e.g., five- or seven-year property) are determined. Short-lived asset costs are added together and then subtracted from the total project cost. The remaining or "residual" cost is then simply assigned to the building and/or other long-lived assets. Although this method is simpler and less time consuming than the engineering approaches, it can also be less accurate. Additionally, the IRS has instructed its agents and engineers to scrutinize studies that employ this approach.

Sampling or Modeling Approach. The sampling or modeling approach uses a created model (or template) to analyze multiple facilities that are nearly identical in construction, appearance and use (e.g., fast food chains and retail outlets). The use of sampling minimizes resources and costs compared to conducting studies on all properties.

Rule of Thumb Approach. In general, this approach uses little or no documentation and is based on a preparer's experience in a particular industry. For example, a preparer will estimate §1245 property as a fixed percentage of project cost by relying on previously determined industry averages (e.g., 40 percent for a manufacturing facility). This type of approach yields high audit exposure, since it lacks sufficient documentation to support its allocation of project costs.

What Methodology Does the IRS Require?

Neither the IRS, nor any group or association of practitioners, has established any requirements or standards for the preparation of cost segregation studies. Although there are no requirements stated, the IRS Cost Segregation Audit Techniques Guide instructs IRS agents and engineers what to look for and the elements of a "quality" cost segregation study.

The IRS has addressed methodologies only briefly, i.e., Revenue Ruling 73-410, 1973-2 C.B. 53, Private Letter Ruling (PLR) 7941002 (June 25, 1979), Chief Counsel Advice Memorandum 199921045 (April 1, 1999). These documents all emphasize that the determination of §1245 property is factually intensive and must be supported by corroborating evidence. In addition, 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." (PLR 7941002).

Despite the lack of specific requirements for preparing cost segregation studies, taxpayers still must substantiate their depreciation deductions and classifications of property. Substantiation using actual costs is generally preferable to the use of estimates. However, in situations where estimation is the only option, the methodology and the source of any cost data should be clearly documented. In addition, estimated costs should be reconciled back to actual costs or purchase price.

What Makes an Engineering-based Study the Most Accurate Approach?

The detailed estimate approach is methodical, relying on solid documentation and utilizing construction-based documents such as blueprints, specifications, contracts, job reports, change orders, payment requests, invoices, appraisals, etc. When estimates are required, they are based on costing data, either from contractors or from reliable published sources (e.g., R. S. Means or Marshall Valuation Service). The sources of estimating data are clearly referenced, including identification of the specific volume, page and item number. Further, the same estimating techniques and unit cost data sources are used for all of the items that comprise the actual cost.

The legislation and procedures used in an engineering-based cost segregation study have been in existence since the enactment of the Investment Tax Credit (ITC) in 1962. When the ITC was repealed in 1986, most companies assumed that cost segregation studies provided no further benefit under the new tax law. However, in a landmark 1997 tax court case, Hospital Corporation of America successfully defended the application of engineering-based cost segregation as a method to differentiate real and personal property under existing tax law.

Who Can Conduct a Cost Segregation Study?

The following qualifications are strongly recommended to ensure an investor obtains the optimum tax savings allowable by law:

- Engineering, construction and tax expertise to accurately evaluate, identify and classify assets to appropriate categories.
- Knowledge of changing tax laws to ensure taxpayers optimize savings within the proper application of current laws.
- Compliance with the IRS Audit Techniques Guide to ensure an accurate study that withstands IRS scrutiny in the event of an audit.

Why Do You Need a Specialist?

While many CPAs are aware of the benefits surrounding cost segregation, they often do not employ true engineering-based methods; therefore, only a minimal amount of building components are identified for accelerated depreciation. For existing properties, where building cost information is unavailable, the entire cost of the building is commonly depreciated over the 39- or 27.5-year life assigned to real property. In this situation, the building owner is incorrectly depreciating his/her assets and not taking full advantage of the benefits currently available from the tax code. But through an engineering-based cost segregation study, a wide range of building components, such as electrical installations, plumbing, mechanical components and finishes can be identified and reclassified into the shorter-lived asset classes. The studies allow property owners to accelerate the depreciation on as much as 25–60 percent of typical buildings.

Cost segregation specialists do not replace the essential role the CPA plays in tax planning and preparation; rather the two complement each other. Cost segregation utilizes a unique combination of construction estimating and tax expertise to properly dissect construction information, compute estimates, and identify subcomponent costs. For new construction, a review of construction invoices alone is not sufficient and for acquired properties, construction cost information is frequently not available or is incomplete. Many CPA firms lack either the necessary tax expertise to properly segregate the different types of property, or the engineering expertise necessary to analyze construction drawings and conduct engineering cost estimates. It is important to note that IRS agents are trained to review the preparer's credentials and level of expertise as part of an audit, as that can affect the accuracy and quality of a cost segregation study. In the Cost Segregation Audit Techniques Guide, the IRS states that the "preparation of cost segregation studies requires knowledge of both the construction process and the tax law involving property classifications for depreciation purposes."

Additionally, there are no set rules that you can use to determine if property is eligible. For example, a light fixture in one room may qualify as §1245 property (property eligible for a shorter accelerated depreciable life), while the exact same light fixture in the very next room may not qualify because of various facts and circumstances on how and why it's being used. This applies to every asset in the building, and the onus (to prove and substantiate that each asset qualifies) is on the taxpayer. This is done by understanding the characteristics of each asset and knowing the circumstances for which legal authority can support your position on each asset.

Once a study is complete, the CPA will file the schedule and, for those owners whose property has been in service for a year or more, prepare and file Form 3115. There is a number of tax issues to consider before a recommendation can be made to perform a cost segregation study, so a knowledgeable CPA should assess the specific situation of each client to determine if a study would be beneficial.

What is Involved in a Study?

A quality cost segregation study evaluates all information, including available records, inspections, and interviews, and presents the findings in a clear, well-documented format. A typical process for conducting a detailed study includes:

- A review of all cost detail for the property including, but not limited to, the general contractor's application for payment, construction invoices, change orders, depreciation schedules, and appraisals.
- An inspection of the facility to fully understand its use and condition, as well as to gather information that further supports the classification of capitalized costs into their appropriate class lives.
- Photographs of qualifying construction components.
- A review of all blueprints (if available) and the performance of quantity take-offs and cost estimates for personal property not segregated in other cost information.
- A reconciliation of all construction costs, and estimates of the actual amounts incurred by tax life must also be performed. This step includes adjusting estimates to account for location, time, and physical condition. An allocation of soft costs to any direct cost in each category to maximize total benefits may also be performed.
- A report that complies with the IRS guidelines stipulated in the Audit Techniques Guide for Cost Segregation Studies.

What About 1031 Exchange Property That Has Been Cost Segregated?

Property owners may discover they have taxable gain in a 1031 exchange of property that has been cost segregated, even though they have acquired like-kind replacement property and otherwise satisfied the requirements of a 1031 exchange. This is due to the accelerated depreciation deductions derived from the cost segregation study, which are subject to "recapture" under tax laws. In other words, the owner must pay tax on the depreciation deductions taken in prior years if the property is later sold at a gain.

Example: The owner of a manufacturing facility had a cost segregation study performed in 2000, in which $1,000,000 of real property was reclassified into personal property. By 2002, the owner realized $300,000 in depreciation deductions on the personal property. In that same year, the owner exchanges the facility for another manufacturing facility of equal value. The owner would typically pay no tax on the exchange. However, the replacement manufacturing facility in this example has only $800,000 of personal property. Therefore, the owner will "recapture" and pay tax on $200,000 of the prior depreciation deductions, due to the difference between the $1,000,000 of personal property in the existing property and the $800,000 of personal property in the replacement property.

Despite the potential of future tax in a 1031 exchange, cost segregation can still be justified due to the tremendous present value of the accelerated depreciation deductions. Based on the fundamental principle of the time value of money, a dollar saved today through reduced taxes is always worth more than a dollar paid in taxes in later years. Furthermore, if the owner exchanges into other real property with similar or greater amounts of personal property, the recapture tax can be avoided altogether. Cost segregation and 1031 exchanges can be integrated effectively to increase cash flow, as long as the tax advisor is familiar with the interaction of the tax laws and how they apply to the client's individual investment situation.

A Valuable Strategy

Cost segregation is one of the most valuable tax planning strategies available to commercial real estate owners today. Effectively, cost segregation studies provide more precisely segregated property information, enabling building owners to achieve the maximum tax benefit allowed by law, which can have a direct and sizeable impact on their cash flow.

Additionally, the incentives included in the 2008 Economic Stimulus Act can result in substantial benefits for property owners, but they are limited to the current tax year. Taxpayers in the process of construction should take full advantage of the bonus depreciation and enhanced expensing rules by having a cost segregation study performed to further decrease their tax liabilities and increase their cash flow.

Working together with an engineering-based cost segregation specialist, CPAs can provide an additional value-added service to their clients.

About the Authors: Scott Zarret has over 10 years of CPA, marketing and business development experience within the professional services arena. Currently, he is the director of Strategic Development at KBKG, Inc., a consulting firm specializing in cost segregation studies. CJ Aberin is a senior manager for Cost Segregation Services at KBKG, Inc. Over the last several years, CJ has performed cost segregation studies for various clients that range from Fortune 500 companies to individual real estate investors. For more information, visit their Web site at www.costsegregation.com or phone 877-525-4462, ext. 501.

Today's CPA offers the self-study exam below for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article.

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Cost Segregation: Why Your Clients Can Benefit From a Comprehensive Study

1. What kinds of professionals are best suited to conduct a cost segregation study?
   a. Tax specialists who can insure maximum tax savings within the applicable law.
   b. Individuals with engineering, construction and tax expertise to properly evaluate and classify assets to appropriate categories.
   c. Individuals who have experience dealing with the IRS Audit Techniques Guide to insure an accurate study that withstands IRS scrutiny.
   d. All of the above.

2. What are the benefits of a cost segregation study?
   a. Increase cash flow by accelerating deductions and deferring income taxes.
   b. Provides information for possible retroactive adjustments to depreciation.
   c. Minimizes the risk of a tax audit.
   d. A and B.

3. Where are the most common methods of conducting a cost segregation found?
   a. An auditing textbook.
   b. Internal Revenue Code.
   c. IRS Cost Segregation Audit Techniques Guide.
   d. Recent Supreme Court decisions.

4. Which cost segregation study technique is typically used for new construction?
   a. Residual elimination approach.
   b. Survey or letter approach.
   c. Detailed engineering approach from actual cost records.
   d. Sampling or modern approach.

5. Who are the best candidates to qualify for a cost segregation study?
   a. Office and industrial buildings.
   b. Manufacturing facilities, retail centers.
   c. Anyone who has purchased property since Jan. 1, 1987, with depreciable costs exceeding $750,000, or has made interior improvements in excess of $400,000.
   d. All of the above.

6. Which approach to a cost segregation study typically gets the most attention and results in the highest audit exposure?
   a. Residual elimination approach.
   b. Detailed engineering approach.
   c. Rule of thumb approach.
   d. Survey approach.

7. What information is evaluated in a cost segregation study?
   a. All the cost detail of the property, including invoices, requests for payment, change orders, and appraisals.
   b. A review of all blueprints and related materials.
   c. Marketing surveys.
   d. A and B.

8. What is a possible tax impact of doing a cost segregation study and then having a Section 1031 exchange with the same property?
   a. Possible recapture of excess depreciation.
   b. Loss of all tax benefits that resulted from the study.
   c. Inability to use cost segregation for a five-year period.
   d. Taxpayer is required to extend the statute of limitations for the year of the study for two years.

9. What does the IRS require in a cost segregation study report?
   a. Substantiation of actual costs.
   b. Reconciliation of estimated costs to actual costs and/or purchase price.
   c. Factually intensive and supported by corroborating evidence.
   d. All of the above.

10. What method of doing a cost segregation study is characterized by modeling techniques of similarly constructed facilities?
   a. Sampling approach.
   b. Detailed engineering approach.
   c. Residual approach.
   d. Rule of thumb approach.

PARTICIPATION EVALUATION (Please check one.)

5=excellent 4=good 3=average 2=below average 1=poor

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