COST SEGREGATION CAN DIRECTLY IMPROVE CASH FLOW FOR AUTO DEALERS

by Scott Zarret

Auto dealers stand to gain substantial increases in cash flow by accelerating depreciation deductions on their dealerships through cost segregation studies. Typically, nearly 30-45% of the cost of a dealership can be reclassified from property depreciable over 39 years to personal property and land improvements depreciable over 5, 7 and 15 years.

For both new and existing dealerships, a cost segregation specialist can identify and reclassify qualified components into the shorter-lived asset classes, thereby minimizing a dealer's overall tax liabilities.

WHY DEALERSHIPS ARE UNIQUE

Dealerships are unique in that they can have significantly more personal property than the average commercial building because they require special service equipment, state-of-the-art showrooms, advanced computer systems, vehicle display areas and specialized electrical components.

They also contain much higher than average percentages of 15-year property due to the asphalt paving, drainage, site lighting and electrical dedicated to the outside areas.

Additional components that can be reclassified to personal property include compressed air systems, floor drains and piping, carpeting, data cabling and specialty lighting in the showroom/office areas. Thus it is critical for clients who own or are constructing auto dealerships to find a cost segregation firm with the right combination of engineering and tax expertise to properly dissect construction information, compute industry standard estimates, and identify and segregate the subcomponent costs.

Additionally, depending on how they're constructed, parking decks can comprise one the most significant elements for reclassification in a cost segregation study.

COST SEGREGATION DEFINED

Engineering-based cost segregation studies allow commercial real estate owners to reallocate real property (Code Sec. 1250) to personal property (Code Sec. 1245), which results in a substantially shorter depreciable tax life and accelerated depreciation methods. By engaging a cost segregation expert, non-structural building components can more accurately be classified into the 5, 7, or 15-year depreciable lives assigned to personal property and land improvements. The taxpayer not only benefits from reduced recovery periods, but can also apply the accelerated declining balance depreciation methods (150% and 200%) available under MACRS, thus generating tremendous cash flow benefits in both current and future years.

While many CPAs are aware of the benefits surrounding newly constructed properties, they often do not employ true engineering-based methods, and therefore only a minimal amount of building components are reclassified into the shorter tax lives. For existing properties, where building cost information is unavailable, the entire cost of the building is commonly depreciated over the 39-year life assigned to real property. In both situations, the property owner is not taking full advantage of the benefits currently allowed by the IRS.

BENEFITS

The example on the facing page illustrates the benefits that can be realized by a typical dealership.

A schedule showing the range of benefits that 12 dealerships realized from cost segregation studies undertaken by our firm is also included. These reflect an assumed effective tax rate of 40% and a discount rate of 8%.

HISTORY OF COST SEGREGATION

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 this Act 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.

Several recent rulings have been issued by the Internal Revenue Service to spur economic growth, which can have a major impact for those clients with previous construction and acquisitions.

Under Rev. Proc. 2002-09, the IRS automatically consents to changes in method of depreciation, reported on Form 3115, and filed with the income tax return in the year the change is elected. Following the 9/11 (i.e., September 11, 2001) tragedy, the Internal

see **COST SEGREGATION**, page 12

EXAMPLE OF BENEFITS FOR AN AUTO DEALERSHIP

Constructions Costs $4 Million
Facility Placed into 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 Benefit

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

PERSONAL PROPERTY & LAND IMPROVEMENT EXAMPLES

Personal Property with a 5 or 7-Year Life

- Air Filtration Systems
- Auto Service Task Lighting
- Auto Service Water, Oil & Waste Piping
- Car Lifts & Foundations
- Carpeting
- Compressed Air Piping
- Decorative Lighting
- Decorative Wood Work
- Folding Partitions
- Pull Pots, etc.
- Public Address System
- Security System
- Signs & Graphics
- Tele/Data Communication
- Window Treatments

Property with a 15-Year Life

- Curbs and Gutters
- Dumpster Enclosure
- Fencing
- Grading
- Irrigation
- Land Preparation Costs
- Landscaping
- Parking Lot
- Site Lighting

Revenue Service issued Rev. Proc. 2002-19, which allows taxpayers to catch up on all deductions from previous years for items reclassified into the shorter tax lives as a result of a cost segregation study. Prior to Rev. Proc. 2002-19, the beneficial adjustment had to be spread out across four years, but this can now be expensed entirely in the year of the change. The resulting Section 481(a) adjustment is reported as a reduction to the current year taxable income and amended returns are not required.

Under Rev. Proc. 2004-11, the IRS reversed the two-year waiting period required to change the method of calculation for depreciation on their property, allowing taxpayers to change the method in any year. Previously, if a taxpayer purchased a property and elected to depreciate it over 39 years, it had to wait two years before it could change depreciation methods and utilize a cost segregation study to take advantage of the shorter-lived personal property asset classes.

The combined effect of the recent tax law changes make now the ideal time for dealership owners to have a cost segregation study performed.

IDEAL CANDIDATES FOR COST SEGREGATION

Dealers who have purchased or constructed a facility since January 1, 1987, with capitalized costs in excess of $750,000 (excluding land), or who have made improvements in excess of $350,000, will likely benefit from having a cost segregation study performed. The taxpayer must also plan on retaining the property for the next few years and have net income that is currently taxable.

While the IRS puts no limitation on the number of years a building owner is allowed to go back and reclaim the depreciation lost by not utilizing a cost segregation study (Rev. Proc. 2002-19), generally it is not advantageous to go back further than 1987, as most of the property cost has already been depreciated.

WHY COST SEGREGATION STUDIES SHOULD BE DONE BY A SPECIALIST

No specific industry guidance exists for auto dealerships (as it does for other industries - i.e. casinos, restaurants, retail facilities, biotech / pharmaceutical). However, the IRS does provide general guidance for what it feels constitutes a ***quality*** cost segregation study and what the Service is looking for in an audit for any building type.

By employing the services of a specialized engineering-based cost segregation firm that understands and meets the IRS's *"13 principal elements of a cost segregation study,"* dealerships can achieve considerable increases in after-tax cash flow.

[Note: The IRS' expectations in this regard are summarized on the last 2 pages of this material.]

For new construction, a review of construction invoices alone is not sufficient and for existing properties, construction cost information is frequently not available, or it may be incomplete. In either case, the same specialist must be engaged to perform the comprehensive analysis that must take place to ensure all the eligible personal property components are identified. Engineering-based cost segregation studies provide the CPA with the information and detailed supporting documentation necessary to comply with strict IRS regulations and requirements for audit defense.

CONCLUSION

Cost segregation represents one of the most valuable tax planning strategies available to auto dealership owners today. An understanding of the benefits of cost segregation and an affiliation with an engineering-based cost segregation provider can have a direct and sizeable impact on an auto dealer's cash flow, and often for the CPA firm as well. By working with a cost segregation specialist, CPAs can achieve the maximum tax benefit allowed by law for their clients.

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In addition to being one of the leading educators in the field of Cost Segregation, KBKG specializes in performing engineering-based Cost Segregation studies that allow commercial property owners to depreciate their buildings in the shortest amount of time permissible under existing tax laws. Since 1999, KBKG's tax and engineering professionals have performed thousands of cost segregation studies nationwide, meeting the "13 Principle Elements of a Quality Study" as outlined by the IRS. For a full brochure of the Firm's range of services and other information, please contact Mr. Zarret at (303) 221-4100 or visit www.CostSegregation.biz.

The accompanying information summarizing the IRS Cost Segregation Audit Techniques Guide *is adapted from material previously included in the December, 2004* Dealer Tax Watch. *For a listing of previous coverage of cost segregation studies in the* Dealer Tax Watch, *see www.defilipps.com.*

COST SEGREGATION STUDY BENEFITS
FOR RECENT "TYPICAL" DEALERSHIPS *

Dealership Type	Total Cost	Year Placed in Service	Increase in Depreciation Expense in Year 1	INCREASE IN CASH FLOW ** Year 1	Years 1-5	NPV (after-tax)
Honda Service Center	$ 6,591,736	2006	$ 105,132	$ 42,053	$ 169,275	$ 132,238
Nissan Dealership	4,836,745	2006	98,064	39,226	178,414	173,255
Oldsmobile/Cadillac Dealership	2,266,063	2006	45,086	18,034	88,843	96,657
Used Car Dealership	1,881,465	2006	20,434	8,173	39,844	42,772
Nissan Remodel	2,301,092	2006	121,447	48,579	194,898	151,170
Audi Dealership	3,000,000	2005	339,220	135,688	243,983	202,873
Chevrolet Dealership	4,880,034	2004	391,650	156,660	232,986	216,017
Chevrolet Dealership	2,800,000	2004	268,499	107,400	148,861	127,488
Ford Dealership	8,674,519	2003	118,836	473,535	572,779	480,020
Ford Dealership	3,817,532	2003	503,771	204,508	271,092	254,758
Suzuki Dealership	2,452,704	2003	265,044	106,018	135,856	121,535
Ford Dealership	4,070,554	1999	89,021	358,809	366,747	278,958

* Cost segregation studies completed by the author's firm, KBKG, Inc., Pasadena, Cal.

** Increases in depreciation expense and cash flow are based on the following assumptions ...
(1) Effective tax rate: 40%
(2) Discount rate: 8%

What the IRS Wants	***COST SEGREGATION STUDIES*** ***IRS AUDIT TECHNIQUES GUIDE*** ***Page 1 of 2***
Thirteen (13) Principal Elements of a "Quality" Report	1. ***Preparation by an individual (or firm) with expertise and experience.*** 2. ***Detailed description of the methodology.*** 3. ***Use of appropriate documentation***, including ◆ Explanation of the treatment of land and land development costs. ◆ Site visit to gain better perspective and understanding of the design and purpose of the project, as well as the use of specific assets. ◆ Land and site preparation costs are also documented by before-and-after photographs. ◆ Review of all pertinent construction documentation, blueprints, construction drawings and contract payments. ◆ Review of the general contractor's Applications for Payment (American Institute of Architects ... AIA ... forms). 4. ***Interviews conducted with appropriate parties.*** 5. ***Use of a common nomenclature or terminology*** that is consistent with the other project documents (i.e., contract specifications, pay requests, etc.). ◆ No creative descriptions that try to disguise the true nature or character of the underlying assets. 6. ***Use of a standard numbering system*** that is consistent with the contract bid documents and pay requests. 7. ***Explanation of the legal analysis***, including relevant citations, to support Section 1245 property classifications. ◆ If applicable, a reconciliation of the classification treatment with possibly conflicting judicial decisions should be included. 8. ***Determination of unit costs and engineering "take-offs."*** ◆ "In a quality study, engineering 'take-offs' are carefully documented to show derived unit costs, and individual property units are clearly identified or highlighted on the 'as built' blueprints." 9. ***Organization of assets into lists or groups*** that directly tie into the taxpayer's fixed asset ledger. 10. ***Reconciliation of total allocated costs to total actual costs.*** ◆ This reconciliation ensures accuracy of the allocations and should list separately-acquired Section 1245 property to prevent possible duplication. 11. ***Explanation of the treatment of indirect costs***, including an explanation of the purpose of each indirect cost, its allocation and any deviations from commonly accepted practice. 12. ***Identification and listing of Section 1245 property.*** 13. ***Consideration of other related aspects***, such as ◆ Elements of cost capitalization (Section 263A), ◆ Changes in accounting method(s) and ◆ Sampling techniques employed in the study.
Report Format - Contents	• A cost segregation report should include the following: ◆ Summary letter/Executive summary ◆ Narrative report discussing the theory, definitions and the rationale behind the study in the narrative section ◆ Schedule of assets, ◆ Schedule of all direct and indirect costs associated with the project ◆ Schedule of property units and costs (with property descriptions) that are segregated into land, Section 1245 property and Section 1250 property ◆ Engineering procedures ◆ Statement of assumptions and limiting conditions ◆ Certificate ◆ Exhibits

What the IRS Wants	***COST SEGREGATION STUDIES*** ***IRS AUDIT TECHNIQUES GUIDE*** ***Page 2 of 2***

IRS Audit Procedures	• Review a copy of the cost segregation study and report.
	• Verify the cost basis and reconcile depreciation records.
	• Conduct a risk analysis to evaluate audit potential.
	• Interview the preparer.
	• Inspect the property.
	• Review and verify the classes of property.
	• Perform a cost analysis.
	  ◆ Newly-constructed property
	  ◆ Existing property
	• Review sampling techniques if sampling techniques were used.
	• Consider IRC Section 263A.
	  ◆ All direct costs and certain indirect costs properly allocable to real property and to tangible personal property (produced by the taxpayer) must be capitalized.
	  ◆ In addition, Section 263A(f) requires the capitalization of certain ***interest expenses***, and changes to real and tangible personal property costs may impact the amount of capitalized interest.
	• Consider possible change in accounting method issues.
	• Research the law, the Regulations and appropriate rulings.
	• Summarize the findings and discuss the challenged assets with the taxpayer.
	• Prepare the final report or the Notice of Proposed Adjustments.

Information Document Requests (IDRs)	• The Appendix to this *Techniques Guide* contains sample IDR language to ...
	  ◆ Identify the participants and their respective roles in the preparation of the cost segregation study / analysis.
	  ◆ Identify the specific properties involved.
	  ◆ Locate the source of property blueprints, drawings and other information.
	  ◆ Obtain a copy of the cost segregation study.
	  ◆ Secure a copy of the study computations and formulae.
	  ◆ Ask specific questions about segregated properties.
	  ◆ Request specific items and amounts in question.

Sources	• IRS *Cost Segregation Audit Techniques Guide*
	Revision date: January 14, 2005.
	• See especially *"Industry Specific Guidance"* included at Chapter 7.2 for restaurants and Chapter 7.3 for retail industries.
	  ◆ *Field Directive on the Planning & Examination of Cost Segregation Issues in the* ***Restaurant*** *Industry*, December 27, 2004, memorandum for Industry Directors, LMSB. This contains a detailed matrix recommending the categorization and general depreciation system recovery period of various restaurant assets falling within both Secs. 1245 & 1250.
	  ◆ *Field Directive on the Planning & Examination of Cost Segregation Issues in the* ***Retail Industry***, December 16, 2004, memorandum for Industry Directors, LMSB.