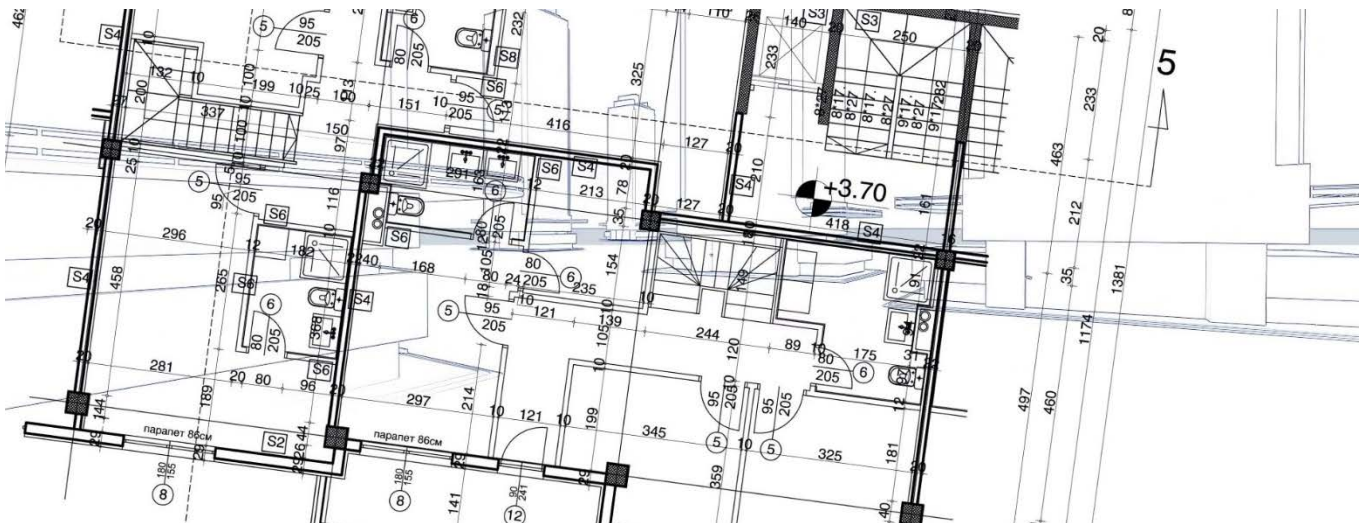


# Understanding Cost Segregation

An Overview for Property Owners and Advisors



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# INTRODUCTION TO COST SEGREGATION

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## What is Cost Segregation?

Cost Segregation is a strategy for accelerating depreciation, reducing taxes and increasing cash flow. Through an engineering-based cost segregation study, costs associated with the purchase, construction, or renovation of a building is segregated into components. Typically these costs are assigned a 39 or 27.5-year depreciable life for tax reporting. But by using the study results, a taxpayer can reclassify component costs to shorter depreciable lives of 5, 7 or 15 years. This accelerates depreciation deductions and increases cash flow by deferring federal and state income taxes.

## History

The laws, rules, and procedures relied upon in cost segregation studies have been around since the enactment of the Investment Tax Credit (“ITC”) in 1962. The legal rationale used to distinguish personal from real property for purposes of the ITC provides a good framework for the classification process in cost segregation studies.

The ITC was repealed through the Tax Reform Act of 1986. While it was not clear if cost segregation studies offered any benefit under the new law, many assumed they did not. However, in 1997 a landmark tax court decision upheld the application of cost segregation as viable. The Hospital Corporation of America case is the seminal case for cost segregation studies and the IRS has agreed that a taxpayer can use a cost segregation study to segregate building costs. As a result, the use of cost segregation studies proliferated, spawning an entirely new industry-segment and specialized professionals to serve it.

Consequently, Congress and the IRS have responded with various laws and rulings, expanding further the complex body of knowledge on this topic. Many have been issued with the intent of spurring economic growth and have had a significant impact on opportunities for property owners to take advantage of cost segregation.

Recent tax law changes have increased bonus depreciation rates to 100% and made it applicable to used property where it was formerly limited to 50% of new property.

All of these developments have made the benefits of cost segregation more widely available and useful to individual and business taxpayers alike.

## What Qualifies

The determination of what property components qualify for shorter depreciable lives is ultimately based on asset-specific facts and circumstances and precedents existing in both case law and IRS guidance.

Determinations are made based on data obtained from construction/cost records and information gathered during the site inspection. Key considerations include whether the property can be easily or readily moved, was it intended to remain in place, and does it relate to the operation and maintenance of the building.

Anyone who owns real estate and expects to pay income taxes during the period of ownership can potentially benefit from a cost segregation study. Studies are most beneficial for properties with a cost basis of at least \$500,000, but can sometimes be worthwhile when costs are lower.

## INTRODUCTION TO COST SEGREGATION

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Property owners should consider using cost segregation study if they:

- Acquired property in the last 15 years
- Recently completed or started a construction project
- Inherited property from an estate and received a stepped-up basis
- Purchased a partnership interest
- Expect to pay income taxes
- Plan on holding the property for at least five years

Examples of assets that may qualify to be reclassified to shorter depreciable lives include:

- Land improvements
- Parking lots
- Fences
- Outdoor lighting
- Landscaping
- Wall and floor coverings
- Security systems
- Cabinets and millwork
- Data and communication cabling
- Decorative lighting
- Window treatments
- Electrical and plumbing service to specific equipment
- Moveable wall partitions
- Certain specialized equipment

### Benefits

There are numerous benefits from performing a cost segregation study. By accelerating depreciation and increasing tax deductions in the early years of property ownership, a property owner increases cash flow. Not only can the increased cash flow improve investment returns, it can also improve debt service coverage ratios when the property is financed with bank or other loans.

A third party study performed by an objective, independent, and qualified professional will withstand IRS scrutiny. It can also correct previously misclassified assets and allow the taxpayer to claim a catch-up adjustment for the difference. Study results may be used to reduce real estate taxes, too.

The following table shows for different industries the average percentage of property costs reclassified to shorter recovery periods as the result of a cost segregation study.

## INTRODUCTION TO COST SEGREGATION

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**Table 1: Average Basis Reallocation**

<b>Apartment Buildings</b>	<b>20-50%</b>
<b>Office Buildings</b>	<b>10-40%</b>
<b>Restaurants</b>	<b>20-50%</b>
<b>Hotels</b>	<b>25-40% Light</b>
<b>Manufacturing</b>	<b>15-40% Heavy</b>
<b>Manufacturing</b>	<b>25-70% Grocery</b>
<b>Stores</b>	<b>15-50%</b>
<b>Retail Facilities</b>	<b>20-50%</b>
<b>Warehouses</b>	<b>8-30%</b>
<b>Processing Plants</b>	<b>20-65%</b>
<b>R &amp; D Facility</b>	<b>20-50%</b>

Source: CCH Practical Guide to Cost Segregation, 4<sup>th</sup> Ed.

### Who Can Prepare a Quality Cost Segregation Study?

Cost segregation studies should be performed by consulting firms with expertise in engineering, construction, tax, and accounting. The IRS's underlying assumption in determining what constitutes a quality study is that the study is performed by "personnel competent in the design, construction, auditing, and estimating procedures relating to building construction."

Cost segregation is a very specialized and complex area. As such, most CPA's offering traditional services refer or outsource these projects to specialist firms. Expertise in cost segregation requires much more than an understanding of accounting and tax law.



## COST SEGREGATION METHODS

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### How is the study performed?

The cost segregation consultant will generally use one of two approaches approved by the IRS, sometimes a combination of both.

The first approach is to examine actual cost data records and construction documents in conjunction with a site visit to identify potential assets for reclassification. This approach is typically used when the subject property has been recently constructed and documents are readily available. The consultant assigns costs to each component based on an analysis of the documents and site visit data.

An alternative approach is used when documentation is not available, typically when a property is acquired or if the study is performed several too many years after initial construction. In this case the consultant reverse engineers the property into separate components and estimates costs using standard construction cost estimating tools. Total actual property costs are then allocated to the components on a proportional basis.

### Data requirements

Information and documents typically requested for a cost segregation study include:

- Legal description of the property
- Date placed in service
- Square footage
- Site drawings
- Architectural plans
- AIA Documents 702 & 703
- Other construction documents and invoices
- Depreciation schedules (if > 1 year from placed in service date)
- Fixed asset listing
- Construction loan documents
- Settlement statement
- Appraisal





## STEPS IN A COST SEGREGATION STUDY

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The major steps in a typical study are:

1. Perform pre-study analysis of potential benefits
2. Execute the engagement letter
3. Gather required information
4. Conduct site visit
5. Review cost information and plans
6. Segregate property into components
7. Quantify direct cost of property components
8. Allocate project and owner indirect costs
9. Reconcile cost detail to depreciation schedules
10. Classify assets into appropriate classes and recovery periods
11. Prepare report
12. Calculate 481(a) adjustment and prepare Form 3115, if necessary



## CONTENTS OF A COST SEGREGATION REPORT

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The deliverable is a self-contained cost segregation report that will satisfy IRS requirements. A quality report will include the following contents:

- Certification by the study's author(s)
- Qualifications of the personnel performing the study
- Project overview and subject property description
- Scope of the study
- Methodology and procedures
- Asset classification summary
- References and citations to tax court cases, revenue rulings, and regulations justifying asset classification
- A detailed "take-off" spreadsheet showing property components and costs
- Reconciliation of project cost to depreciation schedules
- Calculation of adjustment for property acquired and depreciated in prior tax reporting years
- Photographs of the subject property

## COST SEGREGATION & ENERGY EFFICIENCY STUDIES

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Taxpayers who construct or make improvements to commercial buildings may qualify for an additional deduction under IRC Section 179D and 45L. The deduction is available if the taxpayer can demonstrate that certain building systems reduce energy consumption below a threshold.

Building systems that qualify include the building envelope, lighting, HVAC and hot water systems. The deduction amount is the lesser of the cost of the energy efficiency components or \$1.80 multiplied by the square footage of the building.

Any qualifying components can be identified as part of a cost segregation study. Once a qualified consultant determines and certifies that the building's energy consumption meets the threshold for the deduction, the component cost information can be used to calculate the deduction.

Energy efficiency studies can be conducted simultaneously with cost segregation studies if the cost segregation provider has qualified consultants on staff. These consultants are typically professional engineers who perform or oversee the site inspection phase of the cost segregation study.

Taxpayers who take the 179D deduction must reduce the depreciable basis of the property by the amount of the deduction. Since most of the qualifying energy efficiency components are 39 year property, this deduction provides an incremental benefit to the accelerated depreciation deductions realized through the cost segregation study. Combining both studies is therefore a very effective tax deferral strategy.



## INFORMATION FOR CPA'S

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### Retroactive Studies

A "retroactive" study can be performed for properties placed in service before the current tax year. You can claim the difference between the allowed depreciation and what you actually claimed in prior years, all on the current tax return.

- No amended returns or IRS approval
- Depreciation "catch-up" is all claimed in current tax year
- Form 3115 filed with current tax return
- The 481(a) adjustment is captured on Form 4562 on the current tax return

When a taxpayer performs a retro-active cost segregation study, the differences in depreciation deductions for the prior years are accounted for via a catch-up deduction in the current tax year. This is reported on the taxpayer's return as a Section 481(a) adjustment. Under Rev Proc. 2017-30 the adjustment is taken entirely in the current year and does not necessitate the filing of amended returns. The 481(a) adjustment is automatically accepted by properly completing and attaching Form 3115 to the taxpayer's return. Information necessary to complete Form 3115 will be contained in the cost segregation report if it is prepared by a qualified firm and meets the IRS' requirements for a "quality" study.

### Opportunities

CPA's have opportunities to recommend cost segregation to their clients in the following situations:

- Purchase of existing property
- Construction of new property
- Major renovations or leasehold improvements
- Inheritance of property via estate transfers
- Basis adjustments to real property under IRC Section 754
- Compliance and planning under Tangible Property Regulations

CPA's should especially consider cost segregation when their clients are using debt to finance property acquisitions or improvements. The additional cash flow from lower taxes in the early years of ownership can significantly improve the property's debt service coverage, reduce credit risk, and increase the likelihood of loan approval.

## CASE STUDIES

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### Case Study 1 – Newly Constructed Hotel Property

A taxpayer constructs a new hotel property in June of 2017 for a total cost of \$5,000,000, excluding land. Without a cost segregation study, the entire \$5,000,000 cost would be depreciated over 39 years using the straight-line method.

However, by performing a cost segregation study on the property, the cost can be broken down and reclassified to the following depreciation lives:

5 year property	\$ 250,000	5%
7 year property	\$ 150,000	3%
15 year property	\$ 750,000	15%
39 year property	\$3,850,000	77%

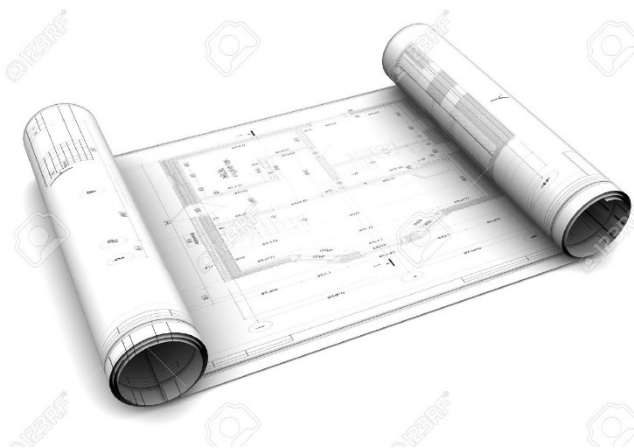
The resulting accelerated depreciation produces a first year tax savings of \$245,000 and a present value benefit over the first five years of \$300,000. Note that costs reclassified to the 5, 7 and 15 year categories are eligible for 50% bonus depreciation in this scenario since it consists of new construction.

Assume the same facts except that the property is placed in service on October 1, 2017. Under the new tax law, the personal property qualifies for 100% bonus depreciation since it is placed in service after September 27, 2017. As a result, the first year savings increases to \$457,000 and the five year present-value benefit increases to \$415,000.

### Case Study 2 – Look-back Study

Assume the same facts in Case 1, except that the property is purchased by the taxpayer in 2014 and the study is performed in tax year 2017. The cost segregation study in this situation is a retro-active study.

A catch-up adjustment is made in the current tax year of 2017 for the increase in depreciation expense for the years 2014 through 2016. As a result, the taxpayer realizes a reduction in tax expense for 2017 of \$305,000. The adjustment is taken by filing a Form 3115 with the 2017 tax return. There is no need to amend the returns for 2014 through 2016.



## FREQUENTLY ASKED QUESTIONS

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### **How much should I expect to save with a cost segregation study?**

The average study will allocate, or reallocate in the case of a look-back study, anywhere from 20 – 35% of the depreciable cost basis to a shorter life. For every \$100,000 moved from 39-year to 5-year, the 10-year net present value savings is approximately \$28,000 (based on a 40% tax rate and a 4% discount rate).

### **Are cost segregation studies recognized by the Internal Revenue Service (IRS)?**

Yes. The Internal Revenue Service recognizes properly prepared cost segregations as a valid tax benefit. And current IRS procedures allow a taxpayer to reflect the tax benefits on a current return without amending prior year returns.

### **Will a cost segregation study put me at higher risk of an IRS audit?**

Studies performed in the first year property is placed in service do not generate any higher risk. However, retroactive studies are slightly more susceptible to audit, because they require the filing of a Form 3115 that is reviewed by a special unit within the IRS. The risk is generally very low and can be mitigated by using a reputable, qualified firm to perform the study.

### **Can cost segregation studies be performed on buildings placed in service in the past?**

Look-back studies can be performed on properties placed in service as far back as January 1, 1987. Of course it may not make sense to perform a study on a property that was placed in service more than 20 years ago, but the facts and circumstances will ultimately be the deciding factors.

### **Doesn't my CPA already do cost segregation for me?**

Probably not, because CPAs simply do not have the engineering expertise necessary to properly break-out all of the assets (costs) that are considered in a cost segregation study.

### **What is the impact on the subsequent sale of a property?**

When a property is sold, a gain or loss will be recognized. Typically, gains are taxed at the lower capital gains rate. However, the amount of gain equal to prior depreciation deductions will be taxed at ordinary rates. This is referred to as "depreciation recapture."

### **When should a cost segregation study be performed?**

Circumstances vary, but generally studies are beneficial in situations where building costs are at least \$500,000 and the owner intends to hold the property for at least five years. However, under the new 100% bonus depreciation rules, studies may be feasible at lesser amounts. Ask for a free benefits analysis to be sure.

### **Is the positive impact of a cost segregation study usually immediate?**

Yes. First year's tax savings usually exceed the cost of the study and the fees are tax deductible.

## FREQUENTLY ASKED QUESTIONS

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### Does a cost segregation study increase the depreciation deduction?

No. It just allows businesses to accelerate a portion of the depreciation instead of taking it equally over a longer period of time. This increases cash flow in the early years of property ownership via reduced taxes.

### What types of businesses typically benefit from a cost segregation study?

Acquisitions, renovations, or new construction projects may benefit as well as buildings constructed or purchased years ago.

Types of property that often benefit from a cost segregation study include:

- Apartments
- Automobile Dealerships
- Banks
- Grocery Stores
- Hotels/Motels
- Manufacturing Facilities & Plants
- Medical Centers
- Office Buildings
- Restaurants
- Retail Stores
- Senior Living Facilities
- Warehouses





## CONTACT INFORMATION

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We appreciate the opportunity to introduce you to the cost segregation process. If you have any further questions, please do not hesitate to contact us using the below information.

### Contact Information:

Office	985.590.7082
Bradley Leggett	985.630.2194 BradleyL@acrs.co

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