Understanding Cost Segregation

An Overview for Property Owners and Advisors

Accelerated Cost Recovery Solutions, LLC
January 2015

Contents

Introduction to Cost Segregation

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, are segregated into components. Typically these costs are assigned a 39-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 law, 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 same 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The ITC was repealed through the Tax Reform Act of 1986.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.

Taxpayers no longer have to spread out a beneficial adjustment from a cost segregation study over four years. Depreciation changes can be reported with their returns in the year of change and changed in any year due to the elimination of the prior two-year waiting period.

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 as personal property is ultimately based on asset-specific facts and circumstances. However, consultants rely heavily on 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 are 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 economically feasible for properties with a cost basis of at least $500,000, but can sometimes be beneficial when costs are lower.

Property owners should consider using a 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 share
- 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

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 and improve investment returns.

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. In some cases, 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.

Table 1: Average Basis Reallocation

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

Source: CCH Practical Guide to Cost Segregation, 4th 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' 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

How is the study performed?

The cost segregation consultant will generally use one of two approaches approved by the IRS, and 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 to 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 yr from date placed in service)
- Fixed asset listing
- Construction loan documents
- Settlement statement
- Appraisal

Steps in a Cost Segregation Study

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

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 & Section 1031 Exchanges

Cost Segregation and IRC Section 1031 "Like-Kind Exchanges" are two tax-deferral strategies available to commercial building owners. Combining the two strategies can yield significant amounts of deferred taxes.

In a Section 1031 exchange, a commercial property owner sells property through a qualified intermediary. The proceeds are then used to acquire property of a similar kind. This results in a deferral of all or some of the gain that would otherwise be taxed.

Since the definition of real property for 1031 exchanges is determined by state law, certain property components that are eligible for accelerated federal depreciation as personal property are treated as real property in the exchange. Property owners can therefore benefit from both the tax-deferral under the 1031 exchange and the accelerated depreciation benefits of a cost segregation study.

While the combination of these strategies is advantageous in many cases, it is not suitable for all situations. Therefore property owners should consult with their advisors prior to executing a 1031 exchange to determine if combining the exchange with a cost segregation study makes sense.

Information for CPA's

Retroactive Studies

A "retroactive" study can be performed for properties that have been capitalized as far back as 1987. 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 retro-active cost segregation study is performed for a taxpayer, 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 adjustment. Under Rev Proc 2012-19 the adjustment is taken entirely in the current year and does not necessitate the filing of amended returns. The 481 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 Study 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 new Tangible Property Regulations

CPA’s should especially consider cost segregation when current period cashflows are important to their clients.

Case Studies

Case Study 1 – Newly Constructed Hotel Property

A taxpayer constructs a new hotel property in 2013 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 deductions produce a present-value cash benefit to the taxpayer of $228,000. 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.

Case Study 2 – Look-back Study

Assume the same facts in Case 1, except that the property is purchased by the taxpayer in 2011 and the study is performed in tax year 2015. The cost segregation study in this situation is a retro-active study.

A catch-up adjustment is made in the current tax year of 2015 for the increase in depreciation expense for the years 20011 – 2014. As a result, the taxpayer realizes a reduction in tax expense for 2015 of $276,000. The adjustment is taken by filing a Form 3115 with the 2015 tax return. There is no need to amend the returns for 20011 – 2014.

Frequently Asked Questions

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 $26,000 (based on a 40% tax rate and an 8% 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 place in service 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. Property classified as real property will be taxed at capital gains rates, while personal property will be taxed at ordinary rates. When a cost segregation study is performed, items that would normally be considered real property are instead allocated to personal property. The ordinary income rate can be higher or lower than the capital gain rate, depending on the situation.

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.

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.

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 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

Authors

Bradley Leggett
Managing Member
bradleyl@acrs.co
985 630 2194

Todd Giustiniano, CPA
Consultant
toddg@acrs.co
985 630 4674

www.ACRS.co