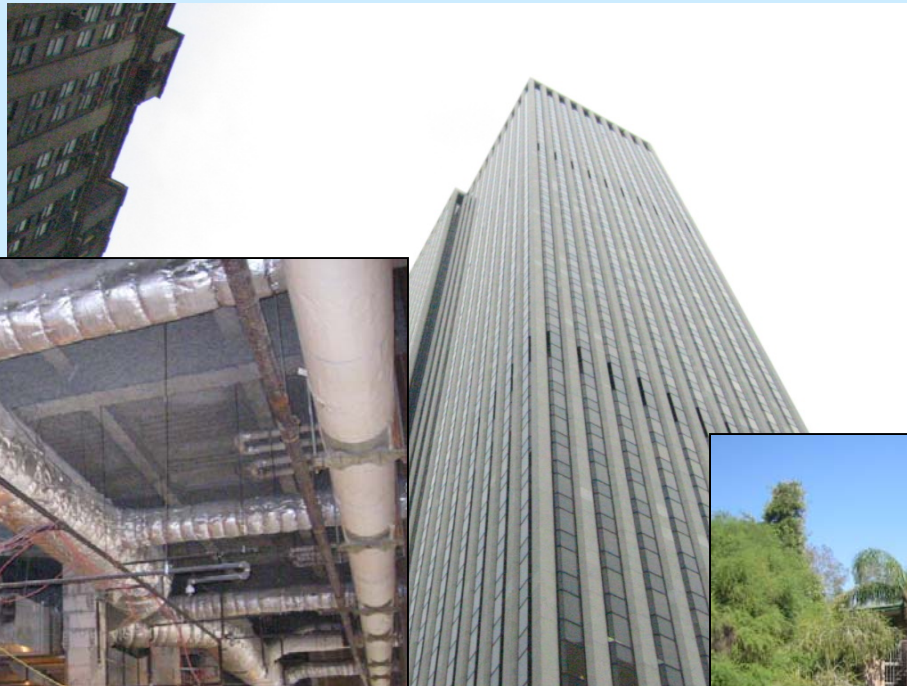




COST SEGREGATION



Cost Segregation

- **What** – Valuation and Engineering Services resulting in property owners recovering and/or minimizing their investments in new construction or acquisitions of property as quickly as possible
- **How** – Reducing costs or current taxes paid
- **Result** – Increase ROI via increased depreciation benefits by properly classifying costs
- **Methodology** – Systematic process of investigation and allocation of capital expenditures into their appropriate cost recovery periods. Distinguishes “real” long-lived property from short-lived property for income tax and financial accounting purposes
 - Personal property (1245): 3, 5 and 7 year
 - Land improvements (1250): 15 year
 - Real property (1250): 27.5, 31.5, and 39 year

Why Perform a Cost Segregation Study?

- Increase current income tax depreciation by categorizing property and capital expenditures into the optimum property classifications
- Reduce property tax and sales/use/transfer tax by distinguishing real property, personal property, and non-tangible costs
- Reduce insurance premiums by distinguishing insurable from non-insurable property

MACRS Example

- A corporate taxpayer invests \$100 in certain property.
- Assuming a 45 percent combined effective federal and state tax rate along with an 7 percent PV factor, the net present value of depreciation tax benefit for 39-year property is \$14.81.
- Using the same assumptions, the depreciation tax benefit for 5, 7, and 15-year property increases to \$37.42, \$35.56, and \$27.70, respectively.
- **Therefore, for every \$100 of property reclassified from 39-year property to 5, 7 or 15-year property, the present value of tax benefit increases from \$13 to \$23 per \$100 of costs, as summarized in the following slide.**

Net Present Value - Savings

	<u>39-Year</u>	<u>15-Year</u>	<u>7-Year</u>	<u>5 Year</u>
Present Value of Tax Benefits (*)	\$14.81	\$27.70	\$35.56	\$37.42
Less: Change from 39-year Property		<u>(\$14.81)</u>	<u>(\$14.81)</u>	<u>(\$14.81)</u>
Increase in Present Value Tax Benefits As A Result of Reclassification		\$12.89	\$20.75	\$22.61

(*) Assumes an initial \$100 investment, a tax rate of 45% and a present value factor of 7% (half-year convention)

(*) Does not consider 30%/50% bonus depreciation

Items Often Overlooked

- Taxpayers are not aware of the magnitude of the potential benefits
- All components of “real estate” are assumed to be real property or 27.5 / 39-year property for tax purposes
- Complexity of the tax law requires familiarity with numerous IRC sections, regulations, case law, and revenue rulings
- Unable to extract the necessary data and detail from contractor invoices and payment applications

Cost Segregation – More than just Federal Tax!!!

- Financial Reporting
- International Accounting Standard 16, *Property, Plant and Equipment*
- Property Tax
- State Transfer Tax
- Insurance Reporting
- Historic – Rehabilitation Tax Credit
- IRC 754 Basis Adjustments Relating to Purchases of Partnership & LLC
Interest in Real Estate and Other Property Intensive Companies
- IRC 754 Basis Adjustments in Connection with Estate Interest in Real
Property
- Bonus Depreciation (50 percent or 30 percent)

Events That Trigger Services

- Construction or Expansion of Property
- Acquisition of Assets
 - Part of Larger Transaction
 - Direct Purchase
- Past Acquisition/Construction of Assets not Properly Classified
[Rev. Proc. 2002-9 and 2002-19]
- Renovation of Existing Property
- Construction or Acquisition of Leasehold Improvements
- Landlord Contribution to Tenant/Leasehold Improvement Projects
- IRS Audit Support

Background

- In general, under the **Tax Reform Act (TRA) of 1986**, property previously classified as 5 and 19-year life property under the Accelerated Cost Recovery System (ACRS) was reclassified as either 3, 5, or 7-year personal property, 15-year land improvements, or 27.5 or 31.5-year real property (buildings) under the **Modified Accelerated Cost Recovery System (MACRS)**.
- The **Omnibus Budget Reconciliation Act of 1993** extended the depreciable life of real property from 31.5-years to 39 years on a straight-line basis.

Background (*Continued*)

- As a result of the TRA of 1986, some site improvements (such as roads, sidewalks, fences, landscaping and shrubbery) not eligible for special treatment under previous law now generate tax savings since they are depreciated over 15 years using the 150 percent declining balance method.
- Furthermore, some components of a building or manufacturing facility may be accessorial to the taxpayer's business, decorative, or may serve both a building function and a productive machinery or process function. The cost of the accessorial, decorative, or dual-functioning property can be segregated between personal property and building classifications. The cost of accessorial, decorative and process related property is generally classified as either 5-year or 7-year property under the MACRS rules and recovered over 5 or 7 years using the 200 percent declining balance method.

MACRS

- Under MACRS, *significant tax benefits* are gained by:
 1. Identifying property normally classified as real property and depreciated on a straight-line basis over 27.5 or 39 years.
 2. Reclassifying real property as either 3, 5, or 7-year property and depreciating under the 200 percent declining balance method (or 15-year property, depreciating under the 150 percent declining balance method).

Benefits of Cost Segregation Tax Services

- Avoid Cost Overruns
- Maintain Proper Project Control
- Maximize Depreciation /Amortization
 - Reducing Taxable Income
 - Little or no Effect on Book Income
 - Increase Cash Flow
- Minimize Property Taxes
- Maximize Available State Tax Credits/Incentives
- Track Assets Properly
- Maintain Support Files

Guidelines for Classifications

- Is the property permanent? “Readily Removable”? How much damage will the property sustain upon its removal?
- Does the property relate to the operation or maintenance of the building or is it accessorial to the taxpayer’s business?
- Is the property an electrical or mechanical component that is required by and used directly with specific items of qualifying equipment?
- Is the property inextricably linked to specific qualifying equipment or is it reasonably adaptable to more general uses?

Cost Segregation – Methodology

New Construction

1. Meet with client, construction manager and/or contractor
2. Examine construction drawings / specifications to identify such assets as land improvements and tangible personal property eligible for reclassification
3. Develop technical support for reclassification from IRC, regulations, judicial decisions, etc.
4. Analyze cost data: construction billing, owners costs, vendors contracts, vendor invoices, owner costs, etc.
5. Physically inspect the facility / property

(Continued)

Cost Segregation – Methodology

New Construction

6. Analyze data and classify costs – Direct, Indirect, Depreciable, Nondepreciable, Amortizable, Expense or Repair
7. Develop cost for tangible personal property and land improvements
 - Utilize actual cost to greatest extent possible
 - Prepare estimates for other installed costs (equipment foundations, wiring, piping etc.)
8. Allocate indirect costs (e.g. design fees, permits, capitalized interest, etc.)
9. Classify the property into applicable asset classes and recovery periods
10. Prepare a written cost segregation report and detailed file that provides an audit trail and documents methodology

Top 10 Commonly Misclassified Assets

- 1) Electrical power and distribution for process related equipment
- 2) Mechanical and plumbing for process related equipment
- 3) Process and equipment related HVAC – exhaust fans, kitchen hoods, ductwork, air conditioning for computers etc.
- 4) Millwork, built-in cabinetry, counters, shelving etc.
- 5) Carpeting or specialized flooring
- 6) Specialty lighting – emergency battery packs, decorative lights, security fixtures etc.
- 7) Telephone, communication and data – wiring and power
- 8) Security equipment including gates, fences, CCTV etc.
- 9) Public address, sound, and music systems
- 10) Signage and other land improvements

Retroactive Cost Segregation

Revenue Procedure 2002-9/2002-19/2004-11

- Methods of accounting; automatic consent. Procedures are provided under which a taxpayer may obtain automatic consent of the Commissioner to change certain methods of accounting.
- Ruled that a change in the method of computing depreciation is an accounting method
- IRS will permit automatic changes in method of depreciation if four conditions are met:
 - Taxpayer used an impermissible method in at least two taxable years immediately preceding the year of change
 - Property qualifies for change in method of accounting under 1.446.1T, generally Section 167, 168, 197 and 1400 property with minor limitations
 - Property is depreciable under Section 167, 168, 197 & 1400
 - Property is held by taxpayer at the beginning of the year of change

Retroactive Cost Segregation

- Revenue Procedure 2002-9 allows a taxpayer who has claimed less depreciation than allowable to change their depreciation method by filing a Form 3115
- Revenue Procedure 2002-19 allows a taxpayer to claim through a negative Section 481(a) adjustment, the difference between the depreciation claimed and the depreciation allowable under the proper method over a one-year period
- Modification to previous Revenue Procedures, which permit changing depreciable lives under Change of Accounting Method
- Favorable depreciation adjustments are now recognized in the year of change. Prior law only allowed recognition over a 4 year period

Purchase Price Allocation

Types of Allocations

1. Allocation under the provisions of Internal Revenue Code Section 1060
2. Allocation for financial reporting in accordance with FASB Statement No. 141, 142 and APB 16
3. Allocation for State Reporting – Real Property Transfer Tax Purposes
4. Allocation for local property tax reporting
5. Allocation for a Rehabilitation Tax Credit
6. Allocation for international reporting
7. Allocation for insurance reporting

Cost Segregation – Methodology

Acquisition of Existing Property

1. Meet with client and property manager
2. Document purchase price and identify property and assets acquired
 - Land owned or leased
 - Land Improvements
 - Building / Leasehold Improvements
 - Furniture, Fixtures, and Equipment
 - Intangible Assets
3. Inspect the property and create fixed assets list – note effective age, condition, building construction type, etc.
4. Perform a valuation study of the assets acquired and consider the following traditional approaches to value:
 - Cost Approach
 - Sales Comparison Approach
 - Income Approach

(Continued)

Cost Segregation – Methodology

Acquisition of Existing Property

5. Allocate purchase price among asset values
6. Perform a “Cost Segregation Analysis” of building and other improvements
7. Classify the property into applicable asset classes and recovery periods
8. Prepare a written purchase price allocation and cost segregation report including a detailed file that provides an audit trail which documents the applied methodology

Example: *Pre – Cost Segregation Study*

400,000 SF Distribution Warehouse / Office

\$18.0 MM – FACILITY ACQUISITION COST

Owner – Self Performed Cost Segregation Study

\$ 2.7 MM – Allocated to Land (15%)

\$15.3 MM – Allocated to Building (85%)

Present Value of Tax Savings = \$2,265,000

Example: *Post – Cost Segregation Study*

400,000 SF Distribution Warehouse / Office

\$18.0 MM – FACILITY ACQUISITION COST

MPS Valuation Cost Segregation Results

\$ 2.3 MM – Allocated to Land (13%)

\$13.0 MM – Allocated to Building (72%)

\$ 1.4 MM – Allocated to 15-Year (8%)

\$ 1.2 MM – Allocated to 5-Year (7%)

Example: *Cost Segregation Benefits*

400,000 SF Distribution Warehouse / Office

Present Value of Tax Savings = \$2,761,000

- **NPV of Tax Savings \cong \$ 500,000**
- **Cumulative Tax Savings at 1st Year \cong \$118,000**
- **Cumulative Tax Savings at 6th Year \cong \$550,000**
- **Cumulative Tax Savings at 15th Year \cong \$600,000**

- Assumes an initial investment of \$100, a combined effective tax rate of 45 percent and discount rate of 8 percent (mid-year convention)
- Does not consider 30 or 50 percent bonus depreciation

How to Achieve Cost Segregation Goals

THROUGH INTEGRATION OF THESE SKILLS

- Appraisals
- Valuation Consulting Services
- Engineering
- Construction Project Management Experience
- Tax Planning

Our Cost Segregation Professionals combine these skills to maximize depreciation benefits associated with the construction or acquisition of properties.

Current Tax Issues

➤ Relevant Court Cases

- Hospital Corporation of America
- Moss
- Walgreens
- Norwest
- Scott Paper Co.
- Morrison, Inc.

➤ Recent Revenue Procedures

- Rev. Proc. 2002-9 and its predecessors

Hospital Corp. of America

- **HCA v. Comm. 109 TC 21 (1997)** – Added creditability to cost segregation.

The court ruled certain assets directly used and related to a specific piece of equipment, and that do not relate to the normal operation and maintenance of a building, are qualified for depreciation over a 5-year life as opposed to being depreciated over 39-years.

- Other assets held as 5-year assets include: carpet, vinyl floors and wall covers, and accordion-style room dividers.
- *Essentially, the IRS has agreed this method of segregating the cost of the assets can be used by the taxpayer.*
- However, the IRS can still challenge on the method used to segregate costs and determine if the particular item qualifies for the shorter life.

Hospital Corp. of America (*Continued*)

- US Tax Court Case
- Reaffirmed prior case law allowing accelerated depreciation of special purpose and moveable Section 1250 property
- Reaffirmed the current methodology in use by MP&S Valuation Solutions, LLC

Norwest vs. Commissioner

- Defined difference between tangible personal property that falls in Asset Class 57.0 vs. Asset Class 00.11 (5 year vs. 7 year)
- Concept of Generic vs. Industry Specific
- **Ruling:** A desk is a desk, a filing cabinet is a filing cabinet no matter what industry it is used in. *Therefore, if asset is generic (Asset Class 00.11) it is 7 year property.*

Walgreen's vs. Commissioner

- Taxpayer claimed Section 1250 leasehold improvements (“LHI”) were included in old ADR Class 50.0, now Asset Class 57.0
- Tax court ruled ADR Class 57.0 does not contain any section 1250 property [103TC 582 (1994)]
- Taxpayer appealed
- 7th Circuit ruled some section 1250 LHI could fall into ADR Class 57.0 if it did not fall within old ADR class 65.0 [F.3d 1006 (7th Cir. 1995)]
- Remanded back to Tax Court for factual determination
- Some assets fit in building services; some fit in Class 50.0 or Class 57.0

Walgreen's vs. Commissioner (*Continued*)

- **ADR Class 65.0**
 - **(current 39-year property)**
 - Interior partitions – glass, drywall, metal, doors, millwork etc.
 - Ceilings
 - Electrical lighting fixtures
 - Interior floor finishes - carpet; vinyl or rubber tile; ceramic tile etc.
- **ADR Class 50.0/57.0**
 - **(current 5-year property)**
 - Emergency lighting, night lighting, exit lighting
 - Decor finishes - primarily a decorative canopy system relating to the Wag's restaurants, with signs

Moss vs. Commissioner

- Tax Court Case (51 TCM 742 [1986])
 - Plan of Rehabilitation Doctrine
 - Expense vs. Capitalize is question of fact
 - Is there a general scheme of improvements?

- Ninth Circuit Appeals Decision
 - Modified Plan of Rehabilitation Doctrine
 - Annual maintenance vs. capital replacement
 - Must analyze business, expenditures and scope of the plan

- Tax Planning
 - Establish a pattern of similar repairs
 - Show repairs are made to structure while capital costs are related to assets with shorter lives

Proposed AICPA Statement of Position

Accounting For Certain Costs and Activities Related to Property, Plant, and Equipment (See Also IAS16 & Future FASB Staff Positions)

- *Component Accounting*
- Component – Separate asset with useful life (economic benefit) > 1 year
- Account for separately
- Segregate at time of acquisition or construction

Useful Life

$$UL + EXT = EA + RUL$$

- *Useful life (UL)* – The period over time which an asset or grouping of assets may reasonably be expected to perform the function for which it was designed.
- *Effective age (EA)* – The apparent age of an asset in comparison with a new asset of like kind.
- *Estimated remaining useful life (RUL)* – The period of which items, or groups of items, are estimated to remain in use.
- *Useful life extension (EXT)* – The approximate life extension due to planned or future anticipated capital improvements that may be expected to extend the design useful life and/or the function of an asset.

Three Traditional Approaches to Value

- 1. Cost Approach**
- 2. Sales Comparison Approach**
- 3. Income Approach**

The Range Of Value Magnitude

V

- Reproduction Cost New
- Replacement Cost New
- Fair Market Value

A

- ❖ In continued use
- ❖ Installed

L

- ❖ In exchange
- ❖ Removal

U

- Liquidation Value
 - ❖ In place
 - ❖ Orderly Liquidation
 - ❖ Forced Liquidation

E

- Salvage Value
- Scrap Value

Cost Approach

- The cost approach is based upon the proposition that an informed purchaser would pay no more for an asset than the cost of producing a substitute with same utility as the subject asset.
- Starting point or basis is the Reproduction Cost New, Replacement Cost New, or a combination of both
- Physical wear and tear functional obsolescence, and economic (external) obsolescence are then subtracted from the RCN
- Land is appraised separately using the sales comparison approach to value

Sales Comparison Approach

- Involves the collection of market data pertaining to the subject Most useful when numerous similar properties have been recently sold or are currently for sale
- If comparables are not exactly similar, the price must be adjusted to equate all comparables as close as possible to the subject. Adjustments are:
 - ✓ Age
 - ✓ Condition
 - ✓ Capacity
 - ✓ Model
 - ✓ Type Of Item
 - ✓ Other

Income Approach

In the income approach, the present value of the future benefits of property ownership is measured. The property or asset's income and resale value upon reversion may be capitalized into a current, lump-sum value.

There are two methods of income capitalization:

1. Direct capitalization

- the relationship between income for a single year and value is reflected in either a capitalization rate or an income multiplier

2. Yield capitalization (Discounted Cash Flow)

- the relationship between the stabilized income of several years and a reversionary value at the end of a designated period is reflected in a yield rate.

Depreciation

- **Physical Depreciation** – the loss in value or usefulness of a property due to the using up or expiration of its useful life caused by wear and tear, deterioration, exposure to various elements, physical stresses, and similar factors.
- **Functional Obsolescence** – the loss in value or usefulness of a property caused by inefficiencies or inadequacies of the property itself, when compared to a more efficient or less costly replacement property that new technology has developed.
- **Economic Obsolescence** – the loss in value or usefulness of a property caused by factors external to the property, such as increased cost of raw materials, labor, or reduced demand.