

Cost Segregation Analysis Webinar Index

a) *Niche Services*

- i. Taken from the "Accounting Today, The 2007 Top 100 Firms"
- ii. 54% of top 78 accounting firms listed Cost Seg as a top niche service for their firm

b) *History*

- i. Under the Modified Accelerated Cost Recovery System (MACRS), 15, 18, or 19-year recovery periods for real property are now 39 years for nonresidential real property
- ii. The wide gap in MACRS recovery periods provides a strong incentive for taxpayers to allocate or reallocate costs of long-lived property to short-lived property, wherever possible.

c) *Past Precedent*

- i. 1986 ACRS to MACRS
- ii. In 1997, as a result of the HCA case, the Service acquiesced to the use of ITC rules for distinguishing § 1245 property from § 1250 property.
- iii. From a statutory standpoint, the primary test for determining whether an asset is § 1245 property eligible for ITC is to determine whether or not it is a structural component of a building.
- iv. The early administrative rulings on ITC focused on a "functional use test" to determine whether an asset constituted
- v. The Service shifted its focus from the functional use test to an evaluation of factors indicating inherent permanency.
- vi. The classic pronouncement addressing inherent permanency was **Whiteco Industries, Inc. v. Commissioner**, 65 T.C. 664, 672-673 (1975).

Important Factors include:

1. Can the property be moved and has it been moved?
 2. Is the property designed or constructed to remain permanently in place?
 3. Are there circumstances that show that the property may or will have to be moved?
 4. Is the property readily movable?
 5. How much damage will the property sustain when it is removed?
 6. How is the property affixed to land?
- vii. Moveability is not the only determinative factor in measuring inherent permanency. In **L. Bean, Inc. v. Comm., T.C. Memo. 1997**: it was determined that, even though the structure could be moved, it was designed to remain permanently in place. Thus, it was determined to be an inherently permanent structure.
1. The manner in which an item is attached to a building or to the land,
 2. The weight and size of the item,
 3. The time and costs required to move the components,

4. The number of personnel required in planning and executing a move,
5. The type and quantity of equipment required for a move, The history of the item or similar items being moved,
6. The time, cost, manpower and equipment required to reconfigure the existing space if the item is removed,
7. Any intentions regarding the removal,
8. Whether the item is designed to be moved, and
9. Whether the item is readily usable in another location.

d) ***Industry Directives***

- i. ATG
- ii. Chapter 7 – covering specific industries:
 1. Casino
 2. Restaurant
 3. Retail
 4. Research Facility
- iii. **No Bright Line Test** in relation to the *factually intensive justification** required by the IRS, only adequately provided for by true Engineering-Based Cost Seg Studies

e) ***Summary of IRS Guidelines***

- i. Detailed Engineering Approach from Actual Cost Records
- ii. Detailed Engineering Cost Estimate Approach
- iii. Survey or Letter Approach
- iv. Residual Estimation Approach
- v. Sampling or Modeling Approach
- vi. "Rule of Thumb" or "Back of Napkin" Approach

I. Engineering Approach:

- "it is the most methodical and accurate approach, relying on solid documentation and minimal estimation."(ATG chapter 3)
- "use of actual cost records contributes to the overall accuracy of cost allocations" (ATG Chapter 3)

II. Detailed Cost Estimation Approach:

- Similar to the detailed cost approach
- Used when cost records are not available or for an acquisition when the purchase price must be allocated.

III. Survey or Letter Approach

- Costs are acquired through a survey of contractors
- They are then used in either the engineering approach or in what's known as the residual estimation approach.

IV. Residual Estimation Approach

- Only costs for short-life property are determined
- The "Residual" cost is then assigned to 39 year property

- It should be recognized that this method generally does not reconcile project costs. In general, residual costs are not estimated or checked for reasonableness.
- It should also be understood that different estimation techniques for short-lived assets can produce a skewed result in favor of § 1245 property (e.g., § 1245 property based on single-unit costs for high quality construction, while the building is based on gross square footage).

V. Sampling / Modeling Approach

- Used for clients with multiple facilities which are nearly identical in construction, appearance and use
- i.e. for fast food and retail outlets

VI. “Rule of Thumb” or “Back of a Napkin” Approach

- Uses little or no documentation
- Allocates money purely as percentages of total cost
- Based on the “experience” of the preparer in a particular industry

f) What is Required by the IRS

- i. “lack of specific requirements”
 - Taxpayers must substantiate their depreciation deductions and classifications of property
 - Substantiation using actual costs is generally preferable to the use of estimates
 - In situations where estimation is the only option, the methodology and the source of any cost data should be clearly documented
 - Estimated costs should be reconciled back to actual costs or purchase price

g) *Cost Segregation Opportunity Types*

- i. Typical Asset Reallocation by property type
- ii. Additional benefit to previous owners who used a 1031 exchange – essentially selling the study twice.

h) *Taxpayer Cost Segregation Qualifications / Recommendations*

- i. Legal Eligibility of Entity:
 - 1. Eligible, Favorable
 - 2. Non-Eligible, Illegal
- ii. Profitability first, must have profit to shield
- iii. Motivation of Taxpayer
 - 1. Business Plans / Strategem
- iv. Implications of the Alternative Minimum Tax

i) *Current Status of Different Property Types*

- i. 1250 Real Property
- ii. 1245 Property Delineation
 - 1. Class Lives, Explanation

2. Amortization Methods, DDB/Straight Line
 3. Examples of controversial or non-obvious property classifications
- j) ***Typical Percentage Re-classed According to Intended Use of Property***
- i. Specific case studies will be shown later
 - ii. Incentive
- k) ***Data Requirements***
- i. An outline of the types of information required to complete a study for a new construction and purchases
- l) ***NPV Estimate Request Form***
- m) ***The Benefit Applied***
- n) ***Apartment Building Case Study (1996 PPA, look-back)***
- i. Total: ~\$18.5 Million
 - ii. 30% Reclassed into short life
 - iii. NPV of Savings: \$748,000
- o) ***Free-Standing Restaurant Case Study (NC)***
- i. Total: ~\$1.5 Million
 - ii. 43% Reclassed into short life
 - iii. NPV of Savings: \$109,495
- p) ***Hotel Building Case Study (NC)***
- i. Total: ~\$6.8 Million
 - ii. 25% Reclassed into short life
 - iii. NPV of Savings: \$285,517
- q) ***Research & Development Case Study (NC & Renovation)***
- i. Total: ~\$7 Million
 - ii. 31% Reclassed into short life
 - iii. NPV of Savings: \$424,951
- r) ***Manufacturing Facility Case Study (NC)***
- i. Total: ~\$3.5 Million
 - ii. 41% Reclassed into short life
 - iii. NPV of Savings: \$220,502
- s) ***Quality Study Procedure***
- i. Estimate: Free, Based on Preliminary Costs
 - ii. Proposal Letter: Includes Fee, Scope of Study, Procedures
 - iii. Document Collection: All Relevant Docs including As-Built blueprints, Pay Apps, Change Orders, Out of Contract Costs, Depreciation Schedules and any other documentation handy for the purposes of reconciling to tax records.
 - iv. Cost Analysis: A preliminary determination of 1245 and 1250 property, Determination of reconcilability, further document procurement if necessary

- v. Engineering Analysis: An in-depth look at the type of property, the functional use of any and all parcels, thorough review of any large dollar components
 - vi. Take Off: In a new construction, analyzing and marking up As-Built blueprints. In a PPA, on-site measurements and documentation of the property. Consultation amongst engineers about questionable functions of property and proper class-life determination of property.
 - vii. Site Visit: Questions arising from study of blueprints addressed, take off for PPA done, meet with clients and specialists at property to further clarify any and all questions about functional use of property, etc.
 - viii. Reconciliation of Costs & Take-Off: Answering any and all questions about how money was spent and details about the costing of large dollar items. A tie-to number is established between the client, CPA, and consultant. Final values for land, buildings and, out of contract costs are all determined now.
 - ix. Work Papers: Thorough documentation of cost sources, analysis and backup of any estimations, cross-referencing tie-to number, and direct costs in the study. These should include all relevant AIA and or tax documents that were referenced for cost in the study. A final 'walk-through' of the property and analysis of all large dollar items is made.
 - x. Final Report: Depending on how the study was sold this can be prepared directly for the client or packaged for the CPA to facilitate easy repackaging and rebranding in the firm's letterhead, etc.
- t) ***Audit Performance***
- i. Audit Experience
 - ii. Engineering Back Up
 - iii. Gratis Hours w/ every Study
- u) ***1031 Exchanges***
- i. Eligibility
 - ii. Procedures
 - iii. Client Benefit
 - iv. Billable Time
- v) ***3115's – Change in Accounting Method***
- i. "Look-Back" Studies
 - ii. Procedures
 - iii. Billable Time