COST SEGREGATION

UNCOVERING HIDDEN CASH FLOW

Why not recover at least 5 to 10 cents for every dollar you spend on new construction or a purchased building? We can provide that cash payback via accelerated tax depreciation by segregating building costs into shorter lived personal property and site improvements.

A cost segregation study carefully breaks down your construction or acquisition (used real estate) and allocates them to specific categories - maximizing accelerated depreciation for qualifying personal property. The shorter the depreciation period, the greater your tax savings. This study could also be used to provide the basis for your property records system. In addition, certain construction costs do not add to value and should be excluded from the property tax basis. These may involve overtime, demolition, etc.

Although the optimal time to begin a cost segregation study is when plans to build, remodel, or expand a building are first drafted, eligibility extends to:

- Buildings and facilities that have been newly constructed since 1987.
- Building renovations and additions completed after 1986.

The first step is the segregation of the project costs into specific asset groups. The costs to be segregated include the actual direct costs of construction or acquisition and the indirect or “soft costs” (i.e. legal, architectural, engineering fees, appraisals, construction management, etc.) The second step is categorizing the assets based on the appropriate depreciable lives for income tax purposes.

By identifying, segregating, and reclassifying costs related to 5, 7, 15, and 20 year property from the 27.5 or 39 real property categories, such property can be depreciated over a much shorter time frame. In addition, the 5, 7, 10, 15, and 20 year property classes are depreciated using accelerated methods, which further increase the deductions in early years.

Critical to establishing this significant cash benefit is a detailed engineering analysis. We provide complete cost analysis and supporting documentation. Our engineers understand accounting and tax codes as well. They perform quantity take-offs from construction drawings or available data for purchased buildings. The key to withstanding IRS scrutiny is a thorough application of engineering standards and our prior successful negotiations with the Treasury. We do not merely rely on broad percentage allocations or contractors lumped costs.

THERE’S HIDDEN CASH IN YOUR BUILDING

If you depreciate newly constructed or purchased buildings over a 39 year tax life (27.5 years for residential rental real estate), you have left cash in the building. You can recover on average 5 to 10 cents...
of every dollar in the building account by accelerating tax depreciation from shorter lived personal property and site improvements.

The primary authority for this segregation of building costs is Revenue Procedure (Rev. Proc.) 87-57, 1987-2CB687, which provides comprehensive instructions and depreciation rate tables for computing depreciation available under Code Sec. 168, as amended by Act Sec. 201(a) of The Tax Reform Act of 1986. These depreciation tables are known as MACRS, Modified Accelerated Cost Recovery System.

Structural components of a building, as defined in Regulations Section 1.48-1(E)(2), include such items as walls, partitions, floors, HVAC, plumbing and plumbing fixtures, etc. and other components relating to the operation or maintenance of the building. Excluded from the definition is machinery or processing materials or foodstuffs.

In contrast to the above definition, Code Section 148-1(C) defines tangible personal property as “any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures....” Tangible property includes all costs (assets) that are necessary/accessory to the operations of the business. Examples include:

- Special purpose area (e.g. clean rooms)
- Primary and secondary electrical distribution systems where the electrical load is carried to equipment, telephone equipment, internal communications and computers
- Waste treatment systems
- Carpeting, vinyl floor coverings and accordion doors/partitions
- Signage
- Cabinetry, decorative millwork and removable vinyl wall coverings
- Decorative and security lighting

Special rules incorporated from Rev. Proc. 83-35, sections 2.02 (iii) and (iv) define Asset Guideline class 00.3, Land Improvements, as “other tangible property”. Thus, costs for site improvements should be removed from construction or acquisition costs and put into this account.

In order to claim underreported depreciation for prior years, the taxpayer may request an automatic change of accounting method. The authority for this claim is Revenue Procedure 99-49. The missed depreciation may be claimed over the four ensuing years (Section 481 adjustment). The cost segregation analysis can be used for buildings placed in service as far back as 1987, even if the year is closed for tax purposes.

Two court cases support the determination of personal property apart from structural components. The most recent is H.E. Butt Grocery Company (2000), which reinforced the claim of added depreciation based upon a cost segregation study. The second and most critical is Hospital Corporation of America v. Commissioner (1997), which provided clear evidence of what the courts consider tangible personal property versus structural components.

**COST SEGREGATION ELEMENTS**

A properly prepared cost segregation analysis must comply with strict IRS requirements. It is definitely more than an accounting exercise or arbitrary allocation of direct and indirect costs. The best cost
Cost Segregation
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segregation team must thoroughly understand tax law; possess construction and engineering knowledge; and, qualify as experts in defending their work upon IRS reviews or in Tax Court.

As part of the cost segregation, experts must answer two key questions, as follows:

- **Function/use test** - does the asset serve any purpose in the building operation? If not, it may be depreciated as part of the equipment.

- **Inherent permanency test** - can the property be easily removed or is the damage to the structure or the item too severe that this movement is not viable? The Tax Court (in Whiteco Industries, Inc.) has created six questions to assist taxpayers in applying the permanency test:
  1. Is the property capable of being moved, and has it in fact been moved?
  1. Is the property designed or constructed to remain permanently in place?
  1. Are there circumstances that tend to show the expected or intended length of affixation?
  1. How substantial a job is the removal of the property, and how time consuming is it?
  1. How much damage will the property sustain upon removal of the property?
  1. What is the manner of affixation of the property to the land?

Some components of a building are attributable to both real property and personal property. For example, certain portions of the wiring and plumbing in a building are properly attributable to the general operation and function of a building. Simultaneously, other portions of wiring and plumbing perform functions specifically allocable to a particular piece of equipment or machinery.

**COST SEGREGATION PROCESS**

The procedures which must be employed are the following:

1. Review the architectural drawings and specifications for the base building, tenant improvements, and land improvements to identify all construction related assets that qualify for accelerated depreciation.

1. Obtain and review copies of approved contractor pay requests, change orders, and miscellaneous invoices in order to segregate these costs properly into the correct asset classifications for federal income tax purposes.

1. Develop and provide a listing of construction costs for which a specific breakdown is required from the contractors involved. If the contractors are not able to provide this information, we will estimate those costs of the assets by using nationally recognized cost estimating manuals (this is especially the case for used facilities).

1. Allocate project indirect costs, such as contractors’ general conditions, architectural/engineering fees, permits, etc., to all project-related assets on a functional basis.

1. Personally inspect the building and tenant improvements to ensure that all qualifying personal property and land improvements have been identified.

1. Compile schedules of MACRS depreciation.

1. Apply relevant IRS regulations, rulings and court cases to support the allocations of property to the various MACRS classifications.
1. Prepare a written report which includes project background information, methodology, fixed asset classifications and descriptions, allocation of project related fees and services, fixed asset classification spreadsheets segregating the assets into personal property (5 or 7 year tax life), land improvement property (15 year tax life), and residential real or commercial property (5 or 7 year tax life). Also, include references to court cases, revenue rulings, tax citations and photographs supporting the position taken regarding the identification of personal property and land improvement assets for federal income tax purposes.

**ACQUIRED PROPERTY**

For purchased property, one key is the cost/value allocated to land versus land improvements, building, and personal property. The most defensible position for the taxpayer is a complete property appraisal. Another approach is to determine the market value of the land only. The balance of purchase price can be assigned to the improvements. The least costly alternative, and the one most likely to be scrutinized by the IRS, is to base the allocation on the assessor’s split between land and real property improvements.

**CONCLUSION**

The highest cash return is available from the specialized industrial or high technology facility. The simple warehouse or office building is at the lowest end of cash flow benefits. For acquired property or new construction, the cash equivalent return (present value of after tax savings) is significant, many times the fee for a cost segregation report (for each $1 million in assets reclassified from a 39 year recovery period to a 5 year recovery period results in more than $200,000 in net present value savings). The most important factor to the taxpayer is the sound and supportable analysis from an experienced cost segregation team.

Braun Appraisers & Auctioneers would be pleased to answer any questions regarding cost segregation, our services and industry information.

Thank you,

Braun Appraisers & Auctioneers, Inc.

Our services include:

- Braun Real Estate Valuations
- Braun Real Estate Auctions-Sales
- Braun Industrial Asset Valuations
- Braun Business Asset Auctions
- Braun Aircraft Group
- Premiere Estates Auction Company
- Braun Capital Group
## COST SEGREGATION CASH BENEFIT ANALYSIS

<table>
<thead>
<tr>
<th>PROPERTY</th>
<th>% OF BUILDING COST RECLASSIFIED (1)</th>
<th>$2 MILLION CONSTRUCTION/ACQUISITION</th>
<th>$10 MILLION CONSTRUCTION/ACQUISITION</th>
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<tr>
<td></td>
<td></td>
<td>CASH CBM(2)</td>
<td>CASH CBM(2)</td>
</tr>
<tr>
<td>Apartment</td>
<td>3-15</td>
<td>40,000 16</td>
<td>200,000 45</td>
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<tr>
<td>Department Store</td>
<td>5-15</td>
<td>50,000 25</td>
<td>250,000 80</td>
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<tr>
<td>Office Building</td>
<td>8-12</td>
<td>50,000 20</td>
<td>250,000 50</td>
</tr>
<tr>
<td>Medical Office</td>
<td>10-15</td>
<td>60,000 30</td>
<td>300,000 100</td>
</tr>
<tr>
<td>Medical Clinic</td>
<td>20-30</td>
<td>115,000 40</td>
<td>575,000 115</td>
</tr>
<tr>
<td>R&amp;D Facility</td>
<td>20-30</td>
<td>115,000 40</td>
<td>575,000 100</td>
</tr>
<tr>
<td>Fast Food Rest. Class 57 – 5 years</td>
<td>40-50</td>
<td>200,000 100</td>
<td>1.0M 330</td>
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<tr>
<td>Retail</td>
<td>25-35</td>
<td>140,000 25</td>
<td>700,000 90</td>
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<tr>
<td>Supermarket</td>
<td>30-35</td>
<td>150,000 50</td>
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<tr>
<td>Hotels</td>
<td>15-20</td>
<td>85,000 17</td>
<td>600,000 50</td>
</tr>
<tr>
<td>Hospital (for profit)</td>
<td>30-35</td>
<td>150,000 30</td>
<td>750,000 75</td>
</tr>
<tr>
<td>Manufacturing (heavy)</td>
<td>30-40</td>
<td>160,000 27</td>
<td>800,000 67</td>
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<tr>
<td>Manufacturing (light)</td>
<td>15-20</td>
<td>85,000 21</td>
<td>450,000 57</td>
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<tr>
<td>Warehouse</td>
<td>8-10</td>
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<td>200,000 50</td>
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<tr>
<td>Distribution</td>
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<tr>
<td>Data Center</td>
<td>25-30</td>
<td>135,000 23</td>
<td>675,000 84</td>
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</table>

(1) Excluding apartments, this column shows the reclassification of costs originally buried in a 39 year building life to 15 year site improvement and 5 or 7 year personal property. For apartments, building shell depreciable life is 27.5 years, while site improvement is 15 and personal property is 5. Result is a significant cash benefit from accelerated tax depreciation. This cash often equates to $.20 (20%) per dollar reclassified, or more. That amount is a cash return (after tax net present value).

(2) CBM- Cash Benefit Multiple is the multiple comparing the average after tax present value (cash equivalent) to one-half of the average expected fee (cash outlay).