



Cost Segregation

How to Free up Cash Flow Now



If you are planning the construction, renovation or purchase of a building, you may be eligible for federal and state tax savings.

Certain assets related to the project may qualify for accelerated depreciation, meaning you can take larger tax deductions over a shorter period. The benefits of larger tax deductions include increased cash flow and lower cost of capital in the early years following a project or purchase.

A cost segregation study, conducted by qualified professionals, can help you identify opportunities to claim accelerated depreciation.

Due to their value as a tax planning tool, cost segregation studies are a smart investment for most companies that meet the qualifying criteria. Studies typically pay for themselves at least seven to ten times over the life of the asset.

WHY CLASSIFICATION IS CRITICAL

Leveraging accelerated depreciation opportunities begins with a comprehensive analysis of capital expenditures to determine appropriate asset classifications.

Asset classifications and depreciable lives:

Commercial buildings and related structural components	39 Year Life
Land improvements	15 Year Life
Nonstructural elements like carpet; wall coverings; equipment; furnishings; specialized mechanical, plumbing and electrical costs	5-7 Year Life

A cost segregation study can identify building costs that would typically be depreciated over a 39 year period and reclassify them, allowing for a shorter, accelerated method of depreciation.

Costs for nonstructural elements, such as carpet, wall coverings and accent lighting, and

exterior site improvements, such as sidewalks and landscaping, can often be depreciated over 5, 7 or 15 years.

The following case studies illustrate how cost segregation can save property owners money.

Case Study: Apartment Complex

The owner of an apartment complex constructed a new building for a cost of \$3.1 million. A detailed cost and engineering analysis of the construction documents, general contractor's payment applications, blueprints, change orders, invoices and on-site inspection were conducted to identify structural building components, land improvements and personal property assets.

Actual costs were estimated and verified according to industry recognized engineering techniques and assigned the appropriate depreciable life for federal income tax purposes.

As a result of the cost segregation study, 24% of the total building cost was classified as personal property and 8% was classified as land improvements. The building owner saw an after-tax benefit of approximately \$164,000 in the first year. The present value after-tax benefit over the tax life of the building was approximately \$189,000.





Case Study: Manufacturing Company

A small manufacturing company built a new \$3 million manufacturing facility. A detailed cost and engineering analysis, on-site inspection and discussions with operations personnel were conducted to identify structural building components, land improvements and personal property assets.

Asset costs were estimated using industry recognized engineering techniques. Appropriate depreciable lives were assigned to each asset for federal tax purposes.

As a result of the cost segregation study, 27% of the total cost was classified as personal property and 18% was classified as land improvements. The result was an after-tax benefit of over \$500,000 in the first year. The present value after-tax benefit over the life of the building was approximately \$226,000.

COST SEGREGATION IS IRS APPROVED

Cost segregation is not a risky or aggressive tax scheme. Court rulings dating back to the 1960s support the practice of segregating costs for tax depreciation on buildings.

Cost segregation studies emerged in 1987 when Congress extended the depreciation for commercial property from 19 to 31.5 years. This created an incentive to classify building assets as personal property. In 1993, the period was extended to 39 years.

In 1997 the U.S. Tax Court ruled that the practice of segregating building costs for tax purposes was allowable. As a result, cost segregation has become an accepted—although still somewhat underutilized—tax planning tool.

In April 2005 the IRS finalized its *Cost Segregation Audit Techniques Guide* which lays out comprehensive audit guidelines and explains what constitutes a “quality” cost segregation study.

According to the guide, cost estimating techniques may be required to “segregate” or “allocate” costs to individual property components such as land, land improvements, buildings, equipment and furniture and fixtures. This type of analysis is generally referred to as a “cost segregation study,” “cost segregation analysis” or “cost allocation study.”

The guide goes on to state: “More taxpayers are submitting either original tax returns or claims for refund with depreciation deductions based on cost segregation studies.”

These studies are prepared for federal income tax purposes because of “the significant tax benefits derived from utilizing shorter recovery periods and accelerated depreciation methods for computing depreciation deductions.”

MULTIPLE DISCIPLINES ARE BASIS OF SUCCESSFUL STUDY

A successful cost segregation study comprises elements of the engineering, architectural, accounting and tax disciplines. The IRS prefers the more accurate use of an engineering based approach in identifying and reclassifying construction costs into applicable segregated categories.

According to the IRS’s *Audit Techniques Guide*, preparation of cost segregation studies requires knowledge of both the construction process and tax law to properly classify assets for depreciation purposes. “The detailed engineering approach from actual cost records, or ‘detailed cost approach,’ uses costs from contemporaneous construction and accounting records, as well as construction contract documents, such as blueprints and specifications. In general, the detailed engineering approach is the most methodical and accurate approach relying on solid documentation and minimal estimation.”



WHERE PROFESSIONAL ASSISTANCE ADDS VALUE

Many property owners can identify some nonstructural items that qualify for accelerated depreciation. However, the greatest savings come from identifying assets in three broad categories: mechanical, plumbing and electrical.

Determining the portion of these costs that qualify as personal property can be a complex process. Many companies lack the internal resources to leverage the full advantage that cost segregation can provide.

It should also be noted that, although cost segregation studies are approved and accepted by the IRS, the procedures of a study must fall within the accepted IRS guidelines published in the *Cost Segregation Audit Techniques Guide*. As a result, the IRS is taking a closer look at studies to ensure they meet its standards.

IS A COST SEGREGATION STUDY FOR YOU?

You may have heard about the tax advantages a cost segregation study can yield, but perhaps you aren't sure whether your property or business situation qualifies for accelerated depreciation.

Candidates for a cost segregation study include for-profit organizations that have done the following since 1986—or are planning to do so in the future:

- Build a new facility.
- Acquire an existing facility.
- Renovate an existing owned facility.
- Leasehold improvements in an existing building.

Typically, the detailed engineering approach is appropriate for new construction projects or acquisitions of \$1 million or more. For projects under \$1 million, a scaled back cost and engineering approach is more appropriate.

In general, the more complex the building is, the higher the gain from a study. Examples of complex buildings are manufacturing plants, restaurants and hotels. Less complex buildings with lower gain are warehouses and distribution centers.

HOW A COST SEGREGATION STUDY CAN STRENGTHEN YOUR BUSINESS

In addition to providing tax relief, a cost segregation study can benefit businesses in a number of ways.

Maximizing tax savings by adjusting the timing of deductions. When an asset's life is shortened, depreciation expense is accelerated and tax payments are decreased during the early stages of a property's life. This, in turn, releases cash for investment opportunities or current operating needs.

Under certain circumstances, segregated assets may qualify for a special 30% bonus depreciation allowance created by the Job Creation and Worker Assistance Act of 2002, or a 50% bonus depreciation allowance under the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Creates an audit trail. Improper documentation of cost and asset classifications can lead to an unfavorable audit adjustment. A properly documented third party cost segregation study can help resolve IRS inquiries at the earliest stages.

Additional tax benefits. A properly completed cost segregation study can also reveal opportunities to reduce real estate tax liabilities and identify certain sales tax savings opportunities.

CATCHING UP: RETROACTIVE COST SEGREGATION

Another favorable advantage of cost segregation studies is that taxpayers can capture immediate retroactive savings on property placed in service since 1987.



Previous rules requiring a four year catch-up period for retroactive savings have been amended to allow taxpayers to take the entire amount of the adjustment in the year the cost segregation study is completed.

This opportunity to recapture unrecognized depreciation in one year presents an opportunity to perform retroactive cost segregation analyses on older properties to increase cash flow in the current year, without amending prior tax returns.

COMPONENTS OF A SUCCESSFUL STUDY

A thorough, detailed engineering cost segregation study involves several steps. The CBIZ cost segregation approach incorporates the following components.

Review of blueprints and specifications. In the initial stages of a study, we review blueprints and specifications in order to compile a preliminary asset listing. This review also helps provide a point of reference to begin discussions with contractors and company personnel involved in the construction project.

Perform an on-site tour. We conduct a thorough site visit in order to identify specific characteristics of the project and quantify items of personal property and land improvements. Photographs are used to further document assets being identified for accelerated cost recovery.

Cost analysis. We analyze all available construction cost data associated with the project. Typically, we rely on your representation of the land value in adjusting the total construction cost to determine cost subject to depreciation.

Assign depreciable life. Each asset is assigned the appropriate tax life as specified by the modified accelerated cost recovery system ("MACRS"). These designations are based upon the most recent court case decisions and IRS guidance at the time of the cost segregation study.

Tax research. Our work is based on research and interpretation of applicable tax law, IRS pronouncements, court cases and revenue rulings. We consult with tax professionals within our Firm to ensure your study reflects current tax law and optimizes your opportunities.

Review findings. Prior to completion of the final report, we review our conclusions with you or your designated representative to ensure your understanding and agreement with the positions reflected in the study.

Our engineering analysis provides an audit trail through a system of schedules which reconcile with the original capitalized project cost. Construction costs are color coded to match and represent property units described in the report. This detail and cross-referencing provides substantiation and documentation for segregation of costs.

GETTING THE MOST OUT OF YOUR PROJECT

Cost segregation is not intended to reduce taxes in the long-term. Its value is in freeing up cash flow in the early years following completion of a construction project or acquisition. A quality study will help you maximize this benefit and ensure claims meet IRS guidelines.

When selecting a firm to conduct your study, look for a methodology that is in line with professional engineering and cost estimating standards. Working with a credible, nationally recognized firm that exceeds IRS standards can help you steer clear of red tape. A firm with local, national and international resources may also be able to identify and assist you with additional tax savings opportunities for your business.



HOW CBIZ CAN HELP

CBIZ takes an integrated approach to cost segregation. Our professionals have backgrounds in construction, engineering and tax and extensive experience determining appropriate asset classifications and tax depreciable lives of real and personal property.

These essential elements ensure that CBIZ clients receive the highest return on their investments and a quality cost segregation report that is properly documented and supportable.

For a free estimate of the tax savings available on your property, please contact:

Kevin Price

CBIZ MHM, LLC

175 South West Temple, Suite 650
Salt Lake City, UT 84058

Direct: 801.364.9300

Fax: 801.364.9301

E-mail: kprice@cbiz.com

Clair Rood

CBIZ MHM, LLC

175 South West Temple, Suite 650
Salt Lake City, UT 84058

Direct: 801.364.9300

Fax: 801.364.9301

E-mail: crood@cbiz.com

ABOUT CBIZ MHM, LLC

CBIZ is one of the largest providers of professional business services to growing companies throughout the United States.

CBIZ provides integrated services in the following areas:

- Accounting and Tax;
- Sarbanes-Oxley Consulting
- Employee Benefits
- Wealth management
- Property and Casualty Insurance
- Payroll
- IT consulting
- HR consulting

CBIZ also provides valuation; litigation advisory; government relations; commercial real estate advisory; wholesale life and group insurance; health care consulting; medical practice management; and capital advisory services.

These services are provided throughout a network of more than 160 offices in 34 states and the District of Columbia.

We serve clients in a wide range of industries with services that include:

- Financial Valuation
- Machinery and Equipment Valuation
- Real Estate Appraisals
- Cost Segregation

Combining innovative thinking with a distinct personal touch, CBIZ provides services and products that are truly unique... Unique because we listen, obtain a thorough understanding of your needs, and then work creatively to provide meaningful and functional solutions... Unique because we take a proactive interest in each client's success.

Our Mission: *To enhance our clients' success and offer a distinct business advantage.*

