Cost Segregation Guide

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Cost Segregation Consultants LLC
An Anchin, Block & Anchin LLP company

IRS Offers Tax Savings Opportunity To Real Estate Owners

What is Cost Segregation?

As a result of a tax case, Hospital Corp. of America, et al. v. Commissioner, 109 TC 21, Code Sec. 168, significant up-front tax savings can be realized by owners of commercial and residential real estate, as well as tenants who have made substantial improvements to their occupied space.

Explanation

In a legal memorandum, the Internal Revenue Service (IRS) stated that when the acquisition of real property is supported by proper supporting documentation (i.e., a specialized cost segregation study prepared by a qualified engineer/appraiser), certain portions of the building and surrounding property can be depreciated over a shorter period than the building itself.

The owner receives the ability to expense these assets over 5, 7 or 15 year periods, based upon the classification of improvement. These lives are far shorter than the 27-1/2 or 39 year lives currently applicable to the building itself, and can provide accelerated tax deductions to the owners of the property.

This benefit applies primarily to property acquired after 1986 and must be supported by the required documentation. Any additional expense determined to be attributable to prior years can be utilized in the year of change, providing the basis for significant tax refunds or tax reductions without amending tax returns.

Effect of 2013 IRS Repair Regulations

A cost segregation study will result in determining the cost of various building systems. Therefore, when a building system or major component of a building system is replaced, the owner will be able to determine the cost that can be deducted as a result of its replacement.

How to Start

Your first step is to evaluate whether your properties fit into the profile above. By completing a short questionnaire and supplying us with a few descriptive facts about the property, we will be able to prepare an estimate of the benefits you will receive from a cost segregation study.

If you acquired property or made substantial improvements after 1986, we can assist you in evaluating your savings. For further information and to determine if a cost segregation study can benefit you, please contact Marc Wieder of Cost Segregation Consultants LLC.

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Cost Segregation Studies

Partial List Of Assets Which Can Potentially Be Re-Classified
Residential Rental Property

Land Improvements – 15 year property:

- Site utilities / drainage
- Parking lot paving
- Sidewalks and curbing
- Exterior lighting
- Underground sprinklers
- Signs and fencing
- Landscaping
- Site improvements – ponds, fountains, etc.
- Concrete parking bumpers
- Carports
- Flagpoles
- Swimming pools
- Tennis courts
- Playgrounds
- Basketball courts

Furnishing, Fixtures and Equipments – 7 year property:

- Office / clubhouse furniture and fixtures
- Indoor sport courts
- Fire extinguishers
- Emergency lighting
- Antenna systems
- Alarm systems
- Floor molding

Distributive Trades and Services – 5 year property:

- Carpeting
- Appliances
- Vinyl tiles
- Smoke detectors
- Counters
- Shelving
- Cabinets
- Window treatments
- Equipment wiring
- Data wiring

See attached spreadsheet for actual results from a study previously done by Cost Segregation Consultants LLC

RESIDENTIAL RENTAL GARDEN APARTMENT DEVELOPMENT

Cost Segregation Study Results

Assumptions:			Tax Rate	40.00%
Original allocation	$ 35,315,022	27.5 yrs.		
			Earnings Rate	8.00%
Cost Segregation:				
	$ 24,518,404	27.5 yrs.	Discount Rate	8.00%
	$ 6,584,754	5 yrs.		
	$ 697,387	7 yrs.		
	$ 3,514,477	15 yrs.		

YEAR	Current Depreciation	Adjusted Depreciation 5 Years	Adjusted Depreciation 7 Years	Adjusted Depreciation 15 Years	Adjusted Depreciation 27.5 Years	Total Adjusted Depreciation	Difference	Tax Savings	Cumulative Savings	Earnings	Cumulative Earnings	Present Value of Cumulative Earnings
1	$ 481,697	$ 1,316,951	$ 99,657	$ 175,724	$ 334,431	$ 1,926,762	$ 1,445,065	$ 578,026	$ 578,026	$ -	$ -	$ -
2	1,284,054	2,107,121	170,790	333,875	891,489	3,503,276	2,219,222	887,689	1,465,715	48,138	48,138	42,633
3	1,284,054	1,264,273	121,973	300,488	891,489	2,578,223	1,294,169	517,667	1,983,382	122,065	170,203	103,071
4	1,284,054	758,564	87,104	270,615	891,489	2,007,771	723,717	289,487	2,272,869	165,176	335,379	135,355
5	1,284,054	758,564	62,277	243,553	891,489	1,955,883	671,829	268,731	2,541,600	189,285	524,663	151,328
6	1,284,054	379,282	62,207	218,952	891,489	1,551,930	267,876	107,150	2,648,751	211,664	736,328	164,225
7	1,284,054		62,277	207,354	891,489	1,161,120	(122,934)	(49,174)	2,599,577	220,588	956,916	167,363
8	1,284,054		31,103	207,354	891,489	1,129,947	(154,107)	(61,643)	2,537,934	216,493	1,173,409	162,320
9	1,284,054			207,706	891,489	1,099,195	(184,859)	(73,944)	2,463,990	211,359	1,384,768	156,365
10	1,284,407			207,354	891,734	1,099,088	(185,319)	(74,128)	2,389,863	205,201	1,589,969	149,689
11	1,284,054			207,706	891,489	1,099,195	(184,859)	(73,944)	2,315,919	199,028	1,788,997	142,887
12	1,284,407			207,354	891,734	1,099,088	(185,319)	(74,128)	2,241,791	192,870	1,981,866	136,048
13	1,284,054			207,706	891,489	1,099,195	(184,859)	(73,944)	2,167,848	186,696	2,168,563	129,221
14	1,284,407			207,354	891,734	1,099,088	(185,319)	(74,128)	2,093,720	180,538	2,349,101	122,472
15	1,284,054			207,706	891,489	1,099,195	(184,859)	(73,944)	2,019,776	174,365	2,523,466	115,831
16	1,284,407			103,677	891,734	995,411	(288,996)	(115,598)	1,904,178	168,207	2,691,673	109,343
17	1,284,054				891,489	891,489	(392,565)	(157,026)	1,747,152	158,580	2,850,253	102,105
18	1,284,407				891,734	891,734	(392,673)	(157,069)	1,590,083	145,503	2,995,756	94,288
19	1,284,054				891,489	891,489	(392,565)	(157,026)	1,433,057	132,422	3,128,178	86,820
20	1,284,407				891,734	891,734	(392,673)	(157,069)	1,275,988	119,345	3,247,523	79,716
21	1,284,054				891,489	891,489	(392,565)	(157,026)	1,118,961	106,264	3,353,787	72,979
22	1,284,407				891,734	891,734	(392,673)	(157,069)	961,892	93,187	3,446,974	66,612
23	1,284,054				891,489	891,489	(392,565)	(157,026)	804,866	80,106	3,527,081	60,613
24	1,284,407				891,734	891,734	(392,673)	(157,069)	647,797	67,029	3,594,110	54,977
25	1,284,054				891,489	891,489	(392,565)	(157,026)	490,771	53,949	3,648,058	49,696
26	1,284,407				891,734	891,734	(392,673)	(157,069)	333,702	40,871	3,688,930	44,760
27	1,284,054				891,489	891,489	(392,565)	(157,026)	176,676	27,791	3,716,720	40,159
28	1,444,738				1,003,048	1,003,048	(441,690)	(176,676)	(0)	14,714	3,731,434	35,881
	$ 35,315,022	$ 6,584,754	$ 697,387	$ 3,514,477	$ 24,518,404	$ 35,315,022	$ (0)			$ 3,731,434		$ 2,776,756 Savings

Cost Segregation Studies

Partial List Of Assets Which Can Potentially Be Re-Classified
Commercial Property

Land Improvements – 15 year property:

- Site preparation
- Site utilities
- Asphalt paving
- Concrete curbing
- Exterior lighting
- Fencing
- Railings
- Flagpoles

Furniture, Fixtures and Equipment – 7 year property:

- Carpeting
- Vinyl flooring
- Wallpaper
- Interior fencing
- Decorative millwork
- Dock equipment
- Fire extinguishers
- Decorative lighting
- Equipment
- Guard rails

Distributive Trades and Services – 5 year property:

- Observation windows
- Pass-thru windows
- Cabinets
- Data wiring
- Equipment wiring
- Filing systems
- Supplemental power supply
- Supplemental HVAC

See attached spreadsheet for actual results from a study previously done by Cost Segregation Consultants LLC

COMMERCIAL WAREHOUSE FACILITY

Cost Segregation Study Results

Assumptions:			Tax Rate	40.00%
Original allocation	$ 6,332,500	39 yrs.		
			Earnings Rate	8.00%
Cost Segregation:				
	$ 5,124,528	39 yrs.	Discount Rate	8.00%
	$ 297,034	5 yrs.		
	$ 75,625	7 yrs.		
	$ 835,313	15 yrs.		

YEAR	Current Depreciation	Adjusted Depreciation 5 Years	Adjusted Depreciation 7 Years	Adjusted Depreciation 15 Years	Adjusted Depreciation 39 Years	Total Adjusted Depreciation	Difference	Tax Savings	Cumulative Savings	Earnings	Cumulative Earnings	Present Value of Cumulative Earnings
1	$ 47,430	$ 59,407	$ 10,807	$ 41,766	$ 38,383	$ 150,362	$ 102,932	$ 41,173	$ 41,173	$ -	$ -	$ -
2	162,365	95,051	18,521	79,355	131,393	324,319	161,954	64,782	105,954	3,429	3,429	3,037
3	162,365	57,031	13,227	71,419	131,393	273,069	110,704	44,282	150,236	8,824	12,253	7,447
4	162,365	34,218	9,446	64,319	131,393	239,376	77,011	30,804	181,040	12,512	24,764	10,213
5	162,365	34,218	6,753	57,887	131,393	230,252	67,886	27,155	208,195	15,077	39,841	11,941
6	162,365	17,109	6,746	52,040	131,393	207,288	44,923	17,969	226,164	17,338	57,180	13,285
7	162,365		6,753	49,283	131,393	187,430	25,064	10,026	236,189	18,835	76,015	14,009
8	162,365		3,373	49,283	131,393	184,049	21,684	8,674	244,863	19,670	95,685	14,249
9	162,365			49,367	131,393	180,760	18,395	7,358	252,221	20,392	116,077	14,348
10	162,365			49,283	131,393	180,676	18,311	7,324	259,545	21,005	137,082	14,324
11	162,365			49,367	131,393	180,760	18,395	7,358	266,903	21,615	158,697	14,240
12	162,365			49,283	131,393	180,676	18,311	7,324	274,227	22,228	180,924	14,105
13	162,365			49,367	131,393	180,760	18,395	7,358	281,585	22,838	203,762	13,925
14	162,365			49,283	131,393	180,676	18,311	7,324	288,910	23,450	227,212	13,707
15	162,365			49,367	131,393	180,760	18,395	7,358	296,268	24,060	251,273	13,456
16	162,365			24,642	131,393	156,035	(6,331)	(2,532)	293,735	24,673	275,946	13,178
17	162,365				131,393	131,393	(30,972)	(12,389)	281,346	24,462	300,408	12,657
18	162,365				131,393	131,393	(30,972)	(12,389)	268,957	23,431	323,839	11,931
19	162,365				131,393	131,393	(30,972)	(12,389)	256,568	22,399	346,238	11,223
20	162,365				131,393	131,393	(30,972)	(12,389)	244,179	21,367	367,605	10,535
21	162,365				131,393	131,393	(30,972)	(12,389)	231,790	20,335	387,940	9,870
22	162,365				131,393	131,393	(30,972)	(12,389)	219,402	19,304	407,243	9,230
23	162,365				131,393	131,393	(30,972)	(12,389)	207,013	18,272	425,515	8,615
24	162,365				131,393	131,393	(30,972)	(12,389)	194,624	17,240	442,755	8,027
25	162,365				131,393	131,393	(30,972)	(12,389)	182,235	16,208	458,963	7,467
26	162,365				131,393	131,393	(30,972)	(12,389)	169,846	15,177	474,140	6,934
27	162,365				131,393	131,393	(30,972)	(12,389)	157,457	14,145	488,285	6,429
28	162,365				131,393	131,393	(30,972)	(12,389)	145,068	13,113	501,398	5,951
29	162,365				131,393	131,393	(30,972)	(12,389)	132,679	12,081	513,479	5,500
30	162,365				131,393	131,393	(30,972)	(12,389)	120,290	11,049	524,528	5,074
31	162,365				131,393	131,393	(30,972)	(12,389)	107,901	10,018	534,546	4,675
32	162,365				131,393	131,393	(30,972)	(12,389)	95,512	8,986	543,532	4,299
33	162,365				131,393	131,393	(30,972)	(12,389)	83,123	7,954	551,486	3,948
34	162,365				131,393	131,393	(30,972)	(12,389)	70,734	6,922	558,409	3,619
35	162,365				131,393	131,393	(30,972)	(12,389)	58,345	5,891	564,300	3,312
36	162,365				131,393	131,393	(30,972)	(12,389)	45,956	4,859	569,158	3,026
37	162,365				131,393	131,393	(30,972)	(12,389)	33,567	3,827	572,986	2,759
38	162,365				131,393	131,393	(30,972)	(12,389)	21,178	2,795	575,781	2,512
39	162,365				131,393	131,393	(30,972)	(12,389)	8,789	1,764	577,545	2,282
40	115,188				93,215	93,215	(21,973)	(8,789)	(0)	732	578,277	2,069
	$ 6,332,500	$ 297,034	$ 75,625	$ 835,313	$ 5,124,528	$ 6,332,500	$ (0)			$ 578,277		$ 337,409 Savings

OFFICE BUILDING

Cost Segregation Study Results

Assumptions:			Tax Rate	40.00%
Original allocation	$ 160,609,827	39 yrs.		
			Earnings Rate	8.00%
Cost Segregation:				
	$ 126,918,354	39 yrs.	Discount Rate	8.00%
	$ 4,082,305	5 yrs.		
	$ 11,530,038	7 yrs.		
	$ 18,079,130	15 yrs.		

YEAR	Current Depreciation	Adjusted Depreciation 5 Years	Adjusted Depreciation 7 Years	Adjusted Depreciation 15 Years	Adjusted Depreciation 39 Years	Total Adjusted Depreciation	Difference	Tax Savings	Cumulative Savings	Earnings	Cumulative Earnings	Present Value of Cumulative Earnings
1	$ 171,853	$ 204,115	$ 411,622	$ 225,989	$ 135,803	$ 977,529	$ 805,677	$ 322,271	$ 322,271	$ -	$ -	$ -
2	4,118,036	1,551,276	3,176,525	1,786,218	3,254,187	9,768,206	$ 5,650,170	2,260,068	2,582,339	26,839	26,839	23,769
3	4,118,036	930,766	2,269,111	1,607,235	3,254,187	8,061,298	$ 3,943,262	1,577,305	4,159,644	215,057	241,896	177,647
4	4,118,036	558,459	1,621,123	1,446,330	3,254,187	6,880,100	$ 2,762,064	1,104,825	5,264,469	346,415	588,311	276,641
5	4,118,036	446,604	1,157,616	1,301,697	3,254,187	6,160,104	$ 2,042,068	816,827	6,081,296	438,425	1,026,736	339,574
6	4,118,036	391,085	1,006,572	1,171,528	3,254,187	5,823,371	$ 1,705,335	682,134	6,763,431	506,450	1,533,186	380,698
7	4,118,036		1,006,572	1,066,669	3,254,187	5,327,428	$ 1,209,392	483,757	7,247,187	563,258	2,096,445	410,196
8	4,118,036		880,895	1,066,669	3,254,187	5,201,750	$ 1,083,714	433,486	7,680,673	603,546	2,699,991	426,447
9	4,118,036			1,066,669	3,254,187	4,320,855	$ 202,819	81,128	7,761,801	639,646	3,339,637	437,355
10	4,118,036			1,068,477	3,254,187	4,322,663	$ 204,627	81,851	7,843,651	646,403	3,986,040	431,765
11	4,118,036			1,066,669	3,254,187	4,320,855	$ 202,819	81,128	7,924,779	653,219	4,639,259	424,718
12	4,118,036			1,068,477	3,254,187	4,322,663	$ 204,627	81,851	8,006,630	659,976	5,299,235	416,405
13	4,118,036			1,066,669	3,254,187	4,320,855	$ 202,819	81,128	8,087,758	666,792	5,966,027	407,089
14	4,118,036			1,068,477	3,254,187	4,322,663	$ 204,627	81,851	8,169,609	673,548	6,639,575	396,916
15	4,118,036			1,066,669	3,254,187	4,320,855	$ 202,819	81,128	8,250,736	680,365	7,319,940	386,096
16	4,118,036			934,691	3,254,187	4,188,878	$ 70,842	28,337	8,279,073	687,121	8,007,062	374,741
17	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	7,933,533	689,481	8,696,543	361,827
18	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	7,587,994	660,705	9,357,247	341,065
19	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	7,242,454	631,928	9,989,176	320,811
20	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	6,896,914	603,152	10,592,327	301,153
21	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	6,551,374	574,375	11,166,702	282,157
22	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	6,205,835	545,598	11,712,301	263,874
23	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	5,860,295	516,822	12,229,123	246,338
24	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	5,514,755	488,045	12,717,168	229,574
25	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	5,169,215	459,269	13,176,437	213,594
26	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	4,823,676	430,492	13,606,929	198,404
27	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	4,478,136	401,716	14,008,645	183,999
28	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	4,132,596	372,939	14,381,584	170,371
29	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	3,787,056	344,163	14,725,746	157,507
30	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	3,441,517	315,386	15,041,132	145,387
31	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	3,095,977	286,610	15,327,742	133,991
32	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	2,750,437	257,833	15,585,575	123,296
33	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	2,404,897	229,056	15,814,631	113,276
34	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	2,059,358	200,280	16,014,911	103,903
35	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	1,713,818	171,503	16,186,414	95,150
36	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	1,368,278	142,727	16,329,141	86,990
37	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	1,022,738	113,950	16,443,091	79,392
38	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	677,199	85,174	16,528,265	72,330
39	4,118,036				3,254,187	3,254,187	$ (863,849)	(345,540)	331,659	56,397	16,584,662	65,774
40	3,952,608				3,123,461	3,123,461	$ (829,147)	(331,659)	(0)	27,621	16,612,283	59,697
	$ 160,609,827	$ 4,082,305	$ 11,530,038	$ 18,079,130	$ 126,918,354	$ 160,609,827	$ (0)	$ (0)		$ 16,612,283		$ 9,659,917 Savings

Assumed the property was purchased on 12/21/06 at a cost of $20,500,000, with 15% allocated to land

Cost Segregation Studies

Partial List Of Assets Which Can Potentially Be Re-Classified
Shopping Center

Land Improvements – 15 year property:

- Site preparation
- Site utilities
- Asphalt paving
- Concrete curbing
- Exterior lighting
- Fencing
- Railings
- Flagpoles
- Signage
- Awnings
- Traffic signals

Furniture, Fixtures and Equipment – 7 year property:

- Carpeting
- Vinyl flooring
- Wallpaper
- Interior fencing
- Decorative millwork
- Dock equipment
- Fire extinguishers
- Equipment
- Guard rails
- Ceiling fans
- Automatic doors

Distributive Trades and Services – 5 year property:

- Service counters
- Slatboard / pegboard
- Observation windows
- Pass-thru windows
- Cabinets
- Decorative lighting
- Security systems
- Music / intercom systems
- Equipment and data wiring

See attached spreadsheet for actual results from a study previously done by Cost Segregation Consultants LLC

SHOPPING CENTER

Cost Segregation Study Results

Assumptions:			Tax Rate	40.00%
Original allocation	$ 6,698,192	39 yrs.		
			Earnings Rate	8.00%
Cost Segregation:				
	$ 4,897,779	39 yrs.	Discount Rate	8.00%
	$ 546,860	5 yrs.		
	$ 81,576	7 yrs.		
	$ 1,171,977	15 yrs.		

YEAR	Current Depreciation	Adjusted Depreciation 5 Years	Adjusted Depreciation 7 Years	Adjusted Depreciation 15 Years	Adjusted Depreciation 39 Years	Total Adjusted Depreciation	Difference	Tax Savings	Cumulative Savings	Earnings	Cumulative Earnings	Present Value of Cumulative Earnings	
1	$ 136,174	$ 109,372	$ 11,657	$ 58,599	$ 99,572	$ 279,200	$ 143,026	$ 57,210	$ 57,210	$ -	$ -	$ -	
2	171,742	174,995	19,978	111,338	125,579	431,890	260,148	104,059	161,270	4,764	4,764	4,220	
3	171,742	104,997	14,268	100,204	125,579	345,048	173,306	69,322	230,592	13,431	18,195	11,304	
4	171,742	62,998	10,189	90,242	125,579	289,008	117,267	46,907	277,499	19,204	37,399	15,637	
5	171,742	62,998	7,285	81,218	125,579	277,080	105,338	42,135	319,634	23,110	60,509	18,270	
6	171,742	31,499	7,277	73,014	125,579	237,369	65,627	26,251	345,885	26,619	87,128	20,360	
7	171,742		7,285	69,147	125,579	202,010	30,269	12,108	357,993	28,805	115,933	21,409	
8	171,742		3,638	69,147	125,579	198,364	26,622	10,649	368,642	29,814	145,747	21,630	
9	171,742			69,264	125,579	194,843	23,101	9,241	377,882	30,700	176,447	21,672	
10	171,742			69,147	125,579	194,726	22,984	9,194	387,076	31,470	207,917	21,559	
11	171,742			69,264	125,579	194,843	23,101	9,241	396,316	32,236	240,153	21,362	
12	171,742			69,147	125,579	194,726	22,984	9,194	405,510	33,005	273,158	21,094	
13	171,742			69,264	125,579	194,843	23,101	9,241	414,750	33,771	306,929	20,764	
14	171,742			69,147	125,579	194,726	22,984	9,194	423,944	34,540	341,470	20,382	
15	171,742			69,264	125,579	194,843	23,101	9,241	433,184	35,306	376,776	19,955	
16	171,742			34,573	125,579	160,152	(11,589)	(4,636)	428,549	36,076	412,851	19,493	
17	171,742				125,579	125,579	(46,163)	(18,465)	410,084	35,690	448,541	18,693	
18	171,742				125,579	125,579	(46,163)	(18,465)	391,619	34,152	482,692	17,609	
19	171,742				125,579	125,579	(46,163)	(18,465)	373,154	32,614	515,306	16,553	
20	171,742				125,579	125,579	(46,163)	(18,465)	354,689	31,076	546,383	15,527	
21	171,742				125,579	125,579	(46,163)	(18,465)	336,224	29,538	575,921	14,537	
22	171,742				125,579	125,579	(46,163)	(18,465)	317,758	28,001	603,922	13,584	
23	171,742				125,579	125,579	(46,163)	(18,465)	299,293	26,463	630,385	12,671	
24	171,742				125,579	125,579	(46,163)	(18,465)	280,828	24,925	655,310	11,799	
25	171,742				125,579	125,579	(46,163)	(18,465)	262,363	23,387	678,697	10,967	
26	171,742				125,579	125,579	(46,163)	(18,465)	243,898	21,850	700,547	10,177	
27	171,742				125,579	125,579	(46,163)	(18,465)	225,433	20,312	720,859	9,429	
28	171,742				125,579	125,579	(46,163)	(18,465)	206,968	18,774	739,633	8,721	
29	171,742				125,579	125,579	(46,163)	(18,465)	188,503	17,236	756,869	8,053	
30	171,742				125,579	125,579	(46,163)	(18,465)	170,038	15,699	772,568	7,424	
31	171,742				125,579	125,579	(46,163)	(18,465)	151,573	14,161	786,729	6,833	
32	171,742				125,579	125,579	(46,163)	(18,465)	133,108	12,623	799,352	6,279	
33	171,742				125,579	125,579	(46,163)	(18,465)	114,643	11,085	810,437	5,761	
34	171,742				125,579	125,579	(46,163)	(18,465)	96,178	9,547	819,984	5,276	
35	171,742				125,579	125,579	(46,163)	(18,465)	77,713	8,010	827,994	4,823	
36	171,742				125,579	125,579	(46,163)	(18,465)	59,248	6,472	834,466	4,401	
37	171,742				125,579	125,579	(46,163)	(18,465)	40,783	4,934	839,400	4,009	
38	171,742				125,579	125,579	(46,163)	(18,465)	22,318	3,396	842,796	3,645	
39	171,742				125,579	125,579	(46,163)	(18,465)	3,853	1,859	844,655	3,307	
40	35,835				26,203	26,203	(9,632)	(3,853)	0	321	844,976	2,994	
	$ 6,698,192	$ 546,860	$ 81,576	$ 1,171,977	$ 4,897,779	$ 6,698,192	$ -	$ -		$ 844,976		$ 502,187	Savings

Cost Segregation Methodology

Federal tax law states that in order to calculate depreciation, a taxpayer must use the proper recovery period and correct method for each asset or property owned. Property constructed or purchased usually consists of many asset types and classes with different recovery periods.

In order for a taxpayer to properly determine which asset classes exist within their property, the property must be separated into individual components. When only lump-sum costs are available, a taxpayer must segregate or allocate these costs to the various asset classes. The method by which this allocation is done is commonly referred to as a Cost Segregation Study.

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Cost Segregation Methodology

The most common purpose of a Cost Segregation Study is to allocate or reallocate building costs to tangible personal property. A building "section (§) 1250 property", is generally 27.5 or 39-year property. Equipment, furniture and fixtures "section (§) 1245 property", are tangible personal property. Tangible personal property has a short recovery period (e.g., 5 or 7 years) and is also eligible for accelerated depreciation (e.g., double declining balance). Thus, a faster depreciation write-off (and tax benefit) can be obtained by allocating property costs to § 1245 property, or by reallocating § 1250 property costs to § 1245 property. In addition, land improvements which are either section 1245 or section 1250 property have a 15 year depreciable life and are eligible for an accelerated depreciation method.

Tangible Personal Property

When determining which assets qualify as tangible personal property, the IRS turned to the investment tax credit rules established in 1962 as well as other references. The following describes some of the IRS' position on the classification of assets:

Treas. Reg. § 1.48-1(c) provides examples of qualifying property, and states that

> …tangible personal property' means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures).

This same subsection states that "tangible personal property" includes

> …all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Furthermore, all property that is in the nature of machinery (other than structural components of the building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

In addition, the regulations provide examples of non-qualifying property. For example, "…buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property."

The Senate Report accompanying the enactment of the Revenue Act of 1978 provided additional insight into Congressional intent by providing further examples of qualifying and non- qualifying property.

> …[T]he committee wishes to clarify present law by stating that tangible personal property already eligible for the investment tax credit includes special lighting (including lighting to illuminate the exterior of a building or store, but not lighting to illuminate parking areas), false balconies and other exterior ornamentation that have no more than an incidental relationship to the operation or maintenance of a building, and identity symbols that identify or relate to a particular retail establishment or restaurant such as special materials attached to the exterior or interior of a building or store and signs (other than billboards). Similarly, floor coverings which are not an integral part of the floor itself such as floor tile generally installed in a manner to be readily removed (that is it is not cemented, mudded, or otherwise permanently affixed to the building floor but, instead, has adhesives applied which are designed to ease its removal, carpeting, wall panel inserts such as those designed to contain condiments or to serve as a framing for picture of the products of a retail establishment, beverage bars, ornamental fixtures (such as coats-of-arms), artifacts (if depreciable), booths for seating, movable and removable partitions, and large and small pictures of scenery, persons, and the like which are attached to walls or suspended from the ceiling, are considered tangible personal property and not structural components. Consequently, under existing law, this property is already eligible for the ITC.

Building and Structural Components

Treas. Reg. § 1.48-1(e)(1) provides a detailed explanation of buildings and their structural components for ITC purposes and has been the primary source for guidance, both with respect to component depreciation and cost segregation studies. The term "building" is described as

> …any structure of edifice enclosing a space within its walls and usually covered by a roof whereby the structure improves the land, and provides shelter or housing for work, office, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease.

Specifically excluded from the definition of the term "building" are the following:

i. a structure which is essentially an item of machinery or equipment,

or

ii. a structure which houses property used as an integral part of an activity specified in section 1.48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure is closely related to the use of the property it houses include the fact that the structure is specifically designated to provide for the stress and other demands of such property and the fact that the structure could not be economically used for other purposes.

The term "structural components" is defined in § 1.48-1(e)(2) of the Regulations as

> …includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefore such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air condition or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.

> However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature of humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components".

Section 1245 and Section 1250 Property

The benefits of the ITC were somewhat offset by the provisions of IRC § § 1245 and 1250, also enacted in 1962. These Code sections result in the conversation of capital gain to ordinary income on the disposition of a property, to the extent its basis has been reduced by an accelerated depreciation method. The definition of property for purposes of § § 1245 and 1250 are very similar to that for ITC and make reference to the regulations under § 48 and the definitions under § 38 property. These interrelated Code sections and the regulations (38, 48, 1245 and 1250) provide the pertinent authority for determining eligibility for ITC.

The primary issue in cost segregation studies is the property classification of assets as either §1245 or § 1250 property. Accordingly, the ITC rules are critical in determining whether a taxpayer has classified property into the appropriate asset class.

Section 1245(a)(3) provides that "section 1245 property" is any property which is or has been subject to depreciation under § 167 and which is either personal property or other tangible property used as an integral part of certain activities. Such activities include manufacturing, production or extraction; furnishing transportation, communication, electrical energy, gas, water, or sewage disposal services. Certain other "special use" property also qualifies as §1245 property, but is not of a primary concern for purposes of this discussion. It is important to note that § 1245(a)(3) specifically excludes a building or its structural components from the definition of § 1245 property.

Section 1250(c) defines "section 1250 property" as any real property, other than section 1245 property, which is or has been subject to an allowance for depreciation. In order words, § 1250 property encompasses all depreciable property that is not § 1245 property.

Land improvements (i.e., depreciable improvements made directly to or added to land), may be either § 1245 or § 1250 property and are depreciated over a 15-year recovery period. Buildings and structural components are specifically excluded from 15-year property. Examples of land improvements include sidewalks, roads, canals, waterways, drainage facilities, sewers, wharves and docks, bridges, fences, landscaping, shrubbery, and radio and television towers.

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. In other words, if an asset is not a structural component of a building, then it can be considered to be § 1245 property. The structural component determination hinges on what constitutes an inherently permanent structure and how permanently the asset is attached to such a structure. Clearly, this is a factually intensive determination and explains the lack of bright-line tests for segregating property into § 1245 and § 1250 classification.

Cost Segregation Methodology

In addition to applying the investment tax credit rules, the IRS applies the findings of various tax court cases in determining whether an asset qualifies as a section 1245 asset.

The following are some of these cases and the IRS' position:

Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664, 672-673 (1975). The Tax Court developed six questions designed to ascertain whether a particular asset qualifies as tangible personal property. These questions, referred to as the "Whiteco Factors," are:

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?

Moveability is not the only factor in measuring inherent permanency. In L.L. Bean, Inc. v. Comm., T.C. Memo. 1997-175, aff'd, 145 F.3d 53 (1st Cir. 1998), 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.

The IRS will consider the following when applying the Whiteco factors:

- The manner in which an item is attached to a building or to the land,
- The weight and size of the item,
- The time and costs required to move the components,
- The number of personnel required in planning and executing a move,
- The type and quantity of equipment required for a move,
- The history of the item or similar items being moved,
- The time, cost, manpower and equipment required to reconfigure the existing space if the item is removed,
- Any intentions regarding the removal,
- Whether the item is designed to be moved, and
- Whether the item is readily usable in another location.

Hospital Corporation of America v. Commissioner ("HCA") (1997). As a result of the HCA case, IRS Chief Counsel issued further guidance to the field in the form of an advice memorandum dated May 28, 1999. It made the following observations and recommendations for field agents examining cost segregation studies:

- The determination of whether an asset is a structural component or tangible personal property is a facts-and-circumstances assessment.
- The use of cost segregation studies must be specifically applied by the taxpayer.
- Allocations must be based on a "logical and objective measure" of the portion of the equipment that constitutes § 1245 property.
- An accurate cost segregation study may not be based on non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records.
- Cost segregation studies should be closely scrutinized by the field.
- A change in depreciation method is a change in method of accounting, requiring the consent of the Secretary of his delegate.

Cost Segregation Methodology

During 2004 the IRS issued the *Cost Segregation Audit Techniques Guide*. This guide is to be applied by IRS tax auditors in determining whether a cost segregation study was properly prepared and whether assets classified as section 1245 property are properly classified.

As part of the audit techniques guide, the IRS has stated six most commonly used methodologies for cost segregation studies.

The six methodologies are as follows:

1. Detailed Engineering Approach from Actual Cost Records
2. Detailed Engineering Cost Estimate Approach
3. Survey or Letter Approach
4. Residual Estimation Approach
5. Sampling or Modeling Approach
6. "Rule of Thumb" Approach

Cost Segregation Methodology

What are the Attributes of Various Cost Segregation Methodologies?

The following discussion takes a closer look at the main components and attributes of each of the methodologies listed above. Keep in mind that these are the steps normally taken in the preparation of a cost segregation study. The examiner's responsibility is to review the steps taken and evaluate the accuracy of the study, as will be discussed in Chapter 5, "Review and Examination of Cost Segregation Studies."

Detailed Engineering Approach from Actual Cost Records

The detailed engineering approach from actual cost records, or "detailed cost approach," uses costs from contemporaneous construction and accounting records. In general, it is the most methodical and accurate approach, relying on solid documentation and minimal estimation. Construction-based documentation, such as blueprints, specifications, contracts, job reports, change orders, payment requests, and invoices, are used to determine unit costs. The use of actual cost records contributes to the overall accuracy of cost allocations, although issues may still arise as to the classification of specific assets.

This approach is generally applied only to new construction, where detailed cost records are available. For used or acquired property and for new projects where original construction documents are not available, an alternative approach (e.g., the "detailed engineering cost estimate approach") may be more appropriate.

The detailed cost approach typically includes the following activities:

1. Identify the specific project/assets that will be analyzed.
2. Obtain a complete listing of all project costs and substantiate the total project costs.
3. Inspect the facility to determine the nature of the project and its intended use.
4. Photograph specific property items for reference. Request previous site photographs that illustrate the construction progress as well as the condition of the property before the project began.
5. Review "as-built" blueprints, specifications, contracts, bid documents, contractor pay requests, and other construction documentation.
6. Identify and assign specific project items to property classes (e.g., land, land improvements, building, equipment, furniture and fixtures, and other items of tangible personal property).

Cost Segregation Consultants LLC has employed at least one and possibly more than one of these methodologies in the preparation of the attached study.

The audit techniques guide also indicated nine principal elements of a quality cost segregation report.

The nine principal elements for which the IRS will be looking for are as follows:

1. Summary letter
2. Narrative report
3. Schedule of assets
4. Schedule of direct and indirect costs
5. Schedule of property units and costs
6. Engineering procedures
7. Statement of assumptions
8. Certification
9. Exhibits

Cost Segregation Methodology

Not all cost segregation studies need to have all nine components listed above. Cost Segregation Consultants LLC included in the report, all elements which we determined to be appropriate.

Change In Accounting Method

Tax law permits a taxpayer to apply the results of a cost segregation study in years subsequent to the year of acquisition or construction.

The IRS' position is that a change in depreciation method, recovery period, or convention for depreciable property resulting from the reclassification of property is a change in accounting method. Such a change requires the consent of the Commissioner (i.e., the taxpayer must generally file Form 3115, Application for Change in Accounting Method) and the adjustment to income is made pursuant to IRC § 481(a). Accordingly, claims for adjustment based on a coast segregation study performed after the original return was filed should not be allowed (i.e., unless a Form 3115 has been filed).

In the event a study is prepared and a Form 3115 is properly filed, the taxpayer will receive as a deduction any additional depreciation the taxpayer was eligible for which had not previously been deducted by the taxpayer.

Cost Segregation Consultants LLC applies as many of the suggested procedures and methodologies stated in the Audit Techniques Guide as we determine are appropriate for the preparation of the Cost Segregation Study Report.

In addition, we consider the results of various tax case law, Section 1245 and Section 1250 of the Internal Revenue Code, in the preparation of the Cost Segregation Study Report.

Information Needed to Estimate Savings

Commercial Property

Location_____________________________

Previously acquired property - detailed tax depreciation schedule
Newly acquired property - cost basis of Building________________________
Land________________________

Constructed property - final AIA report and any other schedules which indicate construction costs

Industrial and Flex Industrial
# of tenants__________
Total rentable square feet__________
Total square feet of office space__________
Total acreage __________
Total #of truck bays__________
# of bays with dock equipment__________

Office Building
Building class (please circle one) - A B C
# of tenants__________
Total rentable square feet__________
Total acreage__________
# of uncovered parking spaces__________
Common hallways are carpeted? Yes____ No____
Common hallways are wallpapered? Yes____ No____

Other amenities: (please circle if landlord owns equipment even if landlord does not operate)
Cafeteria
Gym
Swimming pool
Other:

Shopping Center, Mall or Other Retail
Circle one - Shopping Center Mall Strip Center Other: ie: Big Box
# of tenants__________
Total rentable square feet__________
Total acreage__________
# of uncovered parking spaces__________

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Information Needed to Estimate Savings

Residential Rental Property

Location____________________________

Previously acquired property - detailed tax depreciation schedule
Newly acquired property - cost basis of Building_______________________
Land_______________________

Constructed property - final AIA report and any other schedules which indicate construction costs

Description: (please circle one)
Urban hi-rise
Urban hi-rise with outdoor uncovered parking
Suburban hi-rise
Suburban hi-rise with outdoor uncovered parking
Garden apartment

# of buildings__________
#of units__________
Total acreage__________

Landlord provides tenant with the following: (please check or circle all that apply)

Refrigerator	Window or wall A/C unit	Ceiling fans
Stove/oven	Carpeting	Kitchen cabinets and counters
Dishwasher	Wallpaper	Other:
Disposal	VCT flooring	
Microwave	Smoke detectors	
Washer/dryer	Window treatments	

Common hallways are carpeted? Yes____ No____

Common hallways are wallpapered? Yes____ No____

Other amenities: (please circle or check those that apply)

Landlord owned laundry room
Swimming pool
Tennis court
Playground
Basketball court
Racquetball court
Clubhouse

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Cost Segregation and Important Tax Strategy

By: Marc Wieder, CPA
Anchin, Block & Anchin LLP

As another filing deadline approaches or has come and gone, building owners reeling from unpleasant news from their certified public accountants should review their portfolio of properties. A review could uncover which properties could benefit from a cost segregation study, a well utilized technique to accelerate depreciation deductions on real estate since 1999.

The owner who has filed an extension with the Internal Revenue Service would still have time to complete the cost segregation study and reap the benefits on their tax return before filing in September (the extended filing deadline.)

The owner who has already submitted his tax return should consider the cost segregation study as a tax planning strategy for the next taxable year.

Remember, it is never too late to do a cost segregation study Studies can be done years after acquiring or constructing a property without the need to amend tax returns.

Since its enactment by the IRS in 1999, cost segregation studies have gone through many changes. The IRS issued an Audit Techniques Guide (ATG) on the topic of Cost Segregation. The ATG was developed to assist IRS examiners in the review and examination of cost segregation studies. *The ATG helps to identify acceptable methodology for such a study.*

As most of you know, the main purpose of doing a cost segregation study is to allocate or reallocate the total cost of a property into appropriate property classes for the sole purpose of accelerating depreciation deductions for Federal tax purposes. More specifically, the purpose is to allocate or reallocate the total cost of the property between structural and non-structural components of the property

Structural components are depreciated over 39 years for commercial property and 27% years for residential property, while non-structural components are depreciated primarily over 5 or 7 years, using accelerated methods.

The ATG identifies six commonly used methods. The methods are listed in order of their accuracy and are as follows:

1. Detailed engineering approach from Actual Cost Records.
2. Detailed engineering cost estimate approach. This method is commonly used for new construction and current renovations. Based on my experience, this is the most commonly used method for current and past acquisitions of property, as well as past construction projects where actual

cost records are not available.

3. Survey or letter approach. My experience has found that this method is used to supplement the first 2 methods and is not used for an entire study
4. Residual estimation approach.
5. Sampling or modeling approach.
6. “Rule of Thumb” approach.

Methods 3, 4 and 5 are not commonly used, with Method 4 being the exception at this time. Method 5, sampling and modeling, can be used when you have many properties with similar construction and improvements, such as fast food establishments.

Besides indicating the acceptable methodology to be used, the ATG states three components to the cost segregation report which an IRS examiner looks for. The report should include the following:

1. Classification of assets into property classes.
2. Explanation of the rationale for classifying assets as either Sec. 1245 (tangible personal property) or Sec. 1250 (real property).
3. Substantiation of the cost basis of each asset and a reconciliation of the total costs.

Another very important point raised in the ATG is that a cost segregation study should be performed by qualified professionals. Although the ATG does not specifically identify who is a qualified professional, it does state that there are two important parts to a cost segregation study and that a professional qualified in these areas should perform the study. The areas cited include knowledge of the construction process and the tax law involving property classification for depreciation purposes. Therefore, a study that is done by an accountant along with an engineer or appraiser would meet these qualifications.

Cost segregation studies remain an extremely beneficial method of reducing taxable income from real estate operations. When selecting a professional to perform the studies on your properties, be aware of the quality of the methodology to be applied and who will be involved in the study. You want to be comfortable that the results are defensible against an IRS challenge, should such a challenge occur.

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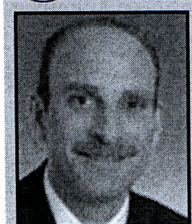
Cost segregation: alive and well

ny Cost Segregation



By Marc Wieder, CPA

The Internal Revenue Service recently issued an Audit Techniques Guide (ATG) in regard to cost segregation studies, a well utilized technique to accelerate depreciation deductions on real estate.

The primary reason to conduct a cost segregation study is to allocate or reallocate the total cost of a property between structural and non-structural components of the property Structural components are depreciated over 39 years for commercial property and 27 years for residential property, while non-structural components are depreciated primarily over 5 or 7 years, using accelerated methods. The ATG identifies six commonly used methods as well as three components to the cost segregation study The most commonly used method remains a detailed engineering cost estimate approach. The three components recommended by the IRS include: classification of assets into property classes; explanation of the rationale for classifying assets (either Sec. 1245, tangible personal property, or Sec. 1250, real property; and substantiation of the cost basis of each asset and a reconciliation of the total costs. Regardless of the method chosen for a cost segregation study, the IRS recommends using a qualified professional for the engagement who understands both the construction process and tax law involving property classifications for depreciation purposes. Therefore, a study that is done by an accountant along with an engineer or appraiser would meet these qualifications.

Cost segregation studies remain an extremely beneficial method of reducing taxable income from real estate operations.

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INSIDERS OUTLOOK

Cost segregation is alive and well in 2005

By Marc Wieder, CPA,
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Cost segregation studies, a well utilized technique to accelerate depreciation deductions on real estate since 1999, have gone through many changes over the past years.

Most recently, the Internal Revenue Service (IRS) issued an Audit Techniques Guide (ATG) on the topic, and as recently as January 14, 2005, made revisions to the ATG. The ATG was developed to assist IRS examiners in the review and examination of cost segregation studies. *These revisions do not mean that cost segregation studies are no longer acceptable, but rather the ATG helps to identify acceptable methodology for such a study.*

As most of you know, the main purpose of doing a cost segregation study is to allocate or reallocate the total cost of a property into appropriate property classes for the sole purpose of accelerating depreciation deductions for Federal tax purposes. More specifically, the purpose is to allocate or reallocate the total cost of the property between structural and non-structural components of the property.

Structural components are depreciated over 39 years for commercial property and 27½ years for residential property, while non-structural components are depreciated primarily over 5 or 7 years, using accelerated methods.

The ATG identifies six commonly used methods. The methods are listed in order of their accuracy and are as follows:

1. Detailed engineering approach from Actual Cost Records.

2. Detailed engineering cost estimate approach. This method is commonly used for new construction and current renovations. Based on my experience, this is the most commonly used method for current and past acquisitions of property, as well as past construction projects where actual cost records are not available.

3. Survey or letter approach. My experience has found that this method is used to supplement the first 2 methods and is not used for an entire study.

4. Residual estimation approach.

5. Sampling or modeling approach.

6. "Rule of Thumb" approach.

Methods 3, 4 and 5 are not commonly used, with Method 4 being the exception at this time. Method 5, sampling and modeling, can be used when you have many properties with similar construction and improvements, such as fast food establishments.

"You want to be comfortable that the results are defensible against IRS challenge."

Besides indicating the acceptable methodology to be used, the ATG states three components to the cost segregation report which an IRS examiner looks for. The report should include the following:

1. Classification of assets into property classes.

2. Explanation of the rationale for classifying assets as either Sec. 1245 (tangible personal property) or Sec. 1250 (real property).

3. Substantiation of the cost basis of each asset and a reconciliation of the total costs.

Another very important point raised in the ATG is that a cost segregation study should be performed by qualified professionals. Although the ATG does not specifically identify who is a qualified professional, it does state that there are two important parts to a cost segregation study and that a professional qualified in these areas should perform the study. The areas cited include knowledge of the construction process and the tax law involving property classifications for depreciation purposes. Therefore, a study that is done by an accountant along with an engineer or appraiser would meet these qualifications.

Remember, it is never too late to do a cost segregation study. Studies can be done years after acquiring or constructing a property without the need to amend tax returns.

In conclusion, cost segregation studies remain an extremely beneficial method of reducing taxable income from real estate operations. When selecting a professional to perform the studies on your properties, be aware of the quality of the methodology to be applied and which qualified professional will be involved in the study. You want to be comfortable that the results are defensible against IRS challenge, should such a challenge occur.

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REAL ESTATE WEEKLY

Property Management

Consultants launch practice to save owners on depreciation taxes

Landmark tax case creates new opportunities for owners to save

Cost Segregation Consultants, LLC has launched a national service practice dedicated exclusively to identifying and securing tax savings for property owners through a new, complex and underutilized property classification technique. Cost Segregation Consultants capitalizes on a recent court decision that clears the way for significant up-front tax savings for owners of commercial and residential real estate, as well as tenants who have made substantial improvements to their occupied space.

Backed by Anchin, Block & Anchin LLP (ABA), one of the largest and most highly respected accounting and consulting firms in the nation, Cost Segregation Consultants helps owners realize significant tax savings - often in the $100,000s, and at times, millions of dollars.

As the result of a 1997 tax case and 1999 IRS legal memoranda, certain portions of commercial and residential properties can be depreciated over shorter periods than the buildings themselves, providing accelerated tax deductions.

"We have helped owners of retail, office, hotel, industrial and multi-family properties around the country realize millions of dollars in savings via our cost segregation and accounting expertise," said Marc Wieder, CPA, Managing Director of Cost Segregation Consultants. "The value of this specialty cannot be underestimated, nor fully achieved without specific knowledge, experience and expertise. We are proud to offer this service at the highest level to owners of all types of property that might benefit from review, analysis and action."

Through the preparation of specialized cost segregation studies prepared by qualified engineers/appraisers, Cost Segregation Consultants, shows owners of multi-family rental, office, shopping center/retail, manufacturing and healthcare/nursing home facilities how to expense these assets over 5-, 7- and 15- year periods - far shorter than the current 27.5- and 39-year lives currently applicable to the buildings themselves.

Only properties acquired after 1986 are eligible under the IRS ruling, and owners who plan on disposing of their properties in the short-term will not benefit.

Land improvements such as parking lot paving, sidewalks and curbing, exterior lighting, swimming pools, tennis and basketball court, playgrounds, landscaping and site improvements such as ponds and fountains, signs and fencing are eligible for 15-year depreciation.

Furnishings, fixtures and equipment such as office and clubhouse furniture, indoor sports courts, fire extinguishers, emergency lighting, alarms, antenna systems and floor molding are eligible for 7-year depreciation. Other items such as appliances, carpeting, vinyl tiles, counters, cabinets, smoke detectors, shelving and window treatments are eligible for an even shorter 5-year depreciation.

The up-front savings can be substantial, and the experts at Cost Segregation Consultants can provide an immediate evaluation of potential tax reductions. For example, only properties acquired after 1986 are eligible under the IRS ruling, and owners who plan on disposing of their properties in the short-term will not benefit, as the savings are based solely on the time value of money and the benefit could be recaptured upon sale.

"If you acquired property or made substantial improvements after 1986, we can assist you in evaluating your savings," said Mr. Wieder. "A visual inspection will also uncover additional items that may be reclassified to depreciate over a shorter period."

Cost Segregation Consultants recently saved the owner of a 24-property residential portfolio over $9 million on a building cost of $164 million. Owners of a New York City shopping center with a $13 million building cost recently saved $837,000 after their cost segregation study was implemented and applied, an over 9% savings.

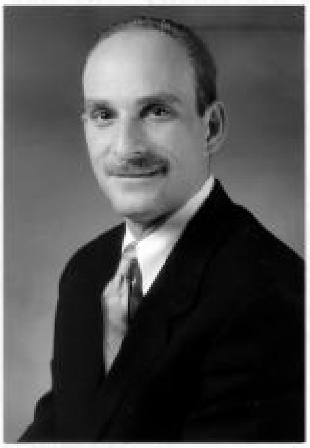
"Your first step is to evaluate whether your properties fit this profile, and whether this accelerated depreciation will help offset any generated income," said Howard Gewirtz, CPA, Managing Director of Cost Segregation Consultants.

For more information about Cost Segregation Consultants and an estimate of the savings on your properties, call Managing Directors Marc Wieder and Howard Gewirtz, at 536-6888.

Why Pay More Than Necessary To The IRS?

Retail property owners can realize substantial tax savings through cost segregation analysis

Marc Wieder



Owners of shopping centers and other retail properties can benefit from an IRS legal memorandum that gives the green light to taking accelerated depreciation deductions on real estate, freeing up valuable cash for property improvements and other investments. The present value of the tax savings of these upfront deductions can be significant. A New York State shopping center which recently received this specialized analysis — known as "cost segregation" — saved over $837,000 on a property valued at over $13 million by reclassifying land improvements, such as site utilities, landscaping, asphalt paving, curbing, exterior lighting and signage, allowing it to qualify for an accelerated 15-year property depreciation. Equipment such as check-out counters, decorative lighting, wall and floor coverings, landlord improvements to tenant spaces, music/intercom systems, railings and automatic door openers are eligible for an accelerated 7-year property depreciation.

Two smaller shopping centers realized $418,000 and $368,000 in savings on properties valued at $7.79 million and $4.38 million, respectively. These benefits are due to a relatively recent court case in which a taxpayer argued that the construction of its property was not one monolithic cost to be depreciated over 39 years, but rather included other assets and components with much shorter lifespans. The taxpayer's court victory, and the IRS's decision not to appeal, resulted in the creation of specific asset classifications which are now eligible for accelerated depreciation.

To realize these new benefits, owners are required to submit proper engineering reports to reclassify certain property from 39-year life assets to 5, 7 or 15 years. While the total deduction over the 39 years does not change, the timing of the deduction does. The present value of this timing element can be significant. For example, the present value of the earnings on the tax savings of a $1 million reclassification with only $100,000 being reclassified as 5-year property, $500,000 as 7-year property and $400,000 as 15-year property is approximately $300,000.

To qualify for reclassification, the property must have been placed in service after 1986. Amended tax returns do not have to be filed, because the IRS has an automatic change procedure that allows taxpayers to file forms with their current tax returns and spread the benefit over 4 years. Current acquisitions or improvements can be classified correctly initially, with the benefit accruing beginning with the current year. Obviously, before undergoing any cost segregation analysis, you must determine if the benefit outweighs the cost. While the cost of the analysis should be relatively inexpensive compared to the ultimate tax savings, the following questions should be asked:

- Does accelerating depreciation help the taxpayer? (i.e., is the taxpayer currently generating taxable income?)
- When was the property placed in service (post 1986)?
- Are there plans to dispose of the property in the short term? (The projected length of owning the property is important because the savings are based solely on the time value of money).
- How large is the property? (A $1 million to $2 million building, which may result in reclassification of about 10 percent of its total value, will generally produce enough savings to justify the cost).
- What type of property is it? (Shopping centers are extremely good candidates, as are hospitals, manufacturing facilities and residential projects with a lot of site improvements).

If your property meets the characteristics described above, the next step is to contact a qualified accounting professional and have them schedule a site visit. Once the building site plans, engineering reports, appraisals and business tax returns are gathered, your accountant should review the results to see just what savings can be generated. The result will hopefully more than justify the effort. **SCB**

Marc Wieder, is managing director of Cost Segregation Consultants, LLC, a national service practice dedicated to identifying and securing tax savings for property owners. He is based in the firm's New York City office.

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New York Law Journal

Your Money Matters

Depreciating Property? Good News

By STEVEN D. LANDO, CPA

If you and your clients are still depreciating real estate over 27.5- and 39 year lives,do I have news for you: Hospital Corporation of America v. Commissioner, 109, T.C. 21 (1997). The broad impact of this decision was confirmed on May 28, 1999, when the IRS chief counsel's office responded to an internal request regarding the Tax Court's decision. The chief counsel's memorandum addressed both the application and implementation of the above (see below). It is only recently, however, that tax and real estate professionals have begun to avail themselves of the benefits of the decision.

Historical Perspective

Real estate and tax specialists have seen a myriad of depreciation methods and lives since the early 1980s. Everything from component depreciation[1] through continuously changing depreciable lives of 15, 18, 19, 27.5, 31.5 and 39 years (currently 27.5 and 39 years for residential and commercial real estate, respectively).

In 1981, Former President Ronald Reagan, utilizing supply-side economics in an effort to stimulate a stagnant, inflation-riddled economy, significantly reduced both tax rates and depreciable lives with the enactment of the Economic Recovery Tax Act (ERTA). An unfortunate consequence of ERTA was the death of the component method of depreciation under the new Accelerated Cost Recovery System (ACRS).[2] The Tax Reform Act (TRA) of 1986 replaced ACRS with the Modified Accelerated Cost Recovery System (MACRS) which continued the prohibition of component depreciation.[3] The ban on using component depreciation, and anything resembling such, has been vigorously enforced by the IRS - until now.

'Hospital Corporation'

The Hospital Corp. of America (HCA) owned, operated and managed 10 different categories of hospitals and related facilities. HCA argued that the construction of each hospital or medical facility was not one monolithic cost to be depreciated as IRC §1250 real property[4] over 39 years, but that some items should be depreciated over accelerated,five-year lives as IRC §1245 tangible personal property.[5] Petitioner argued not for the reinstatement of component depreciation but that these items were not real property to begin with. The IRS argued that the court, by allowing such, would in effect be allowing the use of component depreciation.

The items at issue included: (1)primary and secondary electrical distribution systems; (2)branch electrical wiring, connections and special electrical equipment; (3)wiring and related property items in connection with television equipment; (4)conduit floor boxes, power boxes and outlet jacks relating to telephone equipment; (5)electrical wiring, conduit and connections related to internal communication systems; (6)carpeting; (7)vinyl wall coverings; (8)vinyl floor coverings; (9)kitchen water piping and steam lines; (10)special plumbing connections relating to X-ray equipment; (11)kitchen hoods and exhausts systems; (12)corridor handrails; (13) accordion doors/partitions; (14)overhead lights and related electrical connections; (15)bathroom accessories and partitions; (16)acoustic ceiling tiles; and (17)steam boilers and related accessories.

The Tax Court, much to the chagrin of the IRS, agreed with the petitioner deciding that the above items associated with the hospital and related facilities could be bifurcated between real and tangible personal property, and depreciated over shorter - e.g., five-year-lives.[6]

The Tax Court, in analyzing the issues, reviewed the legislative history applicable to real and tangible personal property under both ACRS and MACRS as well as the intent of Congress in eliminating component depreciation. MACRS continued the ban on component depreciation by providing that improvements made to real property are depreciated using the same recovery period applicable to the underlying property as if the underlying property was placed in service at the time the improvement was made. The court, however, that it was not Congress' intent to redefine IRC §1250 real property to include tangible personal property that would have been IRC §1245 tangible personal property.

In determining what constitutes tangible personal property, the Tax Court looked at the tests developed under prior case law to determine which assets should be characterized as a structural component (treated as part of the building) due to its inherently permanent nature. The court relied on those factors established in Whiteco Industries, Inc. v. Commissioner, 65 TC 664 (1975), which include:

- Is the property capable of being, or has it in fact been, moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that show that the property may, or will have to be, moved?
- How substantial a job, and time consuming, is the removal of the property?
- How much damage will the property sustain upon its removal?
- What is the manner of affixation of the property to the land?

HCA had identified structural components by relying on the analogous factors that were determinative in ascertaining whether property was eligible for the investment tax credit.[7] The relevant income tax regulations define structural components to include walls, partitions, floors, ceilings, plumbing fixtures, electric wiring and lighting fixtures, stairs, escalators, elevators, sprinkler systems, fire escapes, and other components relating to the operation or maintenance of the building. However, a structural component does not include machinery, the sole justification for the installation of which is that it is required to meet temperature or humidity requirements essential to the operation of other machinery, processing of materials or foodstuffs.[8]

The Tax Court had to determine whether the nature of the property at issue related to the operation and maintenance of the building and, thus, was IRC §1250 real property, or was it related to the operation of equipment and, therefore, was IRC §1245 tangible personal property. In its analysis, the court followed the rationale of Scott Paper Co. v. Commissioner, 74 T.C. 137 (1980) in determining, for instance, that while wiring is an example under the regulations, it is not a structural component unless it is related to the operation and maintenance of the building. In reviewing the items at issue and the regulations, the court concluded as follows:

- Items 1 and 2 were part real and part tangible personal property.
- Items 3-13 were tangible personal property depreciable over a five-year life.
- Items 14-17 were structural components, partly due to the fact that sufficient evidence was not offered by the taxpayer to support the treatment as IRC §1245 property.

Counsel's Memorandum

On May 28, 1999, as noted above, the IRS chief counsel's office issued a memorandum in response to an internal request regarding the Tax Court's decision in the Hospital Corp. case The memorandum indicated the following:

- The determination of whether an asset is a structural component or tangible personal property is a facts and circumstances assessment.
- The use of an expert-prepared "Cost Segregation Study" (CSS) must be specifically applied by the taxpayer.
- An accurate cost segregation study may not be based on non-contemporaneous records, reconstructed data, or unsupported taxpayer's estimates.
- A change in computing the depreciation allowances with respect to a particular account is a change in method of accounting requiring a form 3115 filing, and not am ended tax returns.

This last aspect is extremely important as it allows taxpayers to recalculate the depreciation deduction as if the property had been classified using the shorter life, picking up the additional deduction over the next four years. For example, if property with an original basis of $100,000 were reclassified from 39-year real property to five-year personal property after year six, an additional depreciation deduction of approximately $19,000 would be allowed in each of the next four years.[9] Current acquisitions or improvements can be classified as personal property initially, with the tax benefits beginning with the current year.

Cost Segregation Study

A CSS is an in-depth analysis of the costs of a real estate project so as to segregate those items that would qualify as IRC §1245 personal property eligible for accelerated depreciation deductions. The study is performed by a qualified engineer and, in some instances, done with the assistance of a qualified tax specialist. However, not all engineers are capable of preparing the study. Without performing a CSS, the accelerated depreciation deductions will not be available to the taxpayer. This in-depth analysis was the basis for the favorable verdict rendered by the Tax Court in Hospital Corp.

The initial determination for doing a CSS should first focus on the taxpayer and that there is a benefit available from accelerating depreciation deductions. Once that determination is made, cost segregation studies would apply to the following properties:

- property placed in service after December 31, 1986;
- commercial office buildings;
- leasehold improvements including offices, - e.g., law firms;
- manufacturing facilities;
- medical facilities;
- residential property with substantial site improvements;
- large warehouses with numerous site improvements; and
- special-purpose storage facilities,- e.g., frozen food facilities.

However, this may be of little benefit for properties that will be sold within a short period of time (due to depreciation recapture). The benefits of a CSS in reclassifying property are based upon the net present value of taxes saved. For example, reclassifying 10 percent (a conservative estimate) of a $10 million commercial real estate project from 39 years to five, seven - and 15-year personal property, would generate additional depreciation deductions of $600,000 in years one through eight alone,[10] resulting in a benefit of approximately $300,000 (NPV compounded at 8 percent). Residential property (27.5-years) reclassifications would result in a smaller benefit.

For taxpayers that record depreciation differently for book vs. tax, the results can be even more significant. Consider a law firm that, for book and capital account purposes, amortizes leasehold improvements over the lease term (typically 10-15 years). For tax purposes, the improvements are depreciated over 39 years. As such, there is a larger charge against current partners book capital accounts then for tax (in effect - phantom income).

For partners retiring within the lease term, their capital accounts are reduced faster than they received tax benefits. However, for partners who join the firm during or after the lease term but well before the 39 years have expired, they may receive little or no charge to their capital accounts but will receive the tax depreciation deductions over the remainder of the improvements 39-year life. By properly reclassifying those improvements based on a CSS, there is a more equal matching of book and tax income.

(1) Component depreciation was the method whereby an item of property (building), was fragmented into its various elements, e.g.- shell, plumbing, wiring, etc., applying a separate useful life and salvage value to each component.

(2) IRC §168 applies to property placed in service generally after December 31, 1980, replacing IRC §167.

(3) IRC §168 (f)(1) no longer permitted the component method of depreciation under ACRS. This section was replaced by IRC §168 (i)(6) under MACRS.

(4) IRC §1250 defines real property as any real property (other than IRC §1245(a)(3)property) which is or has been subject to the allowance for depreciation provided in §167.

(5) IRC §1245(a)(3) defines tangible personal property, in part, as property which is or has been subject to an allowance for depreciation as provided in §167 and is either (A) personal, (B) other property (not including a building or it's structural components). (6) MACRS generally provides depreciable lives of 5 years for equipment and 7 years for furnishings.

(7) IRC §48 as it related to the definition of IRC §38 - investment tax credit property.

(8) Income Tax Regulation 1.48-1(e)(2).

(9) Five-year property under MACRS would be fully depreciated in year six due to the half-year convention. Assuming the non-residential real property was placed in service in July, the cumulative depreciation under MACRS would have been $13,997. The difference of $86,003, less the annual depreciation that would have been allowed of $2,564 is taken as a negative IRC sec 481A adjustment in each of the next four years. $86,000/4 = $21,500 - $2,564 = $18,936.

(10) This is based on reclassifying the 39-year property as five-, seven-, and 15-year property of $100,000, $500,000 and $400,000 respectively.

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