COST SEGREGATION AND THE ROLE OF THE CONTRACTOR

Contractor participation in a cost segregation study requires surprisingly little time and effort, compared to the long-lasting business relationship it will ultimately establish with the project owner.

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Cost segregation is a unique tax strategy that property owners utilize to accelerate depreciation deductions and increase their cash flow. Over the last several years, cost segregation has become much more widely used by knowledgeable real estate investors. The IRS has issued detailed guidance that clearly illustrates what a project owner needs to have to support depreciation deductions.

The relationship between the contractor and the owner of a construction project has evolved over the years. Today's more knowledgeable contractors are able to capitalize on additional skills, such as cost segregation, to enhance their relationship with current or potential clients. Contractors who are new to cost segregation may not appreciate how valuable a resource it can be. However, it is an invaluable skill for any contractor to learn.

To fully understand why, and more important, how contractors can expand their services, let's first review the cost segregation process.

First we will describe the basic theory of cost segregation. After understanding the underlying theory and the documentation needed to support a well-done study, you will see the critical role an experienced contractor brings to a cost segregation project.

The next section of this article describes the process of the study and the role of a contractor as a resource. We will also discuss common concerns and advantages of participating in the study, including suggestions on how to best assist a client performing a cost segregation study.

In conclusion, we will demonstrate that contractor participation in a cost segregation study requires surprisingly little time and effort, compared to the long-lasting business relationship it will ultimately establish with the project owner.

Theory of cost segregation

Cost segregation is a tax strategy used to increase cash flow by accelerating tax depreciation deductions for taxpayers who have constructed, purchased, expanded, or remodeled a facility. According to the Internal Revenue Service, depreciation for real estate must be spread out over several decades rather than deducted all at once. For income-producing residential property, depreciation must be spread over $27^1/_2$ years. For commercial property, depreciation must be spread over 39 years.

There is also other property that qualifies for depreciation deductions. The tax law also proscribes tax lives for all other property that qualifies for depreciation deductions. The property that cost segregation concentrates on is property with tax lives of 5, 7, and 15 years. This is illustrated in

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EXHIBIT 1 Tax Lives

Property Classifications	Description	Depreciable Life
Commercial Property	Structural components of a building or those needed for the operation and maintenance of the building.	39 years
Income-Producing Residential Property	Structural components of a building or those needed for the operation and maintenance of the building	$27\frac{1}{2}$ years
Personal Property	Assets that aren't necessary for the operation and maintenance of the building, for example specialized plumbing, wiring, and equipment.	5 or 7 years
Land Improvements	Investments in outdoor features of the property.	15 years

Exhibit 1. Instead of depreciating an entire project over $27\frac{1}{2}$ or 39 years, cost segregation is used to identify and "reclassify" property qualifying for these shorter tax lives. Reclassifying assets to shorter depreciable lives results in accelerated depreciation, deferring federal and/or state income taxes to later years.

Depreciation is a method of recovering the cost of a project through tax deductions. These deductions are called depreciation. If a project owner owns a property for $27\frac{1}{2}$ or 39 years, the owner is going to recover its costs through these depreciation deductions over a 30-to 40-year period of time. If the owner is able to segregate some of these costs into shorter tax lives of 5, 7, or 15 years, the owner will achieve larger depreciation deductions in the earlier years of the investment. This translates into lower income taxes and increased cash flow.

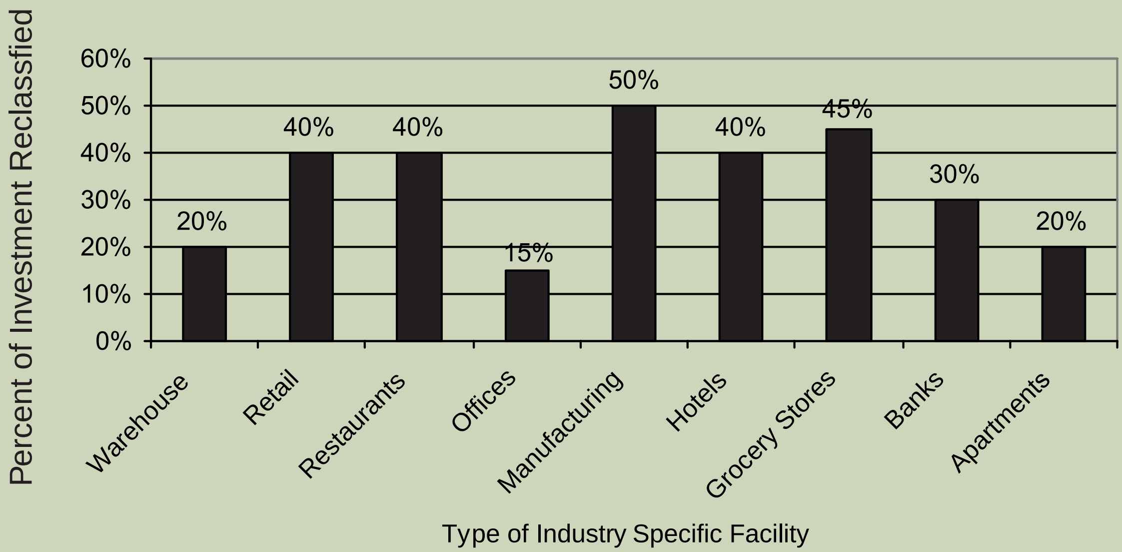
Two recent tax acts—the 2002 Job Creation Act and 2003 Jobs and Growth Act—have provided property owners with even more incentive to identify property in their projects with shorter tax lives. Until January 1, 2005, certain properties qualify for "bonus" depreciation. Bonus depreciation allows for an additional 30% or 50% first-year depreciation allowance. These taxpayer-friendly laws apply to new property such as remodeling, expansion, or new construction projects. A project owner can write off either 30% or 50% of the cost of a 5-, 7-, or 15-year property in one year in addition to the depreciation provided by IRS tables.

When a cost segregation study is conducted, it's not uncommon to identify and reclassify as much as 40% or more of a project's costs. For example, on a recent project costing $4.5 million, the project owner was able to reclassify $115,000 in first-year depreciation from a 39-year timeline into $235,000 on an accelerated timeline. This resulted in an increased write-off of 205%. Results like this make a huge impact in terms of tax benefits. If the previous example had qualified for 50% bonus depreciation, the additional first-year depreciation would have been $1,031,000—an increase of 900%. Keep in mind that results will vary by industry because different types of property naturally have different features that can be reclassified.

The Exhibit 2 bar chart illustrates the percentages of project costs that may be reclassified per building type.

Now that depreciable lives for certain assets are written in black and white, it may seem as though anyone could perform a cost segregation analysis on any given facility. That would be an incorrect assumption. A cost segregation study requires a team of analysts with skills in construction and engineering along with skills in tax law and accounting practice to understand an owner's tax situation. In fact, the IRS has recognized an accurate cost segregation study to utilize a systematic engineering approach that "may not be based on non-contemporaneous records, reconstructed data, or taxpayer's estimates or assumptions that have no supporting records."[1] The legitimacy and importance of accurate cost estimates and quantity take-offs create a vital role for the contractor.

EXHIBIT 2 Percentage of Investment Reclassified Per Industry Type



The process of cost segregation

The following describes a general step-by-step description of the cost segregation process.

Step 1. Information gathering—Identifying assets in the facility.

- For new construction projects, drawings and specifications are examined to identify all assets that may qualify for accelerated depreciation.
- For new construction or a leasehold improvement, contractor's certificate of payment, change orders and invoices are reviewed and reclassified into their appropriate asset classifications.
- For every project, a site visit is conducted, further verifying assets examined from construction documents.

Step 2. Information analysis—Appropriating costs to each asset in the facility.

- Use the information gathered to compile a list of assets that require a further detailed cost breakdown.
- For information not readily available, a visit to the facility is necessary to identify any remaining assets. The cost of the assets are then estimated using nationally recognized cost-estimating manuals.

Step 3. Reporting—Documenting process and results.

Documentation of the cost segregation process and results is essential to the success of the study. The report will allow for discussion between the analysts and the client ensuring that both parties understand and are in agreement with the results and expectations of the study. Furthermore, the report will be the support required by the IRS.

A written report includes:

- Background information about the project.
- Descriptions of asset classifications.
- Supporting information, including: photographs, references to court cases, revenue rulings, tax citations, and any other additional resources specific to each study.

Given the importance of accurate costs for each asset, gathering information is vital to the success of the cost segregation studies. The contractor serves as a vital resource for these activities.

After the short-life assets are identified, the next step is to associate costs to each asset. A schedule of values serves as a general resource to finding accurate project costs. Since each project is unique in cost documentation, it is not accurate to rely

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solely on the schedule of values as the only cost resource. Detailed costs are vital to the accuracy of the study. In some instances contractors are able to provide a more detailed cost report or bid detail. If this information is not available, invoices and work orders are also helpful. Other resources for costs include a schedule of payments from subcontractors for a given project and/or purchase orders from vendors and suppliers. Detailed change orders are also essential for accurate project costs.

Because assets must go through a series of tests to qualify for a shorter tax life, a working relationship between the cost segregation analyst and the project contact (superintendent, project manager, or project engineer) is essential. It is not uncommon for the cost segregation analyst to have questions regarding the function of a certain asset and how it was constructed. One of the more common tests is to understand the removability of an asset and how the configuration can be easily relocated or detached from the building. Another question of importance to the analyst is if the asset requires constant maintenance. These questions are a few examples requiring the expertise of the contractor.

Common concerns of the contractor

There are some concerns contractors have when participating in a cost segregation study. The most common concern is timing. Most owners perform a cost segregation study after the building is completed and occupied. Such timing requires contractors to have to dig into archived files in order to obtain specific information for the past project. Contractors and builders vary on their project documentation and recordkeeping; however, referencing documentation for specific costs after a project has been closed out and documents archived is a time-consuming process no matter how sophisticated the system.

In addition, time is a common concern for contractors. Due to the nature of construction, contractors and administrative supports are heavily focused on current projects and clients. With the intense demands of construction projects and their deadlines, there is simply not enough time in the day to attend to past projects while working on current projects. Naturally, the priority is towards the current project with daily deadlines.

And finally, contractors may be concerned with giving away too much information. Whether the relationship between a client and the contractor is negotiated or awarded through a bid, contractors may resist providing detailed project cost information for fear that they are giving away competitive secrets. For this reason, contractors may hesitate when detailed cost reports or estimates are requested.

Suggestions for the contractor

The following are suggestions for contractors participating in the cost segregation process.

Suggestion #1: Try to encourage clients to initiate cost segregation studies sooner rather than later. Performing a study before a project is archived will save the contractor time from searching for past documentation. In addition, any questions an analyst may have concerning specific assets are easily answered as the construction project is still fresh in the mind of the contractor or engineer. If a contractor prepares for a cost segregation study before the project is archived, the efforts and time for the study could be part of the close-out or even the close-out budget.

Suggestion #2: In order to control when a cost segregation study may occur, inform your client of cost segregation services during the project. Cost segregation is a tax strategy that's on the rise. If a client is already thinking about a cost segregation study, it's beneficial to the contractor to discuss its benefits before the project closes out. Informing a client about the potential benefits of cost segregation will also provide value-added service to the client.

Suggestion #3: The most efficient way to provide services to a client utilizing a cost segregation study is to work with the analyst. Teamwork between the contractor and the cost segregation analyst ultimately saves time. The contractor should allow the analyst to explain what exactly he/she will require before the contractor begins to research costs. The contractor may or may not have a more efficient method of obtaining the costs for specific assets. Because construction documentation is specific to each project, an analyst should keep an open mind when researching costs. As a result, a team effort between both parties must exist. An analyst must be specific about what assets need costs. A contractor must specifically let the analyst know how costs will be researched and obtained. If a contractor is uncomfortable sharing specific unit or bid costs, lump sum assembly costs are generally sufficient for the study. In most cases, a lump sum cost (material and labor) is all that is required for the study. When teamwork between the analyst and the contractor is a success, the client will witness the willingness of both parties to provide the best service. At this point, cost segregation serves as a marketing tool.

Future of cost segregation

The future of cost segregation is bright. Timing regarding when the study is performed leads to success for all parties involved. Although atypical, cost segregation is most beneficial during the preconstruction phase for construction projects. Like value engineering, cost segregation services should be available during and throughout construction. Moreover, a building design may result in more tax benefits if an analyst is available during the preconstruction and design phases. Just as value engineering benefits the owner's budget, cost segregation can benefit the owner by means of tax savings. Also, with a cost segregation analyst on board in the very beginning of the project, a proper tracking mechanism for costing specific assets can be set in place, enabling analysts to have the most accurate results. Furthermore, early tracking of costs will make the data-gathering process nearly effortless for the contractor once the project is complete. If a project does not have cost segregation involved in the early stages of development, the second best time for the study is during close-out, as previously recommended.

Conclusion

Clearly, cost segregation provides great benefits. First and foremost, it provides immediate benefits to the property owners. For contractors, it provides opportunity to offer additional services to clients. Cost segregation analysts depend on the working relationships with contractors and their project documentation for accuracy. Teamwork between an analyst and a contractor will shine through to provide value-added services to the client. ■

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1 IRS Legal Memorandum (ILM 199921045) (1999 TNT 104-65 4/1/99).