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How Project Owners Can Obtain Faster Write-Offs of Their Building Costs and Increase Their Cash Flow

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EXECUTIVE SUMMARY

- Real estate owners are always interested in opportunities to increase the cash flow from buildings that they are either using in their own businesses or leasing to third parties.
- Cost segregation studies can provide increased cash flow to a project owner by accelerating depreciation deductions.
- The use of cost segregation techniques can allow a contractor to obtain a competitive advantage in bidding a project.

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Real estate owners are always interested in opportunities to increase the cash flow from buildings that they are either using in their own businesses or leasing to third parties. Many times cash flow from a real estate project is one of the deciding factors owners consider when deciding whether or not to purchase, construct, or improve a facility. One way to increase cash flow on a real estate project is to depreciate it over a shorter life than the 39 or 27.5-year period required by the Internal Revenue Service.

PURPOSE OF COST SEGREGATION

Cost segregation studies can provide increased cash flow to a project owner by accelerating depreciation deductions. Cost segregation is a tax strategy that has been around for a long time, but not commonly used or understood. A cost segregation analysis involves reviewing the costs incurred to acquire, construct, or improve real property. The result of the analysis is a classification of the purchase, construction, or improvement costs into specific types of assets associated with the facility. These costs are then assigned a tax depreciation life ranging from 5 to 39 years depending on their function.

The Internal Revenue Service (IRS) requires, for federal income tax purposes, that real property be depreciated using a straight-line method over either 27.5 years for residential real property or 39 years for non-residential real property. Most equipment and furnishings of a building are depreciated using a 200% declining balance method over 5 or 7 years depending on the industry the project owner is in. Land improvements associated with real property are required to be depreciated using a 150% declining balance method over 15 years. If a cost segregation study is performed for a project, the amount of the total project costs depreciated over 27.5 or 39 years can be greatly reduced. This will result in the project owner's ability to depreciate more of the project's costs over 5, 7 or 15 years. This quicker write-off of the project's construction costs results in increased cash flow to the project owner by deferring the payment of federal and state income taxes.

IDENTIFYING ASSETS THAT QUALIFY FOR ACCELERATED DEPRECIATION

The purpose of a cost segregation study is to identify the components of the building project costs that can qualify for reclassification into shorter depreciable lives. To do this a detailed review of the project drawings and specifications is required. Also a visit to the facility should be made to ensure that all qualifying personal property and land improvement assets have been identified. From these reviews, all construction-related assets that qualify for accelerated depreciation can be identified. Items that qualify for accelerated depreciation are those that would not be considered a structural component of the building under the IRS criteria. A structural component is defined as one that would damage the building structure if it were removed. Other factors to consider are:

1. Is the property capable of being moved?
2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances which show that the property may or will have to be moved?
4. How substantial a job is removal of the property and how time consuming is it? Is it readily removable?
5. How much damage will the property sustain upon its removal? and
6. What is the manner of affixation of the property to the land?

If the component is easily removed without damage to itself or the building structure, it generally will qualify for a shorter depreciable life.

For manufacturing facility projects, if a component of the construction costs is an integral part of the manufacturing production process, it can usually be classified into a shorter depreciable life. A structural component is defined primarily by the item's function and should be interpreted narrowly to include only items that relate to the overall operation and maintenance of the building. A structural component of a building does not include items necessary for (and relating to) the operation of specific tangible personal property. Both mechanical and/or electrical distribution systems that are used directly with specific items of machinery or equipment have been considered to be part of the equipment they support and thus depreciable over the same life as the machinery or the equipment. The most common types of construction costs that may be reclassified are in the electrical and plumbing areas. For example, specialty wiring to run restaurant equipment or manufacturing machinery are necessary for (or relate to) the operation of specific tangible personal property and thus qualify for shorter depreciable lives.

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ASSIGNING A COST

After the construction-related assets that qualify for accelerated depreciation are identified, then a cost must be assigned to them. This part of the cost segregation analysis is accomplished by reviewing construction contract pay requests, change orders, and invoices. If a specific cost for an item is not identifiable through the project cost documents, then construction cost estimating methods are utilized to determine the cost of the item.

The construction project's indirect costs, such as contractor's general conditions, architectural and engineering fees, and permits are allocated to all the project-related assets on either a functional or a pro rata basis.

The best time to consider a cost segregation analysis is in the planning phase of the project. This allows the contractor to isolate and record all of the costs for the qualifying items as they are incurred instead of waiting until the conclusion of the project. This also provides the project owner with the highest level of detail to support the classification of costs.

CASE LAW, REGULATIONS, AND REVENUE PROCEDURES

In 1997 the U.S. Tax Court ruled, in *Hospital Corporation of America*, that property qualifying as tangible personal property under the former investment tax credit (ITC) rules would also qualify in the same manner for purposes of federal income tax depreciation. In the *Hospital Corporation of America* case, a substantial amount of the investment in building systems, such as electrical and mechanical components, wall coverings, and floor coverings were depreciated over 5 years using accelerated depreciation rather than over the 18- or 19- year period required under prior depreciation law at the time the assets were placed in service. Thus, there is authority to rely on the former ITC regulations, rulings, and court decisions when determining whether property should be depreciated as real property over 39 or 27.5 years, land improvements over 15 years, or personal property over 5 or 7 years.

In 1999, the IRS released an IRS Legal Memorandum (IRS Legal Memorandum 199921045) in which it announced its acquiescence to the theory of the *Hospital Corporation of America* case. The memorandum indicates that the IRS will not contest the reclassification of building costs into different asset categories that result in shorter depreciable lives. However, the IRS advises its field agents to determine that the project owner's reclassification of these costs is based on a detailed cost segregation study by qualified professionals. Without a qualified engineering or architectural study, the reclassification of costs into accelerated depreciation lives will not withstand an IRS audit. For this reason, it is advised to seek the assistance of professionals who deal specifically in this area and who, if necessary, can enlist assistance from engineers. Engineers are often better suited to perform detailed cost segregation analysis, as a result of their knowledge of how a facility is constructed and their cost-estimating experience. In addition, an engineer can perform a cost segregation analysis on an existing building as well as a newly constructed one.

Cost segregation studies can be performed for newly constructed facilities, remodeled or rehabilitated facilities, or newly purchased facilities. For a newly purchased facility it is best to have an engineer involved in the analysis since the purchase price must be allocated among the components of the building based on the building plans and layout.

The best time to classify property between personal property and real property is in the year of purchase, construction, or remodel. But it is also possible to reclassify the purchase, construction, or remodel costs in a later year. The IRS has determined that a change in the method of computing depreciation is a change in accounting method. Normally changes in accounting methods require the permission of the Commissioner of the Internal Revenue Service. The IRS has provided an automatic consent procedure in Revenue Procedure 99-49 that permits a taxpayer who claimed less than the allowable depreciation or amortization, to change the method of accounting to claim the allowable depreciation or amortization.

The automatic consent procedure of Revenue Procedure 99-49 requires that a taxpayer who meets the requirements of the Revenue Procedure, complete and file a current Form 3115, Application for Change in Accounting Method, with the timely filed (including extensions) original federal income tax return for the year of change, and file a copy of the Form 3115 with the National Office of the IRS by the date the original is filed. If a change in accounting method results in additional revenue or expense, Sec. 481(a) of the Internal Revenue Code describes the procedure for the timing of such adjustments. The adjustment from a change in the depreciation method is taken into account in computing taxable income ratably over a four-year period, beginning with the year of change. Revenue Procedure 99-49 also provides a de minimus rule when the Sec. 481(a) adjustment is less than $25,000. This rule allows the taxpayer to elect to use a one-year adjustment period.

The Sec. 481(a) adjustment equals the difference between the total amount of depreciation taken into account in computing taxable income for the property under the project owner's present method of depreciation and the total depreciation allowable for the property under the project owner's proposed method of depreciation for any taxable year prior to the year of change.

> Example: Project Owner built a manufacturing facility for $5,000,000 not including the cost of land in 1997. All of the construction costs for the facility were capitalized and depreciated over 39 years. In 2001, Project Owner had a cost segregation study performed for the facility. The study resulted in 20% of the construction costs being reclassified as personal property depreciable over 7 years and 15% of the construction costs being reclassified as land improvements depreciable over 15 years. For the years 1997-2000, Project Owner was allowed $454,060 of depreciation under the original deprecation method. For the same time period, the depreciation that would have been allowed under the proposed method would have been $1,213,364. This results in a Sec. 481(a) adjustment of $759,304. Project Owner will be able to deduct this amount ratably on his tax returns over the next four years. Project Owner's tax returns for the years 2001 through 2004 will reflect an additional depreciation deduction of $189,826.

BENEFITS OF COST SEGREGATION

The benefits that result from a cost segregation study will vary depending on the type of facility constructed, remodeled or purchased. Examples of facilities that cost segregation studies can be performed for are warehouse, retail, restaurant, office, manufacturing, food processing, banking, hotel, and apartment facilities. The more equipment and process intensive a facility is, the better the resulting benefits will be. For example, a warehouse facility that is mainly a building structure will not require much in the way of specialized equipment wiring or plumbing and mechanical connections. Therefore a cost segregation study for such a warehouse would probably only result in 20% of the construction costs reclassified to lives less than 39 years. On the other hand, a manufacturing facility that relies heavily on equipment will require specialized electrical, plumbing, and mechanical connections and other specialties to enable the equipment to operate and the manufacturing process to function. A cost segregation study for a manufacturing facility may result in 30% to 50% of the construction costs being reclassified to lives less than 39 years, depending on the intensity of equipment used in the manufacturing process.

To accurately compute the benefits from a cost segregation study it is necessary to analyze the net present value of the tax deferral. In other words, determine the time value of money on the tax dollars being deferred today and in the future. How much can a project owner expect to save?

> Example: Project Owner builds a manufacturing facility for $5,000,000 not including the cost of the land. If all of the costs are allocated to 39-year real property, he can expect approximately $128,200 of depreciation per year. Project Owner has a cost segregation study performed for the facility. As a result of the study, he can reclassify 20% of the construction costs to personal property with a

The benefits that result from a cost segregation study will vary depending on the type of facility constructed, remodeled or purchased.

depreciable life of 7 years and 15% to land improvements with a depreciable life of 15 years. Due to the cost segregation study, Project Owner's depreciation expense for the facility will increase by approximately $730,000 over the first five years the facility is placed in service. The net present value of the federal and state income tax deferral over the life of the project, discounted at 7% and based on a 45% combined federal and state income tax rate, will be approximately $270,000.

Properly allocating costs with respect to a project owner's real property is an underutilized tax-planning opportunity. It has been over four years since the Tax Court's decision in *Hospital Corporation of America* provided guidance and support for the use of the investment tax credit rulings and law in reclassifying the construction costs of a project and it has been two years since the IRS' announcement to its auditors to follow the *Hospital Corporation of America* decision. This is a good time to become acquainted with the benefits that can result from a cost segregation study. Project owners wanting to capitalize on this opportunity should be sure to document their analysis of the personal property components of their facility. This should be done by professionals trained in the area of cost segregation, including cost engineers and tax accountants.

The cash flow benefits of providing cost segregation studies for contractors' project owners can be significant. The use of cost segregation techniques can allow a contractor to obtain a competitive advantage in bidding a project. Even if the project owner is aware of the benefits and importance of a cost segregation study, contractors that understand and can facilitate the process will allow owners to achieve greater tax benefits at a lower cost. By getting a cost segregation professional involved early in the construction project, the burden of collecting data on the contractor is lessened. If early on during the project, the contractor is aware of the cost information that will be needed to facilitate the cost segregation analysis, it will be much easier for the contractor to provide the level of detail that serves to improve the benefits that a project owner can realize from a cost segregation study. If a project owner was not aware of the benefits of a cost segregation study before his contractor brought it to his attention, he will be grateful to the contractor for doing so. The goodwill generated from these studies may give the contractor a competitive advantage on future projects. ■