



COST SEGREGATION

**Commercial Real Estate Hot Spots:
Cost Segregation Studies
Presentation to the Columbia
Society of Appraisers**

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Presented by:
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Your Presenter

Joel Ackerman, Tax Principal, Grassi & Co. CPAs

- **Leading regional CPA firm to the real estate/construction industry**
- **Full service tax, accounting and consulting services**
- **Big enough to get the job done; small enough to care**
- **15 years of progressive experience in real estate taxation matters; specialty in consulting areas**
- **Experience in all aspects of the real estate arena**
- **Strong relationships across real estate industry**





Solving Client Problems

Problem: Real estate client thinks he/she is paying too much in taxes

Solution: Make yourself look good and save the client tax money—suggest a cost segregation study!

COST SEGREGATION

Some see buildings.

You see opportunities.

**A Cost Segregation
Study can help!**



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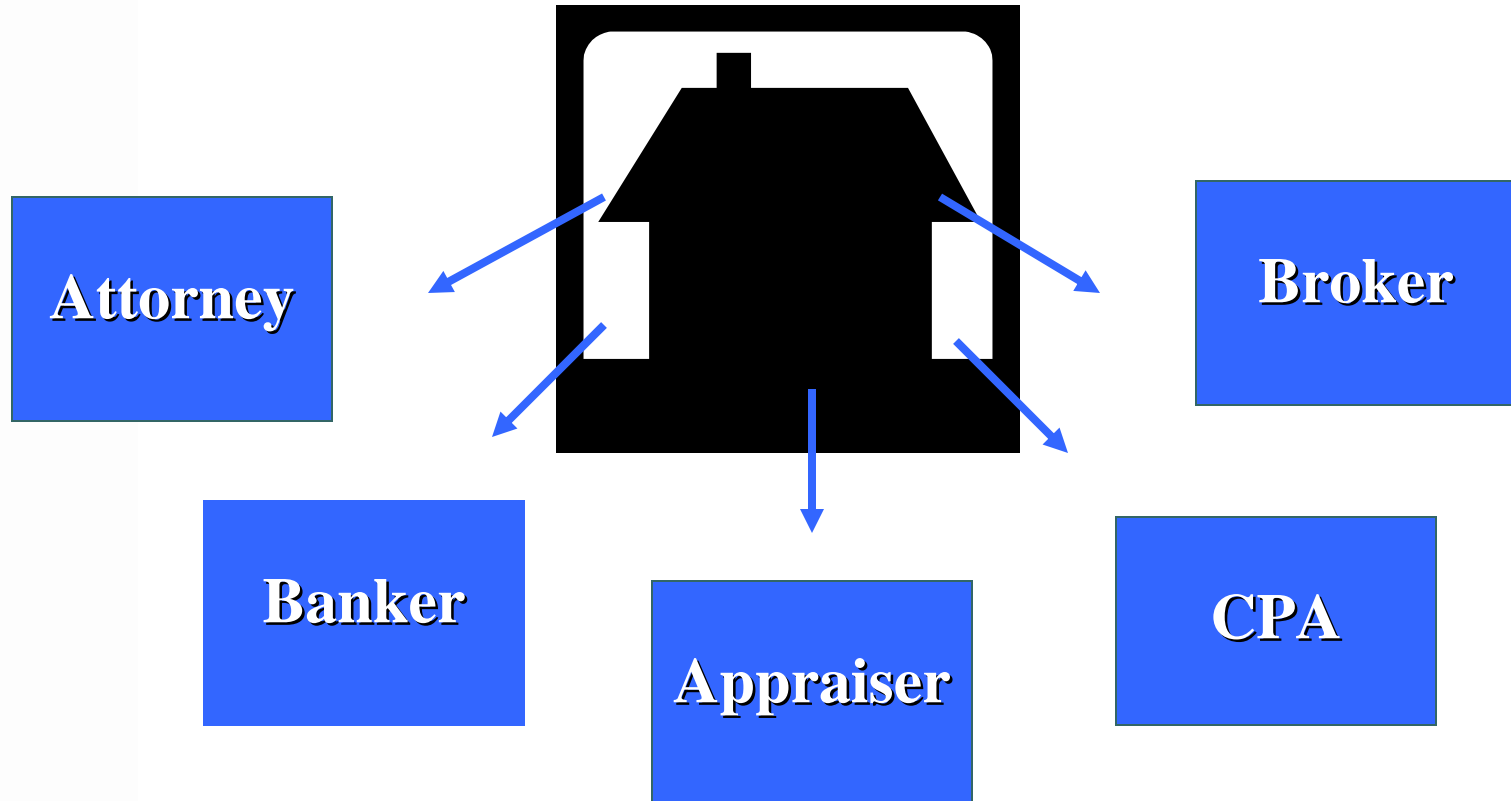


Our Agenda

- **What is Cost Segregation?**
- **Brief Overview on Depreciation**
- **Benefits of Cost Segregation**
- **Reclassified Items**
- **Examples**
- **Recent IRS Developments**
- **Cost Segregation Study Approaches**
- **Wrap-up**

Cost Segregation Studies Are A Good Idea, No Matter Who Suggests Them!

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Cost Segregation

Has your client recently **Constructed**, **Acquired**, or **Inherited** any real estate property?

Depending on when the property was placed into service, Cost Segregation provides an immediate valuable tax savings opportunity.

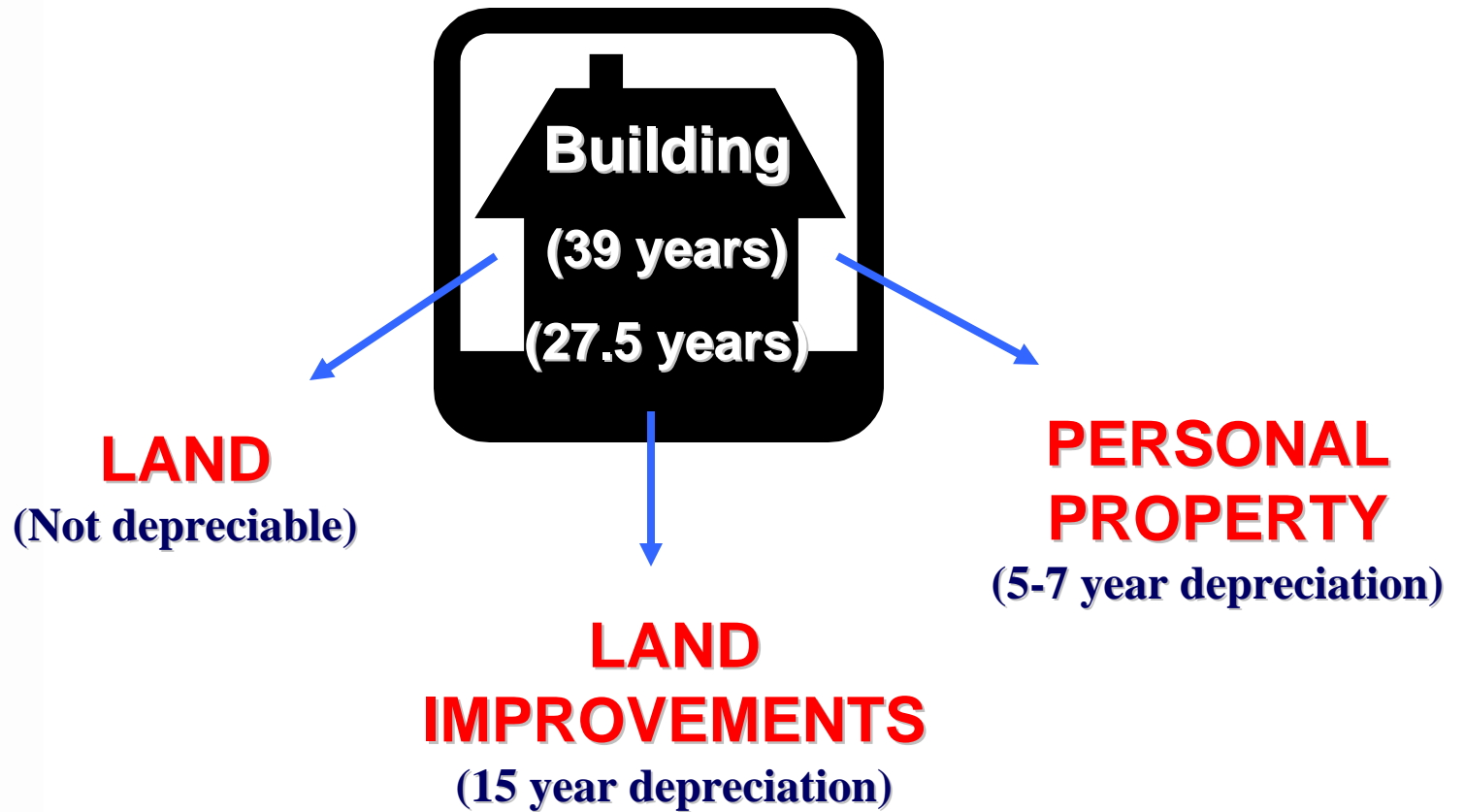


What is Cost Segregation?

- o A tax-deferral technique for real property owners
 - o Identifies items and their costs included in the construction or acquisition of a facility
 - o Qualifies such items for shorter recovery periods and accelerated depreciation

➤ **Benefits of study far outweigh costs!**

Classifications



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Acme Warehousing Corp.

Profitable Warehouse Owner Expanding Operations

Construct New Facility

Purchase New Facility

Expand Own Facility

Obtain Financing

Cost Segregation Study



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Where Does Cost Segregation Apply?

- New construction or renovation
- Acquisition
- Estate tax step-up
- Any existing facility without a previous cost segregation study
- *Owner must be taxpayer, not tax-exempt*

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What is Depreciation?

- Expense for the exhaustion or wear and tear on property used in a trade or business, or for the production of income.
- *No Direct Cash Outlay for Depreciation Expense*
- *For Real Property owners, depreciation is most significant and overlooked opportunities to reduce income tax liability.*

Classes Of Property



REAL PROPERTY:

- Non-residential real property
- Residential rental property
- Land improvements

Life

Method

39 year

Straight line

27.5 year

Straight line

15 year

Accelerated

PERSONAL PROPERTY:

- Office furniture, fixtures, equipment, certain personal property
- Cars, trucks, computer-related equipment, certain personal property

7 year

Accelerated

5 year

Accelerated

Financial Impact

For every \$1,000,000:



NON-RESIDENTIAL:

- Reclassified from 39 years
- After-tax present value of:
 - \$210,000 – 5 year property
 - \$180,000 – 7 year property
 - \$100,000 – 15 year property

RESIDENTIAL:

- Reclassified from 27.5 years
- After-tax present value of:
 - \$170,000 – 5 year property
 - \$150,000 – 7 year property
 - \$74,000 – 15 year property

(40% composite Fed/State tax rate; 10% discount rate)

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BENEFITS of Cost Segregation

- **Optimize depreciation and tax deductions**
- **Increase after-tax cash flow**
 - ✓ Ability to reduce debt service
 - ✓ Increase return on investment to owners
 - ✓ Purchase additional inventory or new products
 - ✓ Expand marketing campaigns
 - ✓ Invest in other areas to become more efficient
- **Creates tax savings throughout life of the asset**
- **It *defers* taxes; it does not eliminate them.**



Small Business Financing

- Small Business Financing assistance through Commercial Mortgage Bank and Long Island Development Corporation programs further enhances the benefits of Cost Segregation.
- Reduced interest expense and increased depreciation expense helps increase overall cash flow.
- Depending on location of property and financing program additional savings available for real estate taxes, energy costs, and sales taxes to additionally increase cash flow.

Cash Flow



**Small Business Mortgage Financing
Through Lender**

↓ Interest Expense

↑ Cash Flow

Cost Segregation Study



↑ Depreciation Expense

↓ Taxable Income

↑ Overall Cash Flow

**Overall increase in cash flow can be used to enhance
business or increase return on investment by owners.**



Typical Short-Lived Items

- Built-in cabinetry
- Land Improvements
- Special Electrical
- Site Utilities
- Landscaping
- Signage
- Demountable Partitions
- Carpet/vinyl tile/wood
- Computer flooring
- Telephone/data/TV wiring
- Decorative items
- Special piping/plumbing
- Emergency lighting
- Site lighting
- Special structures
- Window coverings
- Paving/sidewalks
- Security system
- Vinyl wall coverings
- Intercom system

Example Office Building

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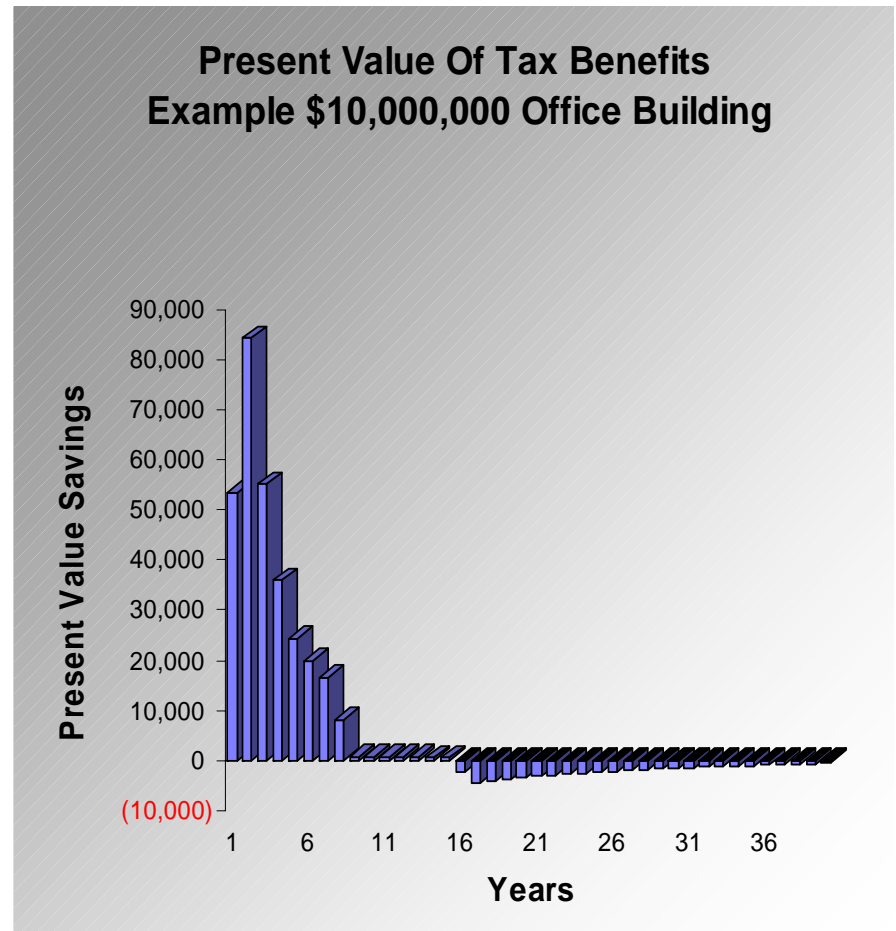
Example Office Building

Example: Office Building



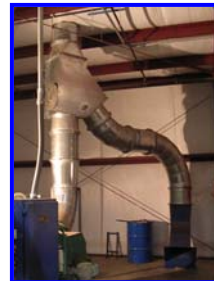
- Total Cost: \$10,000,000
- \$100,000 (1%) classified as 5-year
- \$800,000 (8%) classified as 7-year
- \$800,000 (8%) classified as 15-year
- \$53,384 increased cash flow in year 1
- \$287,369 increased cash flow in year 1-5
- \$248,165 cumulative present value

Assumptions: 35% Federal Tax Rate, 8% Discount Rate, based on Half-Year Convention & no Bonus Depreciation



Example Manufacturing Building

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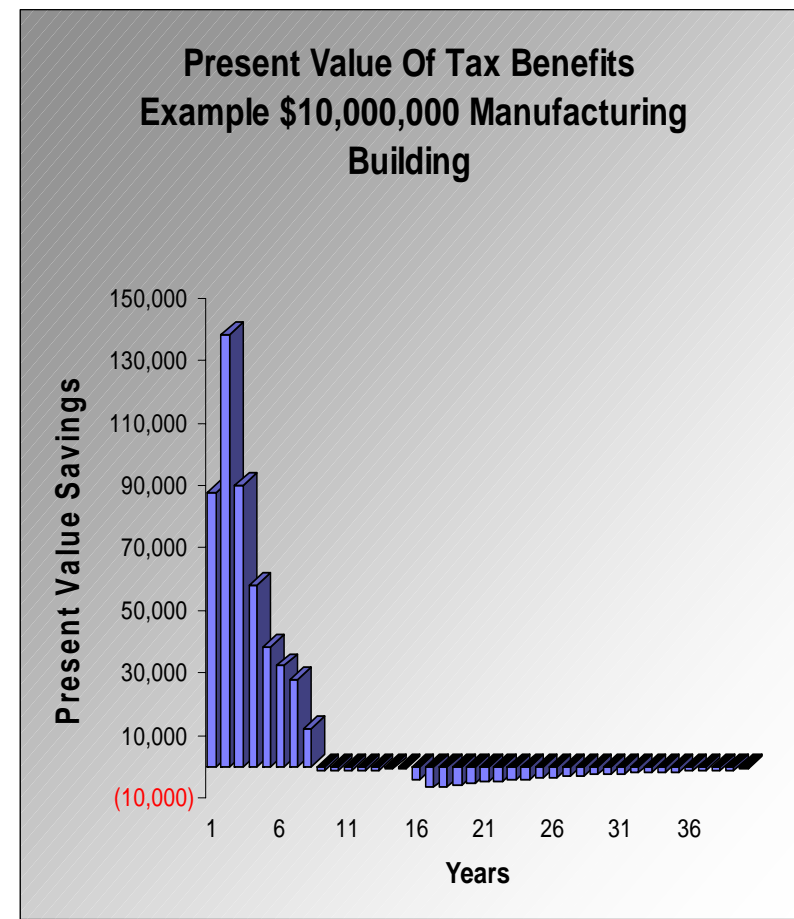


Example Manufacturing Building

Example: Manufacturing Building

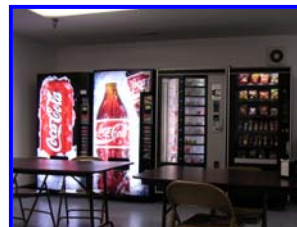
- Total Cost: \$10,000,000
- \$100,000 (1%) classified as 5-year
- \$1,500,000 (15%) classified as 7-year
- \$1,000,000 (10%) classified as 15-year
- \$87,856 increased cash flow in year 1
- \$467,741 increased cash flow in year 1-5
- \$395,924 cumulative present value

Assumptions: 35% Federal Tax Rate, 8% Discount Rate, based on Half-Year Convention & no Bonus Depreciation



Example Warehouse

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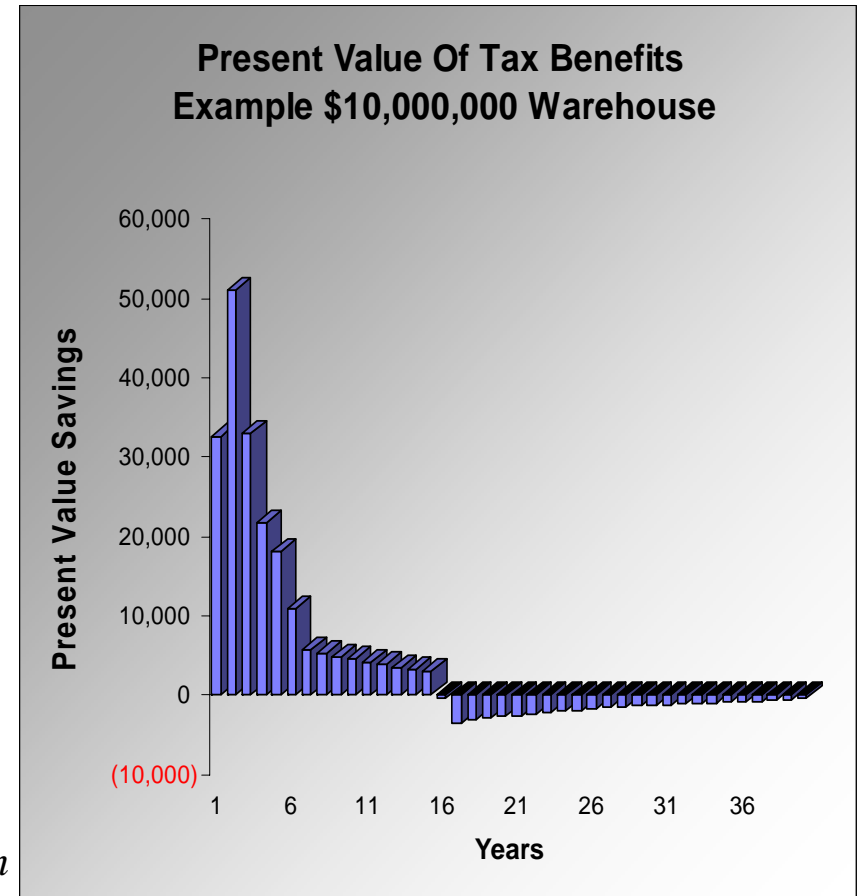


Example Warehouse

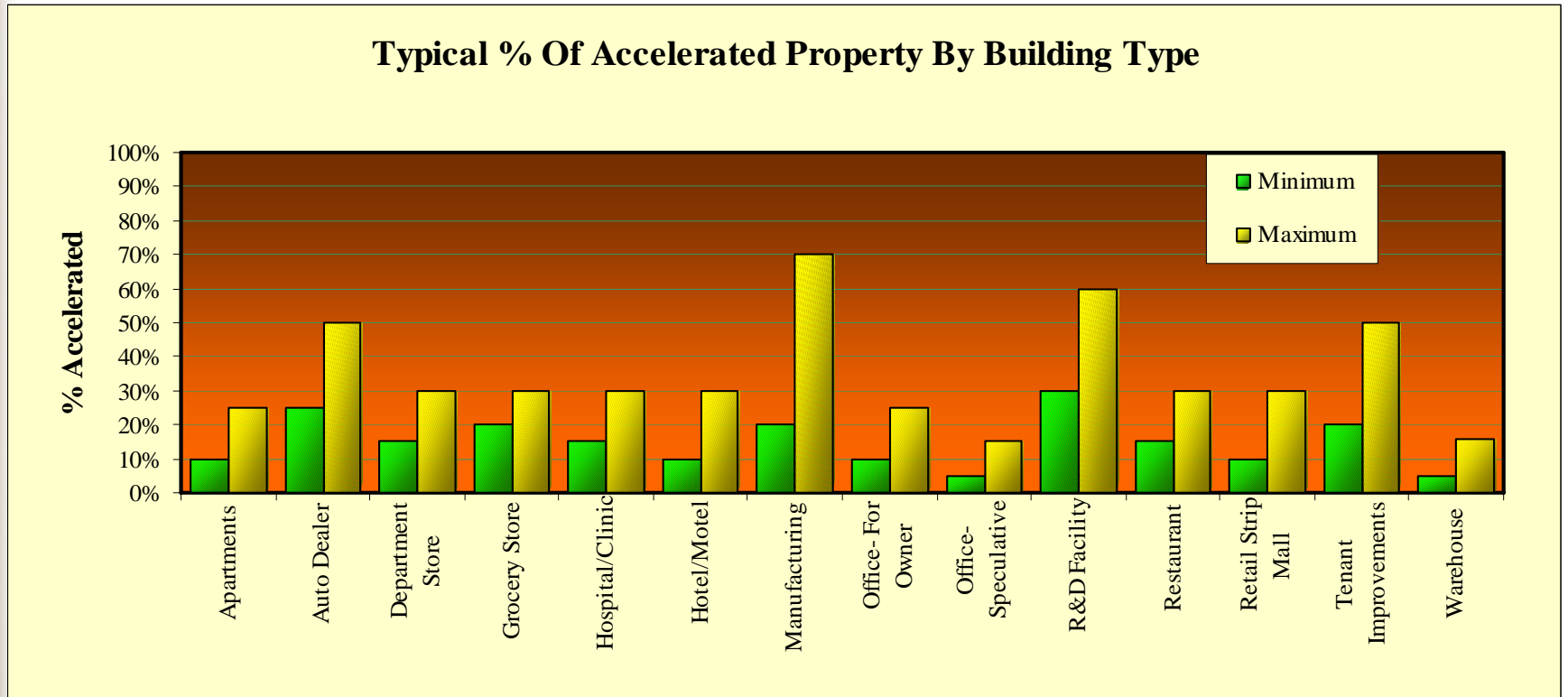
Example: Warehouse Building

- Total Cost: \$10,000,000
- \$300,000 (3%) classified as 5-year
- \$0 (0%) classified as 7-year
- \$800,000 (8%) classified as 15-year
- \$30,064 increased cash flow in year 1
- \$160,035 increased cash flow in year 1-5
- \$145,347 cumulative present value

Assumptions: 35% Federal Tax Rate, 8% Discount Rate, based on Half-Year Convention & no Bonus Depreciation



Financial Impact



Source: SourceCorp Tax Benefits Group

Estimated Allocations

Percentages For New Construction

Property Type	With Sitework						Without Sitework						NPV Benefit Per Million	
	Minimum			Maximum			Minimum			Maximum			Minimum	Maximum
	5-YR	7-YR	15-YR	5-YR	7-YR	15-YR	5-YR	7-YR	15-YR	5-YR	7-YR	15-YR		
Apartments (27.5-yr)	5.00%	5.00%	8.00%	15.00%			5.26%		9.41%				11,730	23,930
Assisted Living (27.5-yr)	8.00%		3.00%	20.00%	15.00%		8.25%		23.53%				15,100	43,000
Auto Dealer	8.00%		22.00%	20.00%	30.00%		10.26%		28.57%				39,400	71,600
Bank	12.00%		6.00%	18.00%	15.00%		12.77%		21.18%				30,000	45,600
Department Store	10.00%		5.00%	15.00%	15.00%		10.53%		17.65%				25,000	45,600
Grocery Store	12.00%		8.00%	16.00%	16.00%		13.04%		19.05%				32,100	48,600
Hospital/Clinic	9.00%		6.00%	20.00%	10.00%		9.57%		22.22%				24,200	50,000
Hotel/Motel	6.00%		4.00%	18.00%	12.00%		6.25%		20.45%				16,000	48,200
Manufacturing		10.00%	10.00%		50.00%	20.00%		11.11%		62.50%			28,700	111,000
Nursing Home (27.5-yr)	8.00%		3.00%	16.00%	15.00%		8.25%		18.82%				15,100	36,800
Office- For Owner		6.00%	4.00%		10.00%	15.00%		6.25%		11.76%			15,000	34,100
Office- Shell Only		1.00%	4.00%		5.00%	15.00%		1.04%		5.88%			6,100	25,100
Office- Professional Service	6.00%		4.00%	10.00%	15.00%		6.25%		11.76%				16,000	35,800
R&D Facility	25.00%		5.00%	45.00%	15.00%		26.32%		52.94%				54,300	104,300
Restaurant	12.00%		3.00%	20.00%	10.00%		12.37%		22.22%				26,700	50,000
Retail Strip Mall	4.00%		7.00%	12.00%	20.00%		4.30%		15.00%				15,400	45,100
Tenant Improvements	20.00%			50.00%			20.00%		50.00%				39,100	97,900
Warehouse	1.00%		4.00%	6.00%	15.00%		1.04%		7.06%				6,200	28,000
Warehouse (Refrigerated)	5.00%		4.00%	12.00%	15.00%		5.21%		14.12%				14,100	39,700





It's Not Too Late...

- IRS regulations now allow to catch up in **one year** depreciation missed in the past.
- Provides additional opportunity to plan for real estate owner's taxes 2008.



IRS Developments


- Bonus Depreciation
- IRS Acceptance At Last - Industry Directives
- March of 2003 – Gaming Industry
- December of 2003 – Restaurant Industry
- Audit Techniques Guide- April 30, 2004
- American Jobs Creation Act of 2004

Bonus Depreciation

Tax acts in 2002 and 2003 provide for special “bonus” depreciation.

- New Construction where Real Property is allocated to the 15, 7, and 5 year class lives
- 9/11/01-5/5/03 – 30% bonus depreciation
- 5/6/03-12/31/04 – 50% bonus depreciation
 - Bonus depreciation for assets is not available in New York State after May 31, 2003.
- Significantly increases tax savings where study is property constructed between 9/11/01 and 12/31/04.





“Rule of Thumb” Approach – Wrong!

- Allocates cost of property as a fixed percentage of costs of purchase (or construction) relying on past industry experience or best estimate.
- Will almost **never** survive IRS scrutiny due to unsubstantiated legal basis for the classification and unsubstantiated basis.



Engineering Estimate Approach

- Detailed review of all construction drawings and specifications
- In-depth visitation of property from which all estimates are conducted.
- Requires very detailed quantity “takeoffs” or estimates that are based on costs derived from nationally recognized cost estimating manuals, such as RS Means or Marshall & Swift.
- All takeoffs are reconciled to the appropriate capitalized cost as provided by the client.



Cost Segregation Risks

Does Cost Segregation have risks?

YES!

- Improperly Implemented Study
- Will Property Owner Be Able to Utilize Increase in Depreciation?



Cost Segregation Risks

Improperly Implemented Study

- Improper Engineering Analysis
 - Uses “Rule of Thumb” analysis
 - Uses an improper form of the Residual Approach
 - Does not follow regulations under IRC § 167 for determining allocated bases.



Cost Segregation Risks

Improperly Implemented Study Cont.

○ **Insufficient Documentation**

- Lack of proper factual documentation of the reclassified assets.
- Lack of legal analysis.
- Insufficient audit trail for allocated indirects and reconciliation of costs.
- Lack of photos or video documenting site visit.
- Lack of “Limiting Conditions” describing scope of study.
- IRS Audit Techniques Guide published by IRS to provide list of all documentation required.

○ **IRS Developments & Materials**

- Failure to keep abreast of recent changes in case law.
- Lack of awareness concerning current trends in IRS audit practices.
- Failure to acquire most recent industry directives, audit guides and internal CPE course materials.



Cost Segregation Risks

Deductibility of Depreciation

- Must analyze closely the function of property and how a significant increase in depreciation will effect property owners.
- Passive versus Non-passive
 - If passive rental property need sufficient passive income to take full advantage of benefits.
 - If Non-passive (i.e. manufacturing facility owned by corporation or tenant improvements) increase in depreciation can be absorbed by income from business.
- If there is any intention on selling property in the next few years, a study may not be worthwhile.
 - Depreciation Recapture
- Will property owner have sufficient basis to deduct losses?
 - If property owned in LLC, mortgage will likely provide enough basis.
 - If property owned in S Corporation, mortgage does not add to basis.

Minimum Project Size

Suggested Minimum Size to Consider Cost Segregation



<u>Property Type</u>	<u>Tax Basis</u>
Speculative Office/Industrial Buildings	\$2,000,000
Office Buildings (owner occupied)	1,500,000
Heavy Manufacturing/Processing	1,200,000
Light Manufacturing	1,500,000
Senior Living	1,500,000
Research & Development	1,500,000
Apartments	1,500,000
Hospitals/clinics/medical office/surgery centers	1,200,000
Hotels/motels	1,500,000

Minimum Project Size

Suggested Minimum Size to Consider Cost Segregation



<u>Property Type</u>	<u>Tax Basis</u>
Retail (department/specialty stores)	\$1,500,000
Tenant Improvements	750,000
Restaurants (one or multiple)	1,200,000
Theaters	1,500,000
Car Dealerships	1,000,000
Warehouses	2,000,000
Strip or Regional Malls	3,000,000
Grocery Stores	1,000,000

Do You Want to Be a Hero to Your Clients?

- Scan through clients for anyone who may have purchased or constructed real property in the past several years.
- Present this valuable tax savings opportunity **NOW** to your clients so the client can take full advantage of depreciation deductions allowed by the Internal Revenue Service.
- Keep your ears open for any real estate transactions occurring where a Cost Segregation Study can provide cash flow benefit.
- Bringing this tax opportunity to the table can lead to future referrals or transactions where your firm can provide services.



QUESTIONS?

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