



Freed Maxick & Battaglia, PC
Certified Public Accountants



Cost Segregation Study

How to free up cash flow now

**Take it to
theMax.**

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

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

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

Due to their value as a tax-planning tool, cost segregation studies are a smart investment for most companies that meet the qualifying criteria. Studies typically pay for themselves seven to 10 times over the life of the asset.

Why classification is critical

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

Asset classifications and depreciable lives:

Commercial buildings and related structural components	39-year depreciable life
Land improvements	15-year depreciable life
Nonstructural elements, such as carpeting, wall coverings; certain equipment and furnishings; and specialized mechanical, plumbing and electrical costs	5- to 7-year depreciable life

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

Costs for nonstructural elements, such as carpet, wallcoverings and accent lighting and exterior site improvements, such as sidewalks and landscaping, can often be depreciated over five, seven or 15 years.

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

Case study: Apartment complex

The owner of an apartment complex, constructed at a cost of \$3.1 million, engaged Freed Maxick to conduct a cost segregation study. Freed Maxick consultants reviewed blueprints and conducted an on-site inspection of the building. They were then able to identify personal assets and land improvements connected to the building that were classified as structural components.

Asset costs were estimated and verified according to industry-recognized valuation techniques and assigned the appropriate depreciable life for federal tax purposes.

As a result of the cost segregation study, 24 percent of the total building cost was classified as personal property assets, and 8 percent was classified as land improvement assets. The client saw a tax benefit of approximately \$164,000 in the first year. The present value tax benefit over the life of the building is an estimated \$189,000.

Case study: Manufacturing company

A small manufacturing company built a new \$3 million facility. Its management engaged Freed Maxick to conduct a cost segregation study.

Freed Maxick consultants reviewed blueprints, talked with operations personnel and conducted an on-site inspection of the facility. Through this process, they identified personal assets and land improvements connected to the facility that might have been classified as structural components.

Take advantage of a cost segregation study

Asset costs were estimated and verified according to industry-recognized valuation techniques and assigned the appropriate depreciable life for federal tax purposes.

As a result of the cost segregation study, 27 percent of the total facility cost was classified as personal property assets and 18 percent was classified as land improvement assets. The client saw a tax benefit of approximately \$50,000 in the first year. The present value tax benefit over the life of the building is an estimated \$226,000.

Cost segregation is IRS-approved

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

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

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

The IRS recently finalized its *Cost Segregation Audit Techniques Guide*, which lays out comprehensive audit technique guidelines and explains what constitutes a “quality” cost segregation engagement.

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

More taxpayers are submitting “either original tax returns or claims for refund with depreciation deductions based on cost segregation studies,” according to the guide.

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

Multiple disciplines are basis of successful study

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

According to the *Cost Segregation Audit Techniques Guide*, preparation of cost segregation studies requires knowledge of both the construction process and tax law involving property classifications for depreciation purposes: “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.”

Where professional assistance adds value

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

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

It should also be noted that, although cost segregation studies are approved and accepted by the IRS, procedures must fall within the accepted guidelines. The IRS is taking a closer look at studies to ensure they meet its standards.

Is a cost segregation study for you?

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

Candidates for a cost segregation study include for-profit organizations that have done the following in the past 17 years – or are planning to do so in the future:

- Built a new facility
- Purchased real property
- Renovated an existing building
- Made leasehold improvements in an existing building

A study is typically worthwhile for building projects or purchases of more than \$500,000. A somewhat scaled-back approach is recommended for studies on properties or projects that cost less than \$1 million.

In general, buildings such as manufacturing plants, restaurants and banks, which contain specialized equipment, have the most to gain. Restaurants, on average, can reclassify 20 percent to 25 percent of total building costs. Assets such as a kitchen sink, range hood and exhaust fan – in addition to lighting for mood enhancement and to illuminate art – can likely be claimed as personal property.

How a cost segregation study can strengthen your business

In addition to providing tax relief, a cost segregation study can benefit businesses in a number of ways, including reducing red tape with the IRS.

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

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

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

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

Catching up: Retroactive cost segregation

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

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

This opportunity to recapture unrecognized depreciation in one year presents an opportunity to perform retroactive cost segregation analyses on older properties to increase cash flow in the current year.

Components of a successful study

A thorough cost segregation study involves several steps. The Freed Maxick approach incorporates the following components.

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

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

Cost analysis. We analyze all available construction cost data and rely on your representation of the land value in adjusting total construction cost to determine costs subject to depreciation. All personal and real property are assigned an appropriate value.

Assign depreciable life. Each asset is assigned the appropriate tax life as specified by the modified accelerated cost recovery system. These designations are based upon the most recent IRS guidance at the time of the cost recovery study.

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

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

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

Getting the most out of your project

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

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

How Freed Maxick & Battaglia, CPAs can help

The Freed Maxick cost segregation group comprises qualified construction engineers, appraisers, and accountants with extensive experience in determining appropriate asset classifications and tax depreciable lives of real and personal property.

Freed Maxick takes an integrated approach to cost segregation. Our professionals have construction, engineering, and tax backgrounds, which are essential elements in ensuring that taxpayers get the highest return on their investments and a quality report that is properly documented.

For a free estimate of the savings available for your property, contact Grant Keppel, CPA at 800.777.4885

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