Recognizing the Value of Next-Generation Cost Segregation Studies

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For the first time in 15 years, cost segregation services have made Accounting Today's list of Top Niche services for increasing business, putting engineering studies at the top of the charts in terms of important consulting services for 2014. So what's driving this sudden attention and popularity?

The answer is simple. The "next generation" cost segregation study has become the most powerful tax tool for real estate clients as a result of the newly revised tangible property regulations (T-Regs) that were passed in late 2013 and early 2014.

This "next generation" cost segregation study has captured the attention of the CPA community because CPAs have always known that a dollar in their client's hand today is worth more than the promise of a dollar tomorrow. The ability for CPAs to assist clients in reducing their tax liability was greatly improved in April 1999. At that time, the IRS issued a legal memorandum allowing taxpayers to segregate various building costs into shorter depreciable lives outside of the standard 39 or 27.5 year class life via a process called Cost Segregation. This was the genesis of the "old school" cost segregation study.

Throughout recent years, the process, application and value of cost segregation have steadily increased. How does the "old school" cost segregation study differ from the "next generation" version?

A simple chart below shows the differences:

Old School:
• Accelerated depreciation through identifying 1245 property vs. 1250 property, land improvements and tenant improvements.

New Generation:
• Accelerated depreciation;
• Energy tax deduction (179D) for heating and cooling systems;

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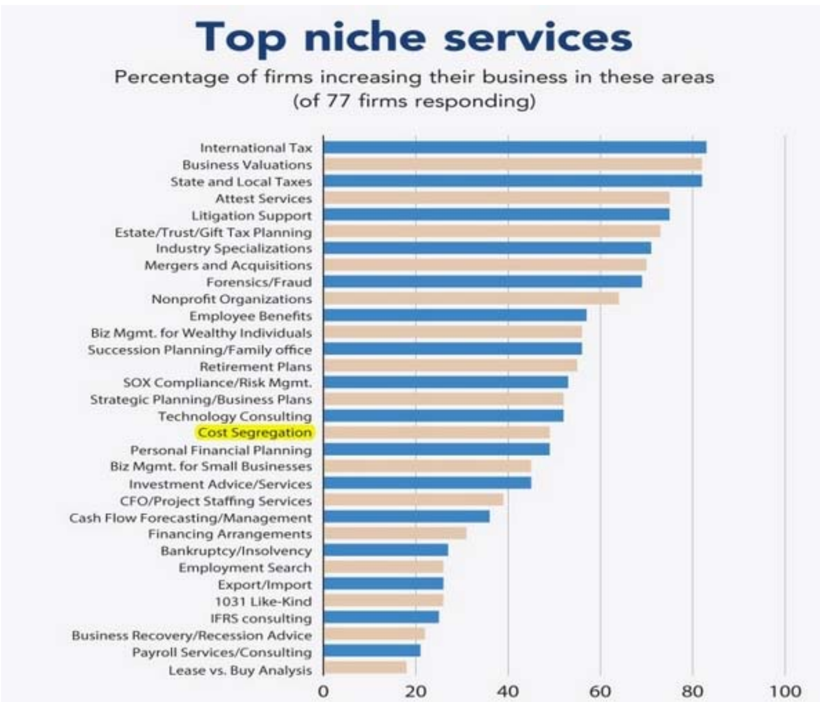
- Energy tax deduction (179D) for lighting systems;
- Energy tax deduction (179D) for building envelope;
- Dispositions for undepreciated and retired assets per Treasury Regulation (TR) 1.1168(i)-8 MACRS, or modified accelerated cost recovery system;
- Expense of undepreciated basis of property subject to qualified repair per TR 1.162-4;
- Expense undepreciated basis subject to routine maintenance per TR 1.263(a) – 3(i);
- Manage and minimize recapture upon property sales;
- Identify and recognize units of property and interdependent systems as defined under the recently issued T-Regs; and
- Bonus depreciation for reclassified assets.

These differences reflect the value of cost segregation to CPAs and their clients as a top consulting service. The use of "next generation" cost segregation studies has helped many firms attract new clients, retain existing clients and secure consistent revenue growth and firm expansion.



Importance of Cost Segregation Cost Studies

I asked Allan Koltin, CEO of Koltin Consulting, if he was surprised by the importance that CPA firms are placing on cost segregation consulting services. He responded, "In visiting my CPA clients over the past month, they are all indicating that the new regulation changes have allowed them to thrive in terms of using cost segregation studies to generate strong revenue while attracting new clients." He added, "Cost segregation and the related tangible property studies are clearly becoming mainstream in the accounting industry. It is typical to see a relevant consulting service being adopted by the five percent innovative CPA firms in the industry and then the trickle effect happens slowly as the other firms see the importance over a decade."

For a more complete understanding, let's go back to the genesis of the "old school" cost segregation. The 1999 IRS memorandums were significant because the building does not only consist of walls, roof and interior rooms, but also land improvements (storm sewers, curbs and sidewalks, parking lots, swimming pools, landscaping, etc.) and personal property (flooring, interior finishes, decorative lighting, kitchens, interior glass and electrical wiring for appliances, etc.).

As I mentioned, the "old school" report helped clients accelerate depreciation of their buildings.

The memorandums were clear in that a typical property's structure is subject to a 39-year recovery period, land improvements are subject to 15-year recovery period, and certain other building components qualify as personal property with a five- to seven-year recovery period. The IRS allows the componentization of buildings for accelerated tax depreciation through the process of a cost segregation study to identify land improvements and personal property that can be separately depreciated over the shorter recovery period. The average commercial building owner will realize approximately 25 to 35 percent of the total costs of their building as shorter class life depreciable assets. This can translate into major tax savings and increase cash flow for savvy real estate investors.

Older Properties

There are also great benefits for clients who have purchased buildings since 1986. The accelerated benefits are not lost for real estate owners who have purchased real estate in a previous tax period. Once a taxpayer files two federal income tax returns using a specific depreciable or non-depreciable life for a particular asset, an accounting method has been adopted for that asset for federal income tax purposes. Prior to the issuance of Rev. Proc. 96-31—the predecessor of Rev. Proc. 97-37, Rev. Proc. 98-60 and now Rev. Proc. 99-49—there was no procedure for an automatic change of accounting method for an asset that erroneously was being depreciated over too long a life or not depreciated at all.

Since depreciation is a non-cash flow item, application of this Revenue Ruling could provide a significant impact on this year's tax return. For example, a substantial tax benefit is achieved in the case where depreciation has not been taken on a building constructed for $8 million with eligible improvements of $2 million and placed in service on Jan. 1, 2000. The cumulative depreciation of $1,114,200 that was not taken previously can now be deducted in the first year of change. Additionally, the balance of the depreciable assets continues to be depreciated over their remaining life, providing an after tax present value benefit of $600,000.

Automatic Change of Accounting Method

Rev. Proc. 87-56 provides the taxpayer with general depreciation guidelines for use in both a cost segregation study and/or change of accounting method. Rev. Proc. 99-49 provides that a taxpayer may file for an automatic change of accounting method for an asset for which depreciation was not taken, or for which depreciation claimed was less than the allowable amount. The amount of "missed depreciation" from the date the asset was placed in service (the Section 481(a) adjustment) can be deducted in the first year of change.

The benefits of this procedure were solidified by the US Tax Court decision in Hospital Corporation of America. In a pro-taxpayer decision, the Tax Court narrowly defined what is considered "real property" for income tax purposes.

Ever-Increasing Benefits

So now we have a historic background to the "old school" study, and we have a glimpse of the "next generation" study. Let's get into the specifics of the changing benefits of these engineering studies that are causing such a commotion with CPAs.

The new issuance of the T-Regs in regard to repair and maintenance expensing rules dictates the necessity for the full deconstruction of 1250 property with a proper cost segregation study to allow future retirement of assets.

The new issuance of these regulations for expensing versus capitalization shows that the IRS recognizes that property owners who make renovations to the structural 1250 assets of their facility must have a proper engineering study to allow the retirement expense for the abandoned property.

A Look Back

This logic also applies retrospectively. A quality engineering report must look at a building's assets that are no longer in service as determined through the review of the blueprints, tax schedules and an engineering site visit. An audit of a client's existing facility will allow a determination of whether assets within the building are currently on the client's depreciation schedule which should have been disposed of from renovations and/or tenant change-overs in which the assets were disposed with no salvage value.

The next generation report should always include an engineering analysis that summarizes the remaining undepreciated basis of a building's components subject to expense as abandonment per temporary Treasury Regulations 1.1168 (i)-8 for disposition of MACRS property.

Sample

Asset	Service Date	Quantity	Price	Total	Un-depreciated Amount
Abandoned tenant renovations	2006	1	$2,745,550.20	$2,745,550.20	$1,518,631.81
Grand Total					$ 1,518,631.81

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