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SOLUTIONS BEYOND THE OBVIOUS

Cost Segregation Studies and the Related Tax Benefits

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WELCOME

Today's Presenters

John J. Callahan, CPA
Partner

- 30+ years of public accounting experience providing tax and consulting services to middle-market clients.
- Primary Industries Served: Automobile dealers, wholesale and retail, manufacturers, real estate entities and various service providers.
- John's areas of expertise focus on pass-through entities, multi-state tax consulting including voluntary disclosures, cost segregations and personal income tax planning.

Michael P. Zeoli, Jr., CPA
Manager

- 10+ years of public accounting experience providing tax and consulting services to closely-held businesses and their owners.
- Extensive experience in the following industries: real estate, construction, wholesale and retail, and manufacturing.
- Mike's areas of expertise focus on pass-through entity taxation, multi-state tax issues, cost segregation studies, and mergers & acquisitions.

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Agenda

- Explain what a cost segregation is, and the related tax benefits
- Identify tax issues that should be considered in conjunction with a cost segregation study
- Identify the most common qualifying assets applicable to cost segregation studies
- Discuss bonus depreciation and section 179 expensing
- Estate planning considerations
- Discuss tangible property regulations

Cost Segregation Overview

- Used to maximize the return on investment of a construction project through special allowance depreciation
- Achieved by reallocating costs into asset classes with shorter useful tax lives eligible for special allowance depreciation
- Increases initial cash flow (time value of money) by accelerating depreciation deductions
- Can be used to establish a Unit of Property (UOP) under the Tangible Property Regulations (TPRs)

Cost Segregation Overview (continued)

- A cost segregation study is most advantageous after new construction of commercial or residential real estate
- A study should also be considered for:
  - Acquisitions of property
  - Remodeled property
  - Expanding upon an existing property

Example: Commercial Office Building

- $10 million new construction of commercial office space
- Without cost segregation, costs are depreciated over 39 years
- Year 1 depreciation deduction increased by $2,435,900
- Projected NPV benefit using a 5% discount rate amounts to $550,000

Depreciation Comparison and Tax Benefits

	5-7 year	15 year	39 year	Year 1 Depreciation	Projected NPV Benefit
No Cost Seg	$ -	$ -	$10,000,000	$ 256,400	$ -
Cost Seg	$ 1,500,000	$ 1,000,000	$ 7,500,000	$ 2,692,300	$ 550,000

Example: Property Types Eligible for a Study

Building Type	Average Reallocation of Costs
Apartment Buildings	5 – 35%
Retail Stores	20 – 40%
Restaurants	20 – 45%
Office Buildings	10 – 30%
Manufacturing Facilities	20 – 60%
Grocery Stores	25 – 45%
Hotels	25 – 45%
Warehousing/Storage Facilities	10 – 25%
Auto Dealerships	35 – 50%

Tax Considerations

- Bonus and/or Section 179 depreciation apply to reallocated costs from the study which magnifies tax benefits
- Unused tax deductions carry forward to future years
- Depreciation recapture will apply to personal property in the year of sale
- Section 1031 (Like-Kind Exchange) rules should be considered
  - Can still be beneficial, however bonus depreciation only applies to excess basis in new property
- Passive activity rules can prevent a taxpayer from receiving the benefits of a cost segregation study

Planning Considerations

- Widely used tax planning tool for real estate professionals and investors
- Study is typically performed in the year construction is completed, or property is acquired
- If performed in later years, Form 3115 must be filed and attached to tax return to claim previously missed deductions - *section 481(a) adjustment*

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Section 1245 – Tangible Personal Property

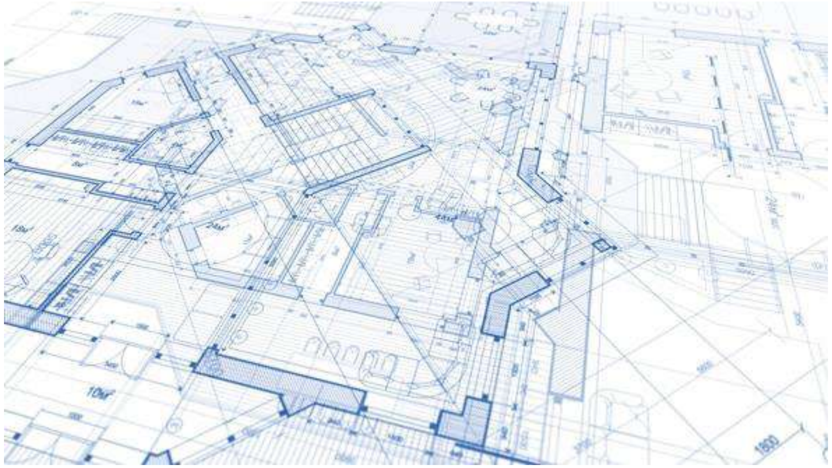
- Equipment
- Furniture & Fixtures
- Appliances
- Decorative lighting
- Decorative millwork
- Counters/Cabinets
- Removable flooring
- Carpeting
- Plumbing fixtures
- Special piping/ventilation
- Electrical wiring
- Reinforced concrete
- Special piping/ventilation
- Electrical wiring
- Reinforced concrete
- Soft Costs

Land Improvements

- Includes improvements directly to or added to land, whether the improvements are 1245 property or 1250 property, provided the improvements are depreciable. Examples might include:
  - Parking lots
  - Sidewalks
  - Roads
  - Drainage facilities
  - Septic systems
  - Sewers
  - Fences
  - Landscaping
  - Swimming pools

Allocation of Soft Costs

- Soft costs are allocated to direct costs on a pro-rata basis. Examples of soft costs include:
  - Architect fees
  - Engineering fees
  - Building permits
  - General conditions
  - Legal & accounting fees
  - Project management costs



Bonus Depreciation - Phase Out under TCJA

- 100% bonus depreciation applies to all assets acquired AND placed in service after 9/27/17 and before 1/1/23. The phase out of bonus depreciation under the TCJA begins in 2023

Year acquired and in service	Bonus depreciation allowable
9/28/17 – 12/31/22	100%
2023	80%
2024	60%
2025	40%
2026	20%
After 12/31/26	0%

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Bonus Depreciation – Qualified Improvement Property (QIP)

- Qualified Improvement Property can be defined as:
  - Any interior improvement made to a nonresidential property AFTER the building was first placed-in-service by ANY taxpayer *(Sec. 1250 real property only)*
  - Improvement must be non-structural in nature
  - Must not be an enlargement of the building
  - Elevators & escalators do not qualify
- QIP replaced qualified leasehold improvements, qualified retail improvement property, and qualified restaurant property as of 1/1/2018

Section 179 Expensing

- Sec. 179 expense allows a business to deduct all, or a portion of the purchase of qualifying property
- 2023 deduction limitation = $1,160,000
- 2023 purchase limitation = $2,890,000
  - Purchases of Sec. 179 qualifying property in excess of limitation results in a dollar-for-dollar reduction in total 179 deduction
- In general, Sec. 179 applies to tangible personal property, such as machinery & equipment, and furniture & fixtures, however the TCJA expanded the definition of qualifying property to include certain real property

Section 179 Expensing – Qualified Real Property (QRP)

- Qualified Real Property includes improvements made to the following components of a nonresidential building:
  - Roofs
  - HVAC systems
  - Fire protection
  - Security systems
- Similar to the rules for QIP, the improvements must be made after the date the building was first placed-in-service by any taxpayer
- Since these improvements are not eligible for bonus depreciation, taxpayers should consider utilizing Sec. 179 expense on QRP rather than on bonus-eligible property

Passive Activity Rules

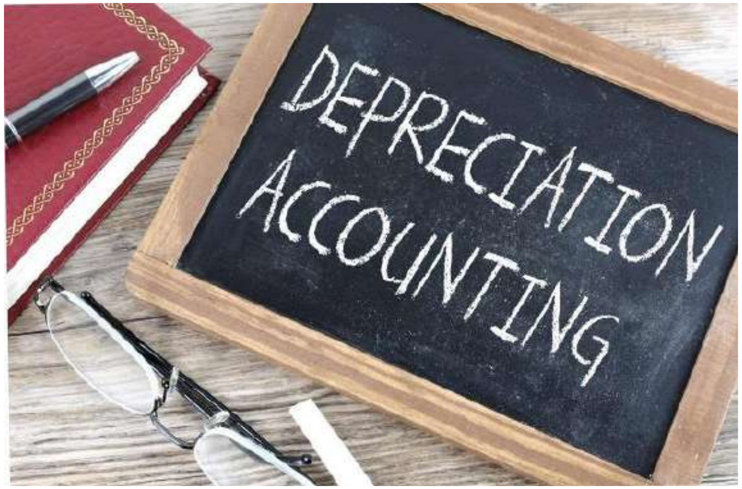
- Passive activity loss rules generally limit the ability of taxpayers to shelter active trade or business income with deductions from passive activities
- Passive losses can only be deducted against income from other passive activities and are carried forward to future years until the taxpayer has offsetting passive income, or disposes of his or her interest in the activity
- Form 8582 is filed each year to track carryforwards of suspended passive activity losses for a taxpayer
- **KEY TAKEAWAY**: be sure to plan ahead and account for these rules when considering a cost segregation study

Passive Activity Rules – Grouping Election

- Section 469 allows for a taxpayer to make a grouping election to combine trade or business activities with passive activities making them one “economic unit” thus allowing losses from the passive activity
- Grouping election is irrevocable once made (remains in effect for all future years)
- There are certain test for determining whether a grouping results in an appropriate “economic unit”:
  - Extent of common control and common ownership
  - Similarities and differences in types of businesses
  - Geographical location
  - Interdependencies between activities

Depreciation Recapture

- Upon sale of a property, the taxpayer is required to recapture depreciation deductions taken on section 1245 - tangible personal property
  - Recapture amount is the lesser of allowable depreciation or the total gain realized
  - Recapture is taxed at ordinary rates
  - Section 1245 property loses value quicker than real property, so best to hold onto for at least 3 years to avoid unnecessary tax consequences



Estate Planning Considerations

- Cost segregation opportunities can arise when a property owner passes away and the property is inherited
- Any gains built up during the decedent's lifetime are forgiven
- The beneficiary receives a “step-up” in basis on the property to the fair market value on the date of death and depreciation starts over

Tangible Property Regulations (TPRs)

- TPRs were effective as of January 1, 2014
- Regs provide guidance on the following:
  - Unit of Property (UOP)
  - Capital expenditures
  - Amounts paid to acquire tangible property
  - Amounts paid to improve tangible property
  - Dispositions
  - When expenditures should be expensed
- Decision making tool to determine whether an expenditure should be capitalized or expensed
- Final regulations have greatly increased demand for cost segregation studies

Demolition Considerations

- When a building is demolished, the building basis must be capitalized as non-depreciable land
- Cost segregation study should be performed prior to demolition if there is value in tangible personal property and land improvements
- Tangible personal property and land improvements can be reallocated and expensed when demolished
- If building is purchased and immediately demolished, there is no opportunity for cost segregation and the entire cost is capitalized as non-depreciable land

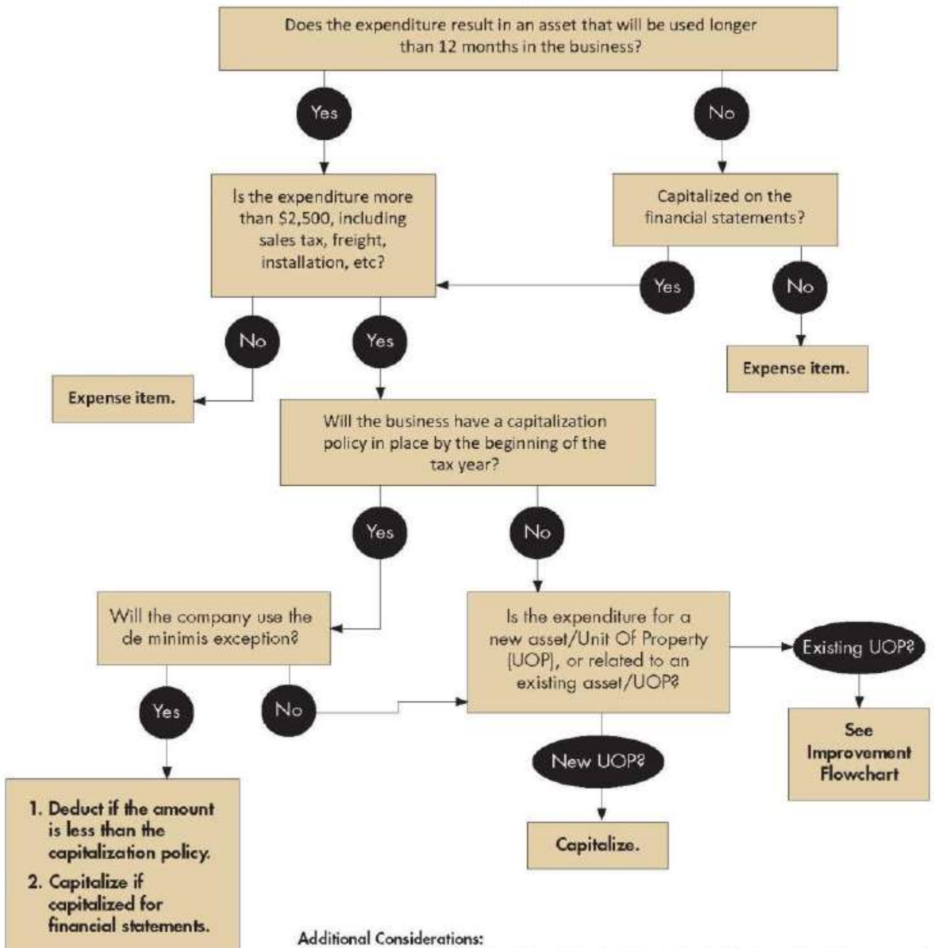
Partial Dispositions

- A partial asset disposition allows a taxpayer to write-off the remaining depreciable basis of items removed during a renovation project in addition to depreciation deductions on the replacement items
- Not retroactive – tax deduction for partial asset disposition is only available in the tax year the renovation was performed
- The following renovation projects commonly result in partial disposition opportunities:
  - Roof repairs
  - Replacement lighting
  - Doors and windows
  - HVAC replacement

Repair Regulations -
Expense vs. Capitalize Analysis Flowchart

The final Repair Regulations contain guidance regarding how to treat expenditures related to tangible property. The following flowcharts will assist in analyzing invoices and determining the proper treatment of expenditures.

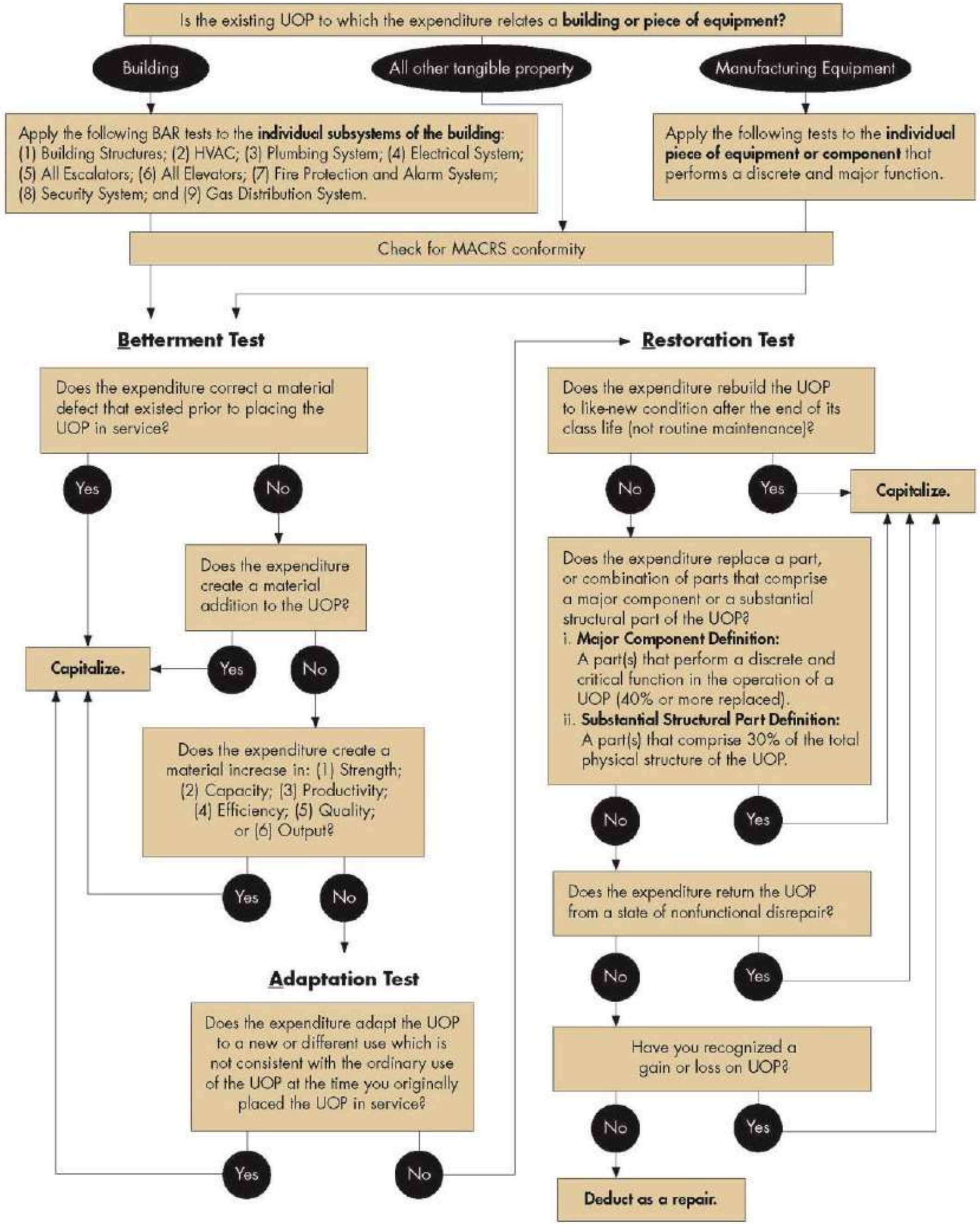
Materials and Supplies Flowchart



Additional Considerations:

1. When applying the flowchart above, it is important to look at the per-unit cost, as opposed to the total invoice cost. It is very common for multiple UOP to be included on one invoice. It is also very common for multiple invoices to make up a single UOP.
2. It is very important to implement a written book capitalization policy prior to the beginning of the tax year, in order to apply the de minimis rules for purchases under a specified threshold.

Improvement Flowchart



Frequently Asked Questions

- What is the typical timeframe for a cost segregation study?
  - Studies usually take 30-60 days depending on complexity
  - Important to consider tax deadlines when inquiring about a study
- How much does it cost?
  - Our fees range from $10,000 - $15,000
  - Dependent on the building type and square footage
  - Renovation projects in progress over multiple years can increase cost
- How much do I have to spend for a cost segregation to be worth it?
  - In general, you should consider a cost segregation study when the initial investment is at least $750,000

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Questions & Contact Us

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