

Cost Segregation:

A Cash Flow Solution

1

What Is Cost Segregation?

- ▲ An engineering based study of new or existing properties or improvements
- ▲ Identifies *personal property* that qualifies for shorter tax depreciation lives
- ▲ Cost segregation report enables the tax preparer to *accelerate* federal tax depreciation

2

What Is A Cost Seg Professional?

- ▲ An individual who is an **expert in construction**, i.e. can differentiate structural items in a building from the non-structural items
- ▲ An individual familiar with the **relevant tax law** that differentiates personal from real property
- ▲ An individual knowledgeable in **construction industry standard estimating procedures**

3

The Opportunity

Recently, there has been increased interest in cost segregation --- Why?

- ▲ It offers cash flow improvement, enabling:
 - ▲ Distribution to owners, or
 - ▲ Reinvestment in property improvements or other business improvement / consulting services.
- ▲ The first year tax savings typically exceed the cost of a study (*as much as 20:1*).
- ▲ Recent beneficial tax law changes have made cost segregation more attractive than ever!
- ▲ Consequently, many commercial property owners are increasingly becoming aware of its cash flow benefits.

4

A Brief History of Cost Segregation

1986

Investment Tax Credit Repealed

- ▲ Distinction between “Section 38” and Non “Section 38” Property thought to be irrelevant

Introduced to “MACRS”

- ▲ Real Property Recovery Periods changed from 19 Year, 175% DB to 27.5 and 31.5 Year SL for Non-Residential Rental and Real Property

5

Landmark Cost Segregation Rulings

1997 – Hospital Corporation of America and Subsidiaries v. Commissioner

- ▲ 1997 – Tax Court finds in favor of HCA and concludes that tests developed for purposes of differentiating property for purposes of ITC are applicable in deciding whether assets constitute tangible personal property
- ▲ 1999 – In Action on Decision 1999-008 the IRS acquiesced in part to HCA in regards to the concept that the ITC analysis (i.e., Cost Segregation) has continued viability under ACRS and MACRS.

RIA: *“The Tax Court’s decision in Hospital Corp. of America that property is section 1245 property for depreciation purposes if it would have qualified for the ITC should stimulate new interest in cases and rulings issued decades ago, and in regulations many assumed to be dormant.”*

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6

Landmark Cost Segregation Rulings

“The IRS (in Legal Memorandum 199921045) sets another hurdle in the way of a taxpayer who bought [a] building sometime in the past and now wants to [have a cost segregation study done] under *Hospital Corp. of America*. ... such a move involves a change in method of accounting that requires IRS’ prior consent.” © Copyright 2003 RIA. All rights reserved.

“IRS’ prior consent” is obtained by filing Form 3115, “Application for Change in Accounting Method”

What Filing Form 3115 Means To You

- ▲ Form Automatically Reviewed by IRS
- ▲ Because of Review, Filing Fee Required
- ▲ Adjustment to income (§481(a) adj.) spread over 4 years
- ▲ Access to closed years (Amended Returns Not Required)

7

Landmark Cost Segregation Rulings

Revenue Procedure 2002-9 (App. Sec. 2.01)

- ▲ Automatic IRS consent of change from one method of depreciation to another method of depreciation
- ▲ 3115 must be filed with current year return, including extensions
- ▲ Copy of 3115 must be filed in IRS National Office
- ▲ ***NO automatic review process***
- ▲ ***NO filing fee required***

8

Landmark Cost Segregation Rulings

Increased Opportunity

Revenue Procedure 2002-19

- ▲ Beneficial §481(a) adjustments *are taken into account in the year of change* rather than being spread out over 4 years. (Sec. 2.02(1))

Jobs and Growth Tax Act of 2003

- ▲ 50% Bonus Depreciation
 - ▲ Extends expiration to 12/31/04
 - ▲ Applies to 20 Year (or less) Property and certain Leasehold Improvements
- ▲ First Year Expensing Election (§179)
 - ▲ Increased from \$24,000 to \$100,000

9

Recent Tax Developments

T.D. 9105 - Reg §1.446 ff (effective 1/2/04)

- ▲ “... the regulations provide that a change in the depreciation method, period of recovery or convention ... *is a change in the method of accounting.*”
- ▲ Example 9. “ ... Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, ... change to this depreciation method, recovery period, and convention *is a change in method of accounting. This method change results in a Section 481(a) adjustment.* The useful life exception ... does not apply ...”

10

Recent Tax Developments

Chief Counsel Notice 2004-7

- ▲ For tax years ending before Dec. 30, 2003, the IRS will not assert that a change in computing depreciation requires the filing of Form 3115

Rev. Proc. 2004-11

- ▲ Makes it easier for taxpayers to fix some depreciation deduction mistakes by waiving the "two-year" adoption of method of accounting rule

11

Who Can Benefit?

Characteristics of Ideal Candidates

1. Own property they depreciate
 2. Pay Income Tax
 - ▲ If generating NOLs, then paid tax recently or expect to pay tax in the near term
- | | |
|---------------------------------|------------------------------|
| ▲ Office / industrial buildings | ▲ Dealerships |
| ▲ Retail facilities | ▲ Hotels |
| ▲ Manufacturing facilities | ▲ Hospitals |
| ▲ Multi-family properties | ▲ Country clubs/golf courses |
| ▲ Restaurants | ▲ Leasehold improvements |

12

Triggering Events

When Should A Study Be Considered?

*Properties can realize increased depreciation expense from a Cost Segregation Study if it has been **PLACED IN SERVICE** since January 1, 1987*

The following events trigger the opportunity for a cost segregation study:

- ▲ Constructing a new property
- ▲ Renovating, remodeling, restoring or expanding an existing site
- ▲ Purchasing an existing property
- ▲ Construction of facility leasehold improvements
- ▲ Owning a facility that has been purchased or improved since January 1, 1987, and on which an engineering based cost segregation study has not been performed

13

MACRS Tax Rate Comparison

Asset						
<u>Year</u>	<u>39 Yr</u>	<u>31.5 Yr</u>	<u>27.5 Yr</u>	<u>15 Yr</u>	<u>7 Yr</u>	<u>5 Yr</u>
1	1.177%	1.455%	1.667%	5.000%	14.290%	20.000%
2	3.741%	4.630%	5.303%	14.500%	38.780%	52.000%
3	6.305%	7.805%	8.939%	23.050%	56.270%	71.200%
4	8.869%	10.980%	12.575%	30.750%	68.760%	82.720%
5	11.433%	14.155%	16.211%	37.680%	77.690%	94.240%
6	13.997%	17.330%	19.847%	43.910%	86.610%	100%
7	16.561%	20.505%	23.483%	49.810%	95.540%	100%
8	19.125%	23.680%	27.119%	55.710%	100%	100%
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16	39.637%	49.076%	56.210%	100%	100%	100%

NOTE: Table is based on HY/MM convention assuming the assets are placed in service in July of Year 1.

14

Putting Cost Seg In Perspective

The Benefits Are Substantial

For example:

An engineering-based cost segregation study performed on a \$9.9M office building purchased in 2001 yields the following benefit in 2003:

- ▲ Current year cash flow improvement of \$320,000 (*due to deferral of federal income taxes*)
- ▲ Net present value of accelerating federal tax depreciation equal to \$375,000
- ▲ Resulting Benefit to Fee Ratio of 18:1

15

The Benefits of Cost Seg

Can The Benefits Actually Be Used?

Many factors affect the amount of the benefit, even whether or not a taxpayer will receive recognizable benefits, from a Cost Segregation Study:

- ▲ Legal Entity Structure/Basis
 - ▲ Pass Through Entities
 - ▲ S Corps ▲ Partnerships, LPs, LLPs
 - ▲ LLCs ▲ Certain Trusts
 - ▲ C-Corps
 - ▲ REITs
- ▲ Motivation of Taxpayer
 - ▲ Depreciation Recapture – Hold Property or Sell Eventually?
- ▲ Net Passive Loss
- ▲ Alternative Minimum Tax (“AMT”)

16

Make An Informed Cost/Benefit Decision

PRICING

- ▲ **FREE** evaluations and proposals
- ▲ “A typical cost segregation study ... will cost between \$10,000 and \$25,000.” *JOA, 8/2004*
- ▲ **Factors affecting price:**
 - ▲ Single v. multi-site engagements
 - ▲ Local, regional or national scope
 - ▲ Volume discounts

COST / BENEFIT

The cost of the study is typically only a fraction* of the first year tax savings!

* Investment in a study typically yields a first year cash savings return greater than 2:1, but in some cases as high as 40:1.

17

Cost / Benefit Decisions

“Rule of Thumb” Thresholds

Purchased /
Constructed
Commercial Property
(incl. building, land &
improvements)



Capitalized Costs
> \$750,000 **

Capitalized Leasehold
Improvements



Capitalized Costs
(net of landlord /
tenant allowance)
> \$350,000 **

** Multiple properties generally can be aggregated to meet the threshold.

18

Cost Segregation Methodology

Per the IRS, a quality study ...

- ▲ Is prepared by an individual with expertise and experience,
 - ▲ "...personnel competent in design, construction, auditing, and estimating procedures relating to building construction" *PLR 7941002*
- ▲ Provides a detailed description of methodology,
- ▲ Uses appropriate documentation,
- ▲ Includes interviews with appropriate party,
- ▲ Uses common nomenclature,
- ▲ Uses a standard numbering system,

19

Cost Segregation Methodology

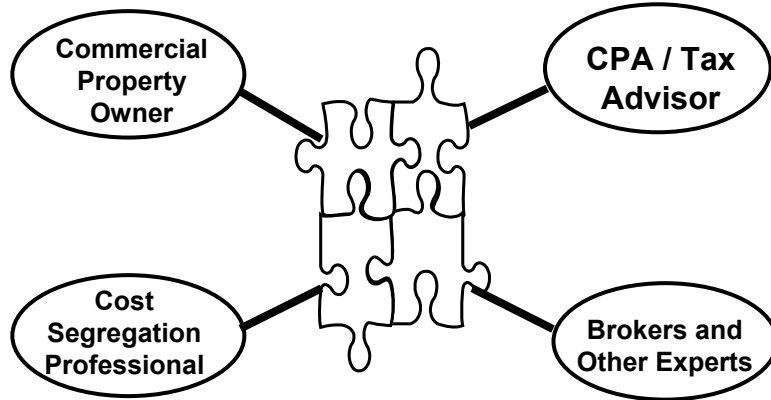
Per the IRS, a quality study ... (cont.)

- ▲ Provides an explanation of the legal analysis,
- ▲ Determines the unit costs and engineering "Take-offs"
- ▲ Organizes the assets into lists or groups
- ▲ Reconciles total allocated costs to total actual costs,
- ▲ Explains the treatment of indirect costs,
- ▲ Identifies and lists the §1245 property,
- ▲ Considers other related aspects

20

The Players

The CASH FLOW and TAX BENEFITS of cost segregation are maximized when all pieces of the puzzle are assembled:



21

Is A Professional Practical?

\$100,000

From 39-Yr to 5-Yr

22

Direct (Hard) Costs

\$100,000
From 39-Yr to 15-Yr

23

Direct (Hard) Costs

\$120,000
From 39-Yr to 7-Yr

24

The Cost Segregation Study Report

Results Reported 3 Different Ways

- 1) **Federal Depreciation Reconciliation**
 - ▲ Reconciles the Federal Depreciation Schedules to the lives and methods resulting from the Study
 - ▲ Can be used to aid in the filing of Form 3115
- 2) **Cost Segregation Summary/Detail**
 - ▲ Gives the results of the Study showing the specific accelerated asset groups and the detail behind each asset group
- 3) **CSI Division Summary/Detail**
 - ▲ Gives the results of the Study in the industry standard Construction Specification Institute (CSI) format with emphasis on data source and costing information

25

The Benefits of Cost Seg

How Are The Cash Flow Benefits Quantified?

First Year Cash Benefit

- ▲ Can be large on assets placed in service three or four years ago or qualified for Bonus Depr
- ▲ NOL carry back opportunities

Years 1-3 Cash Benefit

- ▲ Quantifies benefit for newly placed in service property due to HY convention in initial year

Net Present Value Benefit (over life of the asset)

- ▲ Estimated benefits are based on a 35% Tax Rate and an 5% Discount Rate
- ▲ "Taxpayer specific" benefit calculations are available

26

Proposal Process

To Obtain A PROPOSAL

Provide ONE of the following:

- ▲ Existing Property – Federal tax depreciation schedule (most recent available)
- ▲ New Acquisition – Settlement statement
- ▲ New Construction – General Contractor’s Final Draw Request (G702 & G703)

To Perform The Cost Segregation Study

- ▲ Site plans / blueprints – if available
- ▲ Detail construction cost information – if available
- ▲ Appraisal – if available

27

Sales Cycle

CLIENT Time Requirement

Initial meeting with CLIENT.....	1 hour
Obtain tax depreciation schedule or summary cost information from CLIENT.....	1 hour
Issue proposal	1 day
Meeting with CLIENT to collect available data.....	1 hour
Perform Cost Segregation Study.....	10-30 days
CLIENT review of SUMMARY Report.....	4 hours
Issue / Deliver FINAL Report.....	1 – 2 days

28

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