

Cost Segregation and Energy Efficient Building Deduction

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Cost Segregation-Discussion Outline

- Cost Segregation
 - History and latest developments
 - Cases studies
 - Assets to segregate
- Section 179D
 - Energy Efficient Building Deduction
 - Brief overview

What is cost segregation?

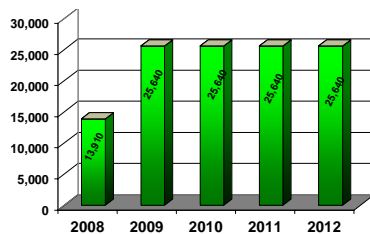
- Cost segregation is the process of assigning class lives to fixed assets for federal and state income tax depreciation purposes.

How does a cost segregation study work?

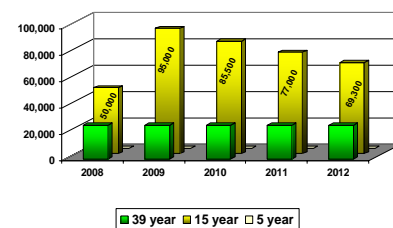
- Building costs are generally classified into three broad categories for federal income tax purposes:
 - Real property 39 years (or 27.5 years) straight line
 - Land Improvements 15 years 150% declining balance
 - Tangible personal property-5 or 7 years 200% declining balance



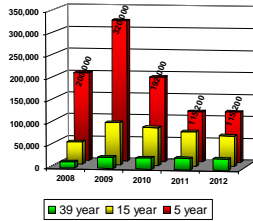
39 year/SL Method-\$1,000,000



15 year 150% DB-\$1,000,000



5 year 200% DB-\$1,000,000



Deductions are drastically increased...

- Depreciation total after 5 years (\$1M)
 - 39 year method: \$ 116,470
 - 15 year method: \$ 376,800
 - 5 year method: \$ 942,400

Increasing Cash Flow...

- Tax reduction in the first 5 years (\$1M)
 - 39 year method \$ 46,588
 - 15 year method \$ 150,720
 - 5 year method \$ 376,960

Historical Background

- Investment Tax Credit (ITC) cases
- 1981 Economic Recovery Tax Act
 - Repealed "component depreciation"
- 1986 Tax Reform Act
 - MACRS
 - Either "land" or "building"

Historical Background

- Hospital Corp of America v. Commissioner (1996)
 - Court ruled that ITC definitions still valid
 - 1986 Act did not alter the underlying definitions of "building" or "personal property"
- Legal Advice Memorandum 199921045
 - IRS acquiescence to HCA case
 - Called for scrutiny of cost segregation studies, but....
 - Specifically mentions cost segregation studies as a legitimate means to identify and allocate costs

Historical Background

- The IRS Audit Guide to Cost Segregation Studies
 - Determination of structural vs. tangible personal property is a facts and circumstances assessment
 - The use of a CSS must be specifically applied by the taxpayer
 - Allocations must be based on "logical and objective measures"
 - CSS may not be based on non-contemporaneous records or reconstructed data, or assumptions that have no supporting records

Historical Background

- IRS audit guide
 - Studies should be closely scrutinized by the field
 - Defines a “Quality Cost Segregation Study”

Historical Background

- IRS definition of a “Quality Cost Segregation Study”
 - Prepared by individual with expertise and experience
 - Use of appropriate documentation
 - Interviews
 - Common nomenclature
 - Explanation of the legal analysis

Historical Background

- IRS definition of a “Quality Cost Segregation Study”
 - Determination of unit costs and engineering takeoffs
 - Organization of assets into lists or groups
 - Reconciliation to total actual costs
 - Identification of Section 1245 Property

Latest Developments

- 2008 Economic Stimulus Package
 - Temporary Bonus Depreciation (50%)
 - Property with depreciation period of 20 years or less
 - Placed in service after 12/31/07 and before 1/1/09
 - Placed in service extended to 12/31/09 – class life of 10+ years

Latest Developments

- Emergency Economic Stabilization Act of 2008 (the “Bailout Package”)
 - Leasehold and Restaurant Improvements treatment
 - Depreciate over 15 years, not 39
 - Restrictions: improvements to existing buildings

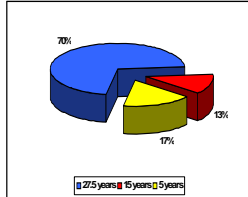
Case Study #1

- Apartment complex, \$18.4 million construction cost
- Assume no “bonus”
- Max federal rate
- New construction



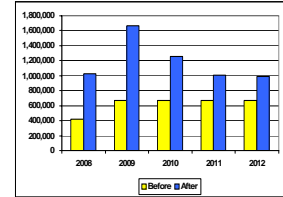
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Case Study #1

- Average \$5 million manufacturing facility
- Assume no "bonus"
- Max federal rate
- Four years after placed-in service date
- First year tax savings: **\$241,000**
- Present value of tax deferrals: **\$694,000**

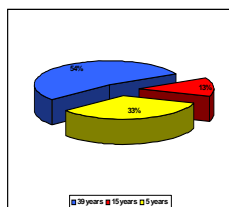
Case Study #2

- Average \$1 million full-service restaurant
- No bonus
- 2006 acquisition (2 years old)
- Max rates



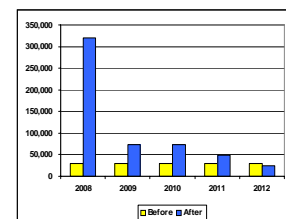
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- Present value of taxes deferred: **\$110,000**

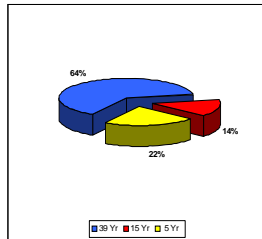
Case Study #3

- Average \$500k dentist office
- 2008 acquisition
- No bonus
- Max rates



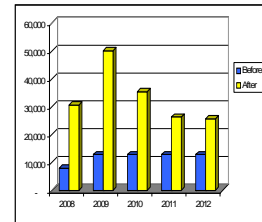
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Case Study #3

- Average \$500k dentist office
- 2008 acquisition
- No bonus
- Max rates
- Tax savings first year: **\$ 9,050**
- Present value of taxes deferred: **\$30,600**

Assets to segregate

- Goal is to segregate three primary categories of property:
 - Building
 - Land Improvements
 - Personal Property

Building (39 or 27.5 year)

- Foundation
- Basic electrical systems
- Basic lighting
- Fire alarm system
- Interior plumbing
- Bath/toilet accessories
- Central Heating
- Central A/C
- Roof top A/C units
- Ductwork
- Door and window frames
- Wood beams and joists

Building (39 or 27.5 year)

- Ceramic tile floor
- Ceramic tile walls
- Paint
- Marble/quarry tile
- Structural steel
- Metal stairs
- Metal frame
- Waterproofing
- Masonry walls
- Doors/windows
- Drywall
- Elevators
- Acoustical ceilings
- Exterior siding
- Roof deck
- Roof covering

Land Improvements (15 year)

- Paving
- Sidewalks
- Curbs
- Landscaping
- Dumpster pads
- Fences
- Storm drainage
- Gas lines-exterior
- Water lines-exterior
- Fire hydrants
- Sprinkler system-exterior
- Flagpoles
- Guard rails
- Pipe bollards
- Patios

Land Improvements (15 year)

- Site lighting
- Storm sewers
- Site plumbing
- Signage
- Masonry walkways

Personal property (5 or 7 year)

- Process trenching
- Process electrical
- Emergency generator
- Emergency lights
- Decorative lighting
- Security system
- Security lighting
- Kitchen plumbing
- Process plumbing
- Process HVAC
- Process ductwork
- Kitchen ductwork
- Decorative millwork
- Crown molding

Personal property (5 or 7 year)

- Kitchen cabinets
- Carpet
- Wallpaper
- Vinyl tile floor
- Access flooring
- Kitchen equipment
- Bank vaults
- Dock levelers
- Dock bumpers
- Window treatments
- Cranes
- Movable partitions
- Material handling systems
- More...

What are good candidates?

- Restaurants
 - Fast food
 - Drive-In
 - Full Service
- Manufacturing
- Medical Facilities
 - Clinics
 - Surgery Centers
- Apartment complexes
- Shopping center
- Office building
- Warehouse
- Hotel
- Many, many more...

Section 179D Deduction

- Immediate deduction for energy efficient improvements
- Applies to property installed as part of –
 - Interior lighting systems
 - HVAC or hot water systems
 - Building envelope

Section 179D Deduction

- Property must be certified to reduce energy consumption by –
 - 50% compared to a “reference building”
 - 16 2/3% for partially qualifying property

Section 179D Deduction

- Amount of deduction
 - Cost of improvements limited to:
 - \$1.80 x s.f. for fully qualifying property
 - or \$.60 x s.f. for partially qualifying
 - Other limitations apply

Section 179D Deduction

- Method of Computation
 - Performance Rating Method (PRM) must be used to compute the reduction in total annual energy and power costs
 - Reduction is compared to a “reference building” (reference building is defined in IRS Notice 2006-52)

Section 179D Deduction

- Certification
 - Not necessary to include certification with the tax return
 - Maintain in tax backup
 - Prepared by a “qualified individual”
 - Engineer or contractor in the jurisdiction where building is located
 - Not related to the building owner



Section 179D Deduction

o Practical considerations

- Vendors of construction materials know if the products qualify and will market them as such (usually to the architect)
- Effective date extended thru 12/31/13



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