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What You Need to Know About Cost Segregation

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What You Need to Know About Cost Segregation

Topics:

- Overview of a Cost Segregation Study
- Tax Implications and Considerations of a Cost Segregation Study
- Investor Benefits and Considerations
- Asset Management Opportunities

What is a Cost Segregation Study?

- A Cost Segregation Study is a study that identifies and allocates building costs into the following tax recovery periods. A typical multi-family property has the following recovery periods:
  - Building: 27.5 years
  - Land improvements: 15 years
  - “Section 1245 property”: 5 years
- History: Hospital Corp of America (1997) – supported the notion of “segregating” building costs using ITC rules.
- Cost segregation methodologies and reports:
  - ✓ Uses engineering based procedures
  - ✓ Follows the IRS Audit Techniques Guide (lists out 13 elements of a “quality cost segregation study.”)

Cost Segregation

- What is the **<u>benefit</u>** of a cost segregation study?
  - ✓ **Substantial tax deferral:** Large amounts of accelerated depreciation in the first 5 to 15 years.
  - ✓ **Includes "bonus depreciation"** on any new property (new construction).
  - ✓ **Benefit is "given back"** after that point in the form of lower depreciation in later years.
  - ✓ **Cost segregation may be combined** with other fixed asset opportunities.

Cost Segregation

- What is the process?
  - ✓ **Benefit estimate:** Calculated based on preliminary (budgeted) information (budgeted numbers, renderings, preliminary architectural drawings, etc.).
  - ✓ **Cost segregation study:** Engineering based approach (review of costs, blueprints, site plans, photos, site visit by engineer, use of software to estimate component costs).
  - ✓ **Must use the IRS prescribed method!**
  - ✓ **Final deliverable:** 50-70 page study with engineering and legal analysis.
  - ✓ **Form 3115** (look-back studies only).

Benefit Estimate – What is the process?

- ✓ Initial “scoping” (benefit estimate):
  - ✓ Based on preliminary information – you can get an estimate of how you would recognize depreciation over the life of the property:
    - ✓ Information that we look at when estimating cost segregation benefits:
      - ✓ Construction budget (with schedule of values)
      - ✓ Preliminary drawings and site plans
      - ✓ Sources and uses
- ✓ Scoping can be more or less formal
  - ✓ Less formal – review information for 2-3 hours and provide 2 page summary
  - ✓ More formal – review more detailed information and provide report based on preliminary information

Sample Estimate of Benefit

Net present value tax savings (6% discount rate)		**$218,868**
Total additional depreciation claimed 2015-2020		**$1,149,992**
Total taxes deferred 2015-2020*		**$367,997**

2015 Analysis		
Depreciation without CSS study		**$363,636**
		-
Estimated depreciation with CSS study		**$1,581,846**
Estimated additional depreciation		**$1,218,210**
Total taxes deferred 2015*	****Sample $10mil property placed in service 2011 (no bonus)/ 2015 Form 3115**	**$389,827**

* Assumes a federal tax rate of 28.0%, a state tax rate of 4.0% (Massachussets)

The actual project – what is the process?

- ✓ Required information:

- ✓ New construction:
  - ✓ As-built drawings
  - ✓ Final payment application with schedule of values
  - ✓ Sources and uses (with detail of indirect costs)
  - ✓ Physical inspection of the building
- ✓ Acquired property:
  - ✓ Settlement statement
  - ✓ Appraisal
  - ✓ Property condition report and/or capital needs assessment
  - ✓ ALTA survey
  - ✓ Physical inspection of the building

The actual project – what is the process?

- ✓ Gather final information (as-built drawings, cost detail, change order detail, etc.).
- ✓ Conduct site visit (take property photos, take-offs) – typically ½ day on site.
- ✓ Finalize report using information collected and cost information (RS Means/Marshall and Swift).
- ✓ Coordinate with tax preparer to make sure results are properly implemented.

✓ Overall timing:

- ✓ Generally – 4 weeks (from date of signed EL) to complete actual study

Examples of “typical” interior costs that get allocated to a shorter recovery period

- ✓ Audiovisual, computer, telecommunication equipment
- ✓ Cabinets, counters, and shelving
- ✓ Electrical service to computers, information systems, and personal property
- ✓ Plumbing service to personal property
- ✓ Appliances (refrigerator, washer, dryer, exhaust fans, garbage disposal)
- ✓ Carpet, vinyl, and non-permanent wood flooring
- ✓ Furniture fixtures and equipment
- ✓ Decorative millwork
- ✓ Certain signs

Examples of "typical" land improvements that get allocated to a shorter recovery period

- ✓ Asphalt
- ✓ Concrete
- ✓ Parking lot lighting
- ✓ Curb and gutters
- ✓ Signage
- ✓ Landscaping

Possible Percentages

- We see the following percentages:

Property Type	5 year	15 year
New construction – typical garden apartment with surface parking and site amenities	12% - 15%	8% - 12%
New construction – typical "zero lot" – single building apartment (no surface parking and very little land improvements)	12% - 15%	1% - 5%
Acquisition – Rehab – garden apartment	3% - 7% (depending on rehab)	3%-8% (depending on rehab)

Form 3115 Process (Lookback study only)

- ✓ Under current IRS rules:
  - ✓ Form Due Date: Last day of tax year (12/31/XX)
  - ✓ IRS User Fee: $9,500
  - ✓ Section 481(a) adjustment:
    - ✓ Measures additional depreciation as of first day of the year of change (1/1/XX)

Cost Segregation Case Study

- ✓ $35mm, 9% LIHTC project currently under construction
- ✓ The developer's pro forma shows $426,000 of personal property, $1,514,000 of site improvements and $ 27,751,676 classified as 27year building costs
- ✓ Based on these classifications, the pro forma reflects a 4.75% IRR
- ✓ CohnReznick's engineers went through the construction drawings & cost detail and determined that the following allocations were sustainable:
  - ✓ $3,398,329 of 5 year personal property
  - ✓ $2,276,868 of 15 year site improvements
  - ✓ $24,067,528 mm of 27.5 year building costs
  - ✓ Depreciation was recalculated using bonus depreciation
  - ✓ Revised IRR of 5.5%

Cost Segregation Case Study

- ✓ The revised projection of IRR reflects the impact of reclassifying development costs more aggressively using bonus depreciation but does NOT reflect several additional value add opportunities:
  - ✓ The potential impact of utilizing the de minimis rule in the tangible personal property regulations
  - ✓ The potential impact of claiming $2,000 per unit of Section 45L energy efficient home credits

Other Issues

- ✓ Do I have to do the cost segregation?
  - ✓ Answer: No, but section 1016 says that your basis is reduced by the greater of allowed or allowable depreciation.
- ✓ Does it always make sense:
  - ✓ Answer: No. If you are doing a 4% acquisition / rehab, you might not want to do a cost segregation on the acquisition, though you might still want a cost segregation on the rehab.
- ✓ What about IRS audit risk?
  - ✓ Answer: Cost segregations have been around for 20 years. A properly performed cost segregation study should withstand an IRS exam.
- ✓ Can I do the study later?
  - ✓ Answer: Yes, but the filing might be non-automatic. Filing the Form 3115 is required
  - ✓ Section 481(a) adjustment
  - ✓ Effect of technical termination (years before 2018)

Other Issues

- ✓ What if I'm taking HTC?
  - ✓ You would generally <u>NOT</u> want a cost segregation because you could lose eligible credit basis.
- ✓ How do the new interest limitation rules affect depreciation?
  - ✓ If I elect to be a "qualified real property trade or business" do I use 30 year or 40 year life?
- ✓ Investor capital account/allocation/reporting issues