New IRS Issued Tangible Property Regulations (TPR) Impact on the Cost Segregation Industry

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What is a Cost Segregation Study?

The identification of items and their cost that qualify for 15, 7 and 5 year recovery periods and accelerated depreciation methods that are normally included in the construction or acquisition of a building(s) and depreciated over 27.5 or 39 years.
Impact of a Cost Segregation Study

Accelerating the depreciation period increases depreciation expense which lowers net income. Lower net income means lower income-tax payments.

It *Defers* Taxes,
It Does Not Eliminate Them.
Financial Impact of a Cost Segregation Study

Every $1,000,000 reclassified from 39 years has an after-tax present value* of:

$220,000 for 5 Year Property
$200,000 for 7 Year Property
$120,000 for 15 Year Property

*Assumes a 40% Tax Rate; 8% Discount Rate
Financial Impact Residential Rental Property

Every $1,000,000 reclassified from 27.5 years has an after-tax present value of:

$180,000 for 5 Year Property
$80,000 for 15 Year Property

*Assumes a 40% Tax Rate; 8% Discount Rate
What Does A Cost Segregation Cost?

• Depends on type of property
• A manufacturing facility will cost more than an office building
• Typical fee ranges from $7,000 to $15,000
Tax Code Changes Create the Opportunity

1981  -  Established Recovery Periods for Business Property at 5-15 Years.
1984  -  Extended Recovery Periods to 19 Years (Tax Act).
1986  -  Extended Recovery Periods from 19 Years to 31.5 Years Straight-Line.
1993  -  Extended Recovery Period from 31.5 Years to 39 Years.
2002-2008  -  Temporary 30% / 50% Bonus Depreciation.
2009  -  Extension of 50% Bonus Depreciation (CO Dated by 12/31/09)
         Expansion of NOL Carry Back to 5 years.
Tax Code Changes Create the Opportunity

2010 - In September extended 50% Bonus Depreciation for 2010

2010 In December increased Bonus Depreciation to 100% for buildings placed in service between 9/08/2010 and 12/31/11

2010 - In December extended QLI for 2011 and 2012

2014 On January 1st bonus depreciation was extended for 2013
At the same time QLI, Retail, & Restaurant were extended for 2012, 2013 & 2014

New Tangible Property Regulations

2015 Bonus and Leaseholds were extended for 2015 and beyond
Cost Segregation Opportunities

- New Construction
- Purchase of Existing Property
- Renovations or Expansions
- Leasehold Improvements
- Existing Property Placed in Service After 1986 ("Look-Backs")
- Real Property Stepped-Up Through Estate
## Typical Percentages of Accelerated Property

<table>
<thead>
<tr>
<th>Property Types</th>
<th>Typical % Eligible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing/Processing</td>
<td>30-60%</td>
</tr>
<tr>
<td>Research &amp; Development</td>
<td>30-60%</td>
</tr>
<tr>
<td>Automobile Dealerships</td>
<td>25-50%</td>
</tr>
<tr>
<td>Medical Office Buildings</td>
<td>30-50%</td>
</tr>
<tr>
<td>Golf Courses</td>
<td>20-40%</td>
</tr>
<tr>
<td>Offices</td>
<td>25-45%</td>
</tr>
<tr>
<td>Restaurants (Single or Multiple)</td>
<td>20-40%</td>
</tr>
<tr>
<td>Apartments</td>
<td>20-35%</td>
</tr>
<tr>
<td>Retail (Dept/Specialty Stores)</td>
<td>35-50%</td>
</tr>
<tr>
<td>Grocery Stores</td>
<td>20-30%</td>
</tr>
<tr>
<td>Hotels/Motels</td>
<td>20-45%</td>
</tr>
<tr>
<td>Senior Living/Assisted Living</td>
<td>15-25%</td>
</tr>
<tr>
<td>Strip or Regional Malls</td>
<td>5-30%</td>
</tr>
<tr>
<td>Tenant Improvements</td>
<td>5-50%</td>
</tr>
</tbody>
</table>
New Construction

1. Analyze Drawings & Specifications and Inspect Property to Identify Various Asset Classes (5, 7, 15, 27.5, 39 years)
2. Perform Quantity Takeoff Where Individual Item Costs Are Not Available
3. Estimate Current Cost of Assets using Recognized Cost Sources
4. Tie to Total Direct Costs by Subcontractor
5. Allocate General Indirect to All Assets and Specific Indirect to Items Where They Apply
Acquisition or Sale/Leaseback

1. Analyze Drawings & Specifications and Inspect Property to Identify Various Asset Classes (5, 7, 15, 27.5, 39 years)
2. Perform Quantity Takeoff of Entire Property From Drawings or Estimate if Drawings Are Not Available
3. Estimate Current Cost of Assets using Recognized Cost Sources
4. Depreciate Current Replacement Cost to Account for Physical Depreciation and Functional Obsolescence
5. Tie to Taxpayers Tax Basis
Restaurant Kitchen HVAC
Supermarket Electrical Riser
The Biggest Gift the IRS Has Handed Out To Real Estate Owners In Years...

IRS Revenue Procedure 99-49
(Supersedes IRS Revenue Procedures 96-31, 97-37 & 98-60)
The Biggest Gift the IRS Has Handed Out To Real Estate Owners In Years...

Through Application 3115 - IRS allows real estate owners the change to “catch-up” on their depreciation deductions if they never took advantage of the MACRS Classifications. A cost segregation study is performed, the taxpayer computes the current depreciation deduction versus the additional depreciation we find as a result of our detailed engineering approach. The difference is then “caught-up” in the year of the election.
Window of Opportunity

Window of opportunity is for buildings that have been acquired, constructed or renovated from 1990 forward.

$ubstantial $avings = Value Billing Opportunity
The Look-Back Benefit

$10 million retail shopping center, placed into service 7 years ago:

Original Depreciation Method: 39-year SL(8MIL/39 Yrs/205K/yr.)

Reclassified Amount with Cost Segregation Study:

- 5-year Property- $1 million
- 15-year Property- $1.5 million

Adjustment Calculation and Resulting Tax Benefit:

Depreciation Reported Previously 1,435,000
Cost Segregation Study Depreciation $3,923,070
Section 481(a) Adjustment $1,358,970
Tax Rate 40%
Tax Benefit in Year of Study $543,588

The Bottom Line – by performing an engineering-based cost seg study, the building owner was able to increase the amount of depreciation expense, thus reducing the current year taxable income, resulting in an increase in cash flow of $544k.
Tangible Property Regulations Overview

• The US Treasury and the IRS worked for over a decade to finalize these regulations

• Taxpayer must employ to determine whether its expenditures made on or for tangible property, both real and personal, must be capitalized and then depreciated, deferred, or deducted as a tax expense.

• The TPRs are required to be implemented by all taxpayers in its first income tax year beginning after January 1, 2014.
Tangible Property Regulations Overview

• Taxpayers do not have a choice in the implementation of the TPRs. Non-compliance with the TPRs subjects a taxpayer to the IRS Circular 230 penalties and to the “use it or lose it” consequences of IRS Regulation 1.1016-3.

• The threat of an IRS denial of the remaining tax deduction of improperly capitalized assets is a strong motivator for taxpayers to devote the necessary time and costs to properly employ the TPRs.
Tangible Property Regulations
Overview —10,000-Feet Observations

- Few objective rules
- What you have done to date (asset groupings, cost segregation, depreciation choices) matter
- Cost segregation still relevant and needed (for write off of old when new improvements are made) and still important for other issues (ability to depreciate different classes)
- Multiple Code Sections changed, not just 263(a), but also sections 162, 168
- Every taxpayer (TP) is affected,
- Just about every TP will have to file a 3115 or two
The process to implement the TPRs consists of the following general steps:

A taxpayer must determine if the expenditure is:

i. Related to the purchase, acquisition, or production of an asset (known as a Unit of Property – UoP)

ii. One related to assets that are already in service.

If the expenditure is related to item (i) above, it must be capitalized. If the expenditure is related instead to item (ii), then the taxpayer must employ the TPR process.
Tangible Property Regulations
Overview

• First determine the appropriate or applicable UoP and then compare the taxpayer’s expenditure to the unit of property using the TPR specified rules known as the restoration, adaption, betterment and improvement (RABI) criteria.

• If the expenditure meets any one of the RABI criterion, then the taxpayer must capitalize the expenditure.

• If none of the criterion is met the taxpayer must deduct the expenditure as an ordinary and necessary expenditure.
Tangible Property Regulations Overview

• After the results of the TPR Study are available, the implementation and reporting of the TPRs requires the completion and submission of IRS Form 3115(s), *Change in Methods of Accounting*.

• The most common new TPR annual election is the de minimis safe harbor (DMSH). The proper adoption and employment of the DMSH enables a taxpayer to avoid the TPR steps on those expenditures and just deduct as an expense.
Building and Structural Components
1.263(a)-3T(e)(2) (UoP)

- **Old Rule:** Taxpayer was required to depreciate building improvements over the life of the original asset (39 years), even if building had been 29 years into its depreciable life; no write off of the replaced component
  - If one replaced a roof, for example, you depreciated two roofs – the original one and the replaced one, or three roofs, etc.
- **New Rule:** replace a roof, recover as a loss the remaining basis of the old roof (or roofs), book the new roof and depreciate it
Unit of Property (UoP)

Is a very important element to these and other regulations

Does the client first need to change its UoP before it makes a method change under the new Tangible Property Regulations?
Unit of Property (UoP) for Buildings

1. Building Structure
2. Building Systems (9) Defines building systems to include (1) the heating, ventilation, and air conditioning systems (“HVAC”); (2) the plumbing systems; (3) the electrical systems; (4) all escalators; (5) all elevators; (6) the fire protection and alarm systems; (7) the security systems; (8) the gas distribution systems; and (9) any other systems identified in published guidance.
Unit of Property (UoP) - 1

- UoP is a very important issue, why?: It is an important criteria in the decision whether a TP can write off an expenditure.
- Generally:
  The smaller the UoP the more likely the expenditure has to be capitalized.
- This issue should almost always be considered in TR issues, most of the time, early.
- If your current UoP does not match what you need/want to do – you must an accounting method change to get it corrected.
Building UoP Examples - 2

- Office building with multiple floors: UoP is the building
- Apartment complex with four buildings: UoP is each individual separate building – correct the UoP in a 3115 filing
- Multi building retail stores
  Each individual separate building
- Office Condos in one building
  Each separate office condo
Building UoP Examples - 3

• Hotel = The building
• Motel with several separate buildings
  Each separate building
• Fast Food Restaurant
  The building or each separate building
• Manufacturing plant
  The building or each separate building
• UoP for tangible personal property is more difficult
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