The Benefits of Cost Segregation and Federal Tax Planning for Assets

Mark Rogers
Director
Grant Thornton LLP
Chicago, IL
mark.rogers@us.gt.com

Daniel McGrath
Senior Director
RSM US LLP
Chicago, IL
daniel.mcgrath@rsmus.com
Cost Segregation Defined

Traditional Definition
Cost segregation is the identification of personal property assets from real property assets that results in an accelerated increase in depreciation expense.

Rebooted Definition
Cost segregation is the componentization of personal and real property assets that can result in an accelerated increase in depreciation or an immediate year one expense while setting up future dispositions.
History

• Investment Tax Credit
• Tax Reform Act of 1986
• Revenue Procedure 87-56
• Revenue Procedure 96-31
• Job Creation and Worker Assistance Act of 2002
• IRS Audit Techniques Guide (Cost Segregation)
• Proposed “Repair” Regulations
• Tangible Property Regulations
• Protecting Americans from Tax Hikes Act of 2015
• IRS Audit Techniques Guide (Tangible Property)
Applying the Rules
Capitalize vs Expense

- Determine if expenditure is required to be capitalized
  - New assets
  - Betterment
  - Restoration
  - Adaptation
  - De minimis capitalization policy
  - Materials & Supplies

- Unit of Property
- Major Component
Applying the Rules
Depreciation Guidelines

• Modified Accelerated Cost Recovery System

• Revenue Procedure 87-56 established recovery periods by:
  • Specific assets used in any business
  • Industry type
  • Activity

• General Depreciation System (GDS) and Alternative Depreciation System (ADS)
Applying the Rules
Standard Depreciation Lives

• Section 1245 Personal Property
  • Typically 5 or 7 years
  • 200% declining balance
  • Carpet, wallpaper, electrical associated with equipment, process plumbing, etc.

• Section 1250 Real Property
  • Typically 15, 27.5 or 39 years
  • Straight-line or 150% declining balance
  • Land improvements, leasehold improvements and buildings
Applying the Rules

Bonus Depreciation

First-year write down of new asset costs:

- 09/11/01 – 05/05/03  30%
- 05/06/03 – 12/31/04  50%
- 01/01/08 – 09/07/10  50%
- 09/08/10 – 12/31/11  100%
- 01/01/12 – 12/31/17  50%
- 01/01/18 – 12/31/18  40%
- 01/01/19 – 12/31/19  30%

Subject to certain qualifications
# Applying the Rules
## 15-year Qualified Real Property

<table>
<thead>
<tr>
<th>Requirements</th>
<th>Leasehold improvements</th>
<th>Retail improvements</th>
<th>Restaurant building and improvements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pursuant to a lease</td>
<td>Interior improvement</td>
<td>Interior improvement</td>
<td>Interior improvement</td>
</tr>
<tr>
<td>Lease not between related parties</td>
<td>Nonresidential real property</td>
<td>Nonresidential real property</td>
<td>Buildings PIS post-2008</td>
</tr>
<tr>
<td>Interior improvement</td>
<td>Open to general public</td>
<td>Open to general public</td>
<td>New or acquired buildings</td>
</tr>
<tr>
<td>Nonresidential real property</td>
<td>Used in retail trade</td>
<td>Used in retail trade</td>
<td>&gt; 50 percent of square footage devoted to prep of and seating for on-premises consumption of prepared meals</td>
</tr>
<tr>
<td>PIS (placed in service) &gt; three years after building PIS</td>
<td>PIS &gt; three years after building PIS</td>
<td>PIS &gt; three years after building PIS</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Does not apply</th>
<th>HVAC units located outside</th>
<th>Enlargement of building</th>
<th>Buildings PIS pre-2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enlargement of building</td>
<td>Elevators and escalators</td>
<td>Elevators and escalators</td>
<td>Section 1245 personal property</td>
</tr>
<tr>
<td>Elevators and escalators</td>
<td>Common area structural components</td>
<td>Common area structural components</td>
<td></td>
</tr>
<tr>
<td>Common area structural components</td>
<td>Internal structural framework</td>
<td>Internal structural framework</td>
<td></td>
</tr>
<tr>
<td>Internal structural framework</td>
<td>Section 1245 personal property</td>
<td>Section 1245 personal property</td>
<td></td>
</tr>
<tr>
<td>Section 1245 personal property</td>
<td>Residential rental property</td>
<td>Residential rental property</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bonus</th>
<th>Yes</th>
<th>No</th>
<th>Yes for pre-2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No</td>
<td></td>
<td>No for post-2008</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Method</th>
<th>15-year</th>
<th>15-year</th>
<th>15-year</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-year</td>
<td>Straight-line</td>
<td>Straight-line</td>
<td>Straight-line</td>
</tr>
<tr>
<td>Straight-line</td>
<td>Half-year or mid-quarter</td>
<td>Half-year or mid-quarter</td>
<td>Half-year or mid-quarter</td>
</tr>
</tbody>
</table>
Applying the Rules
Qualified Improvement Property

- Eligible for bonus depreciation
- 39-year recovery period, straight-line
- Interior non-structural real property
- No third-party lease required
- Placed in service after original building
- Permanent starting 1/1/2016
Finding Cost Segregation Opportunities

Regular maintenance of tax fixed asset additions is recommended

- **Review** the following: *fixed asset ledger, construction in progress report, capital authorization requests, engineer interviews*

- **Triggers** are found among: building, building improvements, leasehold improvements, tenant improvements, land improvements
Finding Cost Segregation Opportunities

• Ask **questions** around the following triggers: *new building, renovation, expansion, equipment change-out*

• **Information** to collect for triggers: *AIA G701-03, invoices, drawings, photographs*
Finding Cost Segregation Opportunities

Identified triggers are scoped against current fixed asset tax law

- **Opportunities** arise in the form of:
  - *qualified improvement property*
  - *qualified leasehold improvement property*
  - *partial dispositions & removal costs*
  - *repair & maintenance costs*
  - *life changes*

**Example #1** - Renovation/Expansion of plant
**Example #2** - Remodel of retail store
The Book to Tax Relationship

• Traditional thinking would suggest that financial book drives the tax book

• Book driving tax might create administrative ease, but risks:
  • compliance with tax law
  • forfeit of significant tax deductions

• Cost segregation does not change what the financial book is doing on a monthly basis

  book asset coded "BLDG"
The Book to Tax Relationship

• Accounting processes need to align with tax strategy

• Collaboration between accounting and tax departments is necessary

• Cost Segregation does create a book to tax difference

• Company's objectives need to be weighed against tax compliance and value
  • Permanent versus timing differences
  • Increase cash flow
Maintaining Proper Methods and Maximizing Deductions

• Re-evaluate (or establish) a capitalization policy

• Consider enhancing capital authorization request requirements

• Develop a pro-active plan to review expenditures when incurred

• Gather supporting documentation (i.e. invoices, capital authorization requests, notes from discussion, etc.)
Maintaining Proper Methods and Maximizing Deductions

• Determine if capitalization is required and assign lives

• Maintain fixed asset tax depreciation in a fixed asset software package (not Excel)

• Confirm that treatment of new expenditures comply with elected methods

• Allow adequate review time in advance of tax return preparation
Questions