© 2011 Thomson Reuters. Originally appeared in the Summer 2011 issue of Real Estate Finance Journal. For more information on that publication, please visit http://west.thomson.com. Reprinted with permission.

Using Cost Segregation to Realize the Full Bonus Depreciation Deduction

*Larry Portal**

In this article, the author describes the benefits of using a cost segregation analyst to maximize the bonus depreciation deduction.

With the recent passing of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, bonus depreciation is back in the spotlight for many real estate owners. The Act allows property owners, who place in service certain qualified property after September 8, 2010, and before January 1, 2012, to depreciate that property 100% the first year. For qualifying property they place in service during the tax year 2012, they can depreciate half of the property's basis in that year.

Bonus Depreciation

Bonus depreciation itself is not a new concept. It has been around since 2001 where under Internal Revenue Code ("IRC" or the "Code") Section 168(k) it applied to qualifying property placed in service after September 11, 2001, through May 5, 2003. Under the provision, the Internal Revenue Service ("IRS") allowed tax payers to claim 30% bonus depreciation. The government continued to encourage new construction by passing the Jobs and Growth Tax Relief Reconciliation Act of 2003 in which they increased the percent from 30 to 50 for property placed in service from May 6, 2003, through December 31, 2005. After that the benefit was shelved until 2008 when the IRS under the Economic Stimulus Act of 2008 resurrected 50% bonus depreciation and then extended it under the Economic Recovery and Stabilization Act of 2009 and the Small Business Jobs Act of 2010. Together these three acts allowed tax payers to claim 50% bonus depreciation on certain qualified property placed in service beginning January 1, 2008, and ending December 31, 2010.

It is under the current Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 that the IRS upped the ante for certain qualified property placed in service after September 8, 2010, and before January 1, 2012, from 50% to 100, and a 100% bonus is enticing. The Act then reverts to the still high 50% for qualifying property placed in service during the 2012 tax year.

Certain Qualified Property

So what is this "certain qualified property" that these Acts keep touting as the must-have assets to get a bonus deduction? According to IRC Section 168(k) the IRS defines certain qualifying property as new:

*Larry Portal is a Senior Managing Director in the Real Estate Solutions practice of FTI Consulting, Inc., and is based in New Jersey where he leads the practice's Business Tax Advisory Group. Contact Mr. Portal at larry.portal@fticonsulting.com.

© 2011 Thomson Reuters

- property that is new with a Modified Accelerated Cost Recovery System ("MACRS") recovery period of 20 years or less;
- computer software as depreciated under I.R.C. § 167(f)(1);
- I.R.C. § 168(e)(5) water utility property that is depreciated under MACRS; and
- 15-year qualified leasehold improvements.

The IRS specifically excludes property required to use ADS lives, 15-year qualified restaurant property, and 15-year qualified retail improvement property from receiving bonus depreciation. Further, the taxpayer must actively opt-out of using bonus depreciation, otherwise the IRS requires taxpayers to claim bonus depreciation.

And so the alluring concept of getting an easy 100% or even a 50% bonus starts to get complicated. Based on this definition it is clear that in order to claim a bonus depreciation deduction a property owner needs to be in tune with the MACRS class life of his property, and there are nine to choose from.

Of the nine MACRS classes, the following six, with the exception of 15-year retail and restaurant property, meet the criteria to qualify for bonus depreciation:

1) three-year personal property such as computer software that is not amortizable under I.R.C. § 197;

2) five-year personal property such as:

   - computers and their associated peripheral equipment,
   - data handling equipment (other than computers) such as adding machines and copiers, semi-conductor manufacturing equipment, computer based telephone central office switching equipment, high technological telephone systems and medical equipment,
   - Section 1245 property used in connection with research and experimentation,
   - personal property used in the personal and professional services and retail and wholesale trades, and,
   - personal property used in residential rentals;

3) seven-year property such as:

   - office furniture,
   - fixtures and equipment,
   - railroad assets,
   - air transport assets,
   - agricultural and horticultural structures,
   - certain oil and gas gathering systems,
   - personal property used in the recreational business and theme and amusement parks, and
   - personal property with no assigned class life;

4) 10-year property such as:

   - certain water vessels,
   - single-purpose agricultural or horticultural structures,
   - fruit or nut bearing trees, and

© 2011 Thomson Reuters

- smart electric meters and grids systems;

5) 15-year property such as:

- land improvements,
- qualified leasehold improvements,
- municipal wastewater treatment plants,
- telephone distribution plants,
- assets used in producing cement (but not cement products),
- water transportation assets for commercial and contract freight and passengers,
- central pipeline transportation assets,
- qualifying retail motor fuel outlets,
- service station buildings,
- car wash buildings,
- billboards, and
- electric utility nuclear power assets; and

6) 20-year property such as:

- farm buildings,
- municipal sewers,
- property used by utility to gather, treat and distribute water, and
- assets used to transmit and distribute electricity.

The remaining three MACRS classes: 27.5-year real residential rental property and 31.5- and 39-year real non-residential commercial property would not qualify for bonus depreciation.

In order to determine the proper MACRS class life the IRS requires property owners to make the distinction between personal property and real property. Personal property typically has an associated class life of three, five, or seven years and is defined in Regulation 1.48-1(c) as:

> all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property.

Further if the property does not relate to the operation or maintenance of a building the property qualifies as personal property. This would include the electrical, plumbing and mechanical systems which support machinery and equipment as well as any decorative features such as lighting and moldings.

Real Property

Real property typically has an associated MACRS class life of 15 years for land improvements and qualified leasehold, retail and restaurant improvements, 27.5 years for residential rental property, or 31.5 and 39 years for non-residential commercial property. According to Regulation 1.48(e)(2) real property, as paraphrased: consists of those structural components of a building which relate to the operation and maintenance of such building excluding any machinery where the “sole justification” for such machinery is to maintain temperature or humidity requirements of other machinery or the processing of materials or foodstuffs. Specifically listed as structural components are:

- walls;
- partitions;

© 2011 Thomson Reuters

- floors; and
- ceilings.

In addition, structural components include any permanent coverings such as:

- paneling or tiling;
- windows and doors;
- central air conditioning or heating systems;
- plumbing and plumbing fixtures;
- electric wiring and lighting fixtures;
- chimneys;
- stairs;
- escalators, and elevators;
- sprinkler systems and fire escapes as they relate to the operation or maintenance of a building.

The IRS also considers most land improvements to be real property. Some examples of land improvement property are:

- sidewalks;
- roads;
- canals;
- waterways;
- drainage facilities;
- sewers (excluding municipal sewers);
- wharves and docks;
- bridges;
- non-agricultural fences;
- landscaping;
- shrubbery;
- radio and television transmitting towers; and
- parking lots.

Even when a property owner is able to sort through the complexities of these rules for the purpose of assigning MACRS class lives, they often are impeded when they realize that the cost information they have for their projects, although correctly categorized from a construction point of view, does not categorize the costs from a MACRS standpoint.

Costs

The standard cost document used for commercial construction project is a contractor's application for payment form G702/G703. A G702/G703 document will display costs categorized according to the American Institute of Architects ("A.I.A.") standards. A typical set of cost categories a property owner would see on their contractor's G702/G703 document are:

- Insurance;
- General Conditions;
- Overhead and Profit;
- Survey;
- Site Work;
- Concrete;
- Masonry;
- Structural Steel;
- Carpentry;
- Roofing;
- Sealants and Caulking;
- Doors;

© 2011 Thomson Reuters

- Frames and Hardware;
- Aluminum;
- Glass and Glazing;
- Flooring;
- Paint and Wall Covering;
- Toilet and Bath Accessories;
- Furniture;
- Fixtures and Equipment;
- Fire Protection;
- Plumbing, Heating, Ventilation and Air Conditioning ("HVAC"), and
- Electrical.

Although on the surface some of these costs, such as Furniture, Fixtures and Equipment, can easily be classified into shorter MACRS tax lives, the owner must be aware that these costs were not grouped according to MACRS classifications and should use caution when classifying entire cost categories to shorter MACRS class lives. Take for example the Paint and Wall Covering cost category from above. The IRS ruled that wall coverings that are removable are considered to be personal property with a typical MACRS life of five or seven years. The property owner verified with their contractor that the wall coverings used at his property were indeed removable and located in the retail area of his store, and, therefore, he wanted to classify this cost as five-year property. The problem is that the IRS considers painting real property with a MACRS class life of 39 years for retail stores. With no distinction made on the G702/G703 between the costs of the wall covering and the costs of the painting the owner has to assign these costs to the longest of the two tax lives for these assets which is 39 years. Hence, the property owner misses the shorter MACRS classification for removable wall covering and its subsequent bonus depreciation deduction. This is where a Cost Segregation Study comes into play.

Cost Segregation Study

To properly make these distinctions between personal and real property and place their construction costs into the correct MACRS classes, property owners hire specialists to perform what is known as a Cost Segregation Study on their property. A Cost Segregation analyst possesses the skills to estimate costs for qualifying property that is otherwise not easily identified within the cost documents of a project. The more qualifying property the owner classifies the greater the bonus depreciation deduction.

A typical Cost Segregation study begins with the owner providing the Cost Segregation analyst with all the supporting cost detail they have for the project's depreciable basis. This cost information may include one or more of the following: the contractor's final application for payment (A.I.A G702/G703), change orders, invoices, an acquisition price, and/or a fixed asset listing. The owner would also provide any available construction drawings associated with the project.

The analyst would then sort the costs into two categories: direct or indirect. Indirect costs are those costs which are "indirectly" related to the construction of the project, such as:

- architect fees;
- contractor's overhead and profit;
- legal fees; and
- permit fees.

© 2011 Thomson Reuters

Direct costs are those costs that "directly" relate to the construction of the project such as:

- earthwork;
- concrete costs;
- electrical costs;
- plumbing costs; and
- mechanical costs.

The IRS guidelines allow the indirect costs to be allocated over all the direct costs to which they relate on a pro rata basis.

The Cost Segregation analyst would then determine whether the remaining direct costs are personal property or real property. It is during this process that the analyst may identify qualifying property that is not specifically listed within the cost information. To determine the costs of this property, the analyst is qualified to estimate the cost of such assets using construction drawings and/or on-site measurements and will assign the costs for these quantity take offs using IRS recognized, independent cost sources, such as R.S. Means or Marshall and Swift. These estimated costs will then be adjusted for physical depreciation, time, and location. This approach is in keeping with IRS standards as cited in their National Office Technical Advice Memorandum of June 25, 1979, which is paraphrased in part:

> Shainberg and Revenue Ruling 66-111 recognizes a basic fact: with respect to a newly constructed (property), the actual costs of separate components or of component groups may not, and in some cases cannot, be known to the builder. In reporting component costs to the owner, the builder normally has to make various assumptions, estimates, and allocations even if the make-up of the components is simple. The categorizing of costs into complex component group accounts, however, calls for estimates and allocations that the builder may not be very well qualified to make. It required careful analysis and measurement of the materials and necessary labor that entered into the in-place items, and an allocation of the reflected costs to the component groupings. An adjustment from the costs thus derived to actual costs may be required, as well as fair and reasonable distribution of all indirect costs in the component group accounts. The consultation is best performed by a consulting firm that employs personnel competent in design, construction, auditing, and estimating procedures relating to (property) construction. They are undoubtedly qualified to make the proper allocation of actual costs that is recognized by Revenue Ruling 66-111 as being acceptable.

Returning to the case of the removable wall coverings from above. A Cost Segregation analyst would measure the quantities of the wallpaper according to how it is priced in the costs books. Assume that R.S. Means lists the cost of heavy weight vinyl wall covering at \$2.80 per square foot ("S.F."). The analyst would take measurements in square feet, either from the construction drawings or from an on-site measurement and establish the quantity. Let's assume the total square feet of wall paper is 2,500 S.F. The total qualifying costs then would be 2,500 × \$2.80 = \$7,000. If this property were placed in service in 2011, simply speaking that would be a \$7,000 tax-write off in the first year that the owner would otherwise miss out on.

Do not let this small amount deceive you—that was just the wall covering. Within the cost buckets of what otherwise would typically be 27.5- and 39-year property lives qualifying property such as:

- computer telephone and cable outlets and their associated wire;
- built-in cabinetry counters and millwork;
- removable floor coverings such as carpet and vinyl composition tile;

© 2011 Thomson Reuters

- supplemental air conditioning systems;
- back-up power generators;
- power outlets, wires, and breakers that serve qualifying equipment;
- kitchen sinks and plumbing systems;
- decorative lighting; and
- site improvements such as paving, sidewalks, curbs, signage, lighting, and underground utilities.

The percent of qualifying property segregated from the total construction cost range from five to 7% for an office building all the way up to 50% or more for computer data centers or other high tech facilities. To put this in perspective, let's take the example of a property owner who constructed a new office building and will place this property in service sometime in 2011. Thanks to the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 any MACRS property with a class life of 20 years or less would qualify for 100% bonus depreciation. The total construction costs are $5,000,000. Realizing the potential benefits, the owner had a consulting firm perform a Cost Segregation Study on their project. Even at the low end, 5% of $5,000,000 is $250,000, which makes quite a bonus. The fee charged to perform this study is typically a small fraction of these true tax savings. Property owners typically find that the study more than pays for itself based on the results.

Conclusion

In the end what is clear is the world of MACRS Depreciation and its promise of 50% and 100% bonuses is a complicated place. Although most property owners are able to muddle through the complexities of the Code they find that having a Cost Segregation study performed leaves nothing on the table and maximizes their deduction.

© 2011 Thomson Reuters