

North Texas Enrolled Agents Cost Segregation Overview & Recent Updates

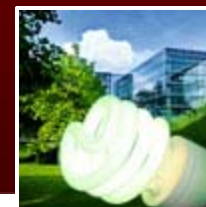


SOLUTIONS FOR TAX PROFESSIONALS AND BUSINESSES
TAX CREDITS • INCENTIVES • COST RECOVERY



Eddie Price, CCSP
Director

About KBKG



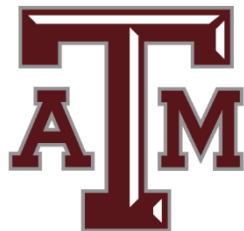
- Established in 1999 with offices across the US including California, New York, Chicago, Dallas, and Atlanta
- Provide turn-key tax solutions to tax preparers and businesses
- Cost Segregation, R&D Tax Credits, Energy Tax Incentives, Repair vs. Capitalization Studies, IC-DISC Export Incentives
- Performed thousands of tax projects resulting in hundreds of millions of dollars in benefits for our clients
- Diverse mix of tax specialists, attorneys, energy consultants and engineers from various disciplines
- A preferred provider for thousands of tax preparers across the country



Eddie Price, CCSP



- Director responsible for KBKG's technical operations of cost segregation practice and all Texas based operations
- ASCSP Certified Cost Segregation Professional, #C0112-08
- American Society of Cost Segregation Professionals
 - 2010 - 2013, Chair Education Committee
 - 2012 - present, Board of Directors
 - 2014 - present, Testing Committee
- 34 years experience in cost segregation industry
- 20 years experience with Big 4 CPA firm
- Texas A&M University
 - Environmental Design
 - Construction Management



Learning Objectives



At the end of this session, you should be able to:

- Explain what cost segregation is, how taxpayers benefit from it, and how it has changed over the years
- Identify tax issues that should be considered in conjunction with a cost segregation studies
- Recognize potential impact of cost segregation on estate planning
- Discuss the impact of the PATH Act of 2015 on cost segregation
- Discuss cost segregation opportunities related to the tangible property regulations and disposition regulations
- Identify new opportunities to immediately deduct abandoned building components, avoid recapture tax, and expense demolition costs



Cost Segregation



- Acquired property
- New construction
- Remodeled property
- Build-outs



MACRS - GDS

- 39 - Year Property
- 27.5 - Year Property
- 15 - Year Property
- 7 - Year Property
- 5 - Year Property

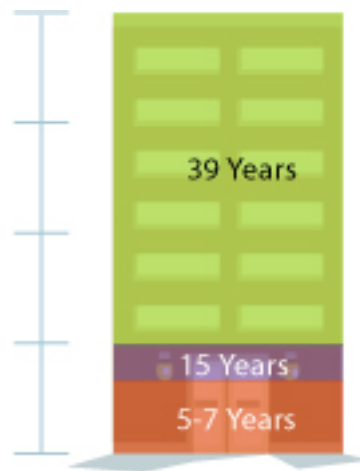


Example: Retail Building Current Year Acquisition



- \$3 million retail building
- Without a Cost Segregation Study the costs are depreciated straight line over 39 years.

With a Cost Segregation Study



Benefits reclassifying from 39 Year Life

\$330,000 depreciated over 5 years

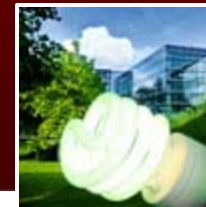
\$360,000 depreciated over 15 years

Increased deductions first 5 years: \$333,000

Increased cash flow first 5 years: \$132,000



Cost Segregation – Tax Planning Tool



- One of the most common tax planning tools for anyone with real estate
 - Performed in year purchased – simply report the allocations on depreciation schedule
- Cost segregation can be done anytime after the building is purchased.
 - No amended tax returns
 - File a Form 3115 and claim any missed deductions in year performed
 - Allows tax preparers to plan when to use deductions
- Without software - typically only makes sense to hire a CCSP engineer for buildings with a building tax basis over \$750,000
- For more information on various tax planning strategies for cost segregation, please see our updates at: <http://kbkg.com/category/cost-segregation>



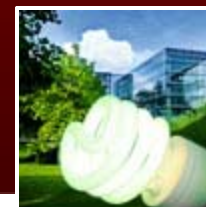
Tax Considerations



- Depreciation deductions will reduce AMT
- On new construction, bonus depreciation can apply to reclassified items in a cost segregation study which magnifies the benefit
- Unused deductions carry forward
- When building is sold, the taxpayer may need to recapture depreciation taken on personal property
- Accounting method changes are addressed with Form 3115
- Passive activity rules can offset the benefit of a cost segregation
- 1031 exchange rules need to be considered



Tax Considerations



- When building is sold, taxpayer must recapture depreciation taken on personal property
 - Personal Property (Sec 1245) recapture is at ordinary tax rates (39%).
 - This is why the hold period should be > 5 years

- Some 1245 property will lose value quicker than 1250 property upon sale.
 - Mitigates 1245 recapture



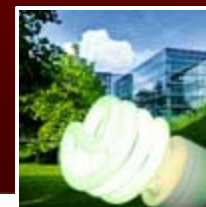
Passive Taxpayer – Self Rental Rule & Grouping Election



- A taxpayer that rents to a business in which they materially participate is subject to the self rental rule Reg. § 1.469-2(f)(6)
- Income is “re-characterized” as non-passive
 - Losses are always passive
 - This may limit the benefits of cost segregation
- Consider paying for leasehold improvements from the operating entity
- Consider “Grouping” Election that allows activities to be grouped for tax purposes. Must be made in year building acquired.



Planning Opportunity – Lease Language



- Lessee perspective:
 - Lease should state the landlord's allowance is only for 39-year property.
 - Increases the lessee's ability to allocate more value to shorter life property.
- Lessor perspective:
 - Lease should state the allowance is for a pro-rata share of all building components.
 - Allows a lessor to accelerate depreciation on a portion of the 1245 components.



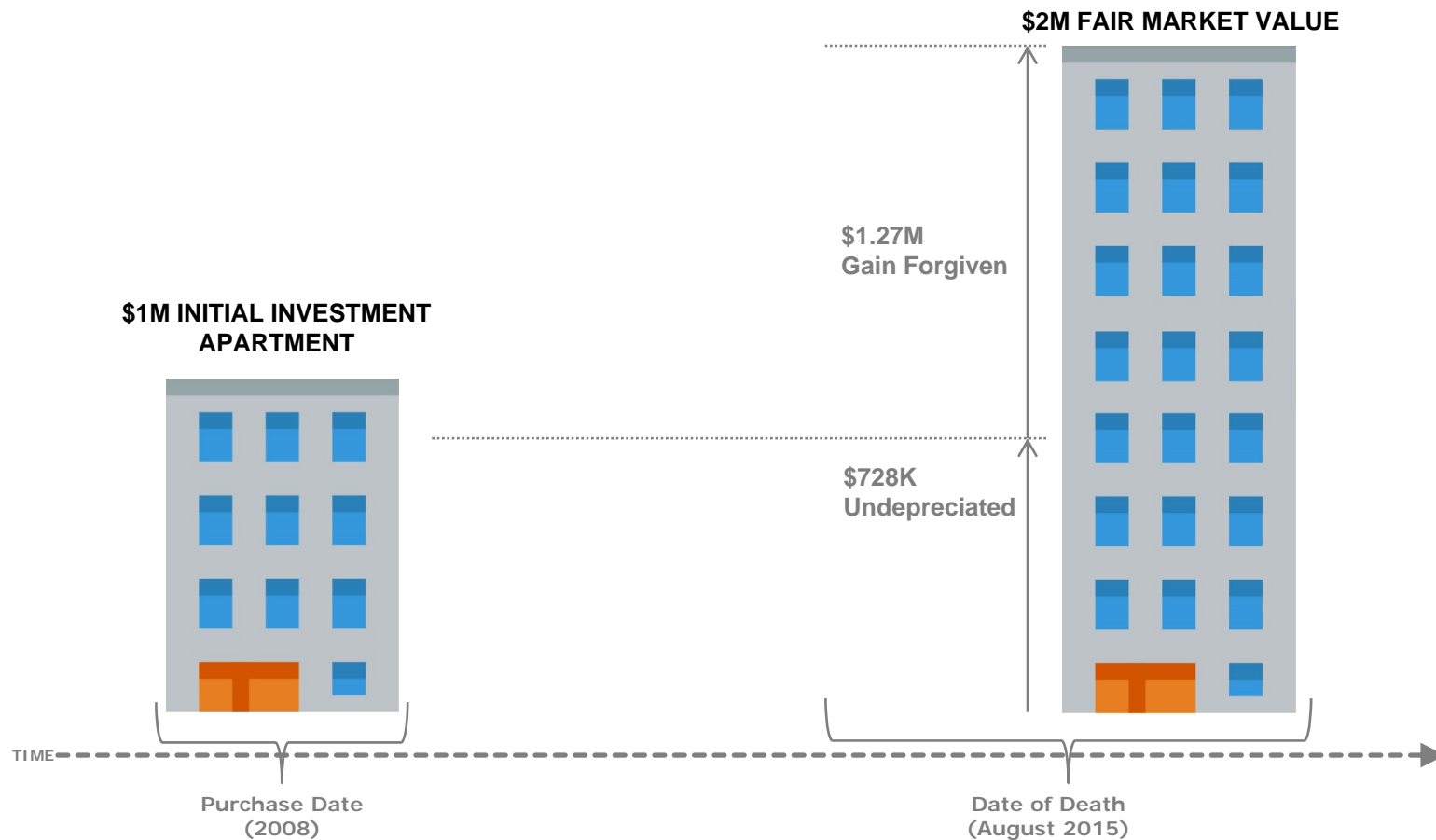
Cost Segregation and Estate Planning: Background



- When a building owner dies and a property is inherited, any gains built up during the decedent's life are forgiven.
- Beneficiary receives a "step up," which means the property's tax basis is reset to fair market value on the date of death and depreciation starts all over.
- This provides an opportunity to apply a cost segregation study on the decedent's pre-stepped up basis creating a permanent tax deduction.



Decedent's Gain Forgiven



Heir Starts Depreciation Over

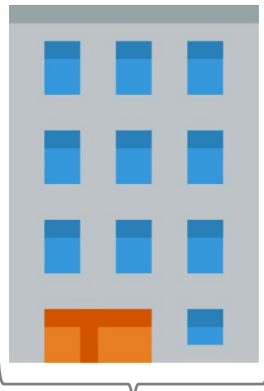


Most tax preparers already know this is a great candidate for Cost Segregation

But it's the original pre-stepped up undepreciated basis that has the most value

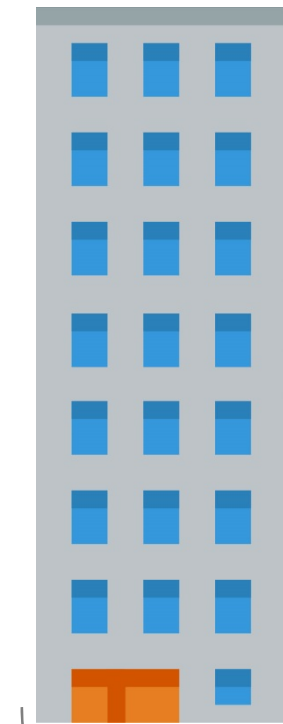
\$2M FAIR MARKET VALUE

\$1M INITIAL INVESTMENT



\$728K
Undepreciated Basis

2008 Purchase Date



Date of Death
2015



Case Study 1

Cost segregation on original pre-stepped up basis

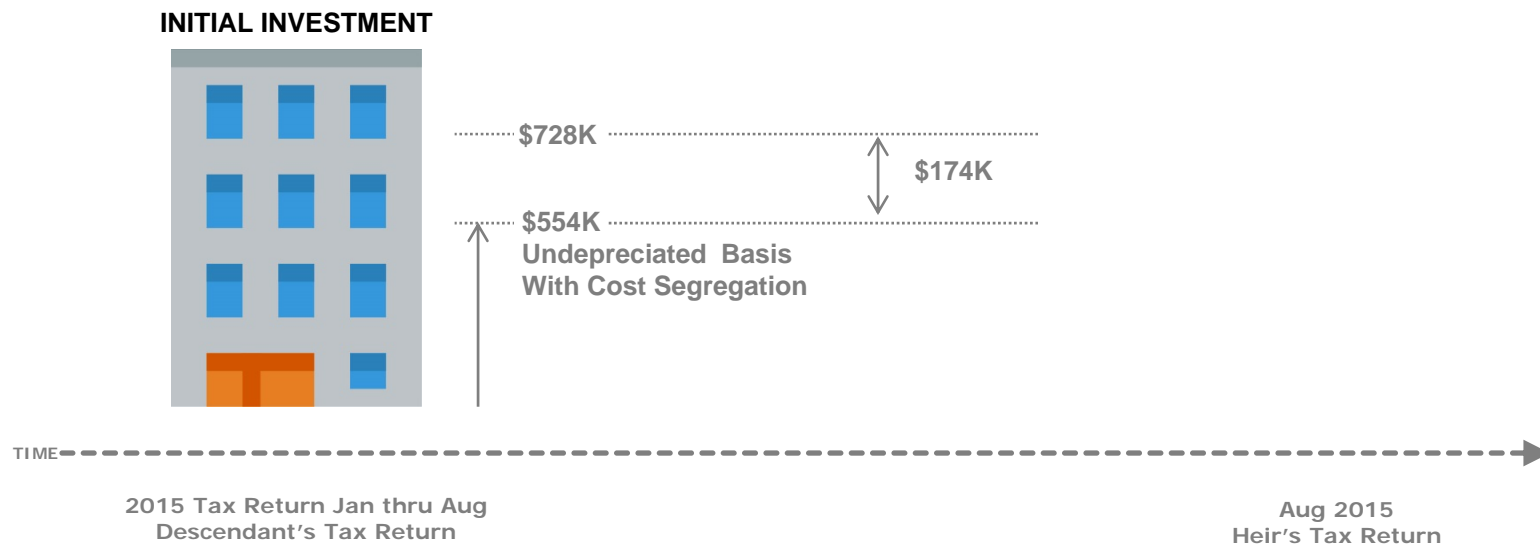


DOD - August 2015.

Must file tax return for income generated Jan thru Aug 2015.

Cost Seg done and Form 3115 filed:

Generates \$174,000 catch up deduction (Sec. 481(a)).



Case Study 1:

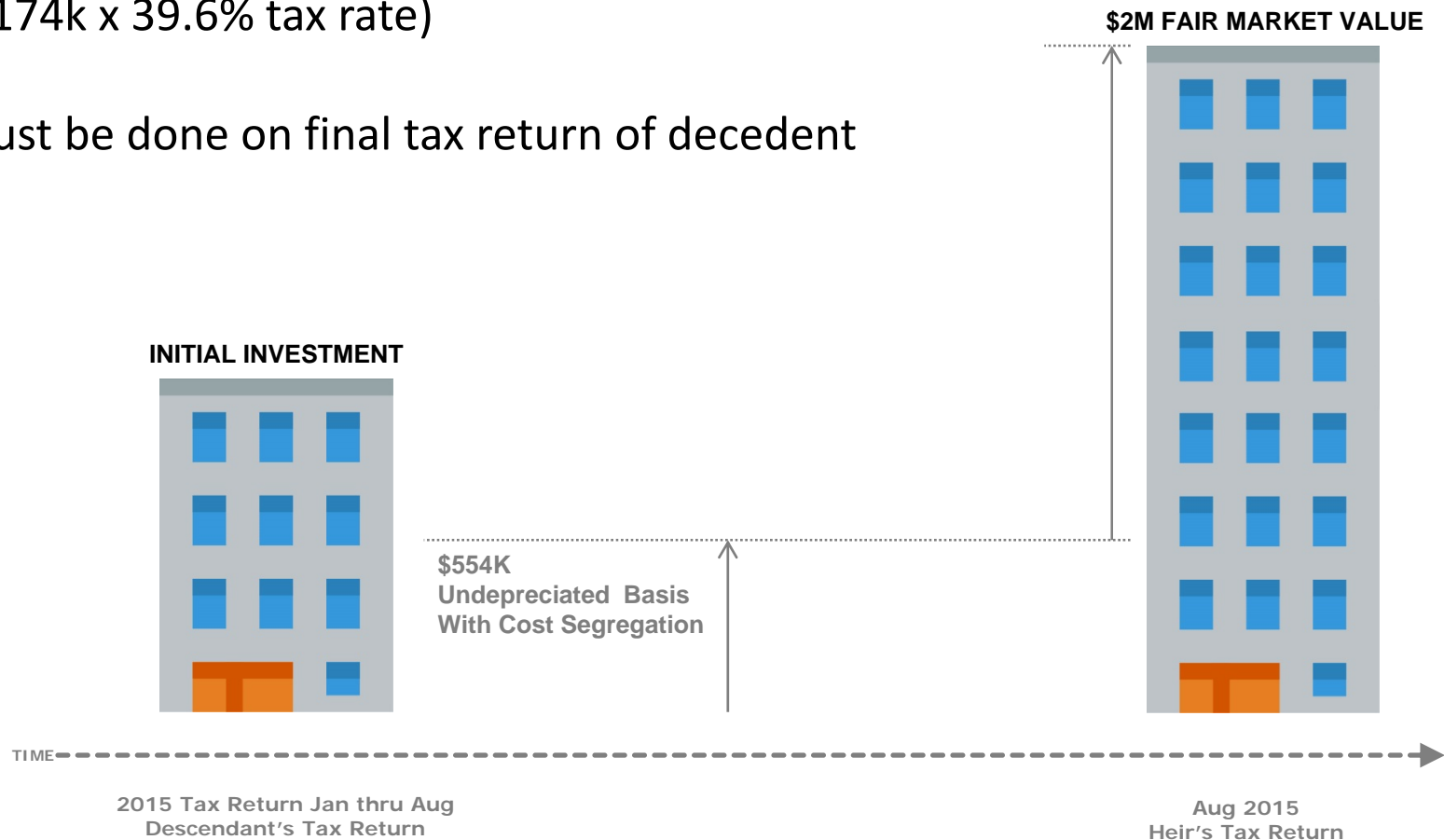
Cost Segregation on original pre-stepped up basis



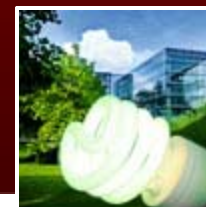
Permanent Tax Savings of \$68,904

(\$174k x 39.6% tax rate)

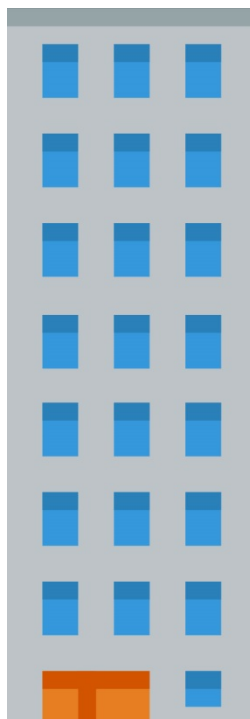
Must be done on final tax return of decedent



Heir Starts Depreciation Over



\$2M FAIR MARKET VALUE



Aug 2015

- After all this - property gets stepped up to fair market value for the heir.
- Can perform a cost seg for the heirs.
- Additional cost to “refresh” original cost segregation is nominal.

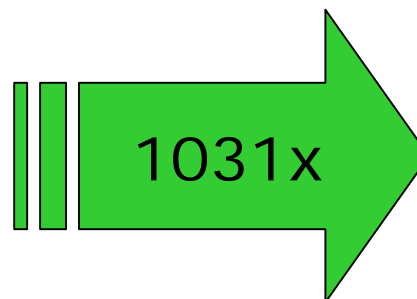


1031X – Step 1 separate Real from Personal property (not affixed)



REAL PROP
Land
1250 (Bldg)
1250(Land Imp)

1245 (non FF&E)



REAL PROP
Land
1250 (Bldg)
1250(Land Imp)

1245 (non FF&E)

PERSONAL PROP
1245 (FF&E)

PERSONAL PROP
1245 (FF&E)



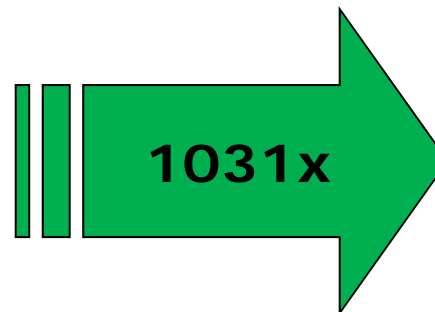
1031X – Step 2: Address recapture issues by Fed law



REAL PROP
Land
1250 (Bldg)
1250 (Land Imp)

REAL PROP
1245(non FF&E)

PERSONAL PROP
1245 (FF&E)



REAL PROP
Land
1250 (Bldg)
1250 (Land Imp)

REAL PROP
1245(non FF&E)

PERSONAL PROP
1245 (FF&E)



Qualified Leasehold Improvements (QLI)



- Qualified leasehold property criteria:
 - Section 1250 property which is an improvement to non-residential real property
 - To interior portion of building occupied exclusively by lessee (not a common area)
 - Placed in service more than three years after the building was first placed in service by any taxpayer
 - Made pursuant to a lease
 - Lease cannot be between related parties
 - See related party rules (Code Section 1504)
 - 80% common ownership in both entities



Qualified Leasehold Improvements – Related Parties



Example

- Penny and Leonard (business partners) own a retail business “*Geek Books for Dummies*” and lease the building from a real estate holding company “*TBBT, LLC*”
- Retail business ownership: Penny (50%) and Leonard (50%)
- TBBT, LLC ownership: Penny 35%, Leonard 35%, Sheldon 20%, Howard 5%, Raj 5%
- TBBT, LLC ownership is (70%) common with the retail business (100%)
- **Unrelated parties** since the threshold is 80%
- **Improvements are QLI - Get Bonus Depreciation and 15-year life!**

- *If related, this would be QIP and get Bonus with 39-year recovery (2016)*

“Don’t you think if I were wrong, I’d know it?”
- Sheldon



Qualified Leasehold Improvements (QLI)



- Qualified leasehold property does NOT include:
 - Costs for the enlargement of a building
 - Elevators or escalators
 - Structural components that benefit a common area
 - The internal structural framework of a building

- Many tax preparers make the mistake of claiming bonus on all tenant improvement / leasehold improvement costs assuming they are all for QLI
 - Roofing, concrete, steel, windows, storefront, masonry, finishes, EIFS, seismic retrofitting, thermal & moisture protection, elevators, lobby area, hallways, bathrooms



Qualified Retail Improvements (QRI)



- Qualified retail improvements criteria:
 - Section 1250 property which is an interior improvement to non-residential real property
 - Interior portion must be open to the general public and used in the retail trade or business of selling tangible personal property to general public
 - Placed in service more than 3 years after the building was first placed in service by any taxpayer **(for improvements prior to 1/1/16)**
 - Building can be owner occupied

- **Bonus eligible on QRI placed in service after 12/31/15**



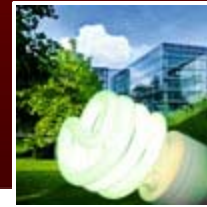
Qualified Retail Improvements (QRI)



- Qualified retail improvements do NOT include:
 - Costs for the enlargement of a building
 - Elevators or escalators
 - Structural components that benefit a common area
 - The internal structural framework of a building



Qualified Restaurant Property (QRP)



Restaurant Property

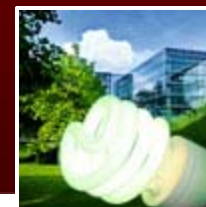
- 15-year recovery period permanently extended
- Specifically excluded from bonus depreciation

Definition of QRP Property:

- Any 1250 property that is a building or an improvement to the building, and
- At least 50% of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals.



Qualified Improvement Property (QIP)



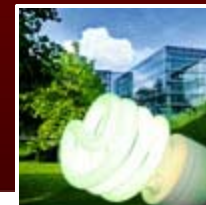
- Qualified improvement property criteria:
 - Effective for property **placed in service after 12/31/15**
 - Section 1250 property which is an interior improvement to a portion of a building which is non-residential real property
 - Must be placed in service after the date the building is first placed in service (**no more 3-year rule**)

- **Bonus eligible**

- May also be eligible for 15-year straight line recovery if also meets the criteria for QLI or QRP



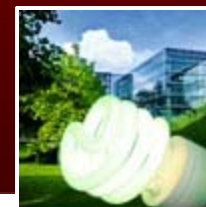
Qualified Improvement Property (QIP)



- Qualified improvement property does NOT include:
 - Costs for the enlargement of a building
 - Elevators or escalators
 - The internal structural framework of a building



Bonus Depreciation



- Bonus depreciation extended by PATH Act but phasing out
 - 50% continues through 2017
 - 40% during 2018
 - 30% during 2019
 - No bonus in 2020



Qualified Improvement Chart

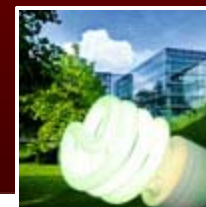


<http://www.kbkg.com/resources>

	Applicable PIS Dates (inclusive)	MACRS GDS Recovery Period	Bonus Dep Eligible	3 Year Rule	Unrelated Parties Rule	179 Expense Eligible	Important Notes	Code Section
Qualified Leasehold Improvements (QLI): 2001 - 2004 Partial	09/11/01 - 10/22/04	39 Year / SL	Y	Y	Y	N/A	39 year QLI qualifies for Bonus. Landlord or lessee can make the interior improvement. See exclusions in definition.	168(e)(6)
Qualified Leasehold Improvements (QLI): 2004 Partial and onward	10/23/04 onward	15 Year / SL	Y ¹	Y	Y	2010 onward ⁶	Landlord or lessee can make the interior improvement. See exclusions in definition.	168(e)(6)
Qualified Retail Improvement Property: 2009 onward	01/01/09 onward	15 Year / SL	N ²	Y	N	2010 onward ⁶	Building can be owner occupied. See exclusions in definition.	168(e)(8)
Qualified Retail Improvement Property: 2016 onward	01/01/16 onward	15 Year / SL	Y	Y	N	2010 onward ⁶	Building can be owner occupied. See exclusions in definition.	168(e)(8)
Qualified Restaurant Property: 2004-2007	10/23/04 - 12/31/07	15 Year / SL	N ³	Y	N	N/A	Applicable to all improvements attached to building.	168(e)(7)
Qualified Restaurant Property: 2008	01/01/08 - 12/31/08	15 Year / SL	Y	Y	N	N/A	Applicable to all improvements attached to building.	168(e)(7)
Qualified Restaurant Property: 2009 onward	01/01/09 onward	15 Year / SL	N ⁴	N	N	2010 onward ⁶	Encompasses the entire building structure as well as interior costs. Can be an acquired building.	168(e)(7)
Qualified Improvement Property (QIP): 2016 onward	01/01/16 onward	39 ⁵ Year / SL	Y	N	N	Y	Applies to interior common areas. Building can be owner occupied. No 3-year rule. See exclusions in definition.	168(k)(3)



Recent Guidance



- Chief Counsel Advice #201310028 Release date: 03/08/13
 - HVAC rooftop units

- Chief Counsel Advice #20140202F Release date: 01/10/14
 - Bonus depreciation denied on self constructed assets that straddle bonus years

- Action on Decision 2017-02
 - IRS rejects the 2015 Stine case ruling signaling an “open for business” standard for determining when a building is placed in service

- Tangible Property Repair and Retirement Regulations
 - <http://www.kbkg.com/resources>



Retail/Restaurant Industry Safe Harbor



- Rev. Proc. 2015-56 provides a safe harbor for certain taxpayers operating retail or restaurant establishments for determining whether expenditures incurred to “remodel” or “refresh” their property can be expensed under the TPRs.
- Generally, the safe harbor benefits those enhancing the physical appearance and layout of their building to maintain a contemporary and attractive environment for their customers.
- Through the adoption of the safe harbor, retailers and restaurateurs can now take advantage of the ability to immediately deduct 75% of “qualified” amounts spent to refresh certain property and are required to capitalize the remaining 25%.

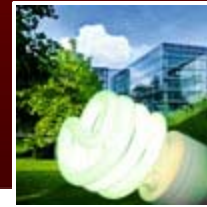


Retail/Restaurant Industry Safe Harbor



- A **qualified taxpayer** is one who has an **Applicable Financial Statement** and:
 - Is in the trade of selling merchandise, including goods to resellers such as warehouse clubs, home improvement stores.
 - **EXCLUDED:** automotive dealers, other motor vehicle dealers, gas stations, manufactured home dealers, and non-store retailers
 - Is in the trade or business of preparing and selling meals, snacks, or beverages to customer order for immediate on-premises and/or off-premises consumption.
 - **EXCLUDED:** hotels and motels; civic or social organizations; or amusement parks, theaters, casinos, country clubs, or similar recreation facilities, special food services, food service contractors, caterers, and mobile food services.

Retirements and Dispositions



- Current regulations allow you to take a loss deduction when you remove components from your building!
- Example: If you pay \$50,000 for all new HVAC units in your building, you need to capitalize that amount.
 - Depreciate that \$50,000 over 39 years
 - Figure out how much the old HVAC was not written off and claim all that as an immediate deduction!
- <http://kbkg.com/solutions/partial-disposition-calculator>
- Can do this on a go forward basis



Retirement of Structural Components



- Example: Taxpayer acquired \$5M building in 2010
 - In 2016 they spent \$1M to remodel portion of 2nd floor (ceilings, walls, lighting, plumbing, ducting, electrical wiring, etc.)
 - We determine the original cost of demolished components is \$470K (from the original \$5M building)
 - Recognize a loss of \$391K in 2016 tax year (original cost basis less depreciation already taken)

- You can only recognize the retirement by taking a partial disposition in conjunction with a timely filed tax return. Otherwise, you forgo the opportunity to recognize the retirement.



Retirements create Permanent Tax Savings!!



- Retirements Convert Recapture tax into Capital Gains
- If you incorrectly continue to depreciate 1245 and 1250 property that was removed from a building, you pay recapture tax upon sale
 - 1245 recapture is at ordinary rates (35%-39.6%)
 - 1250 recaptured at 25%
 - Capital Gains are typically taxed at 20%



Retirements create Permanent Tax Savings!!



- Previous example – \$5M building with \$470K of retirements.
 - If they continue to depreciate the \$470K, they recapture all of it upon sale
 - Let's say \$370K of that was 39 year and \$100K was 7 year property
 - Recapture Tax = \$127,500 ($\$370K \times 25\% + \$100K \times 35\%$)
 - If they did a retirement study
 - Recapture tax on the \$470K = 0
 - Capital gain tax = \$94,000 ($\$470K \times 20\%$)

- Permanent tax savings of \$33,500 upon sale



Removal Costs / Demolition

R.R. 2000-7



- **Old rule:** Removal costs to replace anything had to be capitalized with the new component.
- **New Rule:** Removal costs can be deducted if taxpayer retires old component for tax.

Example: Landlord owns three unit commercial building and pays \$200K for improvements in each space in year 1.

- In year 5, one tenant leaves and new tenant requires landlord to gut and renovate the space costing \$340K
 - Contractor cost detail shows \$40K “demolition” cost to remove old improvements
 - Landlord can expense the \$40K demolition costs and deduct remaining basis in the \$200K cost of the old tenant build out.



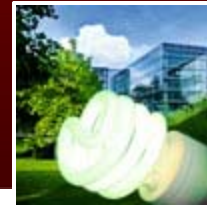
Plan of rehabilitation expenses



- **Old rule** said that if you did repairs to building as part of bigger rehab project, you had to capitalize.
- **New Rule** – Repair and maintenance costs **not incurred by reason of the improvement** can be expensed. So as long as the repair work had nothing to do with the improvements, you can expense the repair.
 - Example 1: B spends \$500K to rewire building and for new lights. Because of electrical work, there was \$30K of cost to cut some drywall, patch, and paint areas rewired.
 - All \$530K is capitalized
 - Example 2: B spends \$500K to rewire building and upgrade electrical. B also spends \$30K to paint and patch areas of the building unrelated to the electrical improvements
 - \$30K can be expensed if it was repair unrelated to any improvement



Plan of Rehabilitation Retroactive Example



- Taxpayer spent \$3M on “Renovations” in 2012
 - Cost seg already done leaving \$2.5M in 39 year recovery.
- KBKG’s review of construction doc’s revealed – scope included “roof” (shingles replaced), “acoustic ceilings” (for only portion of building), “asphalt paving” (for patching and resealing), and “HVAC” (2 of 9 units replaced).
- Based on current rules - \$350K should be repair deductions.
- Recognize additional **\$328K** in current tax year by filing Form 3115 (original cost basis less depreciation already taken).
- **Permanent Tax Savings of \$17,500 upon sale** by avoiding recapture ($\$350K \times .25 - \$350K \times .20$)



What is an “Improvement?”



An “improvement” is defined under § 1.263(a)-3(d) as an amount paid after the property is placed in service which:

1. Betterment – Results in a betterment to the UOP
2. Adapts the UOP to a new or different use
3. Restores the UOP

B-A-R = Improvement (Capitalize)



Buildings: What is the Unit of Property (UOP)?



- Building and its structural components is a single UOP § 1.263(a)-3(e)(2)(i)
- Building structure consists of “building and its structural components other than the structural components designated as building systems ...”
§ 1.263(a)-3(e)(2)(ii)(B)

1. HVAC
2. Plumbing systems
3. Electrical systems
4. All Escalators
5. All Elevators
6. Fire Protection & Alarm Systems
7. Security systems
8. Gas distribution systems
9. REST OF BUILDING
Walls, roof, floors, ceilings, windows, doors, finishes, structure, etc..



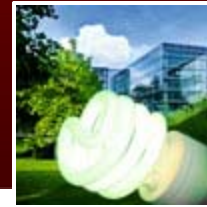
“Betterment?” Examples



- Example 1: Replace asphalt shingles with solar shingles
- Example 2: Extensive renovations to an office space that adds offices, and accommodate more employees
- Example 3: Asbestos removal not a betterment
 - Because the quality of the building did not increase materially



“Adaptation”



- The cost of adapting something to a new use must be capitalized as an improvement.
- Example – Taxpayer converts its manufacturing building into a showroom for its business.
 - Replace some lights, paint walls, and replace other components to provide better layout for showroom and offices.
 - Capitalize
- If taxpayer were only modifying those items for their manufacturing operation, the costs may qualify as a repair deduction



Restoration

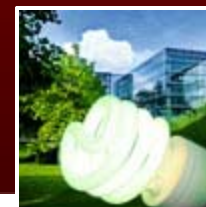


- Replacing Major Component – “Parts that perform a critical function for the building system”
 - Example: Lighting, air conditioning, flooring, water heater etc...

- Replacing a large portion of the building system
 - Example: Replacing more than 50% of the lighting



Restoration Examples HVAC Systems

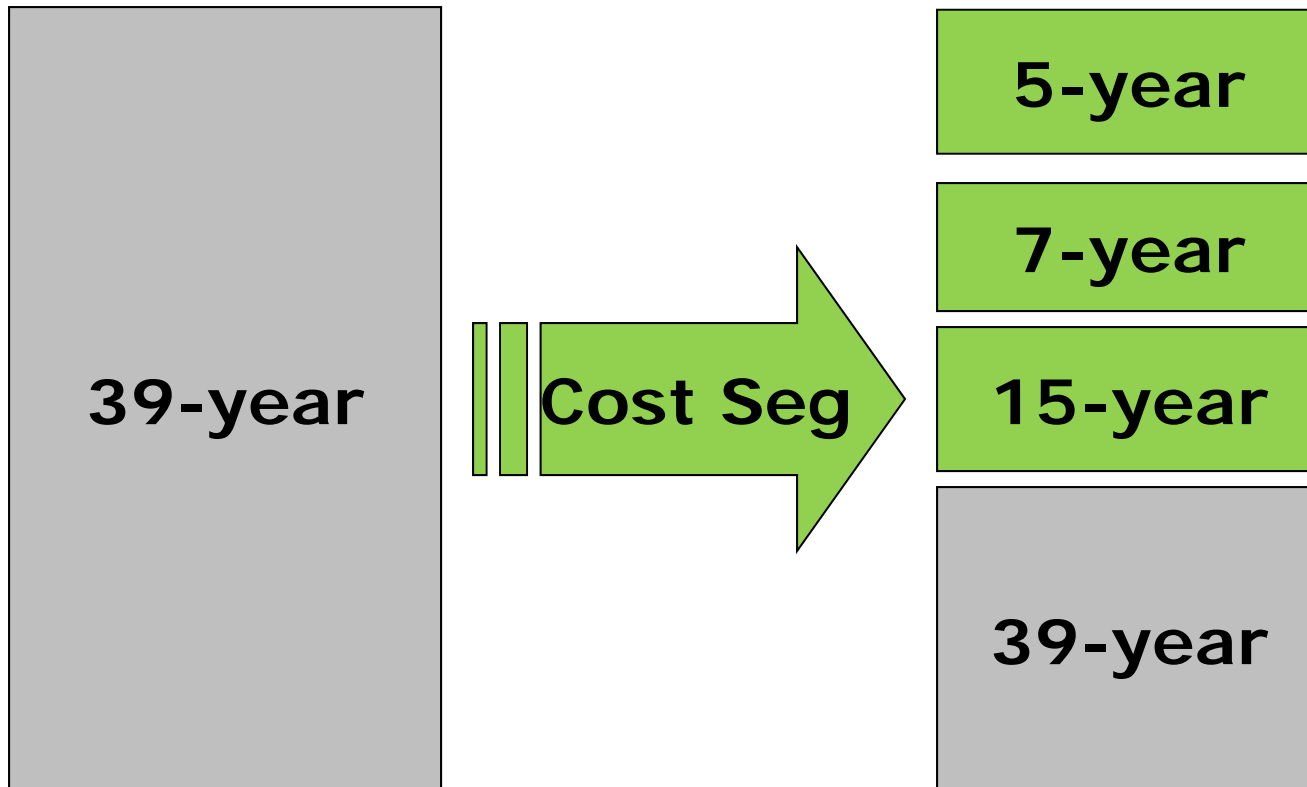


- Office building chiller replaced with comparable unit
 - HVAC system has 1 chiller, 1 boiler, cooling tower, etc.
 - Chiller functions to cool water to generate AC
 - Chiller performs a discrete and critical function of HVAC system
 - Therefore, must Capitalize

- Assume same as above except there were 4 chillers and only one was replaced.
 - Repair expense



“Old School” Cost Segregation Studies



KBKG Enhanced Cost Segregation Studies



39-year



Repairs	
Demo Expense	
Retirements	
IRC 48 Property	
Bonus Rate by Asset Group	
5-year	
7-year	
15-year	
39-year Roof Windows Doors Lighting Plumbing Electrical	Security Elevators Gas Dist HVAC Ceilings Floors



How to choose a cost segregation provider



- Seek out a Certified Cost Segregation Professional (CCSP designation)
- Evaluate resume and bio of persons signing the report (beware of firms that do not post bios and credentials on their websites)
- Consider how long the firm has been doing cost segregation studies and how many they have performed
- Consider experience with tangible property regulations
- Consider who you want defending you if the study goes under IRS audit (ask for references from clients that have gone through audit)
- Low cost or small providers may not have the resources to stay on top of all the tax issues



QUESTIONS & ANSWERS



Eddie Price, CCSP

Director

877-525-4462 x 201

eddie.price@kbkg.com

kbkg.com/management/eddie-price

<http://www.linkedin.com/in/eddieprice>

Twitter: [@aboutcostseg](https://twitter.com/aboutcostseg)

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- Hiring Tax Credits
- Cost Segregation
- Fixed Asset Review
- IC-DISC
- Repair v. Capitalization
- Property Tax
- Sales & Use Tax

