



# Why an Engineered-Cost Segregation Study?

IRS Quote: "Cost segregation is a factually intensive determination that is based on tax law and engineering analysis."

## Summary

The following four topics factually define the quality attributes for the engineering-based cost segregation study.

### I. IRS Expectations

The combination of engineering-based construction analysis and accounting tax definition supports the results expected by the IRS.

IRS Audit Technique Guidelines requirement:

**"A cost segregation report reflects a study's methodology and conclusions. The following elements are found in a quality report."**

### II. Best Economic Results

The best economic results are achieved by the "total" analysis for the clients.

"It has been our experience in the application of cost segregation that the owner of commercial property in the application of the depreciation loses a large part of its benefits because all "accelerated depreciable assets" were not recognized by the "non-engineering" review. Our experience shows that 50% - 75% increased positive economic results are achieved through an engineered-based cost segregation study."

### III. Conflict of Interest - Sarbanes-Oxley Law

Sarbanes-Oxley clearly illustrates the separation of tax analysis and paid "consulting" analysis which may distort the proper tax application results.

**Quoted from the regulations of the Sarbanes-Oxley Act of 2002 Limitation on Non-Audit Services and Auditor Independence**

"The Limitation on the scope of services that are permissible strengthens auditor independence from corporate management and helps prevent auditors from controlling a company's entire financial reporting process by both designing the internal audit system, and then theoretically offering an unbiased opinion (CCH, 2002)."

### IV. IRS Examiners View I

IRS guidelines has case history which illustrates the need to "eliminate internal application" bias, by the tax payer.

**"Examiners will encounter a wide variety of studies and reports, as well as documentation. For example, some studies will be very brief. Other studies may be quite voluminous and complex. "**

Did the taxpayer provide for an engineering-based study methodology.



## I. IRS Expectations

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IRS Audit Technique Guidelines requirement:

**“A cost segregation report reflects a study’s methodology and conclusions. The following elements are found in a quality report.”**

### **1. Summary Letter/Executive Summary**

A quality report contains a summary to identify: the preparer, the date of the study, the taxpayer (or client), the subject property, and the property components classified as land, land improvements, building, or personal property.

### **2. Narrative Report**

A quality report discusses the theory, definitions and the rationale behind the study in the narrative section. This section generally includes a more detailed description of the property/facility (i.e., a physical description and an explanation of the use for which it is intended, as well as a legal description of the property and its location). In addition, the narrative section highlights the regulations, rulings and court cases that support classifying assets as § 1245 property. The narrative also discusses the types and sources of data used (e.g., cost records, contracts, purchase agreements, published estimates) as well as how they were used. A list of potential data sources is included in Appendix Chapter 6.6.

### **3. Schedule of Assets**

A quality report has a schedule of assets that are the focus of the study. Generally, this schedule ties directly to the taxpayer's depreciation records. When a taxpayer reallocates costs of assets already "on the books," a quality report clearly identifies the specific assets impacted (and includes depreciation records from both before and after the reallocation).

### **4. Schedule of Direct and Indirect Costs**

A quality report lists all direct and indirect costs associated with a project. Indirect costs allocated to § 1245 property are clearly identified and explained. Separately-acquired assets are listed and discussed in the report to avoid duplication errors. Costs subject to IRC § 263A are also addressed.



## **I. Continued...**

### **5. *Schedule of Property Units and Costs***

A quality report provides a schedule of property units and costs (with property descriptions) that are segregated into land, § 1245 property, and § 1250 property. This schedule is the final product of the study and serves as the basis for computing depreciation.

### **6. *Engineering Procedures***

A quality report describes the engineering procedures and methodology for determining the cost of each property unit. It also identifies the specific taxpayer records that were reviewed and discusses whether actual cost records or estimating techniques were utilized to break costs into smaller components. A record of inspections and/or interviews is included as well. The use of a common nomenclature or a standard numbering system is also referenced and/or explained.

### **7. *Statement of Assumptions and Limiting Conditions***

A quality report describes the general understanding and conditions applicable to the report. This information may also provide an indication of the overall quality of the study.

### **8. *Certification***

A quality report certifies that the person who signed the report actually developed the analysis, opinions and/or level of experience of the preparer.

### **9. *Exhibits***

A quality report generally includes various exhibits, such as the "Client Cost Sources" and the "Cost Source Reconciliation." These exhibits show the "book" (accounting) records on which the preparer relied in deriving total costs, and may include a reconciliation of the study to the fixed asset ledger. Photographs and/or videos may also be included as exhibits to assist in understanding the assets in the study.



## II. Best Economic Results

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### Example Economic Comparison Engineered vs. Non-Engineered Study

Depreciation Lives Categories	Engineered-cost segregation	Non Engineered
39 yr. straight line method	\$ 104,304	\$ 104,304
Alternative Method		
5 yr. depreciation expense	\$ 205,056	\$ 91,136
15 yr. depreciation expense	\$ 29,504	\$ 11,064
39 yr. depreciation expense	\$ 77,185	\$ 92,831
Total depreciation expense	\$ 311,745	\$ 195,031
Cash Flow Results:		
Increased Accumulated Depreciation Expense	\$ 207,441	\$ 90,727
Tax Rate ( Estimated)	36.0%	36.0%
Estimated Accumulated Tax Savings Benefit	\$ 74,679	\$ 32,662
Increased Savings	\$ 42,017	

The engineered study is significantly more effective than a non-engineered study.



### **III. Conflict of Interest - Sarbanes-Oxley Law**

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#### **Quoted from the regulations of the Sarbanes-Oxley Act of 2002 Limitation on Non-Audit Services and Auditor Independence**

The list of consulting services that auditors may offer their public company audit clients has been drastically reduced. The limitation on the scope of services that are permissible strengthens auditor independence from corporate management and helps prevent auditors from controlling a company's entire financial reporting process by both designing the internal audit system, and then theoretically offering an unbiased opinion (CCH, 2002). A registered public accounting firm must receive advance approval from the company's audit committee before it can perform any audit and non-audit service. After completion of the service, the public accounting firm is required to adhere to detailed reporting procedures as defined in The Act.

A registered public accounting firm may not provide the following nine accounting services contemporaneously with an audit:

- bookkeeping or other services related to the accounting records or financial statements of the audit clients;
- financial information and design and implementation;
- appraisal or valuation services, fairness opinions or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment advisor or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other service that the accounting oversight board determines, by regulation, is impermissible.

A company's audit committee must pre-approve all audit and permitted non-audit services performed by a registered public accounting firm, including tax services. The audit committee's approval of any non-audit services must be disclosed in the company's Form 10-Ks and Form 10-Qs, and audit committees may delegate to one or more independent committee members the authority to grant advance approvals of both audit and non-audit services (Sections 201 and 202).



#### IV. IRS Examiners View

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**“Examiners will encounter a wide variety of studies and reports, as well as documentation. For example, some studies will be very brief. Other studies may be quite voluminous and complex. Regardless of the length of a study or the methodology used, a cost segregation study and report should always”:**

1. ***classify assets*** into property classes (e.g., land, land improvements, building, equipment, furniture and fixtures);
2. ***explain the rationale*** (including legal citations) for classifying assets as either § 1245 or § 1250 property; and,
3. ***substantiate the cost basis*** of each asset and reconcile total allocated costs to total actual costs.

**Does your tax professional provide all of the above to you for your tax records to support your application of cost segregation depreciation?**