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Cash Is King: Utilize Cost Segregation Studies to Increase Cash Flow

November 1, 2009

By Dennis Diersen, CPA

Are you interested in improving your company's cash flow for years to come? Who isn't?

In order to stimulate the economy, recent government incentives encourage eligible companies to do exactly that, which can often be accomplished by performing a cost segregation study.

Most buildings must be depreciated over 39 years for federal tax purposes, while equipment assets may be depreciated over much shorter periods. A cost segregation analysis identifies specific building-related assets that also qualify for shorter federal tax depreciation lives, and the increased cash flow benefits may be significant.

This article discusses that process and who is likely to benefit, and provides insight from tax directors and service providers on what businesses think about these opportunities — and whether they're taking advantage of them.

It shouldn't be news to anyone at this point that we are deeply mired in a significantly slowed economy. Whether engaged in retail, manufacturing, distribution, professional services, real estate or financial services, virtually all have felt the impact of this recession.

Debt financing is hard to come by, if even possible.

No more than in times like these does the old adage “cash is king” ring so true. Business executives and CEOs everywhere are leaving no stones unturned in their efforts to conserve valuable cash flow to weather this economic storm. Typically, every expense category is scrutinized in an effort to minimize cash outflow. However, because it is a “non-cash” expense, depreciation is often overlooked as a source of additional cash.

Recent tax laws, combined with a time-proven tax strategy, can quickly turn the depreciation line item into valuable new cash flow.

What is cost segregation?

Cost segregation is a powerful federal tax deferral strategy that allows the taxpayer to increase current cash flow by accelerating the federal tax depreciation of real estate-related assets. It can be readily applied to a new facility a taxpayer constructs and/or to an existing property the taxpayer acquires.

Cost segregation analyses can also be performed on facilities that a taxpayer constructed or acquired in prior years, and provide a “catch-up” depreciation adjustment that can be fully recognized in the current year without the need to amend any prior year federal tax returns.

Identifying construction-related assets that may be written off for tax purposes over five years, seven years or 15 years, rather than 27.5 years (residential properties) or 39 years (most commercial properties), helps free up much-needed cash flow in the early years of a building’s tax life, and the net present value benefits over the life of the assets may be significant.

Essentially, a dollar today is worth more than a dollar tomorrow.

Favorable tax law changes

With this in mind, all property owners need to be aware that a good thing just got better. Congress enacted various pieces of legislation in 2008 and 2009 that provide commercial property owners the following enhanced depreciation opportunities for the 2008 and 2009 tax years:

- Bonus depreciation (50 percent immediate deduction for certain assets) is reinstated for 2008 and 2009.
- Two 15-year asset categories, set to expire at the end of 2008, are extended through 2009, and a new 15-year asset category is established for 2009.
- Corporate taxpayers may use bonus depreciation to reclaim unused tax credits.
- Net Operating Loss (NOL) carryback rules have been liberalized, allowing for refund claims as far back as five years for taxpayers who qualify. Implementing a cost segregation study to increase the current year loss can add to the refund claim and provide for an even larger cash refund at a time when it is needed most.

Bonus depreciation reinstated

As a result of a severe weakening of the economy in 2008, U.S.

Congress passed the Economic Stimulus Bill of 2008 to resurrect the 50 percent first-year bonus depreciation deduction for 2008, and it extended bonus depreciation through 2009 when it passed the American Recovery and Reinvestment Act of 2009.

Congress originally created bonus depreciation in 2001 to spur investment in equipment purchases and help repair a weakened economy in the aftermath of September 11, 2001. This tax incentive, which expired at the end of 2004, allowed most taxpayers to claim an immediate deduction of either 30 percent or 50 percent of the basis of most newly acquired assets with a recovery period of 20 years or fewer. Not only did it apply to furniture and equipment assets, it also presented great cost segregation opportunities as bonus depreciation applied to short-lived constructed assets and certain longer-lived leasehold improvement assets.

As it stands now, cost segregation can be used to increase a taxpayer's bonus depreciation for newly constructed facilities in 2008 and 2009. Cost segregation can also be used to reclaim bonus depreciation that was missed in earlier years.

Leasehold, restaurant and retail properties

The Emergency Stabilization Tax Act of 2008 extended other tax incentives related to cost segregation that were originally set to expire at the end of 2008. Certain construction costs that are "qualified leasehold improvement property" and "qualified restaurant property" may be depreciated over 15 years instead of 39 years until the end of 2009 (retroactive to the beginning of 2008). The Act also created the new category of "qualified retail property," very similar to qualified leasehold improvement property and applicable for 2009 only, which also may be depreciated over 15 years.

In general terms, "qualified leasehold improvement property" assets are tenant improvements, constructed by the lessor or lessee in a building that is at least three years old, which would normally be considered 39-year real property. Additional provisions must be satisfied, but typical costs include drywall partitions, acoustical ceilings, ceramic wall and floor tile, lighting, wiring, plumbing and ductwork. Common area improvements and structural components of the shell of the building do not qualify.

"Qualified restaurant property" is much more liberal, and it generally includes structural improvements and additions to the shell of a restaurant facility that is at least three years old. Amazingly, the Act eliminated the three-year requirement for 2009; new restaurants placed in service in 2009 are generally qualified restaurant property.

It is also important to note that "qualified leasehold improvement property" assets that are placed in service in 2008 and 2009, and "qualified restaurant property" assets that are placed in service in 2008, will also qualify for bonus depreciation.

What about R&D and AMT credits?

In addition to accelerated depreciation benefits resulting from cost segregation, there is another taxpayer advantage resulting from the reintroduction of bonus depreciation for 2008 and 2009. After passing the Economic Stimulus Act of 2008, which reinstated bonus depreciation in 2008, Congress enacted Sec. 168(k)(4) in July 2008 in recognition of the fact that bonus depreciation may not provide the desired stimulus or cash flow for certain types of taxpayers — including those who had NOLs or unused research and development

(R&D) and/or alternative minimum tax (AMT) credits.

While it may seem a bit convoluted, Sec. 168(k)(4) allows corporate taxpayers to use cost segregation studies in 2008 and 2009 to increase the amount of bonus depreciation, which they can forgo in order to convert some of their old (pre-2006) R&D and AMT credits into refundable credits (i.e. current cash flow).

Bill Flexon, vice president of taxes for Colfax Corporation, confirmed this. “Even though we have a material tax loss carry forward, it is important for us to properly classify and segregate costs so we may maximize the monetization of our unused tax credits pursuant to Sec. 168(k)(4),” he said. Colfax designs, manufactures and distributes fluid handling products and had revenues of $605 million in 2008.

Putting cost segregation in perspective

While cost segregation is certainly a worthy and acceptable federal tax deferral strategy, the concept is not new. Most of the larger accounting firms have provided cost segregation services to some degree since the investment tax credit was available in the 1980s. These firms typically combine in-house engineering and construction expertise with tax department oversight. Congress’s enactment of bonus depreciation at the end of 2001 accounted for a widespread proliferation of firms that provide cost segregation services.

Understanding the mechanics of the federal tax depreciation rules does not necessarily prepare the tax novice for important considerations such as passive activity loss rules, NOLs, Sec. 1031 exchanges and accounting method changes. A careless disconnect between an engineering analysis of the cost of assets associated with a newly constructed or acquired facility, and the circumstances of the taxpayer, can lead to painful consequences when the Internal Revenue Service (IRS) intervenes.

The IRS makes reference to a full-service approach to cost segregation in its very own *Cost Segregation Audit Techniques Guide*:

> “In general, a study by a construction engineer is more reliable than one conducted by someone with no engineering or construction background. However, the possession of specific construction knowledge is not the only criterion. Experience in cost estimating and allocation, as well as knowledge of the applicable law, are other important criteria.”

The combination of both engineering and tax expertise can enhance the results and credibility of any cost segregation analysis that a taxpayer uses as the underlying support for claiming the full benefits of depreciation provided under the Internal Revenue Code.

Marketplace reaction

My colleagues and I reached out to the marketplace to see what companies think and who is actually taking advantage of the potentially large cash flow savings of cost segregation studies. It appears there are four categories of companies in relation to cost segregation studies.

The first group doesn’t own any significant amount of real estate and has no reason to perform a study.

A second group of companies owns real estate, but chooses not to analyze cost segregation for various reasons. The majority of tax directors and chief financial officers we talked to would fit in this category. Reasons they stated for not pursuing these studies include a lack of detailed knowledge about the cost segregation process, the existence of corporate NOLs that mute the benefit, lack of real estate purchases in recent years, the nonprofit status of the entity and the costs of performing the studies.

The third group of companies seeks to perform cost segregation studies on their own. Limiting the upfront cost of the study and doing the best they can with the personnel they have is the attitude for the majority in this group.

Representative of this third group is Robert Madison, a tax accountant who manages the corporate tax function for Alfa Laval, Inc. According to Madison, Alfa Laval leases the majority of its locations, and its cost segregation studies are generally limited to leasehold improvements. Due to the studies' relatively small size and scope, Madison will perform them himself, he said. Alfa Laval is a leading provider of specialized products and engineering solutions based on its key technologies of heat transfer, separation and fluid handling, with global sales of approximately $3.7 billion.

The vice president of finance and chief financial officer of a privately held middle market company provides another typical scenario. He said that the company did not do a formal study, but performed its own internal analysis when it built an office building that was going to be owned by family members and leased back to the corporation. They were able to "move some assets into five- and seven-year lives, while the leaseholder took the building, which was all at a 39-year depreciation life," the executive said.

The fourth group performs studies and seeks outside counsel. "Owens & Minor hired outside consultants to perform a cost segregation study when the company built its corporate headquarters building," said Natalie Wargo, vice president of tax.

Wargo pointed out that "since the company almost never purchases the real estate it uses, we did not have the technical expertise in-house to perform the study." They looked for a "firm with a combination of technical tax expertise and construction engineering expertise." Owens & Minor is a medical equipment wholesale supplier and provider of supply chain management services with annual revenues of $7.7 billion.

Some of the companies have frequent needs in this area and therefore have developed specific expertise in-house. Jim Murphy, manager of worldwide tax at NewMarket Corporation, indicated his company "has experience doing cost segregation studies." Although it has developed internal staff, NewMarket still utilizes "technical consultants in order to properly do the work and be able to successfully defend the work to the IRS," Murphy said.

Murphy suggests that ideally a company would "start the cost segregation work in the construction phase, working with the engineers up front, which creates a smoother and more cost effective process." NewMarket engages in the petroleum additives and real estate development businesses with annual revenues of $1.5 billion.

The tax director of a Virginia-based Fortune 500 company indicated it is currently undergoing a cost segregation study that it decided to "wrap around a full fixed asset review, taking into account the new repair regs that were issued." The company did an informal request for proposals, selected an international accounting firm and is "expecting to achieve just shy of [its] initial estimate of benefit."

The vice president of tax of another Virginia-based Fortune 500 company stated the company "always does cost seg" and that the "50 percent bonus depreciation is an added incentive to perform the studies." How they engage the studies comes down to a cost benefit analysis. "If it's an 8-figure job ($10+ million), they're probably going to hire external help, as the studies pay for themselves." When they look for outside assistance, they seek "a mix of engineering and financial expertise," as well as "the reputation of the firm and their references."

Mark Zettell, a professional engineer and a director in BDO Seidman, LLP's Cost Segregation Services practice notes that "benefit to cost is important, and the more costly and complex projects will certainly yield first-year cost segregation benefits and overall net present value benefits that exceed the fees to perform a study many times over."

That being said, Zettell believes "any investment of $1 million or more for a newly constructed or acquired facility should be examined to determine the potential cost segregation benefit."

He emphasized the "importance for the taxpayer to seek cost segregation proposals from reputable firms, and the need to be able to recognize proposals that provide only credible estimates of the cost segregation benefits." BDO Seidman, LLP, is the U.S. member firm of BDO International, a worldwide network of accounting firms with offices in 110 countries and revenues in excess of $5 billion.

Conclusion

The tax deferral benefit of a cost segregation study is not a new strategy. However, the combination of the current economic conditions and the favorable tax provisions discussed above make it as valuable a planning tool now as it perhaps ever has been.

Keep in mind that some incentive tax provisions are due to expire at the end of the year. The astute planner will not overlook depreciation expense as one stone to be turned over in his or her search for additional cash flow to help weather the current economic storm.

However, a word to the wise might best be in the form of another old adage: *"If it's worth doing, it's worth doing right."*

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