"TAX-FAVORED CONSTRUCTION"! ™© 2006-7

The Difference between the Nail and the Screw,

May Be Worth MILLIONS to Owners!™

New I.R.S. Approved Tax Savings Depreciation!

DEVELOPERS, OWNERS, ARCHITECTS, BUILDERS & CONTRACTORS!

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Part One of a Three Part Series

Tax-Favored Construction! ™© 2006-7

New I.R.S. approved "Cost Segregation" can save and make owners and developers millions. Tax studies and construction design, materials and installation are now inherently interlinked. The consequence of this marriage is the realization or loss of 'quantifiable' and 'substantial' tax, cash flow and insurance benefits. Reportedly, a reclassification of $1,000,000 from 39 year to 5 year property can result in almost $600,000 in first year deductions. Present value cash flow benefits may be up to 10% of the cost of the building. Cost segregation tax studies of construction design, materials, and methods of installation are now inherently interlinked. The consequence of this marriage is the realization or loss of material economic benefits to the owner. What if a cost-segregation study could properly reclassify $1,000,000 from 39 year to 5 year property and $1,500,000 to 15 year property to result in approximately a <u>$550,000 first year tax benefit deduction?</u> Add a zero and that's $5,500,000 increase in cash flow. What if for every $100,000 increase in cash flow the building value goes up some $1,000,000 (10% Cap Rate) or $2,000,000 (5% Cap Rate). Is that something the owner would want to know? What if the owner could reclassify 10-40% (or more) of the depreciation base of that building? What if the HVAC units, plumbing and electrical systems, wall coverings, lighting or removable partitions could save the owner millions? Contractors need to embrace this betterment and inform the owners of the new opportunities in Tax-Favored Construction.

Cost segregation can be applied to *new or existing construction, tenant improvements, build-outs, renovation, remodeling, restoration, expansion, fit-outs, and demolition*. That's right, even demolition can now be structured to save taxes. <u>Maybe it's time to consider *requiring* your architects, brokers, CM and contractors to propose to you a Cost Segregation *option*</u> - prior to final plans and design. Although you can implement a cost segregation study to realize great savings during or after construction, new construction integrated with tax-favored construction™ techniques can yield maximum cash flow savings and valuation enhancements. Maybe it's time to have a third party consultant prepare you a free cost segregation study based on your proposed blue prints. You can find cost segregation consultants (engineer based CPAs and tax attorneys) at www.taxfavoredconstruction.com .

Design, Selection of Materials and Construction Installation ("DIMM"™) [1].

Design, materials, construction methods and installation alternatives aligned with new tax cost segregation integration may yield substantial tax and operating costs savings. This will translate into enhanced cash flow, enhanced ROI, and enhanced valuations.

It's No Longer about Cost Savings with Design & Materials; it's about Tax Efficient Design, Materials, Methods & Installation!

It's no longer about great design, or use of new, fancy or alternative materials – just to be different! It's no longer about new choices that save money on cost! <u>No, it's now about the tax implications of those decisions</u>. Why? Because the potential tax advantages to the client are ‘quantifiable’ and staggering. So, if you failed to make ‘optimal best practices’ decisions which include tax-favored construction options, you may have lost great potential tax savings.

Under prior tax/accounting laws, taxpayers would allocate a building into its component parts, such as Doors, Floors and Walls. The idea was to apply a short depreciation-life to these components to get favorable tax depreciation write-offs. However, after the IRS implemented accelerated cost recovery system (“ACRS”), and the modified accelerated cost recovery system (“MACRS”), ‘component depreciation’ was eliminated. In 1997 the Tax Court ruled in favor of the taxpayer allowing accelerated depreciation write-offs regarding ‘improvements’ using a concept known as Cost Segregation.[2] In 2004, **Revenue Procedure 2004-11** reversed the *IRS imposed 2 year waiting period* required to change your method of depreciation, allowing you to change to a cost segregated and accelerated method in any year. In 2006, you can now take the whole tax benefit in the year of the study, instead of over a four year period.

Cost Segregation is simply a reclassification of the cost makeup of the building’s components and materials into a shorter depreciation schedule. Residential property is depreciated over a 27.5 year schedule. Non-residential property and tenant improvements are depreciated over a 39 year schedule. By reallocating certain amounts out of the 39 or 27.5 year schedule, into a 5, 7, or 15 year schedule, the amount of the depreciation write-off is greatly increased, lowering Federal and State Income Taxes, Transfer Taxes, Insurance Premiums, and Real Estate Property Taxes; and increasing Cash Flow, ROI, and potential Sale Valuation. Cost Segregation also allows for a write-off in the current year of the Cost Segregation Study. This would amount to a dramatic tax benefit for the client. It also allows for carry back refunds and adjustments for prior overpayments, and future tax offsets.

Simply put, the cost-segregation method reclassifies the depreciation with respect to your property into four *more refined* categories:

land,

land improvements,

personal property, and

building

Some of these categories have a drastically shorter depreciation life schedule, which can increase your current tax deductions dramatically. There’s reportedly 20-40% (or more) of your building waiting to save you immediate Federal and State income taxes, real property taxes, transfer taxes, and insurance premiums. Not to mention the increase in cash flow, the increase in ROI (return on investment) and sales price valuation!

That's right, a paper transaction, requiring an engineering / tax accounting report, can save you thousands. Those experienced in commercial property valuation methods understand immediately how incredibly powerful it is to increase the efficiency of our building financial statements on our commercial property. Unlike certain residential property where valuation is based upon 'comp sales', commercial property valuation is in large part based upon 'cash flow'. When one tweaks the cash flow efficiency by increasing rents and decreasing expenses, the value of our building can increase dramatically. If Value = NOI (Net Operating Income), Divided By Cap Rate then, if the efficiency tweak results in a $150,000 NOI, that property may yield $1,500,000 in valuation at a 10% Cap Rate (or $3,000,000 in Valuation, at a 5% Cap Rate). You can see, this is a matter of money, hence a real concern for building owners and tenant improvers.

That alone, is one example of the power of commercial property, but with the new tax laws now in place, that picture is made much more vivid (and profitable). Suppose you also conduct a cost-segregation study and file an ***IRS FORM 3115*** (Application for Change in Accounting Method). What if you reclassify 20-40% (or more) of the depreciation base of that building, currently depreciated over 39 years, to a current deduction, or over a 5, 7, or 15 year period? That's real money, and real added value in your pocket now without any waiting periods!

Case examples have shown a building with a $3,600,000 cost with a $190,000 net present value of tax savings ("NPVTS") and a $40,000 tax savings in year 1; a $3,200,000 building cost with a $78,000 NPVTS, and a $122,000 tax savings in year one. CPA firms have reported example of a $4,000,000 building purchased four years earlier, with a 30% reclassification and a present value cash flow savings of over $300,000 from reduced taxes. That can have a big impact.

Now stop for a moment, and reflect. The tax law reclassification didn't require you to spend a million dollars on a facelift, or rehab. <u>It didn't require any cash</u> investment to return an immediate and substantial deduction against income; and a huge valuation increase. It lowered your Federal and State income taxes, lowered your real estate property taxes, lowered your transfer taxes, and lowered your insurance premiums – all without cash out of your pocket! For every $100 spent on services, you may realize reportedly $2000-$4000 in tax benefits, or 10-20 times the fee. Potential benefits clearly far outweigh the costs. This is a serious matter that deserves your *immediate* attention.

If there was ever a 'get-rich-quick- real estate system, this would be it; or in the minimum, this would be a big part of it! This is the new and approved IRS cost reclassification method.

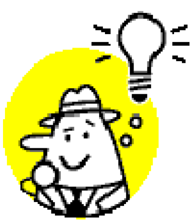
<u>OK. What Do I Have To Do?</u>

Call an approved tax-favored construction consultant and get a free cost segregation estimate of potential tax savings for your existing properties or new purchases. You can find cost segregation consultants (engineer based CPAs and tax attorneys) at www.taxfavoredconstruction.com .

The Detail. The task is to distinguish between IRC 1245 (tangible personal property) and IRC 1250 (real property). More specifically, between tangible personal property, land, land improvements and the buildings structural components. The issue is whether the components (or property items) are **inherently permanent?** There is no easy bright line test, and you shouldn't make the ultimate determination anyway.

However, you probably are best advised to keep original cost documentation and proper records in a form that is synchronized with the necessary work-papers and expectations of your client's team of Cost Segregation Engineers. Your client's experts (made up of engineers, tax lawyers, and CPA's) will expect you to deliver the appropriate and defensible supporting documentation necessary for them to obtain your mutual client their well deserved tax benefits. Make sure you save the original cost records – and this means from the sub-contractors and material-men as well!

Personal Property. *Treasury Regulation 1.48-1(c)* says tangible personal property is all property "except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures)." Examples are: furniture, carpeting, fixtures, window treatments, printing press, transportation, office equipment, refrigerators and display racks.



Structural Components. Although the treasury regulations define structural components one way, the Tax Court cases give us the best guidance in distinguishing between personal and structural property. *Treasury Regulations 1.48-1(e)(2)* says structural components are any property that "relates to the operation or maintenance of a building,".

Case law [2] teaches us that the basic conceptual questions are the following:

- Can it be 'moved'?
- What is the degree of difficulty to move it?
- Was it *designed or constructed to be moved* (or remain permanently)?

I
s it attached to the land or permanent concrete? Is it permanently 'glued' or affixed? Maybe the framing or tracking is permanent. So then the question remains, is the item screwed or bolted onto such permanent framing in a fashion intending for it to be removable, moved, changed, updated, seasonally modified?

- In moving it, will it cause substantial or material damage?
- Was it intended to be temporary, changeable, removable?
- I call it "Reasonably Removable", "Without Material Destruction" ("RROD").

Duty of Documentation or Record Keeping

The IRS Chief Counsel gave us guidance on what would be an acceptable or non-acceptable Cost Segregation Study. In *CCA 199921045* it states:

> **[an] "accurate cost segregation study may not be based on noncontemporaneous records, reconstructed data or taxpayer's estimates or assumptions that have no supporting records"**

This should be crystal clear. The IRS will require your client's to base their tax reductions on ***contemporaneous records****, and original cost, contract, materials, labor and overtime documentation*. The study should be **done by engineers**, CPAs and tax lawyers, not just CPAs. Visit www.4costsegregation.com for a more detailed analysis of this I.R.S. approved depreciation method.

The Difference Between The Screw & The Nail May Be Millions In Tax Savings! ™

The SCREW  **or**  **The NAIL?**

That is the *Conceptual* Question!

The issue is whether it's inherently permanent? It's the same concept as the **shirt with detachable collars!** The answer can mean the difference in millions of dollars; and between being the best-in-the-industry, or malpractice.

Tax-Favored Construction ™

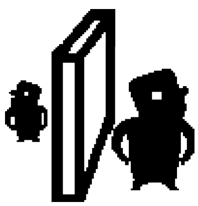
Alternative Design, Materials & Installation Methods (DIMM™)

If the issue is whether it's *inherently permanent*, if is not permanent, it's 'movable' and potentially tax-favored property. The property or item must be movable with minimum destruction to the structure and potentially, the item.

Destruction. If you have to DESTROY the property to remove an item, it may very well not be 'movable', and not a tax-favored method of construction. I would say material damage or destruction to the item or the permanent structure should not be incurred if you expect to qualify it as tax favored property.


Nails or Permanent Fastening Systems. If you have to NAIL an item to the structure, its removal will probably cause a certain amount of destruction to the premises or the item itself. Hence, it might not be considered 'movable'. Alternative fastening systems will be a key concern to find potential tax-favored construction methods.


Glue or Permanent Fastening Systems. If you have to GLUE an item to the structure, its removal will probably cause a certain amount of destruction to the premises or the item itself. Hence, it might not be considered 'movable'. Alternative fastening systems will be a key concern to find potential tax-favored construction methods.


Modular or Prefabricated Construction. Modular construction may be a key consideration to designing interiors (and potentially exteriors) which are 'movable' and a potentially tax-favored method of construction. You're the experts here, image what you could offer, design and construct while saving your client major money in taxes and insurance.


Easily Removable Fastening Systems. The BOLT, like the screw may be behind the design element necessary to obtain tax-favored construction. 'Easily Removable' is <u>not</u> the legal or tax definition; remember we don't have a bright-line definition. However, "easily" is defined as "1) without difficulty or effort. 2) without doubt. 3) very probably." But we should also add, *Without material destruction. All of these are informative, as we look for alternative design, material and

installation methods. I call it “Reasonably Removable”, “Without Material Destruction” (“RROD”)!TM

**The Removable SCREW.** Although not a silver bullet, it’s the concept of the screw that illustrates tax favored construction.

**Track, Modular or Prefabricated Lighting.** The Tax court in the *Morrison*[4] case taught us that if the lighting fixtures and electrical connections didn’t supply basic illumination but were decorative or accessory in nature, it was 1245 property; and tax-favored construction. However, in the *Duaine* case decorative lighting fixtures that were the building’s ***only light source*** were structural components, not 1245 property.

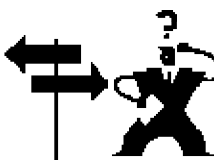
**Modular or Prefabricated Flooring?** It is possible to design and install flooring in a manner that is tax-favored as well. Recall how the ‘computer’ flooring was built years ago to help cool the big corporate main frame computers. If a framed structural base is permanently attached to the concrete or structure, and a modular framed flooring system is attached in a ‘reasonably removable’ manner, it may be tax-favored construction.

**’Roof’ as a <u>Separate Component</u> of ‘Building’.** Although the roof is part of the ‘building’, and depreciated over 27.5 or 39 years, the benefit of keeping each item separately listed is to allow for write-offs when a particular item is deemed worthless. For example, if a roof is valued in the cost study at $150,000 and it needs replacement in two years from that date, the net depreciable amount or the adjusted tax basis (i.e. prox. $130,000) <u>becomes a write-off in that year of replacement</u>. Otherwise, if the roof was not separately stated and its cost was contained in the general number for ‘building’, there would be <u>no write-off</u> at that time. Big difference.

**The Principle Lesson.** Cost Segregation requires each

item or component of construction to be **<u>separately stated</u>**, and supported by "***<u>contemporaneous records"</u>*** *of original cost, contract, materials, labor and overtime documentation* - for maximum use by your client.

**<u>Your Principle Duty.</u> <u>Architectural Blueprints.</u> <u>Original Material Cost Documentation</u>.** You probably have a duty to your client to deliver the original material cost documentation in a form usable by Cost Segregation experts so that your client can optimize tax benefits. This includes the cost documentation from the **SUBS (Subcontractors).** It includes the blueprints and change orders.

**Decisions. Knowledge. Education. Consultants.** As you can see there is no bright line test, but there is a 1rhyme or reason. That's why specialized tax advisors must be consulted. For example, case after case HVAC units were not allowed as 1245 tangible personal property, but it was allowed in the *Piggly Wiggly* case. There are many cases where the plumbing and electrical systems were not allowed as 1245 property, but in the *Schrum* case it was. **Removable 'partitions'** were held to be 1245 property in the Metro National case, but not the Dixie Manor case. '**Wall coverings'** were held to be 1245 property in the Hospital Corporation of America case, but not in the Duaine case.

<u>In Closing. Opportunity Abounds for the Owner and Developer if Builders, Generals, Construction Managers (CM's) and Design Firms Use Tax-Favored Construction ™</u>

You can see that it is imperative that you hire a tax-favored construction™ or cost segregation consulting firm that has the material classification knowledge necessary for **recommending design, material, methods of installation and construction options.** The benefit to you is 'quantifiable' and 'staggering'. This will be the norm soon, very soon. **Don't sign another contract without incorporating this option, or requiring a free proposal on the tax savings estimates connected to your projects.** You can find tax-favored construction and cost segregation consultants (engineer based CPAs and tax attorneys) at www.taxfavoredconstruction.com .

Part Two of this article will deal with the specific design and material choices as identified from the point of view of the ***IRS, by CSI code***.

See www.4costsegregation.com for more information on the detail of cost segregation studies. This CSI classification is an excellent way to get up to speed on the *specific* conceptual choices that you will have to document for your clients.

Call us at 949-798-6206 or email us at

rrydstrom@gmail.com for more information.

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Published or quoted numerous times (in Commercial owners/brokers associations including AIRE and Constructor Magazine (AGC), Apartment Associations and CPA journals, etc., and in the 110th Congress of the United States of America.
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1 ***Special Warning On Selection of Material And Strict Liability For Moving Slabs & Cracks!***

Strict liability has the same effect as being in the path of a B-1 or B-52 on a cluster raid. *All in its path pay, Innocent or Guilty!* That's right, not only developers, builders, generals, manufacturers but CM's may be held responsible for strict liability without fault for defects relating to *design*, *selection of materials and construction installation*. For example, once a developer/contractor/CM is sued for strict liability, a sub (i.e.: *concrete-sub)* will be sued to indemnify the developer/contractor/CM for a defective foundation slab, which moved and deformed with extensive cracks! (Watch this potentially growing area of liability!) *Stearman v Centex Homes (2000) 78 CA4th 611;   [9]La Jolla Village HOA v Sup Ct (1989) 212 CA3d 1131*. Strict Liability generally allows for punitive damages. *Barrett v Sup Ct (1990) 222 CA3d 1176*), *San Francisco Unified Sch Dist. v. WR Grace (1995) 37 CA4th 1318.*

2 Hospital Corporation of America [HCA] v. Commissioner, 109 TC 21 (1997); (AOD) 1999-008 – Cost Segregation does not constitute component depreciation. Treasury Department regulations 1.446-1T.

3 AC Monk & Co v United States, No. 78-126-CIV-4, 1981 U.S. Dist. LEXIS 17764; Albertson's v. Commissioner, 94-1 U.S. Tax Cas. (CCH) P50, 016; 73 A.F.T.R.2nd (RIA) 558 (9th Cir. 1993); Boddie-Noelle Enters. V. United States, 96-2 USTC section 50,627 (Fed. Cl. 1996) aff'd 132 F. 3rd 54 (Fed. Cir. 1997); Hospital Corporation of America [HCA] v. Commissioner, 109 TC 21 (1997); (AOD) 1999-008 – Cost Segregation does not constitute component depreciation. Treasury Department regulations 1.446-1T.; King Radio Corp. v. United States, 486 F. 2d 1091 (10th Cir. 1973), aff'd, D.C. No. KC-3320); Piggly Wiggly Southern, Inc. v. Commissioner, 84 T.C. 739 (1985), aff'd 803 F. 2nd 1572 (11th Cir. 1986), nonacq., 1988-2 C.B.1.; Whiteco Industries, Inc. v. Commissioner (65 TC 664 (1975)); Schrum v. Commissioner, T.C. Memo, 19930124, aff'd in part and vacated in part, rem'd 33 F.3d 426 (4th Cir. 1994) on remand, T.C. Memo. 1995-103, aff'd in part and vacated in part without published opin. 114 F 3d 1177 (4th Cir. 1997), Metro National Corporation v. Commissioner (52 T.C.M. 1440 (1987)); Dixie Manor, Inc. v United States (79-2 US Tax Cases 9469 (W.D. Ky. 1979)); Duaine v. Commissioner (49 T.C.M. 88 (1985)); Morrison, Inc. v Commissioner (891 F2nd 857 (11th Cir. 1990)); etc.

4 Duaine v. Commissioner (49 T.C.M. 88 (1985)); Morrison, Inc. v Commissioner (891 F2nd 857 (11th Cir. 1990))