Cost Segregation Overview

Tangible Property Regulations Update

TCJA Overview and Update

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Bio
Kevin Jerry is the Executive Vice President of Cost Segregation Services, Inc. (CSSI). Kevin is a nationally recognized speaker on the subject of Cost Segregation, and the Tangible Property Regulations. Kevin has spoken at such venues as the American Institute of Certified Public Accountants; the Maryland CPA Association, the Kentucky CPA Association, the Florida CPA Association, Hong Kong Trade Association and Penn State University. Kevin has two finance and accounting degrees and completed his advanced degree in Taxation with an emphasis on depreciation.

Cost Segregation

Cost Segregation Will Save You Tens of Thousands of Dollars

What is Cost Segregation

Cost Segregation is a congressionally approved application by which commercial property owners restructure depreciation so each building component is depreciated separately based on it's class life (From RP 87-56) instead of under the class life of the of the building structure.

The benefit is a reduction the amount of taxes owed in the current or future tax years.

Cost Segregation is simple, legal and is recommended by the Journal of Accountancy, the AICPA, the top 20 US Accounting firms and even the US Treasury.

"A taxpayer can substantially increase cash flow by segregating property costs."

AMERICAN SOCIETY OF CPA'S

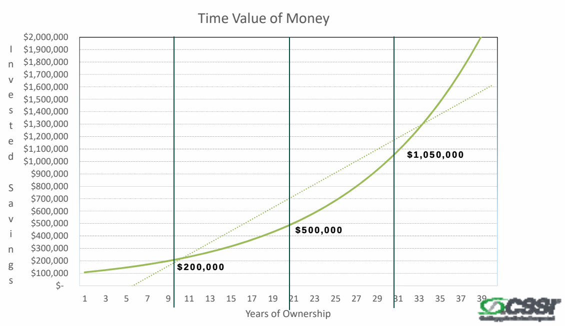
"Some taxpayers are reluctant to use cost segregation, equating it with a high-risk tax shelter. In truth, this reluctance is misplaced. If the cost of the components in the engineering report is well-documented, the cost segregation technique is no more aggressive than using any permissible depreciation method under the Internal Revenue Code".

- JOURNAL OF ACCOUNTANCY

Who is CSSI

- CSSI is the nations premier engineering based cost segregation and building owner consulting firm.
- We have performed over 20,000 studies. We have never had a study overturned by the I.R.S. We have never missed a deadline. The buildings we segregate are between brand new and twenty years old (from date of occupancy).
- The bases of our projects range from $150,000 to $2,500,000,000.

Why is Cost Segregation beneficial?



Example

$1,000,000 Building

- The IRS allows you to depreciate your building at $25,641 per year with straight line 39 year depreciation
- Simple math - $1,000,000/27.5 years
- $35,700 per year with straight line 39 year
- $13,200 tax savings per year (based on 37%)
- But inflation wipes away 2% per year.
- In 10 years instead of having $13,200 in buying power, you only have $9,000. Inflation erodes the future benefit of depreciation .

Depreciation using Cost Segregation

SAME $1,000,000 Building

The IRS allows you to componentize the assets of the building that are not structural related. 15% -20% of a typical building can be componentized.

This will create additional depreciation of $150,000 in the first year,

More importantly a $55,500 tax savings right now depending on the marginal tax rate and if bonus is applied.

In 10 years you now have $75,000. Compound interest increases your buying power.

How the Process Works

How Does Cost Segregation Work?

- Personal property is separated from real property (1245 vs 1250
- Code Sec. 1245 personal property (Code Sec. 1245(a)(3)(A)), which consists of items such as office furniture and fixtures, and appliances that are furnished to tenants. The principal characteristic of Code Sec. 1245 personal property is that it is readily moveable rather than permanently affixed.
- New construction is not the only circumstance when cost segregation can be performed. Any buildings purchased after the year 2000 with a cost over $200,000 are candidates because of Form 3115 and IRC Section 481.

Form 3115

- An automatic change to depreciation is required. You have to let the IRS know you changed your depreciation method. This is done with a form 3115.
- The taxpayer uses the new method of accounting to determine income from that day forward.
- A change in method of accounting requires consistency. So Cost Segregation is applied from the original date of occupancy as if the taxpayer had always used cost segregation.
- This is called a Code Section 481a adjustment.

Form 3115 (Rev. December 2018) Department of the Treasury Internal Revenue Service

Application for Change in Accounting Method

▶ Go to *www.irs.gov/Form3115* for instructions and the latest information.

OMB No. 1545-2070

Name of filer (name of parent corporation if a consolidated group) (see instructions)

Identification number (see instructions)

Principal business activity code number (see instructions)

Number, street, and room or suite no. If a P.O. box, see the instructions.

Tax year of change begins (MM/DD/YYYY)

Tax year of change ends (MM/DD/YYYY)

City or town, state, and ZIP code

Name of contact person (see instructions)

Name of applicant(s) (if different than filer) and identification number(s) (see instructions)

Contact person's telephone number

If the applicant is a member of a consolidated group, check this box ▶ ☐

If **Form 2848,** Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box ▶ ☐

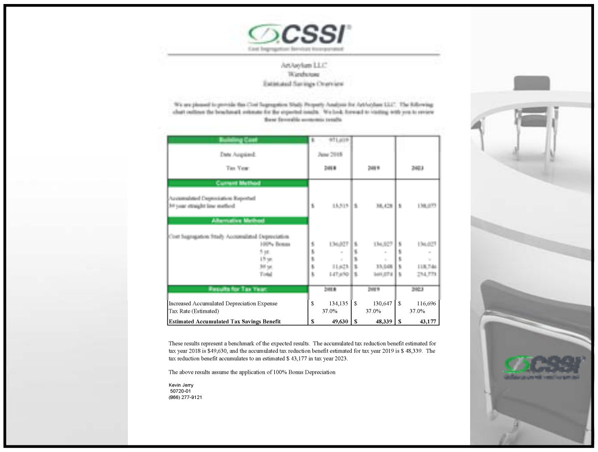
Check the box to indicate the type of applicant.

☐ Individual
☐ Corporation
☐ Controlled foreign corporation (Sec. 957)
☐ 10/50 corporation (Sec. 904(d)(2)(E))
☐ Qualified personal service corporation (Sec. 448(d)(2))
☐ Exempt organization. Enter Code section ▶
☐ Cooperative (Sec. 1381)
☐ Partnership
☐ S corporation
☐ Insurance co. (Sec. 816(a))
☐ Insurance co. (Sec. 831)
☐ Other (specify) ▶

Check the appropriate box to indicate the type of accounting method change being requested. See instructions.

☐ Depreciation or Amortization
☐ Financial Products and/or Financial Activities of Financial Institutions
☐ Other (specify) ▶

Caution: To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes **(1)** all relevant information requested on this Form 3115 (including its instructions), and **(2)** any other relevant information, even if not specifically requested on Form 3115.
The taxpayer must attach all applicable statements requested throughout this form.



CSSI
Cost Segregation Services Incorporated

ArtAsylum LLC
Warehouse
Estimated Savings Overview

We are pleased to provide this Cost Segregation Study Property Analysis for ArtAsylum LLC. The following chart outlines the benchmark estimate for the expected results. We look forward to visiting with you to review these favorable economic results.

Building Cost	$ 971,019		
Date Acquired:	June 2018		
Tax Year:	**2018**	**2019**	**2023**
Current Method			
Accumulated Depreciation Reported 39 year straight line method	$ 13,515	$ 38,428	$ 138,077
Alternative Method			
Cost Segregation Study Accumulated Depreciation			
100% Bonus	$ 136,027	$ 136,027	$ 136,027
5 yr.	$ -	$ -	$ -
15 yr.	$ -	$ -	$ -
39 yr.	$ 11,623	$ 33,048	$ 118,746
Total	$ 147,650	$ 169,074	$ 254,773
Results for Tax Year:	**2018**	**2019**	**2023**
Increased Accumulated Depreciation Expense	$ 134,135	$ 130,647	$ 116,696
Tax Rate (Estimated)	37.0%	37.0%	37.0%
Estimated Accumulated Tax Savings Benefit	**$ 49,630**	**$ 48,339**	**$ 43,177**

These results represent a benchmark of the expected results. The accumulated tax reduction benefit estimated for tax year 2018 is $49,630, and the accumulated tax reduction benefit estimated for tax year 2019 is $ 48,339. The tax reduction benefit accumulates to an estimated $ 43,177 in tax year 2023.

The above results assume the application of 100% Bonus Depreciation

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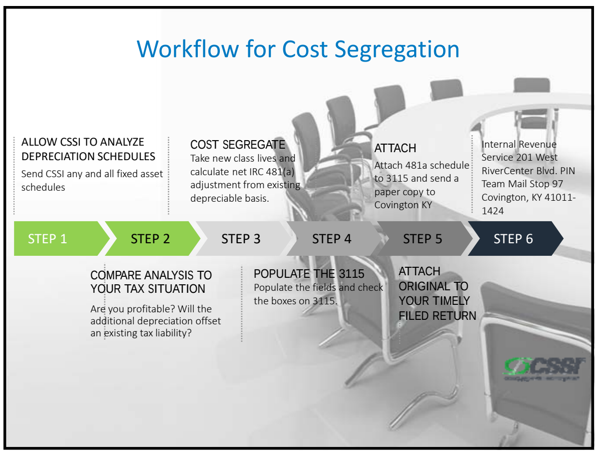

These Regulations will save you tens of thousands of dollars
OR
Cost you tens of thousands of dollars

It's your choice

This is not your CPA's job

"The final tangibles regulations combine the case law and other authorities into a framework to help you determine whether certain costs are currently deductible or must be capitalized.

The final tangibles regulations also contain several simplifying provisions that are elective and prospective in application"

INTERNAL REVENUE SERVICE WEBSITE

"The final tangibles regulations apply to anyone who pays or incurs amounts to acquire, produce, or improve tangible real or personal property. These regulations apply to corporations, S corporations, partnerships, LLCs, and individuals filing a Form 1040 with Schedule C, E, or F.

The final tangibles regulations affect you if you incur amounts to acquire, produce or improve tangible real or personal property in carrying on your trades or businesses.

The rules are most significant for those that regularly incur large capital expenditures, e.g. businesses with substantial real estate holdings. The final tangibles regulations are effective for taxable years beginning on or after 1-1-2014".

INTERNAL REVENUE SERVICE WEBSITE

Expense Versus Capitalize

$100,000 Repair

- Capitalize over 27.5 years
  - $3,571 deduction per year
  - $1,320 cash reduction
- Expense as a repair
  - $100,000 deduction in the current year
  - $37,000 cash reduction

Moving Forward

Units of Property

The first step

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Tell the IRS what your building(s) look like

Unit of Property Declaration to the IRS

"Proposed method":

"The taxpayer will account for its apartment complex consisting of twenty five buildings as separate units of property. Each building will be a separate unit of property and will consist of the building, its building structures and building systems. The building structures will also include the carpeting and cabinets installed in the building. The taxpayer will divide its current one line asset on its depreciation schedule into five separate buildings using a reasonable method to divide up that one asset. The reasonable method will employ the square footage of each building compared to the total square footage of all buildings multiplied by the price paid for the apartment complex. Additionally, the taxpayer will account for its land improvements consisting of its parking lots, landscaping, and outside lighting as one unit of property, separate from the building units of property"

Moving Forward

The second step

Safe Harbors

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DE-MINIMIS SAFE HARBOR

DMSH – ANNUAL ELECTION

- De minimis Safe Harbor (Acquire or Produce) tangible property
- Allows expensing of amounts under $2,500
- Calculated on an invoice or item level. An invoice MUST be available
- Elected annually by including a statement with the taxpayer's tax return for the year elected.
- The expenditure MUST have a receipt. Taxes and freight on the invoice must be added to the total if they are on the invoice.

DISPOSITION OF AN ASSET

PAD – ANNUAL ELECTION

- Determination of basis of disposed asset IN THE CURRENT TAX YEAR
- Calculate the value of the asset removed. For example:
  - Drywall
  - Wiring
  - Exteriors
  - Roofs
  - Pavement
  - Carpeting
  - Flooring
- Cost Segregation is a CERTAIN METHOD for calculating PADs
- The removal costs can be written down but a 3115 with MC 21 must be filed with the return if removal costs have been capitalized in the past.

SMALL TAXPAYER SAFE HARBOR

STSH – ANNUAL ELECTION

- If your building has a cost basis of $1M or less, and your trade or business is less than $10M average annual gross receipts, a special rule CAN be utilized:
- Can elect to expense expenditures if the annual amount spent is less than $10,000 or 2% of unadjusted basis on a building-by- building basis.
- Example: $300k building = $6,000 limit.
- If limit is exceeded, it does not apply to any amounts.
- Gross receipts include interest, dividends, rents, royalties, and annuities.

ROUTINE MAINTENANCE SAFE HARBOR

AMAZING OPPORTUNITY METHOD CHANGE 184

- Deductible if you reasonably expect (at time the building is placed in service) to perform more than once during the 10 year period from when the building system was placed in service
- Routine Maintenance Safe Harbor does not apply to making the component better.
- Consider the recurring nature of the activity, industry practice, replacement history, manufacturer's recommendations, and your experience

Moving Forward

Safe Harbors do not apply?

Go to the third step

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Improvement and Restorations

Safe Harbors don't Apply?

EXPENSE IT UNLESS:

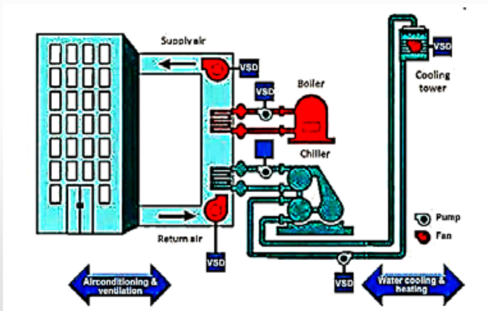
R - Restoration – If the expenditure was made less than two years after occupancy, it is called a restoration and must be capitalized.

A – Adaptation – If the expenditure adapts the unit of property to a new or different use it must be capitalized.

B – Betterment – Measurably (over 10%-20%) improves the building or component being replaced. If it measurably increases the capacity, size, productivity, efficiency, quality, or output it **MUST be capitalized**.

I – Major Improvement or Expenditure - If the expenditure is more than 33%-40% of the replacement cost of the building system component or if it replaces more than 33% of all the like components it **MUST be capitalized.**

Improvement and Restorations



Betterments, Restorations and Improvements

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Betterments (B)

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Betterments

- M owns a building that it uses for its retail business.
- Over time, the waterproof membrane (top layer) on the roof of M's building begins to wear, and M began to experience water seepage and leaks throughout its retail premises.
- To eliminate the problems, M put a new rubber membrane on the worn membrane.
- The new membrane is comparable to the worn membrane Moreover, the new membrane is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure.
- M can expense the membrane.

Betterments

- R owns an apartment building.
- The building contains an HVAC system that incorporates 10 roof-mounted units.
- After many years of use of the HVAC system, R begins to experience climate control problems.
- R pays an amount to replace the two specified units.
- The two new units are expected to be 10 percent more energy efficient than the replaced units.
- The replacement is not expected to materially increase the productivity, efficiency, strength, quality, or output of the HVAC system.
- R can expense the units.

Betterments

- B owns an apartment building that was constructed with insulation that contained asbestos.
- Several years after B places the building into service, B determines that certain areas of asbestos-containing insulation have begun to deteriorate and could eventually pose a health risk to employees
- Therefore, B pays an amount to remove the asbestos-containing insulation from the building structure and replace it with new insulation that is safer to employees, but no more efficient or effective than the asbestos insulation.
- The removal and replacement of asbestos is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure.

Betterments (This a key slide)

- E acquires an apartment building.
- Immediately after the acquisition and during the following two years, E pays amounts for extensive repairs.
- The work includes repairing damaged drywall, repainting, re-wallpapering, replacing windows, repairing and replacing doors, replacing and re-grouting tile, repairing millwork, and repairing and replacing roofing materials.
- These repairs must be capitalized because the amounts ameliorate material conditions that existed prior to E's acquisition of the building.

Improvements

- K owns an apartment building.
- K discovers several leaks in the roof of the building and hires a contractor.
- The contractor discovers that a major portion of the decking has rotted and recommends the replacement of the entire roof. K pays the contractor to replace the entire roof, including the decking, insulation, asphalt, and various coatings.
- Therefore, K must capitalize the amount paid as an improvement.

Improvements

- O owns an apartment building.
- The building contains a HVAC system that incorporates ten roof-mounted units.
- A contractor recommends that O replace three of the roof-mounted heating and cooling units.
- The three roof-mounted heating and cooling units are not a significant portion of a major component of the HVAC system and must be expensed.

Improvements

- R owns an apartment building.
- R pays an amount to replace 30 percent of the wiring throughout the building with new wiring that meets building code requirements.
- However, the portion of the wiring that was replaced is not a significant portion of the wiring.
- Therefore, the replacement of 30 percent of the wiring is not the replacement of a major component and must be capitalized.

Improvements

- S owns an apartment building.
- S pays an amount to replace 8 of the total of 20 sinks located in the various restrooms.
- The 8 replaced sinks, by themselves, do not comprise a significant portion of a major component (the 20 sinks) of the plumbing system.
- Therefore, under paragraph (k)(6) of this section, the replacement of the 8 sinks does not constitute the replacement of a major component or substantial structural part of the building and must be expensed.

Improvements

- V owns and operates an apartment building.
- V decides to refresh the appearance of the building by replacing the floors in the lobby.
- The hotel lobby comprises less than 10 percent of the square footage of the entire hotel building.
- V pays an amount to replace the wood flooring in the lobby with new wood flooring of a similar quality.
- These repairs are not required to be capitalized

Improvements

- V decides to refresh the appearance of all the public areas of the hotel building by replacing all the floors in the public areas.
- The public areas comprise approximately 40 percent of the square footage of the entire hotel building.
- Therefore the replacement of all the public area floors constitutes the replacement of a major component of the building structure and must be capitalized.

The Opportunity

Form 3115 and a 481a adjustment

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Form 3115

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- The taxpayer uses the new method of accounting to determine income from that day forward.
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- This is called a Code Section 481a adjustment.

Form 3115

- An automatic change to is required. You have to let the IRS know you changed your expense method.
- This is done with a form 3115.
- The taxpayer uses the new method of accounting to determine income from that day forward.
- A change in method of accounting requires consistency.
- So the Tangible Property Regulations are is applied from the original date of occupancy as if the taxpayer had always used the Tangible Property Regulations.
- This is called a Code Section 481a adjustment.

Real Life Examples

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Betterment and Improvements

Real World Examples

Asset	Description	Tax Period	Tax Cost	Tax End Depreciation
20	Roof Repair	7/1/1995	$57,787	$32,034

Repair and Maintenance Conclusion

The units of property are each individual building and land improvements. The roof serves a major and discreet function within the structural components building system. The repair is less than 30% of the replacement cost of the entire roof.

Betterment and Improvements

Real World Examples

Asset	Description	Tax Period	Tax Cost	Tax End Depreciation
18	Building Improvements	27.5	$61,657	$35,165

Repair and Maintenance Conclusion

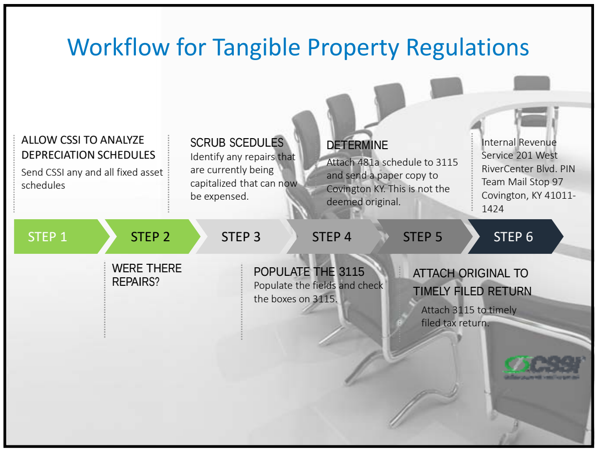
These repairs are the total repairs on all buildings for the entire year. The units of property are each individual building and land improvements. The repair was for rotting wood on multiple buildings. The repairs were for less than 30% of the exterior of each individual unit of property.

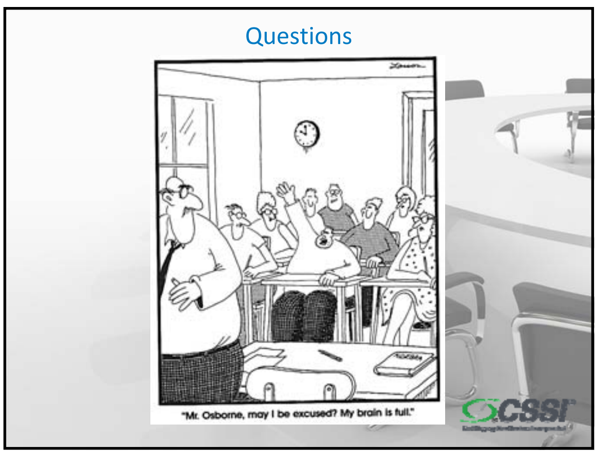
Real World Examples

Asset	Description	Tax Period	Tax Cost	Tax End Depreciation
32	Pavement Repairs	27.5	$52,557	$46,054

Repair and Maintenance Conclusion

This repair was done to the upper layer only within the single building unit of property. The repair is less than 30% of the replacement cost of the entire parking lot system. This follows the example under 263(2)(i).


Workflow for Tangible Property Regulations
ALLOW CSSI TO ANALYZE DEPRECIATION SCHEDULES
Send CSSI any and all fixed asset schedules
SCRUB SCEDULES
Identify any repairs that are currently being capitalized that can now be expensed.
DETERMINE
Attach 481a schedule to 3115 and send a paper copy to Covington KY. This is not the deemed original.
Internal Revenue Service 201 West RiverCenter Blvd. PIN Team Mail Stop 97 Covington, KY 41011-1424
STEP 1
STEP 2
STEP 3
STEP 4
STEP 5
STEP 6
WERE THERE REPAIRS?
POPULATE THE 3115
Populate the fields and check the boxes on 3115.
ATTACH ORIGINAL TO TIMELY FILED RETURN
Attach 3115 to timely filed tax return.


Questions
"Mr. Osborne, may I be excused? My brain is full."