

Cost Segregation Update

June 2005

We have seen a significant increase in the number of projects related to properties either constructed or acquired in prior years subject to the catch-up provisions of Rev. Procedure 2002-9. Even today I received a call from an accounting firm with a client interested in studies on more than 10 properties dating back to 1998. With all this interest, I thought it might be helpful to give you some ideas on which properties might be good or poor candidates for this type of analysis.

New Construction

If the client has the original construction plans you can go back as far as you want. If you have the contractor cost detail (Final Pay Application) and a listing and description of what other costs were incurred, the better. My experience is that after some time the construction plans are difficult to locate. The key issue is what was originally constructed. If the property has changed significantly since originally constructed, and you don't have the original plans, I would typically not recommend a study. An analysis can still be attempted, but the credibility is severely weakened because of the assumptions necessary to take.

Acquisitions

Once again, proving what was there when the property was acquired is key. Typically the construction drawings are not available, so a study is normally performed based on a physical inspection of the property. This is not an unusual situation and we have not heard of anyone being challenged using this approach. An important issue is the condition of the property at the time of acquisition. The values of the various building components are not only dependent on their age, but how they have been treated and maintained prior to acquisition. The closer of the date of the analysis to the date of the acquisition increases the credibility of a study. If the property has changed significantly since the date of acquisition, and construction drawings representing the property at the date of acquisition are not available, I would not recommend a study.

Property Size

The interesting thing about this is that we are doing studies on properties with a cost we normally would have not recommended for an analysis. As you know, we normally are looking at the present value of the after-tax deductions over a 27.5 or 39 year period on a property that was recently constructed or acquired. But, when you consider the impact of adding all of the deductions that should have been taken in prior years and converting it into a current year deduction it has a significant increase in the present value of the deductions. In the restaurant property example outlined below, if we had performed the analysis of the property at the date originally placed in service, the after-tax present value of the study would have been roughly \$120,000. Because of the catch-up, the incremental deduction in the current year increases by \$380,000, or \$152,000 after-tax at a 40% tax rate. This plus the remaining years deductions increases the present value benefit of a study to over \$190,000. So you can see, if you are looking at a property that we once might have considered too small, it could still be a viable candidate if the catch-up deduction is large enough.

As I normally do, below I have summarized some of our recent projects. I hope this information helps you identify opportunities in order to generate significant benefits for your clients and prospects and additional fee revenue for your firm.

1. Construction of **Retail Center** in Houston with a Grocery Store and Drug Store
Tax basis in improvements \$17,622,831
Identified 44.8% as short lived property (5, 7, or 15 year) –Significant tenant improvement allowance and land improvements
After-tax present value of **tax deferral \$1,025,000**
First three years **additional depreciation \$2,000,000**
Ratio of benefits/fees –85 times
2. **1995** Construction of new **Toyota Dealership in Oklahoma**
Tax basis in improvements \$1,934,000
Identified 37.8% as short lived property (5, 7, or 15 year)
Created **catch-up deduction** in current year of approximately **\$400,000**
3. Acquisition of Large **Nissan Dealership** in Texas
Tax basis in improvements \$4,459,000
Identified 40.6% as short lived property (5, 7, or 15 year)
After-tax present value of **tax deferral \$220,000**
First three years **additional depreciation \$538,000**
Ratio of benefits/fees--36 times
4. **2000** Construction of 10,000 square foot Specialty **Restaurant**
Tax basis in improvements \$1,748,000
Identified 41.2% as short lived property (5, 7, or 15 year)
Created **catch-up deduction** in current year of **\$380,000**
5. Construction of a 264 unit **Apartment** project in **Oregon**
Tax basis in improvements \$17,040,000
Identified 28.9% as short lived property (5 or 15 year)
After-tax present value of **tax deferral \$635,000**
First three years **additional depreciation \$1,860,000**
Ratio of benefits/fees--66 times
6. Acquisition of a **high end grocery store and multi-tenant retail facility** in **North Texas in 1997**
Tax basis in improvements \$8,649,000 (\$69,000 had been booked as 39 year property)
Identified 9.8% as 5 year property and 19% as 15 year property
Created catch-up deduction in current year of approximately **\$1,225,000**
7. Acquisition of **Honda dealership in South Texas**
Tax basis in improvements \$2,400,000
Identified 35% as short lived property (5, 7, or 15 year)
After-tax present value of **tax deferral \$110,000**
First three years **additional depreciation \$300,000**
Ratio of benefits/fees-- 24 times
8. Construction of a new **hotel** in **Connecticut**
Tax Basis in improvements \$8,576,000
Identified 16.1% as short lived property
After-tax present value of **tax deferral \$236,000**
First three years **additional depreciation \$665,000**
Ratio of benefits/fees—32 times

9. Construction of a new **all-suites hotel** in **Florida**

Tax basis in improvements \$5,448,000

Identified 34.7% as shorter lived property

After-tax present value of tax deferment \$315,000

First three years additional depreciation \$817,000

Ratio of benefits/fees—35 times

10. Acquisition of two **apartment** projects with **876 units** in **Maryland**

Tax basis in improvements \$50,635,000

Identified 14.4% as shorter lived property (5 or 15 year)

After-tax present value of tax deferment \$1,020,000

First three years additional depreciation \$3,166,000

Ratio of benefits/fees—43 times

We also have other projects in progress relating to apartments, commercial laundries, outpatient surgery centers, building materials retailer, eye vision clinics, medical clinics, preschool facilities, manufacturing, a large airplane hangar, refrigerated warehouses, single and multi-tenant office, and automotive dealerships. I will update you on these projects in the near future.

Please call if we might be of assistance to you with one of your clients or prospects.

John Wilmoth

WILMOTH & ASSOCIATES, LLC

940-458-2860

Fax 940-458-2862

HYPERLINK "<mailto:jwilmoth@coserv.net>" johnwilmoth@earthlink.net