

Cost Segregation Update

March 2006

Our firm was founded 6 years ago to be a resource for local accounting and professional firms that wanted to bring professional cost segregation services to their clients and prospects without having to make the investment in people and intellectual capital. During this time we have had the privilege of working with over 80 firms in analyzing over \$2,000,000,000 of projects.

In addition to our normal review of recently completed projects we will be giving sales tips to help you in your efforts to develop and close cost segregation engagements.

Sales Tip #2

This month's topic relates to properties that were **acquired or stepped up in basis** because of the death of the owner. In this situation the analysis is very different from a typical cost segregation study of a newly constructed facility. **First**, there are no construction costs or contractors available to secure costs of specific items; **second**, there typically are no construction drawings to assist in quantifying the various property elements; and **third**, the basis for the analysis is **relative fair market value** of the various property components, **not replacement cost**.

Item **one** is the easiest to deal with. The depreciable basis is the total consideration, or fair market value in the case of the estate step-up, less the fair market value of the non-depreciable land.

Item **two** is a little tougher. Since often there are no construction drawings we work from available floor plans, surveys, or other information. We supplement this with on-site inspections to identify and quantify the various property components. All of our field staff are architectural or civil engineers and have years of experience in construction materials and methods.

Item **three** is where most firms struggle. The first part of this aspect of the engagement is to determine the current replacement cost as the date of the analysis. This is where most firms stop, thinking these are the conclusions. They are not. Since an income tax allocation is based on relative fair market value the study must consider the loss in value related to physical deterioration and functional obsolescence. It only makes sense that a construction related item years old has less utility and value than an identical item that is new. We follow accepted professional valuation methodologies in quantifying this loss in value related to curable and incurable depreciation. We also consider the impact of functional obsolescence. Functional obsolescence is the loss in value within a property as a result of the development of new technology. This includes such things as changes in design, materials, or process resulting in overcapacity, inadequacy, excess construction, or lack of utility. A good example of this relates to the sanitary sewer system. Historically, this system was comprised of heavy duty cast iron piping. Today, materials have developed to the point where PVC is typically used for this function. Therefore, in determining the current replacement cost the consultant needs to consider the materials **used today** in their analysis. By replacing the cast iron system costing \$30 per foot with PVC costing \$17 per foot the functional obsolescence is quantified. Our experience is that most firms are clueless when it comes to the valuation related aspects of these studies, including the Big Four and their former cost segregation staff. It seems that the only people who understand these techniques were trained by the major corporate valuation firms, such as American Appraisal or Marshall and Stevens. Four of our staff, including myself, was trained at American Appraisal.

As the focus of the **IRS** increases on cost segregation you can be sure they will train their

valuation engineers to understand the differences in studies of new construction versus acquisitions/estate step-ups.

As we always do I have summarized some of our recently completed projects. Healthcare, auto dealerships, and hotels have once again been hot areas. 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 an ambulatory surgery center with 2 OR's and overnight beds**
Construction cost \$3,080,000
Identified **29.6%** as short lived property (5, 7 or 15 year)
After-tax present value of **tax deferral \$321,000**
First three years **additional depreciation \$909,000**
Ratio of benefits/fees –25 times

2. **Construction of a 454 unit garden apartment project—our 3rd for this client**
Construction cost **\$27,995,000**
Identified **38%** as short lived property (5, 7 or 15 year- significant land improvements, including \$600,000 swimming pool)
After-tax present value of **tax deferral \$1,590,000**
First three years **additional depreciation \$6,869,000 (includes 50% bonus)**
Ratio of benefits/fees (don't ask)

3. **Construction of a sensitive materials warehouse facility in Wisconsin**
Construction cost \$2,640,000
Identified **24.4%** as short lived property (5, 7, or 15 year)
After-tax present value of **tax deferral \$119,000**
First three years **additional depreciation \$411,000**
Ratio of benefits/fees –28 times

4. **Construction of an office/distribution center in the Southeast US**
Tax basis in improvements **\$18,995,000**
Identified **30.6%** as 5, 7, and 15 year property
After-tax present value of **tax deferral \$865,000**
First three years **additional depreciation \$2,640,000**
Ratio of benefits/fees—72 times

5. **Acquisition of a 474,000 square foot distribution facility in Mississippi**
Tax basis in improvements \$6,948,000
Identified **13%** as shorter lived property (5, 7, or 15 year)
After-tax present value of **tax deferral 108,000**
First three years **additional depreciation \$253,000**
Ratio of benefits/fees –25 times

6. **Acquisition of two extended stay hotels in Florida and North Carolina**
Tax basis in improvements \$6,299,000
Identified **22.6%** as shorter lived property (5 or 15 year)
After-tax present value of **tax deferral \$236,000**
First three years **additional depreciation \$617,000**
Ratio of benefits/fees 14 times

7. Acquisition of a **Lincoln Mercury automobile dealership** in South Texas

Tax basis in improvements \$4,298,590

Identified **29%** as shorter lived property (5, 7, or 15 year)

After-tax present value of **tax deferral \$199,000**

First three years **additional depreciation \$509,000**

Ratio of benefits/fees 40 times

We also have other projects in progress relating to apartments, hotels, outpatient surgery centers, medical office buildings, self storage facilities, distribution centers, corporate office buildings, an eye surgery clinic, a large private airplane hangar, food processing, multi-tenant office, an R&D facility, 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

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