

If you have or are planning to build a new facility, remodel a current facility, or buy an existing facility, applying the cost segregation technique can dramatically increase your cash flow by accelerating your depreciation expense. This method allocates a portion of the construction costs from real property (e.g. section 1250 property) to tangible personal property (e.g. section 1245 property), which reduces the depreciable life from 39 years to a much shorter period (often 5 years). The traditional method allocates 100 percent of the electrical costs to the building, which has the longer depreciable life.

The pivotal issue is determining how much of the construction costs can be classified as tangible personal property.

## 1. Tangible Personal Property - Section 1245 property

- Any property that is contained in or attached to the building
- Normally depreciated over 5 years to 7 years
- Eligible for accelerated depreciation and bonus depreciation
- Examples are: equipment, refrigerators, and presses

## 2. Real Property - Section 1250 property

- A structural building and any component that is related to the operation or maintenance of that building
- Normally depreciated over 39 years
- Examples are: walls, ceilings, floors, central air, fixtures (lights, sinks, etc.), basic plumbing and sprinkler system

A good rule of thumb for industrial electrical construction is that 40 percent to 70 percent of the electrical construction costs could qualify as tangible personal property. Another guideline is that approximately \$16,000 savings will be obtained for every

\$100,000 of construction costs that are reclassified as section 1245 property.<sup>1</sup> The following four categories are prime electrical construction targets for taking advantage of the cost segregation technique:

### 1. Primary and Secondary Electrical Systems:

This includes MCC's, transformers and related conduit and wire. The percent or portion of the electrical load that is allocable to the facility's production equipment can be classified as personal property and can be depreciated over 5 years.

### 2. Branch Wiring and Special Electrical

**Equipment:** The most important factor is the ultimate use of the electrical power. If the power is used for personal property, then it can be classified as section 1245 property. Otherwise, it is deemed section 1250 property. It does not matter if the wiring is contained within the wall, or not.

### 3. Electrical Systems for Special

**Communication Equipment:** These components (e.g. conduit, wire, boxes, etc.) are part of the equipment they support. If the equipment is related to production equipment, it is personal property. If the equipment is related to the operation or maintenance of the building, then it is real property.

**4. Lighting:** If the lighting provides basic illumination for the building, it is part of the building (i.e. section 1250 property). If it is specialty lighting (i.e. plant growing, decorative, etc.) and the removal of the lighting would not negatively affect the use of the building, then it is personal property or section 1245 property.

Implementation of this technique is crucial. We would encourage your company to engage a qualified tax preparer and an outside engineer to work closely together.

The tax preparer should review the related regulations and case law to ensure proper implementation. The IRS addresses this topic in AOD 1999-008, and the Treasury Department adds clarity with temporary regulation section 1.446-1T. The Scott Paper Co. v.

# Reduce Taxes and Improve Cash Flows



Commissioner (74 TC 137 (1980)) and Hospital Corporation of America v. Commissioner (109 TC 21 (1997)) cases also provide important points related to the proper implementation of cost segregation.

Also, the IRS created several tests that must be passed before the costs can be classified as tangible personal property. The purpose of these tests is to determine if the electrical asset is part of the building or part of the processing equipment.

These tests are:

- Can it be removed?
- Is it difficult to remove it?
- How much damage will the removal cause to the building or the property?
- How is it affixed to the building?
- Is it designed to be permanent?
- What is the intent (permanent or temporary)?

In addition, the allocation of the construction costs must be accurate and reasonable. It cannot be based on an estimate, reconstructed date, or assumptions with no supporting documentation. Thus, the engineer's report is the critical element of the cost segregation technique and a properly prepared report will provide adequate documentation for the tax returns. The engineer report will address the cost segregation by classifying the purchase, remodel or construction costs into various categories, depending on the situation. These categories are: tangible personal property (e.g. section 1245 property), real property or building (e.g. section 1250 property), land improvements, and land.

The cost segregation technique also has some disadvantages. The IRS does not like cost segregation, but does tolerate it. This attitude has caused taxpayers to shy away from or overlook this opportunity. The personal property might also be eligible for recapture of depreciation and the company will incur a fee for the engineer report, usually between

\$10,000 and \$25,000. Finally, there is a risk of possible penalties, created by material underpayment of taxes if the IRS reclassifies the section 1245 to section 1250 property. However, this risk can be mitigated by obtaining a high quality engineer report and acting in good faith.

The advantages of cost segregation are significant: increase cash flow by accelerating depreciation through the shorter depreciable life of an asset and utilizing bonus depreciation options, and subsequent write-offs if the asset needs to be disposed of or replaced.

Most CPA's and engineers, who are familiar with cost segregation, agree that the advantages far outweigh the disadvantages. In fact, the technique is no more aggressive than any other depreciation method as long as the engineering report is well documented.

<sup>1</sup>Jay A. Soled and Charles E. Falk, "Cost Segregation Applied," Journal of Accountancy Aug. 2004: 28-34.

## For more information...

contact Scott Peterson at [scott.peterson@interstates.com](mailto:scott.peterson@interstates.com), Jaron Vande Hoef at [jaron.vandehoef@interstates.com](mailto:jaron.vandehoef@interstates.com), or Doug Post at [doug.post@interstates.com](mailto:doug.post@interstates.com) or give us a call at (800) 827-1662.