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If walls could talk money; paying less federal income tax

Hidden within the walls, roof, plumbing, electrical system and many other aspects of your commercial building are yearly federal income tax savings waiting to be discovered. Through a specialized depreciation procedure called "cost segregation," property owners who have built, purchased or renovated a building during the past 10 years stand to save big in tax dollars.

Cost segregation is gaining popularity among taxpayers who are eager to take full advantage of the IRS-approved depreciation rules. Until recently, it was mostly the clients of Big Four accounting firms who were presented with this opportunity. The past couple of years, specialized firms and cost segregation boutiques have made it their business to make the benefits of cost segregation available to businesses of nearly all sizes.

What is cost segregation?

The principle goal of a cost segregation study is to increase cash flow from constructed buildings, purchased properties and renovations by accelerating depreciation expense deductions. Through this analysis, the components of a building are re-classified into proper class "lives" according to government legislation, case law and IRS revenue rulings. For businesses that own or lease a facility, depreciation is one of the most significant, but often overlooked opportunities to reduce income tax liability.

The tax benefits resulting from a deferral of tax payment and accelerated depreciation are easily demonstrated. For example, for each million dollars that is reclassified from a 39-year life into a 7-year class life, the taxpayer realizes approximately \$230,000-\$310,000 in additional cash flow during the first five years. Also consider that for each million dollars that is re-classified into a 15-year class life, the taxpayer realizes approximately \$90,000 to \$232,000 in additional cash flow the first five years.

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Property owners should carefully weigh several important factors when choosing a cost segregation provider. Most turn to their CPA for initial guidance; however, most accounting firms do not have on staff cost segregation specialists such as engineers and architects. There are a number of providers that specialize in working with the CPA to bring this opportunity to his or her client.

Demand the “Dynamic Duo”: Pursue a cost segregation provider that tackles the study using what is called a “combined approach.” This provider will begin with an “invoice approach,” which entails a detailed analysis of the actual construction costs from invoices, applications for payment and change orders. The specialist will then put on his “engineering hat” and pursue the areas where the invoice approach has left personal property on the table. Most of the benefit associated with the “engineering approach” is in the more technical areas, such as plumbing, electrical and mechanical estimating. An effective provider will not only have a sound background in accounting and the IRS rules associated with depreciation, but also construction engineering and/or architecture. Using the “dynamic duo” approach ensures that available depreciation benefits are maximized.

Look for variety of experience: The most effective cost segregation studies are performed by companies with experience in nearly every building type and size. A provider that understands your business and the components that go into your building is going to ensure the resulting benefits are maximized, yet done so “by the books.”

Take a “look-back”: It's a common misconception that in order for a cost segregation study to be completed, the commercial building must be new. Not true. Even older buildings qualify and often result in a significant tax deduction and increase to cash flow. Accounting firms that do not have in-house engineers or architects typically do not attempt look-back studies.

Require compliance with new, IRS audit guidelines: On April 30, 2004, the IRS issued an internal document titled *Cost Segregation Audit Techniques Guide* for the express purpose of assisting Internal Revenue Service examiners in the review and examination of cost segregation studies. The document defines a number of principle elements that auditors should look for in both the approach to the study itself (such as how unit costs and engineering “take-offs” are determined) as well as the data and documentation that should be contained within the final report (such as the engineering procedures utilized and a statement of assumptions and limiting conditions).

Make sure the company can and will stand behind its findings: Cost segregation studies are best performed by a team of experts that include CPAs, research specialists, architects and construction

engineers. A crack research staff is a must because IRS rules and regulations are ever changing. It's also helpful to select a financially-strong provider in the event there are any IRS-contested items within the final tax return.

Opportunity expires 12/31/2004

As businesses begin closing out the year 2004, now's a good time to weigh the benefits of a cost segregation study. Year end also brings an expiration of a Congress-legislated "bonus depreciation" opportunity. Subsequent to the tragedy of Sept. 11, 2001, Congress passed legislation, in the form of a temporary incentive, which provides for 30 percent bonus depreciation to be taken in the first year. In 2003, Congress increased the bonus depreciation to 50 percent to be taken in the first year. To qualify for bonus depreciation, several criteria must be met:

1. The property's original use (the first use to which a property is put, despite its current use) must have commenced with the taxpayer after Sept. 10, 2001, and
2. There was no written binding contract for the acquisition of the property before Sept. 11, 2001. If the written binding contract was effective after May 5, 2003, the property may qualify for 50-percent depreciation instead of the 30-percent.

Stanton Williams is president of Fort Worth-based SOURCECORP Tax Benefits Group, a publicly-traded, 20-year-old company that is a nationwide provider in tax saving programs such as LIFO accounting, construction audits and cost segregation.

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