How to Increase Your ROI in Real Estate Ventures

Norbert Crabtree, CSP360
Luis Ramirez, Abbott, Stringham & Lynch
Sblend A. Sblendorio, Hoge Fenton Jones & Appel, Inc.

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Why This Seminar?

- **Opportunity**
- **Tax Environment**

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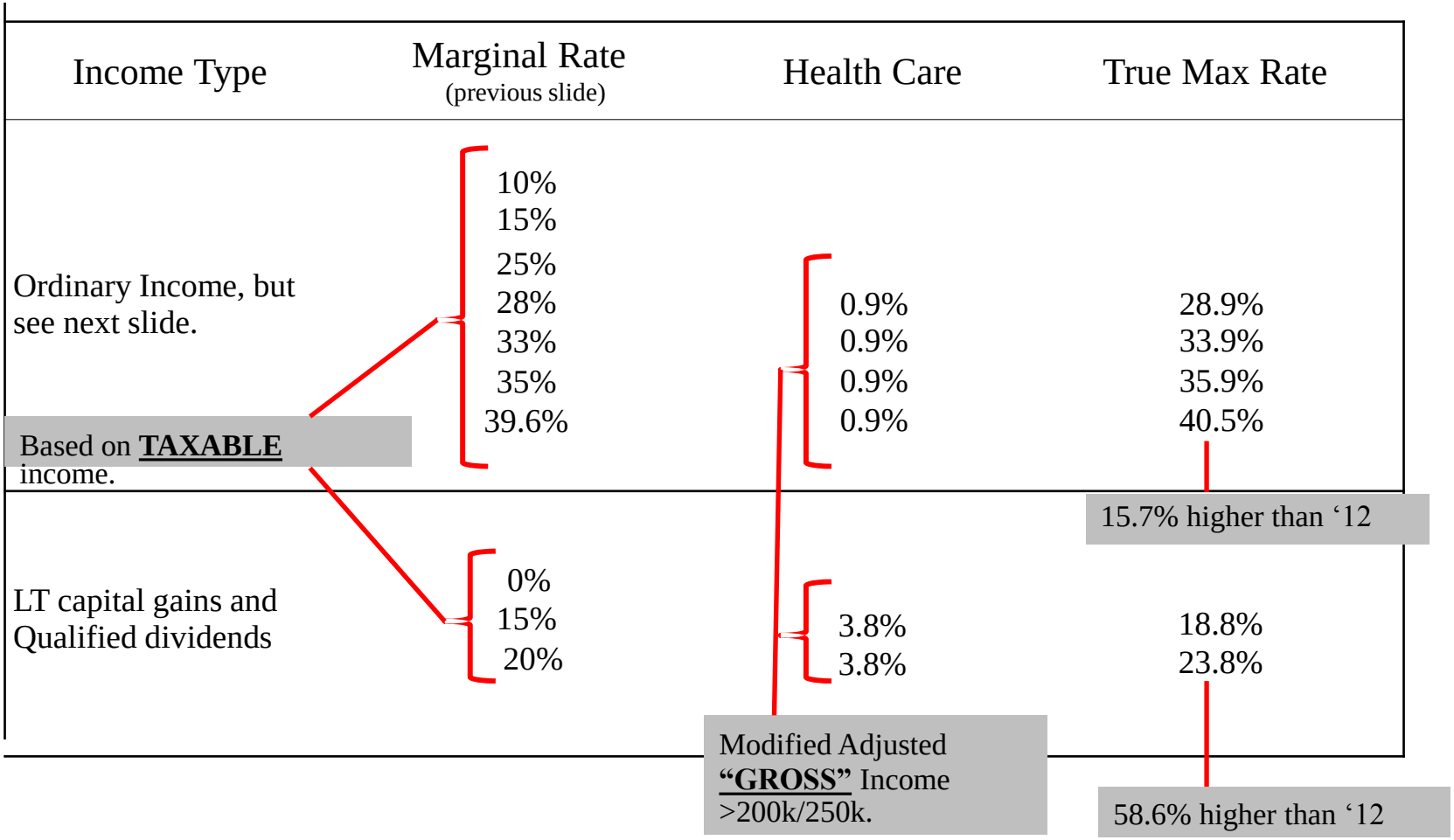
Tax Environment

- **Frequent tax legislation – 29 major laws in 12 years**
- **Eleventh-hour tax bills (ATRA of 2012, signed into law in 2013)**
- **A large number of "extenders" will expire at end of 2013 – R&D, bonus depreciation and 179**
- **Legislative uncertainty**
- **Judicial uncertainty**
- **IRS in state of meltdown – it cannot handle what is already on its plate and now is responsible for ACA**
- **Unreasonable complexity – 74,000 pages of tax law 523% increase in length of Code and 705% increase in length of Regs; based on pages)**

2013: More Than Meets the Eye…



2013: More Than Meets the Eye…

Income Type	Marginal Rate (previous slide)	Health Care	True Max Rate
Net Investment income:			
Interest, ordinary dividends, rents, royalties, passive activity income, and certain gains on dispositions of assets.	10% 15% 25% 28% 33% 35% 39.6%	3.8% 3.8% 3.8% 3.8%	31.8% 36.8% 38.8% 43.4%

Based on **TAXABLE** income.

Modified Adjusted **"GROSS"** Income >200k/250k.

24% higher than '12

Final Repair Regulations Issued

- **After 9 years of back and forth, on Friday the 13th (September 2013), the IRS released the long-awaited final repair regulations**
  - Advance Notice of Proposed Rule Making in 2004
  - Proposed regulations in 2006 – **Subjective, lack of bright-lines, slightly unfavorable to taxpayers**
  - Re-proposed regulations in 2008 – **Objective, bright-line tests, taxpayer favorable**
  - Temporary and proposed regulations issued on December 23, 2011 – **Highly subjective, no bright-lines, highly unfavorable to taxpayers**
  - Final regulations issued September 13, 2013 – **Highly subjective, limited bright lines, unfavorable to taxpayers**
- **The final regulations represent a 180 degree change in direction from the proposed regulations released in 2008. The elimination of the 50% or more test for determining whether there has been a restoration completely changes the tone of the regulations**
- **The regulations will lead to greater disputes with IRS auditors and increase compliance costs**

Important Changes in Final Regulations

- **New safe harbor small taxpayers owning buildings with an unadjusted basis (i.e., generally cost) of $1 million or less; applies to taxpayers with average annual gross receipts (over preceding 3 years) of $10 million or less; deduct lesser of 2% of unadjusted basis of the building or $10,000**
- **Rev. Procs. 2012-19 and 2012-20 with their 19 automatic accounting method changes will be superseded by two new procedures that reportedly simplify the change process and reduce the number of required changes**
- **We expect the IRS to release the new Rev. Procs. shortly before the holidays**
- **We continue to believe that all taxpayers with depreciable property will need to make at least one automatic change to conform to one or more provisions of the new final regulations. At the time of this presentation, we do not know how the changes will be made**
- **Many taxpayers will be required to capitalize previously expensed repairs**

Keep These Critical Points in Mind

- **Distinguish between unit of property (UOP) and building system**
- **Distinguish between structural component (Regs. §1.48-1(e)(2)) and major component or substantial structural part**
- **Late GAA elections are no longer needed; in fact, nearly everyone can forget about using GAAs**
- **Partial disposition are no elective and Treasury has provided examples of "reasonable methods" of determined the unadjusted basis of portion of the property disposed**
- **Going forward, generally a good idea to determine and then track cost of building and the 8 building systems identified in the final regulations**
- **Cost segregation studies will continue to be an important tool and more focus should be placed on using them to accurately separate and classify fixed assets**
- **Watch out for elections, tax return statements, and forthcoming 3115 requirements – mixed bag a trap for unwary, the harried or the uninformed**

Key Elections

- **De minimis safe harbor (statement required); §1.263(a)-1(f). Also be sure that taxpayer has written policy in place treating as an expense for non-tax purposes (1) amounts paid for property costing less than a specified dollar amount; and (2) amounts paid for property with an economic useful life of 12 months or less**
- **Capitalize and depreciate rotable, temporary or emergency spare parts (Election made by capitalizing the amount paid and beginning to recover costs through depreciation)§1.162-3(d)**
- **Capitalize all repair and maintenance costs for both book and tax purposes (statement required); §1.263(a)-3(n)**
- **Safe harbor for small taxpayers (statement required); §1.263(a)-3(h)(6)**
- **Partial disposition (Election made by reporting the gain, loss or other deduction on timely filed (including extensions) original Federal tax return); 1.168(i)-8(d)(2)(i)**

What is the Property Being Improved?

- **Analysis must start with determining the unit of property (UOP)**
  - Have to know the UOP to determine if the expenditure results in a betterment
  - Have to know the UOP to determine if the expenditure results in a restoration
  - Have to know the UOP to determine if the expenditures adapts the property to new or different use
- **By relating expenditures to the repair of a larger rather than a smaller UOP, taxpayer is in a better position to argue there is betterment, restoration or change in use**

Determining UOP Under the Regulations

- **Step 1:** **Apply the "functional interdependence standard unless a special rule apples – All components that are functionally interdependent comprise a single UOP. Components of property are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component**
- **Step 2:** **Apply special rules for: (1) buildings; (2) leased property; (3) plant property (separate if performs a discrete and major function or operation); (4) condominiums, (5) co-ops and (6) network assets**
- **Step 3:** **Determine if components of the UOP are treated differently for tax depreciation**

UOP – Buildings

- **UOP = building and its structural components**
  - Expenditures restore UOP if they restore the building structure or a building system
  - A roof is considered part of the building structure (shell)

- **Apply repairs standards separately to the building structure and nine defined "building systems."**
  1. HVAC
  2. Plumbing systems
  3. Electrical Systems
  4. Escalators
  5. Elevators
  6. Fire protection and alarm systems
  7. Security systems for protection of building and occupants
  8. Gas distribution system
  9. Any other system defined in published guidance

Building Really Constitutes Up to 9 UOPs

- **Even though the regulations repeatedly state that a building is a separate UOP, it is not treated as such and thus, the regulations are misleading**

- **A building is treated as if it is up to 9 different UOPs**
  - This is a radical departure from past treatment and it goes against existing case law
  - Since 1981 componentization of buildings has been prohibited; so this change generally will require all taxpayers who have experienced building repairs in the past to file a 3115 changing their method of accounting for repairs and maintenance of their buildings
  - This change is retroactive to the time the building was acquired (i.e., 39 yrs, 27 ½ yrs)

UOP Examples

- ***Example 1:*** HVAC system incorporating 10 roof-mounted units is a building system and treated as a UOP
- ***Example 2:*** Two elevator banks consisting of 3 elevators each is a building system and treated as a UOP
- ***Example 3:*** Plumbing system in a office condominium is a building system and treated as a UOP
- ***Example 4:*** Extension to office building is compared to the building structure and the buildings systems to determine if it is an improvement
- ***Example 5:*** Power plant's boiler, turbine, generator and pulverizer are each treated as separate UOPs. Turbine blades are not separate UOPs
- ***Example 6:*** Laundry plant's sorter, boiler, washer, dryer, ironer, folder and waste water treatment plant are separate UOPs
- ***Example 7:*** Tortilla-making equipment is a UOP. Not plant property, so not broken into components

UOP Examples

- ***Example 8:*** Locomotive is a single UOP
- ***Example 9:*** Computer and printer are separate UOPs
- ***Example 10:*** HVAC system of leased building is a building system and is treated as a UOP
- ***Example 11:*** Driveway constructed by lessee adjacent to leased building is separate UOP
- ***Example 12:*** Driveway constructed by lessee but owned by lessor adjacent to leased building is separate UOP
- ***Example 13:*** Two separate office spaces in same building subject to separate leases treated as two separate UOPs
- ***Example 14:*** Leased aircraft if separate UOP
- ***Example 15:*** Warehouse extension added to retail sales facility is not a separate UOP

UOP Examples

- ***Example 16:*** Truck tractor and tires treated as separate UOP because tractor treated as 3-year property and tires 5-year property

- ***Example 17:*** Change is class of property as result of cost segregation study results in separate UOP because portion of property reclassified from nonresidential real property (with a 39- year life) to qualified retail improvement property (with a 15-year life)

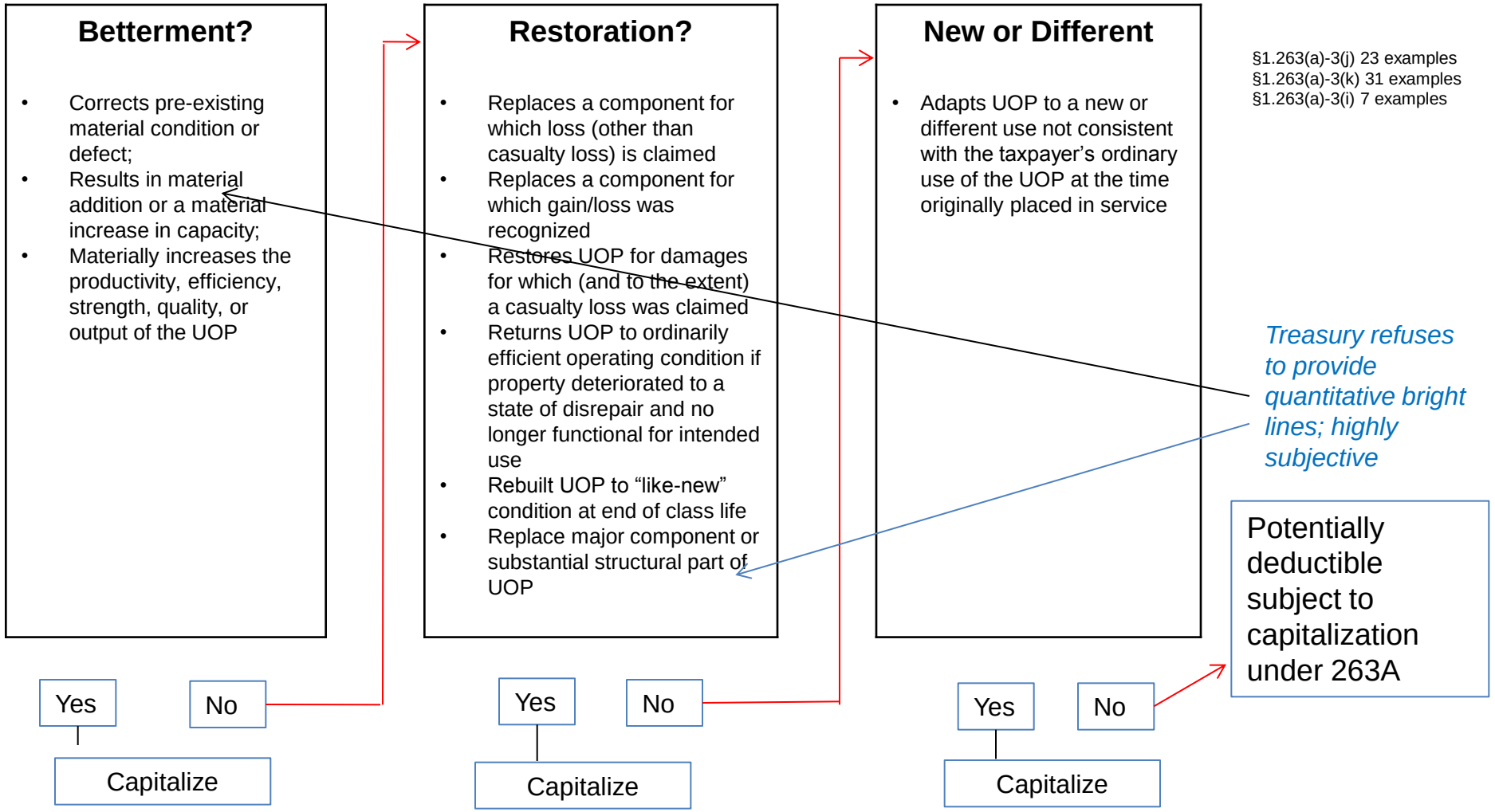
- ***Example 18:*** As a result of a cost segregation study, a parking lot was reclassified from nonresidential real property to land improvements. The parking lot and the nonresidential real property are separate UOPs

- ***Example 19:*** As a result of a cost segregation study, wiring that was originally treated as 7-year property was reclassified as nonresidential real property. The wiring is a structural component of the building and part of the electrical system of the building

Capitalization Threshold

- How do you determine when a UOP is improved?
- Final regulations retain general format provided in the temporary regulations
- New rules under the temporary regulations§1.263(a)-3(d) provide that a UOP is improved if the amounts paid for the activities performed after the property is placed in service:
  1. Result in a betterment;
  2. Restore the UOP; or
  3. Adapts the property to a new or different use.

What Constitutes an "Improvement"?



Betterment

- **An amount paid results in a betterment only if it:**
  1. **Ameliorates (Fixes) a pre-existing material condition or defect (regardless of whether taxpayer was aware of the defect),**
  2. **Results in a material addition, or**
  3. **Results in a material increase in capacity, productivity, efficiency, strength, QUALITY or output.**
- **Replacements due to technological improvements or product enhancements do not necessarily require capitalization**
- **Although many commentators requested a quantitative bright line test for applying betterment standards this was rejected by the IRS and Treasury.**
- **However, the many examples provide some outright conclusion**
- **The final regulations remove the taxpayer's treatment of the expenditure on its financial statements as a factor to be considered**

Betterment – Example Summaries

- ***Example 1:*** Remediation of soil contamination by previous owner is a betterment
- ***Example 2*****:** Replacement of asbestos insulation with new insulation that is no more efficient or effective is not a betterment
- ***Example 3:*** Performance of manufacturer recommended scheduled maintenance immediately following purchase of used machine does not result in a betterment
- ***Example 4:*** Amounts paid to inspect, retune, and replace minor components shortly after the purchase of a used machine does not result in a betterment
- ***Example 5:*** Repairs and maintenance to a newly purchased assisted living building to bring it up to high standards of purchaser results in a betterment

Betterment – Example Summaries

- ***Example 6:*** Building refresh limited to cosmetic and layout change and general repairs and maintenance does not result in a betterment
- ***Example 7:*** Building refresh along with increase in storage space, second loading dock, and second overhead door results in betterment as to the addition, but the building refresh expenses in Example 6 remain deductible
- ***Example 8:*** Building remodel to offer higher end products to different type of customer results in betterment and causes related expenses to be considered betterments because they directly benefitted or were incurred by reason of the improvements to the store buildings
- ***Example 9:*** Relocation of cash registers to relocated retail store is not a betterment
- ***Example 10:*** Relocation of machines where the reinstallation results in an increase in capacity is a betterment

Betterment – Example Summaries

- ***Example 11:*** Expansion bolts added to anchor framing to cement foundation to resist seismic forces by order of local government results in a betterment
- ***Example 12 :*** Addition of concrete lining to meat packing plant by order of Federal inspector to combat oil seepage does not result in a betterment
- ***Example 13:*** New roof membrane placed on worn membrane does not result in a betterment
- ***Example 14:*** Reinforcement of columns and girders supporting a second floor to permit storage of heavier supplies results in a betterment
- ***Example 15*****:** Amounts paid to deepen a channel to allow for ingress and egress and unloading of barges results in a betterment
- ***Example 16:*** Amounts paid to redredge the channel described in Example 15 due to siltation does not result in a betterment

Betterment – Example Summaries

- ***Example 17:*** After redredge in Example 16 the channel incurs further siltation. This siltation is dredged along with a deepening of the channel to 25 feet. The deepening along with the siltation removal is a betterment
- ***Example 18:*** Removal and replacement of drop-ceiling and repainting of original ceiling does not result in a betterment
- ***Example 19:*** Stairway & mezzanine retail space added to one floor retail space with high ceilings is a betterment
- ***Example 20:*** Replace 2 of 10 HVAC units that are 10% more efficient than prior units to resolve climate control problems are not betterments
- ***Example 21:*** Insulation to reduce annual power costs by 50% is a betterment
- ***Example 22:*** Restaurant adding a drive-through service area, including a partition of current space to the drive-through, is a betterment
- ***Example 23:*** Upgrade of electrical system is a betterment

Example 6: Building Refresh Not a Betterment

- Replace and reconfiguring display tables and racks to provide better exposure of the merchandise
- Make corresponding lighting relocations and flooring repairs
- Move one wall to accommodate the reconfiguration of tables and racks
- Patch holes in walls
- Repaint the interior structure with a new color scheme to coordinate with new signage
- Replace damaged ceiling tiles
- Clean and repair wood flooring throughout the store building, and
- Power-washing building exteriors.

Example 8: Building Remodel is a Betterment*

- Replace large parts of the exterior walls with windows
- Replace the escalators with a monumental staircase
- Add a new glass enclosed elevator
- Rebuild the interior and exterior facades
- Replace vinyl floors with ceramic flooring
- Replace ceiling tiles with acoustical tiles
- Remove and rebuilding walls to move changing rooms and create specialty departments.
- Upgrade electrical system
- Remodel all bathrooms by replacing contractor-grade plumbing fixtures with designer-grade fixtures that conserve water and energy.
- Clean debris, patch holes in walls, repaint existing walls with a new color scheme to match the new interior construction, and to power wash building exteriors to enhance the new exterior façade.

* Because the refresh occurred at the same time as the remodel, Treasury requires the refresh expenses to also be capitalized because "…while not betterments by themselves, directly benefitted and were incurred by reason of the improvement to G's store buildings' structures…"

Summary of Conclusions from the §1.263(a)-3(j)(3) 23 Betterment Examples

Not a Betterment

- Replacement of asbestos insulation with similar non-asbestos insulation (Ex 2)
- Minor repairs and maintenance shortly after purchase (Ex 3, 4)
- Retail refresh limited to cosmetic and layout changes (Ex 6, 7)
- Relocate cash registers (Ex 9)
- Add concrete lining to meat plant (Ex 12)
- Roof membrane (Ex 13)
- Removal of drop ceiling (Ex 18)
- Replace 2 of 10 HVAC units that are 10% more efficient (Ex 20)

Betterment

- Remediation of soil by previous owner (Ex 1)
- Bring assisting living building up to higher standards (Ex 5)
- Retail refresh along with increase storage, second loading dock (Ex 7)
- Major remodel of retail (Ex 8)
- Relocate machines increased capacity (Ex 10)
- Doubling depth of channel (Ex 15)
- 25% increase in depth of channel (Ex 17)
- 50% reduction in energy or power costs (Ex 21)
- Add restaurant drive through

Restoration

Amount is paid to restore UOP if it:

1. Is a replacement of a UOP and the taxpayer has properly deducted a loss for that component;
2. Is for the replacement of a component of a UOP and taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component.
3. Is for the repair of damage to a UOP for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss or casualty event (but only to the extent of the claimed casualty loss).
4. Returns the UOP to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;
5. Results in the rebuilding of the UOP to a like-new condition after the end of its class life; or
6. Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property.

   -- It is this provision the IRS uses to say roof replacements now must be capitalized.

Class Lives

	Class Life ***	General Depreciation	Alternative Depreciation
Office equipment furniture & fixtures	10	7	10
Information systems	6	5	5
Automobiles	3	5	5
Residential Real	40	27.5	40
Nonresidential Real	40	39	40
Land improvements	20	15	20

****** Restoration - results in the rebuilding of the UOP to a like-new condition after the end of its class life***

Major Component or Substantial Structural Part

- **Capitalization required for an amount paid for the replacement of a major component or substantial structural part:**
  - **Major component: Part or combination of parts that perform a discrete and critical function in the operation of the UOP**
  - **Substantial structural part: A part or combination of parts that comprise a large portion of the physical structure of the UOP or that perform a discrete and critical function in the operation of the UOP**
- **The final regulations continue with a highly subjective facts and circumstances approach, but clarify the approach by adding new definitions**
- **Incidental component, even though performs discrete function, is not restoration (e.g., power switch – See Example 13 following)**

Restorations – Example Summaries

- ***Example 1:*** Abandonment of freezer components followed by the recognition of a loss results in a restoration
- ***Example 2:*** Sale of replaced freezer component results in a restoration
- ***Example 3:*** Repair of storm damage for which a casualty loss was claimed results in a restoration
- ***Example 4:*** Repair of storm damage for which insurance proceeds were received results in a restoration
- ***Example 5:*** Repair of storm damage for which casualty loss was claimed results in a restoration with limitation based on adjusted basis
- ***Example 6:*** Repairs to farm buildings that have fallen into a state of disrepair and can no longer be used for their intended purpose results in restoration

Restorations – Example Summaries

- ***Example 7:*** Rebuild of rail cars to like-new condition before end of class life does not result in a restoration. (Seems like this would qualify as a restoration since the rebuild results from replacement of major component or substantial structural part)
- ***Example 8:*** Same as Example 7, result if restoration if done after end of class life
- ***Example 9:*** Heavy maintenance of aircraft after end of class life that does not restore the aircraft to like-new condition is not a restoration
- ***Example 10:*** Replacement of engine, cab and petroleum tank result in restoration because the new items constitute a part or combination of parts that comprise a major component and a substantial structural part
- ***Example 11:*** Same facts as Example 10, and in addition, the company logo is painted on the cab and a taillight is fixed. The repair of the taillight is deductible while the painting of the logo must be capitalized because it directly benefits and was incurred by reason of the restoration of the tractor

Restorations – Example Summaries

- ***Example 12:*** Amounts paid to remove and replace leaking gas tanks including permit fees and amounts paid to improve the gasoline distribution system, constitute a restoration
- ***Example 13:*** Replacement of power switch assembly on drill press does not result in a restoration
- ***Example 14:*** Replacement of entire roof constitutes a restoration
- ***Example 15:*** Replacement of roof membrane does not result in restoration
- ***Example 16:*** Replacement of 1 of 3 furnaces of buildings HVAC system does not result in a restoration
- ***Example 17:*** Replacement of sole chiller unit in HVAC system is a restoration
- ***Example 18:*** Replacement of 3 of 10 roof-mounted heating and air conditioning units does not constitute a restoration

Restorations – Example Summaries

- ***Example 19:*** Replacement of fire protection system including alarm and sprinkler results is a restoration
- ***Example 20:*** Replacement of electrical system results in a restoration
- ***Example 21:*** Replacement of 30% of electrical system wiring does not result in restoration
- ***Example 22:*** Replacement of plumbing fixtures in all of the restrooms including the toilets, sinks, and associated fixtures with modern fixtures results in a restoration
- ***Example 23:*** Replacement of 8 of 20 sinks does not result in a restoration
- ***Example 24:*** Update of guest rooms to attract customers and remain competitive results in a restoration. This example appears to reinstate the general plan of rehabilitation
- ***Example 25:*** Replacement of 100 of 300 exterior windows does not result in a restoration

Restorations – Example Summaries

- ***Example 26:*** Replacement of 200 of 300 exterior windows does result in a restoration
- ***Example 27:*** 100 of 300 windows of modern building with 90% of building surface area comprised of the 300 windows is a restoration
- ***Example 28:*** Refresh of hotel lobby by replacing wood flooring does not result in a restoration
- ***Example 29:*** Refresh of hotel by replacing wood flooring in all public areas of a hotel results in a restoration
- ***Example 30:*** Replacement of 1 of 4 elevators with no partial disposition election does not result in a restoration
- ***Example 31:*** Same as example 30, but with partial disposition election, does result in a replacement

Environmental Cleanup

- **Capitalize environmental cleanup costs to the extent they are incurred to ameliorate a material, pre-existing condition or defect**
- **Required to capitalize environmental remediation costs where the taxpayer contaminated property in the course of its business operations, disposed of the property, and later reacquired property to clean up the contamination**
- **§198 provides for a deduction for taxpayers that incur certain environmental remediation expenditures that are otherwise required to be capitalized under §263A**
- **If unusual situation, IRS suggest a PLR request**
- **See Rev. Rul. 94–38, in which a taxpayer was permitted to deduct the costs of remediating property that it continuously owned and contaminated in the course of its operations because the taxpayer restored the property to the condition it was in prior to the circumstances necessitating the expenditure**

Summary of Conclusions from the §1.263(a)-3(k)(7) 31 Restoration Examples

Not a Restoration

- Replace power switch (Ex 13)
- Roof membrane (Ex 15)
- Replace 1 of 3 furnaces in HVAC system (Ex 16)
- Replace of 3 of 10 roof-mounted HVAC units (Ex 18)
- Replace 30% of electrical (Ex 21)
- Replace 8 of 20 sinks (Ex 23)
- Replace 100 of 300 exterior windows comprising 8.3% surface area (Ex 25)
- Replace lobby floors which comprise < 10% square footage (Ex 28)
- Replace 1 of 4 elevators (Ex 30)

Restoration

- Replace entire roof (Ex 14)
- Replace single chiller in HVAC (Ex 17)
- Replace of sprinkler system (Ex 19)
- Replace entire electrical system (Ex 20)
- Replace all toilets and sinks with similar quality and function (Ex 22)
- Replace 200 of 300 exterior windows comprising 16.67% surface (Ex 26)
- Replace 100 of 300 exterior windows comprising 30% of surface area (Ex 27)
- Replace floors in all public areas comprising 40% of sq. footage (Ex 29)
- Replace 1 of 4 elevators and claim partial disposition loss (Ex 31)

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New or Different Use

- **Capitalizable improvement if paid to adapt a UOP to a new or different use**
- **Capitalizable improvement if the adaptation is not consistent with the taxpayer's ordinary use of the unit of property at the time originally placed in service by the taxpayer**

New or Different Use – Example Summaries

- ***Example 1*:** Amounts paid to convert a 30-year-old manufacturing facility to a showroom adapts the building to a new or different use because the conversion is not consistent with the intended use at the time it was placed in service
- ***Example 2:*** Amounts paid to convert 3 retail spaces to 1 larger space does not result in adaptation to a new or different use because building space was designed to be reconfigured
- ***Example 3:*** Amounts paid to repaint interior walls and to refinish hardwood floors in contemplation of a sale of the building does not result in adaptation to a new or different use
- ***Example 4:*** Amounts paid to clean up contaminated land upon closing of manufacturing operation do not result in adaptation to a new or different use. Grading of land to accommodate sale to residential developer does result in adaptation to a new or different use

New or Different Use – Example Summaries

- ***Example 5:*** Amounts paid to reconfigure part of a retail pharmacy building into a walk-in clinic results in the adaptation to a new or different use
- ***Example 6:*** Amounts paid by a grocery store to add a sushi counter and chairs, additional wiring and outlets, and associated plumbing does not result in adaptation to a new or different use
- ***Example 7:*** Amounts paid to relocate interior walls, add additional wiring and outlets, replace floor tiles and doors, and repaint the walls to create outpatient surgery space in a hospital emergency room area do not result in adaptation to a new or different use

Summary of Conclusions from §1.263(a)-3(l)(3) 7 Change in Use Examples

Not a Change in Use

- Combine 3 leased retail spaces into 1 leased retail space (Ex 2)
- Minor refresh of building in anticipation of sale (Ex 3)
- Clean up contamination after closing manufacturing plant (Ex 4)
- Convert a portion of grocery store space to a sushi bar (Ex 6)
- Convert a portion of hospital emergency room to an outpatient surgery center (Ex 7)

Change in Use

- Convert manufacturing plant to showroom space (Ex 1)
- Regrade land to accommodate sale of land for residential development (Ex 4)
- Reconfigure part of a retail pharmacy to a walk-in clinic (Ex 5)

Things to Consider Now

- **Capitalization policy in place before 12/31/13**
- **Review history for significant improvements that can be expensed or should be capitalized**
- **Review partial dispositions in recent past**
- **Consider RE-GROUPING ACTIVITIES**
- **Consider Cost Segregation Study**

Sale of Low-income Apartment Complex in Glendale, AZ (October 2013)

- **Price: $4.2M**
- **Units: 172**
- **Personal Property**
  - Shop equipment (maintenance, gardening, repair tools)
  - Office equipment (computers, peripherals, furniture)
  - In-unit appliances (refrigerators, stoves and washer/dryers)

Purchase of Stand-alone Restaurant in Los Gatos, CA (September 2013)

- **Price: $4.1M**
- **GLA: 7,200 sq. feet**
- **Personal Property**
  - Under lease, all restaurant fixtures are owned by landlord
  - Under lease, fixtures include typical restaurant equipment: walk-ins, commercial mixers, ovens, stoves, racking, prep tables, etc.
- **Other:**
  - Building is listed as historically-significant
  - Building underwent major remodeling in 2010

Sale of Office Building in Mountain View, CA (February 2013)

- **Price: $10.2M**
- **Building Size: 58,000 sq. feet**
- **Personal Property: Roof/HVAC (replaced within last 5 years), elevator, office management equipment**
- **Other:**
  - Built in 1979
  - Maintained and repaired but never any significant upgrade or update

Tax Deduction Opportunities

1. To segregate the cost of the eight building systems for purpose of applying the improvement and disposition rules under the final regulations
2. Identifying expenditures in prior years or current years that do not constitute improvements to buildings or building systems and can be expensed as repairs
3. The focus on proper fixed asset reporting has focused taxpayers on cost segregation & the tax savings that can be generated
4. Reviewing the results of a prior year cost segregation study to identify dispositions of 1245 property
5. Segregating the cost of structural components of buildings that were disposed of in prior years
6. To identify opportunities for deductions/credits for energy efficient improvements to buildings
7. Identifying the cost of removal of a structural component not subject to capitalization under 263(a)

263(a) Study Methodologies

- **Good Candidates: Repairs and Renovations for property held for more than one year costing more than $250,000**
- **Question: What is the depreciable tax basis in the original property being renovated?**
- **Question: Description of items being repaired or replaced**
- **Question: HVAC, roofing, ceilings, drywall, building lighting, windows, plumbing, electrical**
- **Engineering based review of repair or renovation expenditures and prior years depreciation schedules to determine improvement vs. repair standards**

263(a) Study Methodologies

- **Timing: complete study prior to filing tax return on current year expenses, study takes up to 45 days**
- **Filing: File form 3115 with tax return to pick up prior years expenses**
- **Great Candidates include: Commercial and Multifamily Property Owners, Retail, Hotels, Banks, Restaurants, and Manufacturing**
- **Rule of thumb: repairs or renovations should have been performed in last 15 years or as long as there is significant book value**

263(a) Study: Benefits to Client

- **Benefit: Claim immediate expense deductions that would normally depreciate over 39/27.5 years**
- **Benefit: Accurate classification of assets for tax depreciation purposes**
- **These benefits are in addition to any benefit claimed under a cost segregation study**
- **These benefits can uncover tax incentives for energy efficient buildings – 179D**
- **Benefit analysis is done by our engineers at no charge**

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263(a) Study Examples

- **Client : 150 unit Apartment complex located in CA**
- **Project: Analyzed $ 53,000,000 of net book value items on the depreciation schedule**
- **Results: $ 675,000 adjustment**

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263(a) Study Examples

- **Client : McDonalds operator – 10 units**
- **Project: Re-Categorized previously capitalized amounts for reimaging expenses**

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263(a) Study Examples

- **Client : Egg Producer**
- **Project: Analyzed $ 800,000,000 of net book value items on depreciation schedule**
- **Results: $ 82,000,000 adjustment**

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263(a) Study Examples

- **Client : Tug Boat Operator**
- **Project: Analyzed $ 600,000,000 in previously capitalized items**
- **Results: $ 78,000,000 adjustment**

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Client Discussions: Cost Segregation

1. **What is cost segregation?**
2. **History & background**
3. **What properties are classified as 5-year and 15-year**
4. **Cost segregation opportunities**

Tax Deduction Opportunity 3, 4 & 5: Consider a new cost segregation study & review prior studies

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Goal of Cost Segregation Studies

Would you Rather Get Your Money Back Today or in 39 Years?

- **Goal = to identify all construction-related costs that can be more quickly depreciated over 5, 7, 10 and 15 years and reclassified from 39, 31.5 and 27.5 years**
- **Traditional depreciation for Real Property is 39 years for commercial property and 27.5 years for residential rental property**
- **Reducing tax lives results in accelerated depreciation deductions, a reduced tax liability, and increased cash flow**

"You must pay taxes. But there's no law that says you gotta leave a tip."

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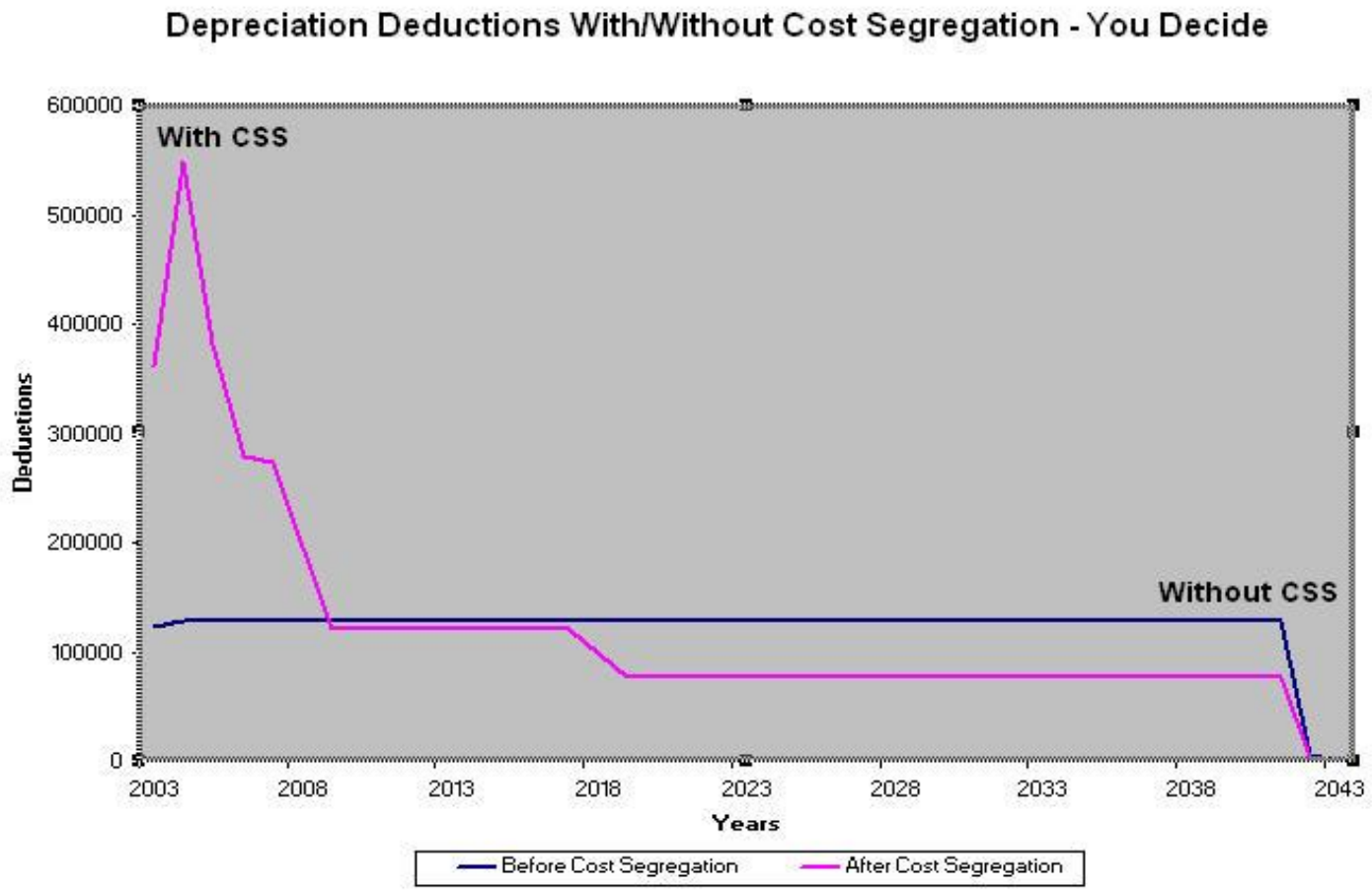
Timing Illustration



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Cost Seg – History & Background

HCA Case (109 TC 21 (1997))

- **Old ITC case law can be used in determination of structural component vs. personal property for purposes of MACRS**
- **Reaffirmed by IRS on its acquiescence**

Cost Seg – History & Background

- **Raised flooring is *not* a structural component. Rev. Rul. 74-391**

- **Raised flooring *is* a structural component. FSA 200110001**

Cost Seg – History & Background

- **HVAC system is *not* a structural component. *Piggly Wiggly Supermarkets, Inc. V. Comr.*, CA-11, 11/13/86**

- **HVAC system *is* a structural component. *Publix Supermarkets, Inc.* 92-1 USTC ¶50,240, 4/28/92**

Cost Seg – History & Background

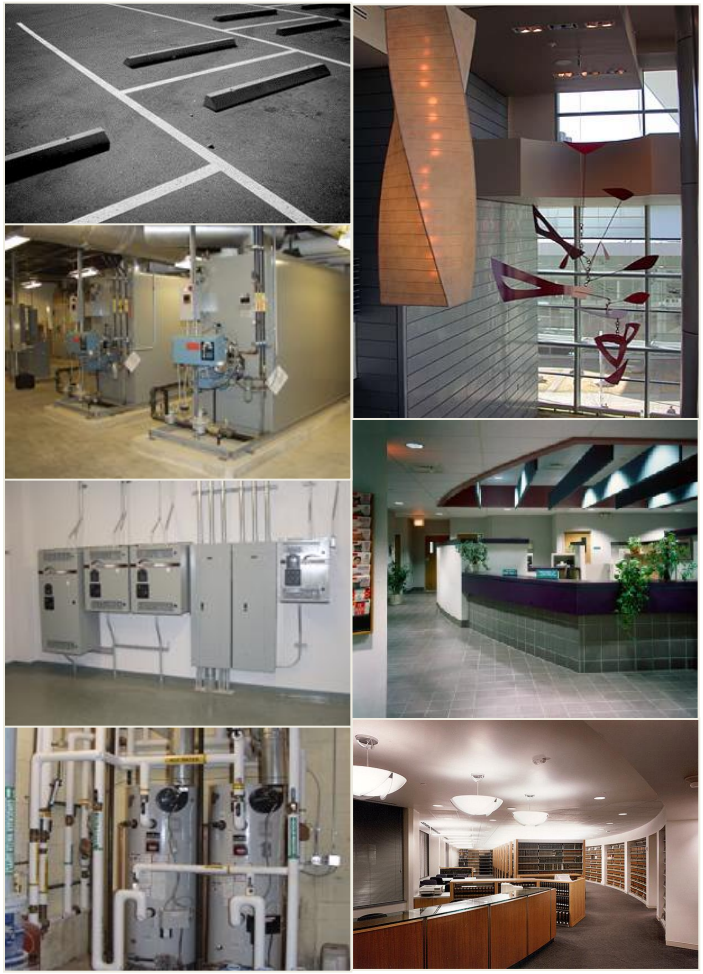
IRS Cost Segregation ATG (4/30/04)

- **"The preparation of CSSs requires knowledge of both the construction process and the tax law…."**
- **"In general, a study by a construction engineer is more reliable than one conducted by someone with no engineering or construction background."**
- **"Experience in cost estimating and allocation, as well as knowledge of the applicable law, are other important criteria."**

Qualifying Property

- **Any building *placed in service* since January 1st, 1987**
- **Existing buildings *undergoing renovation,* remodeling, restoration, or expansion**
- **Major *lease hold improvements* to any building made after January 1st, 1987**
- ***Inheritance* of commercial and investment real properties**
- ***Preconstruction planning* to recommend possible modification to the building designs to increase shorter-life asset classification**

Items To Be Reclassified in a Cost Segregation Study



- Site Improvements (landscaping/parking)
- Light Fixtures
- Branch wiring
- Special Plumbing
- Flooring
- Millwork
- Millwork Window Coverings
- Partition Walls
- Cabinetry
- Furnishings
- Shelving
- Wall Coverings

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Cost Segregation Studies – Opportunities

- **The *optimal time* to perform a study is the year the property is placed in service**
- **Current IRS procedures allow a taxpayer to *recover* any missed depreciation on properties *without amending* prior tax returns**
- **The benefits of Cost Segregation are amplified with bonus depreciation**
- **The Peco case has opened the door to additional marketing opportunities**

NEW CONSTRUCTION
Indirect / Soft Costs
+
General Contractor Costs
+
Direct Costs outside General Contract

OR

ACQUIRED PROPERTY

Purchase Price

Land Cost

Building and Site Implementation Cost

MACRS* - GDS

39 - Year Property

27.5 – Year Property

15 - Year Property

7 - Year Property

5 - Year Property

3 – Year Property

**Modified Accelerated Cost Recovery System*

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Client Discussion & Tax Savings Opportunity
Green Tax Incentives – 179D & 45L

- **With 179D, millions of dollars refunded to building owners and designers**
- **Less than 3% have claimed the benefits**
  - Can look at improvements back to 2006 - Form 3115
  - Up to $1.80 / sf. for energy efficient systems
  - All types of buildings and garages
  - Abandonment study on the old property
  - Design professionals – direct and indirect benefits – 3-year window of **opportunity**
- **71 billion square feet of commercial space**
  - Reduce Energy Cost and Tax Liabilities
  - Increase in Asset Value
- **Federal Proposal – Expand & Enhance 179D**

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Challenges

- **Awareness**
- **IRS Requirements**
  - Independent engineering certification
  - ASHRAE 90.1 – 2001
  - Regional challenges
- **Planning**
  - New construction
  - Existing buildings

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Over $ 119,390 Energy Tax Deduction

Hampton Inn, Florida – 66,328 square feet

- Envelope – Insulated glass, double pane thermal break windows and doors, white reflective single-ply roofing system
- Lighting – Low-voltage fluorescent
- HVAC – Natural gas units, split unit systems, motion activated room thermostat, continuous flow hot water service

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45L – Opportunities

- **Applies to apartments, condominium complexes, assisted living & senior living facilities & campus housing**

- **$2,000 tax credit per unit for energy efficient construction**

- **A contractor, developer or owner is eligible for the credit**

Thank you!

Norbert Crabtree, Business Development Executive, CSP360
ncrabtree@csp-360.com
716.847.2651

Luis Ramirez, CPA, Principal, Abbott, Stringham & Lynch
lramirez@aslcpa.com
408.377.8700

Sblend A. Sblendorio, Hoge Fenton Jones & Appel, Inc.
sas@hogefenton.com
925.460.3365

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