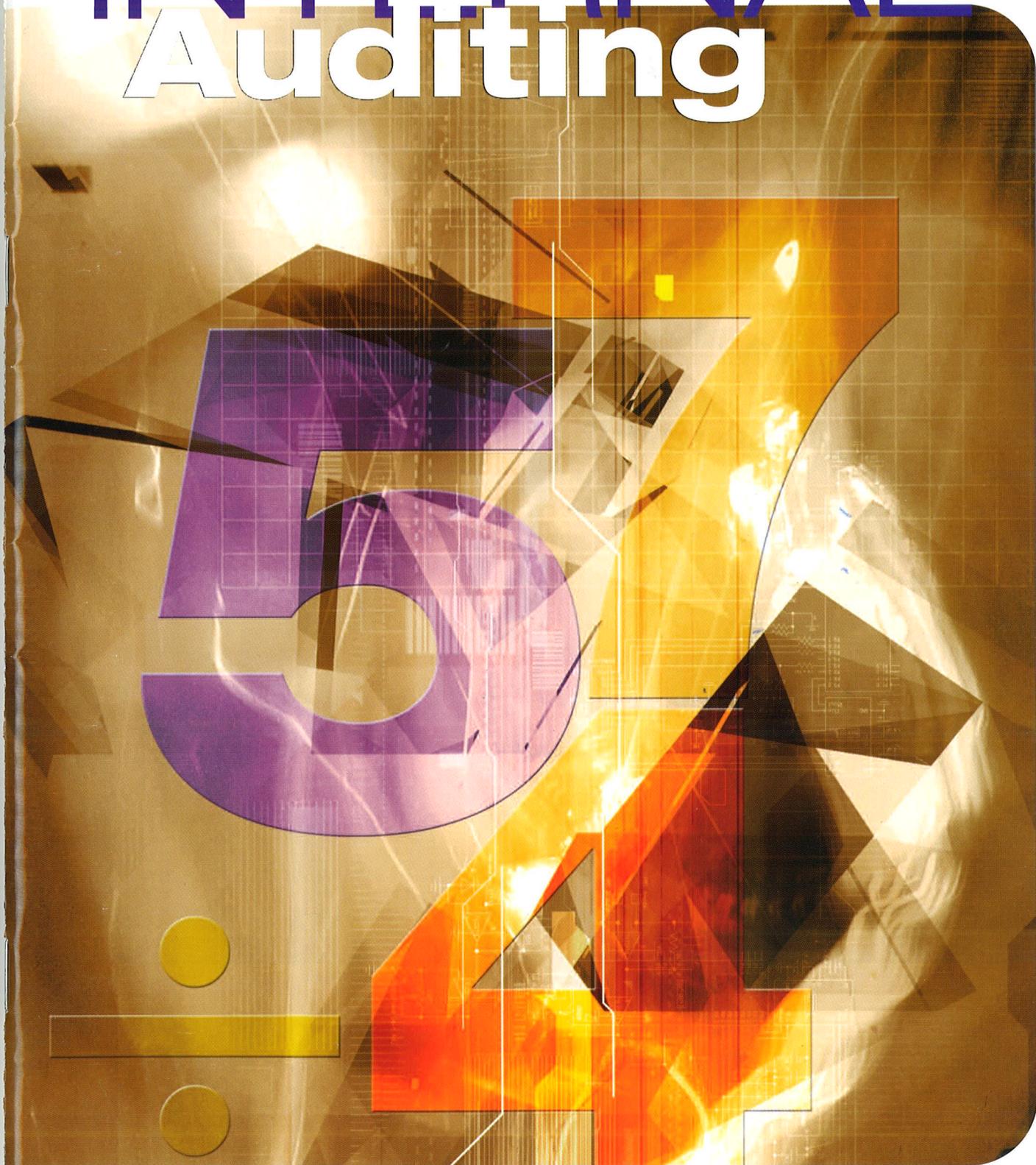


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INTERNAL Auditing



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ARE COST SEGREGATION STUDIES OF VALUE

This article examines the usefulness of real estate cost segregation studies to internal auditors in improving profitability and managing risk.

TO THE INTERNAL AUDIT FUNCTION?

KWEKU BOISON

The Institute of Internal Auditors defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance processes.¹

The internal auditing function serves to evaluate and improve all aspects of the organization's governance and systems of internal control, including the management of risk. The goal of the internal auditor is to improve organizational prof-

itability and assist in the attainment of other organizational goals.

The focus of this paper is to bring forth the service value of the internal auditor who capitalizes on his/her knowledge of real estate cost segregation studies to improve the organizations' profitability and overall management of financial risk.

The internal auditor and real estate cost segregation

A key part of the internal auditor function is to review and evaluate the effectiveness with which the unit of organization is run and how well its risks are managed. Among the risks facing an organization is financial risk. The role of the internal auditor is to provide assurance to management that all key risks, including financial risk, are being managed effectively. Can the internal auditor faithfully provide this assurance to management when the organization is not taking advantage of the benefits that accrue from real estate cost segregation studies?

The internal auditor plays a dual role in the organization as a provider of assur-

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**COST SEGREGATION
STUDY IS AN
OPPORTUNITY
OFTEN
OVERLOOKED BY
ORGANIZATIONS.**

ance and as a consultant for improvement in the organization's practices. In both spheres of function, the internal auditor is best placed to bring the value of the benefits of cost segregation to the organization. The primary benefit is the significant improvement in cash flow. This is achieved through the acceleration of depreciation deductions and the deferment of tax liabilities. The reclassification of costs the studies provide through the segregation studies presents additional benefits that the organization can take advantage of. These are discussed below.

How much can be saved?

The average net present value of additional cash flow is \$20,000 for every \$100,000 of 39-year property that is reclassified. Typically 15–40 percent of a building's overall costs can be reclassified to one of the shorter cost recovery periods. The actual amount of present value savings depends on the type of property, the design, and the specific construction components.

What is a real estate cost segregation study?

A real estate cost segregation study is an Internal Revenue Service (IRS) sanctioned practice of identifying assets within a real estate, as well as their costs, and reclassifying those assets and the associated costs for federal tax purposes. Allocating the acquisition or construction cost of a building between real and personal property, based on case law and IRS guidance, allows organizations owning real estate property to reduce their overall current income tax burden and free up capital by improving their cash flow from owned real estate property. Cost segregation study is an opportunity often overlooked by organizations. By current tax law, commercial real estate properties are depreciated over 39 years, and residential rental buildings are depreciated over 27.5 years. Management of organizations, however, may not be aware that a significant proportion of their real property could be depreciated over five, seven, or 15 years instead.

To qualify for a cost segregation study

Since cost segregation studies create tax benefits, the property owners must be considered by the IRS to be "taxable entities." Any type of entity that owns real estate and pays tax could be a beneficiary of cost segregation studies, including but not limited to:

- C Corp;
- S Corp;
- Individual (enterprises);
- Partnership;
- LLC.

Nonprofit entities cannot take advantage of a cost segregation study unless for some outlying reason, such as satisfying a correlation between real property or personal property and donor contributions.²

To determine if a cost segregation analysis is beneficial for your organization, the internal auditor should ask the following questions:

- 1 Has the organization purchased, constructed, expanded, or renovated any property after 1986, or has the organization installed leasehold improvements in an existing building?
- 2 Is the cost of the building or improvement (land excluded) at least \$500,000?
- 3 Is the organization planning on retaining the said property for at least the next few years?

If the internal auditor's answers to these questions are in the affirmative, then cost segregation is a valuable tool for the organization.

Qualifying properties

Properties that qualify for the benefits of cost segregation are residential rental property and nonresidential rental property. In section 168(e)(2)(A)(i) of the Internal Revenue Code (IRC), residential rental property is defined as any building or structure from which 80 percent or more of the gross rental income for the taxable year is rental income from dwelling units. A dwelling unit is a house or apartment used to provide living accommodations in a building or structure.³

EXHIBIT 1 Schedule of Typical Range of Reclassification of Real Property to Personal Property

INDUSTRY/ACTIVITY	PERCENTAGE RANGE OF REAL PROPERTY RECLASSIFIED TO SHORT-LIVED PERSONAL PROPERTY
Auto Dealerships (with repair/collision shops)	15% – 30%
Restaurants	15% – 40%
Hotels and Motels	20% – 40%
Heavy Manufacturing	25% – 70%
Light Manufacturing	15% – 40%
Multi-Unit Residential Housing	15% – 25%
Office Buildings	15% – 25%
Medical Offices	20% – 35%
Nursing Homes/Assisted Living residences	15% – 30%
Retail Businesses	10% – 40%
Warehouses	10% – 30%

Hotels, motels, and other establishments with more than one half of the units used on a transient basis are not considered residential rental property. These will fall within the ambit of the non-residential real property.⁴

Section 168(e)(2)(B) defines nonresidential real property as a section 1250 property that is not residential real property or property with a class life of less than 27.5 years.⁵ Nonresidential real property is depreciated over 39 years.

The enactment of the Revenue Reconciliation Act of 1993 extended the recovery period for depreciating non-residential real (commercial) property placed in service from 31.5 years to 39 years. With such a lengthy recovery period, it has become increasingly important to identify any personal property (IRC Section 1245 property) included in nonresidential or residential rental real property constructed and to have such personal property reclassified for shorter and accelerated recovery periods.

Benefits of cost segregation studies

Savings by property type. Federal and state income tax savings can be realized by taking advantage of the accelerated depreciation allowed for personal property. The outcome of cost segregation studies does not increase the total amount

of depreciation that can be written off. Instead, the increased depreciation deductions translate into lower taxable income in the earlier years of the real property's useful life. The result is an increase in cash flow, allowing the funds to be invested or used for other purposes in the business. The change in timing of deductions is presented to the organization in the form of the net present value of tax savings and/or expense over the life of the property.⁶

Superficially, properties valued at \$1,000,000 and above are ideal candidates for a cost segregation study. At that value, even a warehouse, a property type that commonly sees only 15 percent of assets reclassified to shorter-lived property, can benefit from such a study. However, where short-lived assets range to 50 percent or higher of the property value, properties valued at even as low as \$500,000 can be worthwhile subjects for a study. Today, virtually all real property purchases entail the simultaneous acquisition of tangible personal property. For this reason, internal auditors should routinely recommend the use of cost segregation studies whenever the expenditures for an acquisition, including leasehold improvements, equal or exceed \$750,000.⁷

Exhibit 1 lists some typical ranges of reclassifications of real property to per-

EXHIBIT 2 Schedule of Expansion of Depreciation by the United States Congress⁹

Statute	Additional Depreciation Allowance	Bonus Recovery Period
Job Creation and Worker Assistance Act of 2002	30% additional first year depreciation allowance for qualified property	
Jobs and Growth Tax Relief Reconciliation Act of 2003	50% additional first year depreciation allowance for qualified property	15 years depreciation allowance instead of 39 years: 1. Qualified Leasehold Improvement Property 2. Qualified Restaurant Property
American Jobs Creation Act of 2004	50% additional first year depreciation allowance for qualified property. Reduction in depreciation class life.	15 years depreciation allowance instead of 39 years: 1. Qualified Leasehold Improvement Property 2. Qualified Restaurant Property Depreciation class life for Motorsports Entertainment Complex reduced to 7 years.
Tax Relief and Health Care Act of 2006	50% additional first year depreciation allowance for qualified property in Gulf Opportunity Zone	15 years depreciation allowance instead of 39 years: 1. Qualified Leasehold Improvement Property 2. Qualified Restaurant Property
Emergency Economic Stabilization Act of 2008	50% additional first year depreciation allowance for qualified property Reduction in depreciation class life.	15 years depreciation allowance instead of 39 years: 1. Qualified Leasehold Improvement Property 2. Qualified Restaurant Property 3. Qualified Retail Improvement Property

sonal property. The savings depend upon the type of industry in which the property is used, a strong indicator of the percentage of short-lived assets in the real property.⁸

Bonus depreciation. Following the historical events of September 11, 2001 and their impact on the economy, Congress has, at various times, enacted targeted

expansions of depreciation to stimulate economic growth and provide tax relief to business owners owning commercial property.

Subject to the respective prerequisites in Section 168(k) of the IRC, the depreciation expansions detailed in Exhibit 2, also referred to as “bonus depreciation,” were available to taxpayers.

EXHIBIT 2 Schedule of Expansion of Depreciation by the United States Congress⁹, cont'd.

		Depreciation class life for Motorsports Entertainment Complex reduced to 7 years.
American Recovery and Reinvestment Tax Act of 2009	50% additional first year depreciation allowance for qualified property	15 years depreciation allowance instead of 39 years: 1. Qualified Leasehold Improvement Property 2. Qualified Restaurant Property 3. Qualified Retail Improvement Property
Hiring Incentives to Restore Employment (HIRE) Act of 2010	50% additional first year depreciation allowance for qualified property. Reduction in depreciation class life.	15 years depreciation allowance instead of 39 years: 1. Qualified Leasehold Improvement Property 2. Qualified Restaurant Property 3. Qualified Retail Improvement Property Depreciation class life for Motorsports Entertainment Complex reduced to 7 years.
Small Business Jobs and Credit Act of 2010	50% additional first year depreciation allowance for qualified property. Reduction in depreciation class life.	15 years depreciation allowance instead of 39 years: 1. Qualified Leasehold Improvement Property 2. Qualified Restaurant Property 3. Qualified Retail Improvement Property Depreciation class life for Motorsports Entertainment Complex reduced to 7 years.

The expansion of depreciation for personal property and real property adds tremendous value to cost segregation studies. First, there is the favorable 15 year depreciation period for qualified property and the immediate deduction of 50 or 100 percent of the tax basis of the qualified personal property. Then there is the shorter

depreciation life of the remaining tax basis of the personal property (where depreciation deduction is other than 100 percent). The net result of the depreciation expansion provides increased cash flow benefits in the first year and increased net present value over the life of the personal real estate property.

EXHIBIT 2 Schedule of Expansion of Depreciation by the United States Congress⁹, cont'd.

<p>Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010</p>	<p>100% first year depreciation allowance for qualified property.</p> <p>Election to forgo 100% first year depreciation allowance, 50% first year depreciation allowance, or both.</p> <p>Retroactive restoration of 50% additional first year depreciation allowance for qualified property.</p>	<p>All depreciation taken in first year. (Applies to personal property with an MACRS depreciation period of 20 years or less, certain leasehold improvement property, and certain water utility property)</p> <p>15 years depreciation allowance instead of 39 years:</p> <ol style="list-style-type: none"> 1. Qualified Leasehold Improvement Property 2. Qualified Restaurant Property 3. Qualified Retail Improvement Property <p>Depreciation class life for Motorsports Entertainment Complex reduced to 7 years.</p>
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Under the rules of the Alternative Minimum Tax (AMT), the bonus depreciation is exempt from AMT depreciation adjustments.¹⁰ Therefore, the AMT taxpayers get the full benefit of the bonus depreciation as regular taxpayers do.

The internal auditor needs to explore the options available to his/her organization. The savings in tax payments following cost segregation studies is often dramatic, and the reduction to cash outflow may just as well be seen as a “free loan” from the federal government. These savings have for most companies prove to be the difference between life and extinction.

Retroactive or “look-back” studies. Generally, if cost segregation is not reflected on the organization’s original return for the year that a real estate property was placed in service, the taxpayer can file an amended return to reflect the cost segregation for the “placed in service year.”¹¹ IRS Revenue Procedure 2004-11 sections 4.01 and 4.02 allow taxpayers to capture in the immediate year retroactive savings on property acquired or constructed

after 1986. Previous rules extended to the taxpayer a four-year catch up period for retroactive savings from depreciation adjustments. Rev. Proc. 2004-11 amended these rules, allowing taxpayers to take the entire amount of the unrecognized depreciation as an adjustment in the year cost segregation is completed. This opened up the opportunity for retroactive or “look-back” cost segregation studies on older properties to increase cash flow in the year of study.¹² Even more enticing is the retroactive extension of the 50 percent first year depreciation for qualified properties placed in service between January 1, 2010 and September 8, 2010.¹³

The IRS further facilitates the procedure for taxpayers to make use of depreciation adjustments by granting “automatic” consent. Under the automatic consent, the taxpayer receives permission for the change if the taxpayer (1) attaches an original Form 3115 to a timely filed (including extensions) original return of the taxpayer for the year of change, (2) files a copy of the Form 3115 with the

IRS at the address specified in the applicable revenue procedure, no later than when the original return was filed, and (3) follows the other instructions in the applicable revenue procedures.¹⁴

Write-off provisions—section 179. Another incentive for allocating real estate costs to shorter-lived property is the expensing provision of IRC §179. The ceiling limitation for expensing capital amounts invested in qualified section 179 property (qualifying tangible property acquired by purchase for use in the active conduct of a trade or business)¹⁵ was at \$250,000 for property placed in service in the tax years that began in 2008. This limit was reduced by the amount by which the cost of section 179 property placed in service in the tax year exceeds \$800,000.¹⁶ The ceiling limitation and the threshold remained the same for 2009. The Hiring Incentives to Restore Employment (HIRE) Act of 2010 extended the timeframe for the benefit of these provisions to 2011, while maintaining the established ceiling and threshold.¹⁷ In The Small Business Jobs and Credit Act of 2010 the U.S. Congress increased the amount a business can write-off from \$250,000 to \$500,000 of qualified capital expenditures. This is subject to a phase-out once these expenditures exceed \$2,000,000 for tax years 2010 and 2011. This statute has since been followed by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which allows businesses to write-off up to \$500,000 of qualified capital expenditures, subject to a dollar-for-dollar phase-out once these expenditures exceed \$2,000,000 for the 2011 tax year.

By maximizing the costs allocable to tangible personal property, the taxpayer can not only get an immediate write-off under §179, but also qualify for a shorter recovery period under §168 for any remaining basis in the property. Thereafter, first year bonus depreciation provides even more incentive for taxpayers to segregate cost into shorter recovery periods.¹⁸

Internal auditors, by definition, are duty-bound to urge their organization to take advantage of these capital recovery provisions set forth by Congress to improve cash availability.

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Reduction in quarterly estimated tax payment. While organizations are required to file and pay estimated taxes every quarter of the calendar year, those organizations that have taken advantage of the tax savings from cost segregation studies have reduced cash outflow for quarterly tax payment by reducing taxable income.

Property tax savings. We are in times of fiscal austerity, and state and local governments are increasingly looking to assess more taxes on properties within their jurisdiction. The assessments are based on the jurisdiction's perceived value of the property. The organization can contest for a lower property tax assessment if it can carve out the cost of personal property from the reported cost of construction or acquisition of real estate property. The process of cost segregation studies provides the documentary support for the organization to accomplish this.

Section 1031 exchanges. Under the rules of Section 1031 of the IRC, it is typical for the organization to apply the regular depreciation rate to both the exchanged basis of the property given up and to the excess basis (the excess of the fair value of the new property over the fair value of the property given up), if the excess exists.

The organization could, however, opt to use a cost segregation study to accelerate depreciation deductions and decrease tax liability.

Purchase price allocation. The previous Statement of Financial Accounting Standards, SFAS 141 (Revised 2007) Business Combinations, now codified under the new Accounting Standards Codification (ASC) and cited as Business Combinations FASB ASC 805, provides the following guidance in paragraph 20 for measuring identifiable assets acquired in a business combination transaction:

The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition date fair values.¹⁹

This process has come to be known as purchase price allocation, where the price of the business purchased is allocated among the respective assets and liabilities in the business acquisition. For example, to report the real estate piece in a merger or other business combination, the internal auditor could urge maximum value of the transaction if the services of a cost segregation practitioner are utilized for the accurate and advantageous reporting of the value of the real estate on behalf of the organization. The process involves an appraisal of the land "as though vacant and available," then using cost segregation techniques to allocate the improvement into the appropriate tax or financial reporting lives. The benefits of involving cost segregation professionals are realized in tax savings to the organization.

Conclusion

This article has examined the value of real estate cost segregation studies to the internal auditor's roles as a consultant of best practices and as a provider of assurance to organization management that all key risks, including financial risk, are being managed effectively. With the benefits that have been discussed, the internal auditor enhances the faithfulness of his/her representations to management if he/she capitalizes on knowledge of real estate cost segregation studies to improve the organizations' profitability and overall management of financial risk. ■

NOTES

¹ The Institute of Internal Auditors, Definition of Internal Auditing <<http://www.theiia.org/guidance/standards-and-guidance/ippf/definition-of-internal-auditing/>> (accessed May 3, 2011).

² Kweku Boison. "Real Estate Cost Segregation: A Planning And Reporting Tool For The Certified Public Accountant" *Construction Accounting and Taxation*. 20, 4 (July/August 2010): 12-22.

³ Internal Revenue Code §168(e)(2).

⁴ *Ibid.*

⁵ *Ibid.*

⁶ Bruce A. Desrosiers and Wayne J. DelPico. *The Practice of Cost Segregation Analysis: Maximizing Tax Benefits for Building Acquisitions and Construction*. (Reed Construction Data, 2004), 11.

⁷ Jay A. Soled and Charles E. Falk. "Cost Segregation Applied," *Journal of Accountancy* (August 2004). <<http://www.journalofaccountancy.com/issues/2004/Aug/CostSegregationApplied.htm>>.

⁸ Grant G. Keppel. *Real Estate Cost Segregation: A Practitioner's Guide* (RIA, 2006).

⁹ *Op. cit.* note 2.

¹⁰ Internal Revenue Code §168(k)(G).

¹¹ *Op. cit.* note 8.

¹² *Op. cit.* note 2.

¹³ Internal Revenue Service. *IRS Revenue Procedure 2011-26*.

¹⁴ *Op. cit.* note 8.

¹⁵ Internal Revenue Service. Cost Segregation Audit Techniques Guide: Chapter 2. October 1, 2004. <<http://www.irs.gov/businesses/article/0,,id=134133,00.html>>

¹⁶ Internal Revenue Service. Publication 946—How To Depreciate Property (2010). <<http://www.irs.gov/publications/p946/index.html>> (accessed November 1, 2009).

¹⁷ The Hiring Incentives to Restore Employment Act of 2010, Title II Section 201.

¹⁸ *Op. cit.* note 15.

¹⁹ Financial Accounting Standards Board of the Financial Accounting Foundation. Financial Accounting Series. Statement of Financial Accounting Standards No. 141 (Revised 2007). Business Combinations.