

Choosing a Cost Segregation Consultant

By Jacob D. Hopper – Bedford Capital Consulting

There is no doubt that cost segregation has made its mark as one of the most beneficial tax planning strategies available to commercial real estate owners today. Most owners have read about the tremendous benefits associated with cost segregation and recognize the opportunity. The most significant challenge for owners when it comes to cost segregation is figuring out how to choose a provider.

Brief Overview of Cost Segregation

Cost segregation studies are used to accelerate depreciation deductions, defer income tax and improve cash flow. A cost segregation study allows a taxpayer to accelerate substantial depreciations deductions by identifying costs that can be allocated to shorter recovery periods, primarily five-, seven-, and/or 15- year periods as apposed to 27.5- or 39-year periods. It should be noted that a cost segregation study does not create new tax deductions; it simply pushes deductions into the early years of ownership. This front-loading of deductions allows the taxpayer to take advantage of the time value of money — which we all know can be a significant benefit.

Professional Qualifications

Although there are not currently any professional designations or certification procedures for cost segregation providers, the IRS does provide guidance on this issue. Chapter four of the IRS's Cost Segregation Audit Techniques Guide (ATG) lists 13 principle elements of a quality cost segregation study. It should come as no surprise that the first element listed is "preparation by an individual with expertise and experience." Clearly, the IRS does not want unqualified individuals without any experience performing cost segregation studies. The IRS recognizes that knowledge of both the construction process and tax law (specifically depreciation) are highly important. The ATG states, "In general, a study by a construction engineer is more reliable than one conducted by someone with no engineering or construction background". The ATG also stresses to field agents and auditors that "a quality study identifies the preparer and always references his/her credentials, experience and expertise in the cost segregation area."

Preferred Methodology

There are a number of methodologies currently being used to perform cost segregation studies. The most common are the detailed engineering approach (based on actual or estimated cost records) and the residual approach. The detailed engineering approach generally produces more accurate and reliable results and is therefore the preferred methodology. The residual approach is an abbreviated method which only identifies costs that qualify for accelerated depreciation. The remaining (residual) costs are then allocated to a single line item such as "building" (27.5- or 39-year). In addition to being a less accurate method, the residual approach can create greater risk in the event of an audit. When hiring a cost segregation consultant, make sure that they are performing

studies based on the detailed engineering approach. You can learn more by searching the IRS Website, www.irs.gov, for cost segregation methodologies.

Ask the Right Questions

It is important to know what questions to ask when evaluating potential cost segregation providers. Here are some of the more important ones:

- How long has the firm been performing cost segregation studies?
- How many cost segregation studies has the firm performed?
 - You may have to do some homework here because there are a number of start-up firms claiming to have performed 5,000 studies or more. Of course this isn't necessarily true, but how will you know unless you check it out.
 - To put things in perspective an experienced cost seg engineer can do about 50 engineering-based studies per year. With some basic math you can get a rough idea of how many studies a firm might have performed; assuming they have been at maximum capacity the whole time.
 - Most firms, even the ones with experience, have less than 5 engineers. A firm with 5 engineers can complete approximately 250 studies per year using the assumptions above. Therefore a firm with 5 engineers would have to be in business for approximately 20 years to complete 5,000 studies.
- Who will be performing the work? Does the firm employ degreed engineers? Does the firm employ any professional engineers (P.E.s)?
 - Since the IRS has stressed the importance of engineering-based studies in the ATG, many firms have jumped on the engineering bandwagon. Unfortunately, this has become somewhat of a buzz word that firms use to market themselves.
- What methodology does the firm use?
 - This may also require some work. You can start by asking what methodology they use. If they can't answer the question or they indicate that they use a residual method you should look elsewhere.
 - Basically, you want to verify that the firm uses a detailed engineering approach and provides a detailed breakdown of all costs, including those that do not qualify for accelerated depreciation. If they don't, you could be facing additional risk in the event of an audit.
- Does the firm subcontract its cost segregation work to a third party? If so what are the third party's credentials? What type of quality assurance measures are in place for this arrangement?
- Does the firm carry professional liability insurance? If so, what are the limits, does the policy specifically cover cost segregation and does the carrier have an acceptable rating?

- How will the firm defend its work in the event of an audit, if at all? Is there an additional expense for this service? Does the firm retain the necessary records? What is the firm's experience with respect to defending its work before the IRS?
- Ask for references and follow up with them. In addition to asking the references if they were generally pleased you may want to ask some of the following questions...
 - How were you introduced to the firm?
 - Were they responsive and did they complete the study on time?
 - How many cost segregation studies have you done with them?
 - Have you ever done a cost segregation study with anyone else?
 - Would you use them again?

Project Fees

The fees associated with cost segregation studies have come down considerably in recent years, making it feasible for smaller property owners to take advantage of this valuable tax planning strategy as well. This is primarily due to competition — there are simply more providers in the market today. It is also due, in part, to the fact that there are fewer firms charging on contingency (where the fee is based on a percentage of tax savings). The IRS says, "Examiners should closely scrutinize studies performed on contingency fees." Property owners and their advisors should avoid cost segregation providers charging on a contingency basis. The reason for this is that a contingency fee arrangement creates an incentive for the cost segregation consultant to be overly aggressive. Appropriate fees for a cost segregation study will depend on a number of factors, including the size of the property, the type and complexity of the property, and the amount of time it will take to complete. Most cost segregation providers bill on a fixed fee basis.

Although fees have come down significantly, some clients still are not satisfied. For those of you who buy purely on price, it is important to keep in mind that the lowest fee is rarely associated with the highest value. As outlined above, there are many things to consider when selecting a cost segregation provider. The savings produced by these studies certainly afford you the ability to make a decision based on factors other than the fee. The last thing you want is a cost segregation study that won't stand up to an audit — even if you do save a few bucks on the front end.

American Society of Cost Segregation Professionals

While there are currently no professional designations or certification procedures for cost segregation consultants and there are no required methodologies, the future for such developments is bright. The American Society of Cost Segregation Professionals (ASCSP) has been established as a non-profit corporation in response to the growing need for credentials, technical standards and a code of ethics for the cost segregation industry. Membership will be open to all cost segregation providers who meet the

standards currently being developed by ASCSP. The society expects to complete the standards, administer testing and provide credentials to successful applicants sometime this year. To learn more, visit www.ascsp.org.

The bottom line is that you should seek advice from qualified professional with cost segregation experience. Make sure you are working with a firm that employs real engineers as well as the appropriate tax experts. You may end up paying a bit more for the expertise, but it will be well worth it – especially if you are ever called into an audit. Chances are their results will be better anyway.

Jacob Hopper is the Director of Strategic Development for Bedford Capital Consulting, a national professional services firm specializing in engineering-based cost segregation services.

For more information about cost segregation and Bedford Capital Consulting, or to contact a representative in your area please visit www.bedfordcap.com. Alternatively, you can call Bedford's national headquarters at (800) 257-8962.

This article has been published by the following:

www.rebusinessonline.com

www.lodgingoperator.com

AAHOA Lodging Business

© 2007 Bedford Capital Corporation. All Rights Reserved

© 2007 Publications. All Rights Reserved