

# Cost Segregation Analysis

Single-Family Rental Property  
[ADDRESS]

[DATE OF REPORT]



[DATE OF REPORT]

[FULL NAME OF CUSTOMER]

[ADDRESS OF CUSTOMER]

[CITY, STATE ZIP CODE]

Dear [FULL NAME OF CUSTOMER]:

We have completed our cost segregation analysis of the single-family rental property located at [ADDRESS OF PROPERTY]. The purpose of our analysis was to assign cost components to individual assets for determining federal income tax depreciation under the Modified Accelerated Cost Recovery System ("MACRS") defined in section 168 of the Internal Revenue Code.

The results of our analysis are summarized below:

Property Type	US Federal Income Tax Depreciable Life	Cost Basis
Land	Non-depreciable	
Residential Real Building	27.5	
Appliances	5	
Tangible Personal Property	5	
Total Cost Basis		

The following report and accompanying exhibits contain our findings including a description of the subject property, tax considerations, and MACRS classification for each identified property unit. Our report is subject to the attached Statement of General Assumptions and Limiting Conditions.

Sincerely,

Mycostseg.com

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## Scope of Service and Procedures

We have performed a cost segregation analysis for U.S. federal income tax depreciation purposes of the single-family rental property located at [ADDRESS OF PROPERTY]. The subject property was acquired on [PURCHASE DATE] for \$[PURCHASE PRICE].

Our methodology followed professional cost segregation procedures. We performed the following steps in completing this assignment:

- Reviewed data provided by the owner including square footage, age, construction details, and floor layout.
- Estimated the cost basis of the residential real property.
- Estimated the cost basis of tangible personal property.
- Segregated the cost basis into appropriate recovery periods for U.S. federal income tax depreciation purposes.
- Prepared a written report and conclusions.

## Applicable Law and Tax Support

The Modified Accelerated Cost Recovery System (“MACRS”), set forth in Section 168 of the Internal Revenue Code of 1986, describes recovery classes to be used for Federal income tax depreciation purposes. The Tax Reform Act of 1986 requires the use of MACRS for determining depreciation for most tangible depreciable property placed in service after December 31, 1986. The depreciation recovery classes (3, 5, 7, 10, 15, 20, 27.5 and 31.5/39 years) are based on midpoint lives of the old Asset Depreciation Range (“ADR”) system, which was in effect between 1971 and 1980. The class lives and corresponding recovery periods of assets are published in Revenue Procedure 87-56. The deduction for depreciation is calculated by using the applicable method, the applicable recovery period and the applicable convention.

Section 168 provides that property in recovery classes 3-year through 10-year is recovered using the 200 percent declining balance method, switching to the straight line method in the first year in which the straight line method produces a larger allowance. Property in recovery classes 15-year and 20-year is recovered using the 150 percent declining balance method, also switching to straight line at the appropriate time. Residential rental property (27.5 years) and non-residential real property (31.5/39 years) are recovered using the straight-line method.

The Asset classes from Rev. Proc. 87-56 relevant to this analysis may include the following:

Asset class 00.3 of Rev. Proc. 87-56 defines “Land Improvements” as 15-year property under the general depreciation system. This category includes “improvements directly to or added to land, whether such improvements are section 1245 or section 1250 property, provided such improvements are depreciable. Examples of such assets might include sidewalks, roads, canals, waterways, drainage facilities, sewers, ... wharves and docks, bridges, fences, landscaping, shrubbery, or radio and television transmitting towers...”

Asset class 57.0, Distributive Trades and Services, of Rev. Proc. 87-56 is defined as 5 year property “...assets used in wholesale and retail trade, and personal and professional services...” For residential rental property, the IRS has ruled that the rental of MACRS 27.5-year residential rental property is a Class 57.0 activity.

With respect to the property analyzed, tangible personal property and other tangible property defined in Asset class 57.0 of Rev. Proc. 87-56 is eligible for depreciation over 5 years and Land improvements or site improvements defined in Asset class 00.3 are eligible for depreciation over 15 years, and Section 1250 residential real property and its structural components are eligible for depreciation over 27.5 years.

Section 1.1.245-3(a)(1) of the Federal Income Tax Regulations states, “The term section 1245 property means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and which is either –

- i. Personal property (within the meaning of paragraph (b) of this section),

- ii. Property described in section 1245 (a)(3)(B) (see paragraph (c) of this section), ...”

Reg. Section 1.1245-3(b) defines personal property as “(1) Tangible personal property (as defined in paragraph (c) of section 1.48-1, relating to the definition of “section 38 property” for purposes of the investment tax credit, and (2) Intangible personal property...” Section 1.48-1 (c) defines tangible personal property as any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building.

Section 1.48 contains regulations relating to the classification of both “tangible personal property” and “other tangible property” eligible for the investment tax credit (“ITC”). ITC was repealed as a result of the Tax Reform Act of 1986. However, according to a recent tax court case, Hospital Corporation of America, 109 TC No. 2 (1997), when segregating personal property from real property (i.e., buildings) for depreciation purposes, the taxpayer must rely upon the guidelines previously established for determining ITC eligible property.

In addition, the special rules under sub-section 5.05 of Rev. Proc. 87-56 discuss the issue of the inclusion of certain “other tangible property” within asset class 00.3. This sub-section states:

Asset guideline class 00.3, “Land Improvements,” includes other tangible property that qualifies under section 1.48-1(d) of the Income Tax Regulations. However, a structure that is essentially an item of machinery or equipment or a structure that houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) of the Code, if the use of the structure is so closely related to the use of the property that the structure clearly can be expected to be replaced when the property it initially houses is replaced, is included in the asset guideline class appropriate to the equipment to which it is related.

Therefore, there is a differentiation within the “other tangible property” inclusion in Asset class 00.3 for those structures within a qualified activity that essentially support or house an item of machinery or equipment within that activity. Rev. Proc. 87-56 directs us to include such structures within the respective MACRS asset class of the equipment it supports or houses. With respect to the facility analyzed, we determined the proper class life based upon the following concepts. In general, an item is considered to be tangible personal property if it can be removed without causing structural damage to the building. For example, movable partitions are considered tangible personal property if the partitions can be moved without causing damage to the building. Masonry block walls, doors, rest room partitions, structural plumbing, structural office partitions and structural electrical wiring do not qualify because they are of a permanent nature.

However, some components of a building are utilized as both real property and personal property. These dual-functioning components are thus providing services relating to both building functions and equipment functions. Certain portions of the wiring and plumbing perform building related functions, such as general-purpose lighting and rest room related piping, respectively. However, other portions of the wiring and plumbing perform equipment or

process related functions, such as process equipment hook-ups, waste drains, etc. This naturally leads to the concept of allocating the costs of the dual-service property between the equipment portion and the structural related portion to arrive at the property cost basis of the personal and real property.

This concept of allocation has been accepted by the courts for identifying tangible personal property eligible for the investment tax credit, including the results of Scott Paper Co., 74 TC 137 (1980), Illinois Cereal Mills, Inc., 789 F2d 1234, (7th Cir. 1986), affirming the Tax Court, 46 TCM 1001, and Morrison, Inc. 891 F2d 857, (11th Cir. 1990) affirming the Tax Court, 51 TCM 748. Therefore, our cost segregation analysis has followed this procedure to properly account for the eligible cost of personal property.

In analyzing the facilities, we also applied a functional use test to determine whether special-purpose equipment qualifies as depreciable tangible personal property. For example, the Internal Revenue Service has held that safety equipment units that service an entire building are structural components, and, therefore, do not qualify as depreciable tangible personal property. However, comparable equipment, which is necessary and used directly in a specific process or in the operation of a machine, will qualify as depreciable tangible personal property (see Rev. Rul. 75-78, 1975-1C CB 8).

Finally, under certain circumstances, we classified property as either tangible personal property, other tangible property, or real property based upon an analysis of the permanency, function, or appearance of the property in question. These “inherently permanent”, functional use and appearance tests were established by the Courts in various cases, and consist basically of addressing the following questions:

- Does the property lack permanency?
- Does the property relate to the operation or maintenance of the building, or is it an accessory to the taxpayer’s business?
- Is the property an electrical or mechanical component that is closely related to qualifying equipment?
- Is the property “in the nature of machinery,” as that concept has been expanded to include even permanent assets that are an integral part of the qualifying machinery?
- Is the property machinery and is the sole justification for its installation the fact that it is required to meet temperature or humidity requirements essential for the operation of other machinery of the processing of materials or foodstuffs?

## Description of Property

The property analyzed in our study was a single-family rental property located at [PROPERTY ADDRESS]. The building was approximately [PROPERTY SQUARE FOOTAGE] square feet in area and was built in [YEAR BUILT].

The property included a kitchen, [QUANTITY] bedroom[s], [QUANTITY] bathroom[s], and living area. The interior build-out of the property included kitchen appliances and related power and plumbing connections, removable floor coverings, kitchen cabinetry and countertops, and kitchen sink.



## Summary and Conclusions

We have conducted a cost segregation analysis of the single-family rental property located at [PROPERTY ADDRESS]. The purpose of our analysis was to assign cost components to individual assets for determining federal income tax depreciation under Internal Revenue Code Section 168. No other use is intended or should be inferred.

The results of our analysis are detailed in the table below and have been made based on the facts and data made available to us by the owner.

Based on the analysis, it is our opinion that the items of property identified and the distribution of costs set forth in the accompanying schedules are a fair and a reasonable analysis of the subject property and its costs.

## **Certification**

We hereby certify that:

- We have no present or contemplated future interest in the property.
- Neither our employment nor our compensation in connection with this report is in any way contingent upon the conclusions reached or costs estimated.
- No persons/entities other than those acknowledged in this report prepared the analysis, costs, or conclusions set forth in this report.
- To the best of our knowledge and belief, the statements of fact contained in this report are true and correct.
- This report sets forth all of the assumptions and limiting conditions affecting the analysis, costs, and conclusions contained herein.

## **Statement of General Assumptions and Limiting Conditions**

This report has been produced with the following general assumptions and limiting conditions:

1. An investigation has not been made of, and no responsibility is assumed for, the legal description of the property or legal matters, including title or encumbrances. Title to the property is assumed to be good and marketable unless otherwise stated. The property is assumed to be free and clear of any liens, easements or encumbrances unless otherwise stated.
2. Data furnished by the owner, upon which all or portions of this report are based is believed to be reliable, but has not been verified. No warranty is implied as to the accuracy of such information.
3. This report has been produced only for the purpose stated and shall not be used for any other purpose by any person other than the party to whom it is addressed without our prior written consent.
4. Neither this report nor any portions thereof may be disseminated to third parties, except outside tax counsel and the Internal Revenue Service by any means without the prior written consent and approval of Mycostseg.com.
5. No one associated with this report shall be required by reason of this report to give further consultation, provide testimony, or appear in court or at other legal proceedings, unless specific arrangements have been made.
6. The recovery periods, conventions, and classes are deemed to represent the allowable ADR classes to the taxpayer.
7. Mycostseg.com is not your tax planner or tax preparer. We are not responsible for correctly utilizing the findings of this report to file your tax return in accordance with US Internal Revenue Code guidelines and/or IRS procedures.
8. Acceptance and/or use of this report constitutes acceptance of all the forgoing General Assumptions and Limiting Conditions.

