

COST SEGREGATION STUDIES

A TAX SAVING STRATEGY



Increase cash flow.

Accelerate depreciation.

Reduce tax.



KBKG, INC.

COST SEGREGATION SPECIALISTS
& REAL ESTATE CONSULTANTS

719 East Union Street, Pasadena, CA 91101

Experience

Expertise

Value

Quality

Educators

Partnering

COST SEGREGATION STUDIES



COST SEGREGATION

Cost Segregation is a strategic tax savings tool that allows companies and individuals, who have constructed, purchased, expanded, or remodeled any kind of real estate to increase cash flow by accelerating depreciation deductions and deferring federal and state income taxes.

In general, it is easy to identify furniture, fixtures, and equipment (FF&E) that are depreciated over 5 or 7 years for tax purposes. However, a Cost Segregation Study goes far beyond that by dissecting construction costs that are usually depreciated over 27 ½ or 39 years. The primary goal of a Cost Segregation Study is to identify all construction-related costs that can be depreciated over 5, 7 and 15 years. For example, 30% to 90% of the total electrical costs in most buildings can qualify as personal property (depreciated over 5 or 7 years). Reducing tax lives results in accelerated depreciation deductions, a reduced tax liability, and increased cash flow.

TIMING IS EVERYTHING

The ideal time for a Cost Segregation Study can vary depending on a client's tax situation. At KBKG, our team of engineers and tax experts work together with clients and their accountants to recommend the best tax planning solution to fit their needs. A free preliminary analysis can help determine the right timing and strategy for any investor.

POST-PURCHASE, REMODEL, OR CONSTRUCTION: "LOOK-BACK" STUDIES

A Study can be completed anytime after the purchase, remodel, or construction of a property. In fact, current Internal Revenue Service procedures make it easy to go back and claim missed depreciation on assets acquired *as far back as 1987* without amending prior tax returns.

YEAR PLACED IN SERVICE:

The optimum time for a Study for new owners, is during the year a building is constructed, purchased, or remodeled. This allows an owner to immediately optimize tax savings and accurately classify assets before the building even begins to depreciate.

PRE-CONSTRUCTION:

For investors who are in the planning phases of construction or remodeling, the best time to consider a Cost Segregation Study is before the infrastructure of the building is set. KBKG's Pre-Construction Consulting allows the project's accountant and construction contractor to accurately track items that qualify for accelerated depreciation and ultimately saves time and money.

"Current IRS procedures make it easy to go back and claim missed depreciation on assets acquired as far back as 1987 without amending prior tax returns."

BENEFITS OF COST SEGREGATION

- Generates immediate *increase in cash flow* through accelerated depreciation deductions.
- Provides an easy opportunity to *claim 'catch up' depreciation* on previously misclassified assets.
- *Reduces income taxes* and can also reduce real estate property taxes.
- Provides an *independent third-party analysis* that will withstand IRS review.

WHAT KIND OF REAL ESTATE QUALIFIES?

Any structure used for business or as rental property, is eligible for the benefits of Cost Segregation. The graph below represents the percentages of project-related construction costs that could be reclassified from either 27 ½ or 39-year real property to 5, 7, or 15-year property.

AVERAGE COST REALLOCATION WITH A COST SEGREGATION STUDY BASED ON PROPERTY TYPE	PROPERTY TYPE	PERCENTAGE REALLOCATED
<p><i>Based on our experience for each property type, the following percentages of project-related construction costs could be reclassified from either 27 ½ or 39-year real property to 5, 7, or 15-year property.</i></p>	Warehouses	10-17%
	Offices	12-25%
	Apartments	20-30%
	Retail Stores	15-32%
	Auto Dealerships	20-35%
	Hotels	25-35%
	Grocery Stores	27-37%
	Restaurants	23-40%
	Banks	25-43%
	Medical Facilities	25-43%
	Golf Courses	35-50%
	Manufacturing Facilities	30-60%

“Every \$100,000 in costs reclassified from Building to Personal Property can result in more than \$20,000 in net present value savings”

Other projects benefiting from Cost Segregation include shopping malls, airports, sports facilities, driving ranges, resorts, industrial buildings, auto service centers and more.

Any leasehold improvements can also benefit from a Cost Segregation Study. Interior build-outs generally produce a proportionally higher ratio of qualifying property. Therefore a Cost Segregation Study that analyzes the costs of leasehold improvements can be even more beneficial.

FREE PRELIMINARY ANALYSIS

A free preliminary analysis can easily be conducted to estimate approximately how much a Cost Segregation Study can benefit an investor. This process requires some basic property information including:

- A copy of the property’s detailed tax depreciation schedule for the most recently completed year
- An appraisal of the property *(if available)*
- A schedule of construction costs such as an AIA document, a contractor’s payment application, a schedule of values for the building, or any other summary of the project’s costs *(if available)*
- A brief description of the property, including general use (retail/office), square footage, and number of tenants *(if rented)*

We will review this basic project information, estimate the potential tax savings, and issue a proposal. Our proposals include a flat fee based on our estimated time and material to complete the project so that our clients know the final cost of a Study before we begin.

COST SEGREGATION STUDIES

“The preparation of cost segregation studies requires knowledge of both the construction process and the tax law involving property classifications for depreciation purposes.”

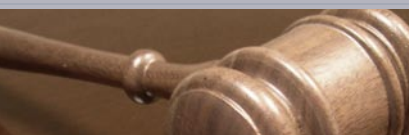
- Cost Segregation Audit Techniques Guide: Section 4.3

WHO CAN CONDUCT A STUDY?

The following qualifications are needed to ensure an investor obtains the optimum tax savings allowable by law:

- **Engineering, construction, and tax expertise:** to accurately evaluate, identify and classify assets to appropriate categories.
- **Knowledge of changing tax laws:** to ensure taxpayers optimize savings within the proper application of current laws.
- **Knowledge of prior court cases and rulings pertaining to individual assets:** to determine what is personal property. According to the IRS’s Chief Counsel Guidance in 1999, the IRS recognizes that there is “No Bright Line Test” for identifying personal property. As rulings in various court cases have proven, different circumstances for the exact same type of asset can change how the asset is depreciated for tax purposes. Therefore, a specialist needs to evaluate the construction method, use, and application of laws pertaining to each asset.
- **Compliance with the IRS Audit Techniques Guide:** to ensure an accurate study that withstands IRS scrutiny in the event of an audit. The IRS Audit Techniques Guide, issued in 2004, outlines the criteria of a quality Cost Segregation Study and provides direction to IRS field agents when reviewing a report that does not employ the methods suggested. KBKG not only meets but exceeds this criteria.
- **Proactive identification of other opportunities:** to recognize additional areas of tax savings. An independent third party who specializes in Cost Segregation Studies and other real estate tax services can determine if an investor can benefit from other studies such as: Fixed Asset Studies, Abandonment Studies, and more.

HISTORY OF COST SEGREGATION



■ 1959

Shainberg vs. Commissioner: The courts ruled (and the IRS subsequently agreed) on the validity of segregating costs for tax depreciation on buildings.



■ 1973

Revenue Ruling 73-410 clarified that a taxpayer may separately depreciate parts of used property if a qualified appraiser ‘properly allocates the costs between non-depreciable land and depreciable building components as of the date of purchase.’



■ 1975

Whiteco Industries, Inc. vs. Commissioner: The Tax Court, based on an analysis of judicial precedent, developed six questions designed to ascertain whether a particular asset qualifies as tangible personal property.



■ 1986

Investment Tax Credit (ITC) is repealed and the new MACRS recovery periods for building depreciation are increased dramatically for property placed in service after 1986.

*Residential Property: 27 ½ yrs.
Commercial Property: 31 ½ yrs. & increased again to 39 yrs. in 1993.*

WHAT IS INVOLVED IN A KBKG STUDY?

A quality Cost Segregation Study evaluates all information including available records, inspections, and interviews, and presents the findings in a clear, well documented format. Our process for conducting a detailed Study includes:

- Review of cost detail** | A review of all cost detail for the property including but not limited to: the general contractor's application for payment, construction invoices, change orders, depreciation schedules, and appraisals.
- Inspection of facility** | An inspection of the facility to fully understand its use and condition, as well as to gather information that further supports the classification of capitalized costs into their appropriate class lives.
- Photograph & documentation** | Photographs are taken of qualifying construction components and included in our report.
- Review of blueprints** | A review of all blueprints, if available, and the performance of quantity takeoffs and cost estimates for personal property not segregated in other cost information.
- Cost reconciliation** | A reconciliation of all construction costs and estimates of the actual amounts incurred by tax life. This step includes adjusting estimates to account for location, time, and physical condition. We also perform an allocation of soft costs to any direct cost in each category to maximize your total benefits.
- Report preparation** | Our report complies with the IRS standards stipulated in the Audit Techniques Guide for Cost Segregation Studies.

“Experience in cost estimating and allocation, as well as knowledge of the applicable law, are other important criteria.”

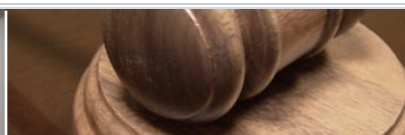
- Cost Segregation Audit Techniques Guide: Section 4.3



■ 1987

Revenue Procedure 87-56 provides class lives and recovery periods for assets.

The wide gap in MACRS recovery periods provides a strong incentive to reallocate costs of buildings placed in service as far back as 1/1/1987.



■ 1997-1999

Hospital Corporation of America vs. Commissioner (HCA): The most recent landmark case that provides legal support to use Cost Segregation Studies for computing depreciation.



■ 1999

Action on Decision (AOD) #CC-1999-008: the IRS acquiesced to the application of ITC principles in the HCA case. Later that year, the IRS Chief Counsel issued further guidance (CCA 19992145) supporting the use of Cost Segregation Studies.



■ 2004

IRS issues Audit Techniques guide which outlines the criteria of a quality Cost Segregation Study and provides direction to IRS field agents when reviewing a report that does not employ the methods suggested.

CASE STUDY



NEW CONSTRUCTION OF AN APARTMENT BUILDING

The best way to illustrate the direct financial benefits of a Cost Segregation Study is through the following case study:

A taxpayer constructed an apartment building for \$2.2 million and placed it in service in 2005. Initially, \$200,000 is identified for furniture and equipment such as stoves, dishwashers, and other appliances. The remaining \$2 million of project costs are treated as 27 ½-year property.

Assume the following:

- 16% of the construction-related costs should have been classified to a 5-year depreciable life, as identified by the Cost Segregation Specialist
- 9% of the costs should have been classified to a 15-year depreciable life, as identified by the Cost Segregation Specialist
- 41% federal and state tax rate
- 8% expected rate of return

Here is how the depreciation deductions would compare in the first 5 years with a Cost Segregation Study versus without a Cost Segregation Study.

The potential benefits derived from a Cost Segregation Study could be significant whether a company is adding a \$500,000 expansion or building a new \$40 million hotel. The benefits of a Study are magnified even more if it falls within the bonus depreciation time period.

To see what your Estimate of Savings may look like, go to www.costsegregation.biz to view our Savings Calculator

INCREASED DEDUCTIONS WITH A COST SEG STUDY VS WITHOUT A STUDY: FIRST 5-YEARS*

	WITH STUDY			Total Deductions	WITHOUT STUDY	Increased Deductions	After Tax Increased Cash Flow
	5- Year Reclass	15- Year Reclass	27.5- Year Reclass		Total Deductions		
2005	\$64,000	\$9,000	\$27,273	\$100,273	\$36,364	\$63,909	\$26,203
2006	\$102,400	\$17,100	\$54,545	\$174,045	\$72,727	\$101,318	\$41,540
2007	\$61,440	\$15,390	\$54,545	\$131,375	\$72,727	\$58,648	\$24,046
2008	\$36,864	\$13,851	\$54,545	\$105,260	\$72,727	\$32,533	\$13,339
2009	\$36,864	\$12,467	\$54,545	\$103,876	\$72,727	\$31,149	\$12,771

(* Taken from detailed Estimate of Savings)

Total: \$287,558 \$117,899

SUMMARY OF SAVINGS

Increased Depreciation Deductions Years 1-5:	\$287,558
After Tax Increased Cash Flow Years 1-5:	\$117,899
After Tax Increased Cash Flow Year 1:	\$26,203
Net Present Value After Tax:	\$75,919

EXAMPLE- COST SEGREGATION PRESENT VALUE SAVINGS ANALYSIS FOR AN APARTMENT COMPLEX

Project Cost (Less Land):	\$2,000,000	(* After FF&E Deducted)
Tax Rate:	41%	
Present Value Factor:	8%	
Current Tax Year:	2005	

Property Class	WITH A STUDY		WITHOUT A STUDY	
	Estimated Reclass	Depreciable Basis	Estimated Reclass	Depreciable Basis
5 Year Property	16%	\$320,000	0%	0%
7 Year Property	0%	0%	0%	0%
15 Year Property	9%	\$180,000	0%	0%
27.5 Year Property	75%	\$1,500,000	100%	\$2,000,000
		\$2,000,000		\$2,000,000

Year	WITH STUDY					Total Deductions	W/O STUDY Total Deductions
	5 Year	7 Year	15 Year	27.5 Year			
1	64,000	0	9,000	27,273		100,273	36,364
2	102,400	0	17,100	54,545		174,045	72,727
3	61,440	0	15,390	54,545		131,375	72,727
4	36,864	0	13,851	54,545		105,260	72,727
5	36,864	0	12,467	54,545		103,876	72,727
6	18,432	0	11,219	54,545		84,197	72,727
7		0	10,629	54,545		65,174	72,727
8		0	10,629	54,545		65,174	72,727
9			10,629	54,545		65,174	72,727
10			10,629	54,545		65,174	72,727
11			10,629	54,545		65,174	72,727
12			10,629	54,545		65,174	72,727
13			10,629	54,545		65,174	72,727
14			10,629	54,545		65,174	72,727
15			10,629	54,545		65,174	72,727
16			5,312	54,545		59,857	72,727
17				54,545		54,545	72,727
18				54,545		54,545	72,727
19				54,545		54,545	72,727
20				54,545		54,545	72,727
21				54,545		54,545	72,727
22				54,545		54,545	72,727
23				54,545		54,545	72,727
24				54,545		54,545	72,727
25				54,545		54,545	72,727
26				54,545		54,545	72,727
27				54,545		54,545	72,727
28				54,545		54,545	72,727
	\$320,000	\$0	\$180,000	\$1,500,000		\$2,000,000	\$2,000,000

BENEFITS OF A COST SEGREGATION STUDY			
Increased Deductions	Increased Cash Flow (aft. tax)	Present value of changes in cash flow	Year
63,909	26,203	26,203	2005
101,318	41,540	38,463	2006
58,648	24,046	20,615	2007
32,533	13,339	10,589	2008
31,149	12,771	9,387	2009
11,470	4,703	3,200	2010
(7,553)	(3,097)	(1,951)	2011
(7,553)	(3,097)	(1,807)	2012
(7,553)	(3,097)	(1,673)	2013
(7,553)	(3,097)	(1,549)	2014
(7,553)	(3,097)	(1,434)	2015
(7,553)	(3,097)	(1,328)	2016
(7,553)	(3,097)	(1,230)	2017
(7,553)	(3,097)	(1,139)	2018
(7,553)	(3,097)	(1,054)	2019
(12,870)	(5,277)	(1,663)	2020
(18,182)	(7,455)	(2,176)	2021
(18,182)	(7,455)	(2,015)	2022
(18,182)	(7,455)	(1,865)	2023
(18,182)	(7,455)	(1,727)	2024
(18,182)	(7,455)	(1,599)	2025
(18,182)	(7,455)	(1,481)	2026
(18,182)	(7,455)	(1,371)	2027
(18,182)	(7,455)	(1,270)	2028
(18,182)	(7,455)	(1,176)	2029
(18,182)	(7,455)	(1,088)	2030
(18,182)	(7,455)	(1,008)	2031
(18,182)	(7,455)	(933)	2032
\$0	\$0	\$75,919	

\$75,919
Total value of accelerating depreciation deductions and cash flow.



TAX PLANNING STRATEGIES USING COST SEGREGATION

As Cost Segregation Specialists and Real Estate Consultants, we not only have the engineering knowledge to conduct a quality study, but also the tax expertise to identify tax planning opportunities. Here are some brief examples of how a Study can be used in a variety of situations:

ESTATE TAX PLANNING

Cost Segregation within Estate Tax Planning creates “free money” by accelerating depreciation on the same property multiple times. In a community property state a family can take accelerated depreciation on the same short life assets up to three times by having a Study performed while both spouses are alive, after the first spouse is deceased, and after the second spouse is deceased.

PASSIVE LOSSES

By moving idle funds to pay down leveraged real estate, a taxpayer can turn non-deductible passive losses into passive income, which done in conjunction with a Cost Segregation Study can provide immediate tax savings.

NET OPERATING LOSSES

Taxpayers that are deemed to be ‘real estate professionals’ for IRS purposes can create losses on their rental properties through the use of a Study. These losses can offset other types of income. If a net operating loss is created, the taxpayer can carry their losses back to prior years, recovering previously paid tax.

LIKE-KIND (1031) EXCHANGES

By either conducting a Look-Back Study on the old property, or performing a Study on the acquired property, a taxpayer can create additional tax deductions that create an opportunity to take cash out of an exchanged property while mitigating the impact of the income created by the “boot.”

SECTION 179/ BONUS DEPRECIATION

A Study works well in conjunction with other depreciation rules. A newly constructed asset with a life of 20 years or less that is placed in service within the allowable time frame, will qualify for bonus depreciation. Therefore, a Study can create a significant increase in bonus depreciation deductions. Also, shorter-lived assets that qualify as 1245 property will typically create more benefits under the IRC Section 179 provisions.

LEASE PROVISIONS TENANT IMPROVEMENTS

When a tenant enters into a lease agreement and receives allowances for improvements from the landlord, it is important to address which costs the improvements are covering. A landlord will want to allocate the allowances to shorter-lived assets whereas a tenant will want the allowances allocated to structural components so that out of pocket costs go to pay for shorter lived assets.

FIXED ASSET STUDIES

Similar to a Cost Segregation Study, a Fixed Asset Study evaluates a company's assets and assigns the appropriate tax lives to misclassified assets. While a Cost Segregation Study focuses on buildings, a Fixed Asset Study encompasses all fixed assets a company owns. This results in immediate and substantial cash flow by accelerating deductions on assets that were previously placed in service with improper tax lives.

A proper Fixed Asset Study requires not only tax expertise, but also an understanding of engineering and construction concepts. KBKG's team of qualified engineers visit client locations to inspect and photograph assets, identify their use and function, and review supporting documentation including purchase orders, invoices, and blueprints. Our team then calculates the "catch-up" adjustments using our proprietary software. Our deliverable is a comprehensive report that includes all required documentation per IRS guidelines including technical memos, supporting case law, detailed schedules of assets, and cost records for reclassified property. KBKG's thorough analysis ensures that all assets are accurately classified in order to optimize tax savings.

ABANDONMENT STUDIES

An Abandonment Study is an expanded Cost Segregation Analysis specifically for non-residential income producing properties (leased properties). Not only does an Abandonment Study provide the benefit of quicker depreciation deductions, but also the advantage of writing off any "structural" components that are removed when new tenants move in.

The benefits of an Abandonment Study are even greater than those of a Cost Segregation Study. The value of disposed "structural" components are generally the highest costs spent in any given suite. Owners who are not appropriately writing these off are simply leaving big dollars on the table and paying excessive tax. An Abandonment Study allows owners to claim these losses and significantly increase tax savings.

PRE-CONSTRUCTION CONSULTING

We understand the value and savings a Cost Segregation Study brings an investor upon the purchase of a building. We also understand the importance of making sure a Study is performed in the most effective and efficient way possible. Proper planning through Pre-Construction Consulting cuts our time and costs and enables us to identify a greater percentage of shorter-lived assets. This increased efficiency allows us to pass these savings along to our clients. Our Pre-Construction consultants ensure that tax benefits are taken within the optimum time frame and that the cost of a Cost Segregation Study is minimized.

PARTNERING OPPORTUNITIES

Our Partnering program allows CPA firms, attorneys, and other real estate professionals to take full advantage of Cost Segregation Studies by offering these services to their clients. Whether a firm simply wants to work with us in referring a client, or start up their own Cost Segregation line of service, we can help. For information on Partnering opportunities, please feel free to contact us at (626) 449-4225.

KBKG Partnering Opportunities

At KBKG, we partner with other professionals to help offer Cost Segregation Services to mutual clients.

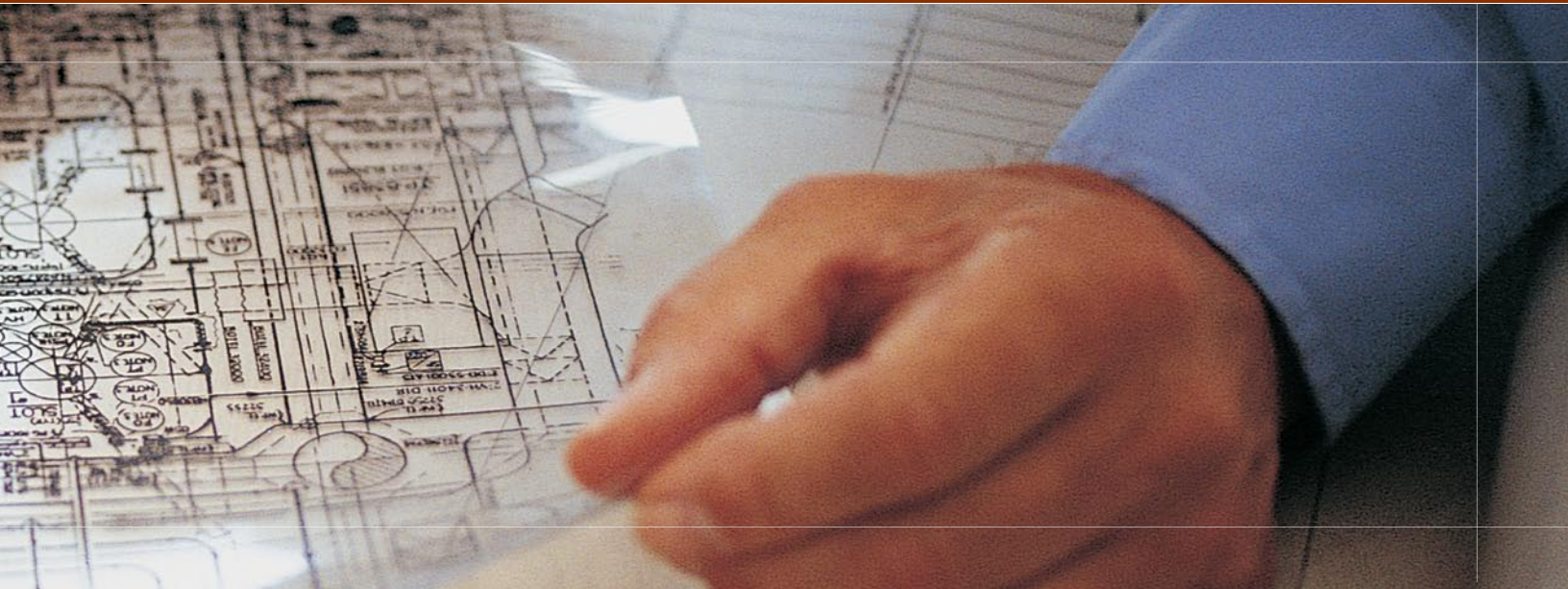




KBKG, Inc. is a consulting firm specializing in Cost Segregation Studies. Our origin dates back to the 1940's through our affiliated accounting practice that was founded in Pasadena, California. Our firm offers a unique combination of heritage, vision, and teamwork. We provide a variety of services to real estate owners, Certified Public Accountants (CPAs), and other consultants.

We emphasize recognizing opportunities and providing value to our clients. The strength of our firm is in understanding the complexities of taxation and construction engineering. Over the years we have used our experience and expertise to take advantage of ever changing tax laws for the benefit of our clients.

- EXPERIENCE** | KBKG has performed hundreds of Cost Segregation Studies, Abandonment Studies, and Fixed Asset Studies throughout the United States.
- EXPERTISE** | With over 60 years of tax expertise, through our affiliated accounting firm, our combination of tax and engineering knowledge makes us uniquely qualified to perform Cost Segregation Studies. Our team of specialists includes engineers, construction specialists, and tax experts. Through our affiliated accounting firm, we have the ability to identify and resolve any tax issues that may be affected by a Cost Segregation Study.
- EDUCATORS** | We hold numerous educational seminars on Cost Segregation throughout the year for CPAs, attorneys, property owners, and other real estate professionals. Please contact us if you are interested in attending our next event.
- VALUE** | At KBKG, our focus is to bring value to our clients. Through detailed work, high quality studies, and timely completion of projects, we ensure our clients' satisfaction and create significant tax savings. Our experts proactively identify other savings opportunities that may exist in relation to property such as Fixed Asset Studies, Property Tax Savings, Abandonment Write-offs, Pre-Construction Consulting and more.
- QUALITY** | Our service conforms to all IRS criteria for a quality Cost Segregation Study stipulated in the Cost Segregation Audit Techniques Guide.
- PARTNERING** | We understand the importance of a client's relationship with their CPA. We do not want to substitute that role, but rather foster strong relationships with CPAs and other real estate professionals to maximize the value we bring to a client.



Our goal is to bring value to our clients by providing quality service, building long-term relationships, and ensuring a high standard of professional ethics.

We strongly believe that the best affirmation of our abilities comes from other professionals and our clients.

“Prior to being introduced to cost segregation, I paid too much in income taxes. KBKG, Inc. has done five or six studies on my various holdings over the last several years and has saved me tremendous amounts of tax. I usually am wary of recommending professional services but I do not hesitate referring KBKG, Inc.”

*- Dave Howard
HH Armistead & Co.*

“We assumed our prior accountant had allocated our costs of construction of our restaurant in a way to best accelerate our deductions for the improvements. Thus, it came as a surprise to find out that very significant costs were being depreciated over unnecessarily long periods of time. We likely would have had to replace items well before the end of the initially claimed depreciation periods. We were pleased to find that KBKG was able, even retroactively, to significantly accelerate our depreciation expenses.”

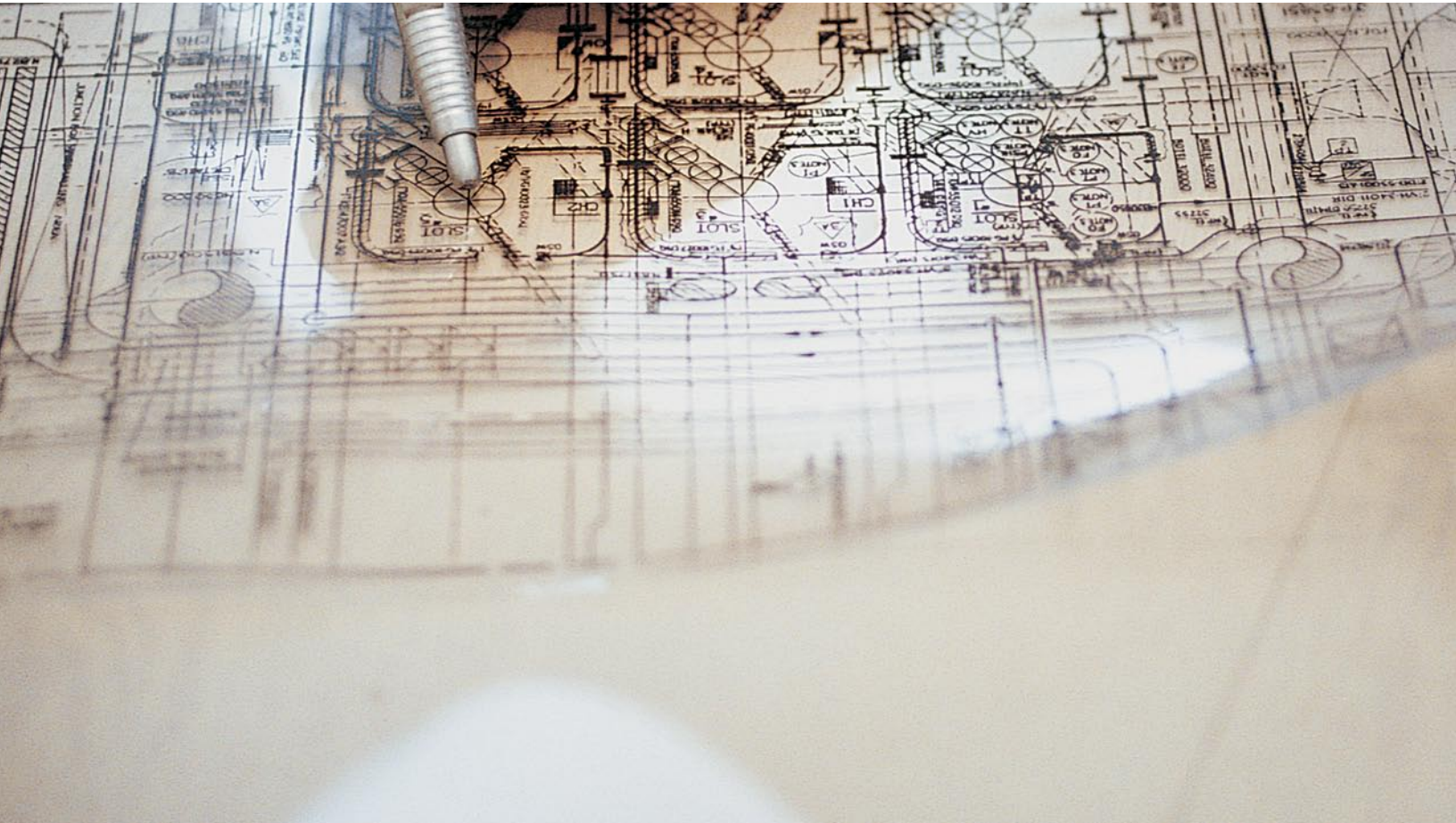
*-Bob Kull
The Lobster Restaurant*

“We have worked with KBKG on several cost segregation projects and have been happy with the service and knowledge they offer. Cost segregation has been a tax planning tool we have used with many clients to dramatically decrease their tax liability. KBKG’s engineering and tax expertise has added value to the service we bring our clients. Our clients are happy with their tax savings and we are happy to work with KBKG.”

- Steven M. Berkson, CPA

“When KBKG first brought up the benefits of a Cost Segregation Study, we were skeptical. But after researching the issue, we realized that this was a tool widely used by Fortune 500 companies to accelerate depreciation. With KBKG’s help, we dramatically increased our depreciation expense, which significantly reduced our tax liability.”

*- Craig Hofman
Hof’s Hut & Lucille’s BBQ*



KBKG, INC.
COST SEGREGATION SPECIALISTS
AND REAL ESTATE CONSULTANTS

719 East Union Street
Pasadena, CA 91101
(626) 449-4225
fax: (626) 449-3324
www.costsegregation.biz
info@kbg.com