

Choosing a Cost Segregation Provider

Caveat Emptor / Let the Buyer Beware

By Conrad Jennings

I have personally done over 1000 cost segregation studies over my 14 plus years in this business and have been the quality control check for countless others. Over the past few years I have seen numerous cost segregation studies, done by other providers, and have been, to say the least, very disappointed and disturbed by what they are selling as a cost segregation study. The amount of money that they are charging for this inadequate work, which will not stand up to IRS scrutiny, is criminal. Look, most people will spend countless hours researching which car to buy or TV is the best but will take a web page describing a particular cost segregation provider at face value. Remember a web page can say anything, whether true or false, so please as a potential buyer of these services ask a few simple but important questions before you sign a contract with any provider.

Should you choose a cost segregation provider based on reputation?

- The thing to remember here is that just because a provider has been in business for many years does not mean that they have maintained a quality staff and/or product. If a provider has done nothing to retain quality personnel and keep them current or does not constantly re-evaluate and update their product than you may want to look elsewhere.
- If you currently work or have worked in the past with a specific provider it would still be a great idea to ask these same questions of them. They may look the same from your perspective but behind what you see may be something totally different.

How many cost segregation studies have been done by the provider and the individuals who perform their work?

- The number of studies is important but it is also important to know the size and type of properties that they have done to see if they have a wide experience base. No two properties will be exactly alike. There is always some differential that needs to be evaluated with every property whether it is in the cost documentation, the site work requirements or the specialty requirements of a specific client.
- An experienced cost segregation specialist can do about 60 to 75 engineering-based studies per year depending on the size and complexity of the projects. With some basic math you can get a rough idea of how many studies a firm might have performed – assuming maximum capacity and assuming they are being truthful about their number of years in business and the number of qualified employees they have.
- As with the accounting industry the cost segregation world follows the same tax filing calendar so there are production and work load peaks and valleys to keep in mind.

Does the cost segregation firm have degreed engineers on staff?

- The IRS stresses in the Audit Techniques Guide that an engineering-based study is best. However, many firms believe that strictly by having an engineer on staff that they give credence to their studies. It takes many years of actually doing studies and dealing with the accounting requirements and tax laws related to cost segregation to get a firm grasp of what it takes to produce a quality cost segregation study and report. You will also find firms saying that they have engineers on staff when in truth they do not.
- Check the credentials of the firm and of the people who are actually doing the work. You may find that although their title has the word engineer in it, they are not actually engineers at all.

What cost segregation methodology does the firm use?

- Although the IRS strongly suggests the use of the engineering based study they do not specifically refute other methodology approaches. However, the IRS does require adequate documentation related to a study and the engineering approach provides the best defense against audit issues. Start by asking what methodology they use. If they can't answer the question, or you discover that they use a residual or rule of thumb method you should probably look elsewhere.
- The residual method is an abbreviated method in which only short-lived asset costs (e.g., 5, 7 or 15 year property) are determined. These assets costs are added together and then subtracted from the total project cost. The remaining or "residual" cost is then simply assigned to the building and/or other long-lived

assets. Although this method is simpler and less time consuming (and therefore usually done at a much lower fee) than the engineering approaches, it is also less accurate. The residual study is relatively easy to identify by looking at a sample report. Simply look for single line items for the 39 or 27.5 year components of the property (usually labeled as “building” or by a standard construction category). If you see these items you can be assured that the IRS will as well.

- Verify that the company uses a detailed engineering approach which gives a detailed account of ALL building components, even the 39 and 27.5 year components that do not qualify for accelerated depreciation. Not only will you lower your risk in the event of an audit but you position yourself for additional tax write-offs (possible retirement of asset) if you ever renovate or remodel the property in the future.
- Methodologies that yield accurate cost allocations expedite the Service's review, saving time and resources for taxpayers, practitioners, and Service examiners alike. A study that is both accurate and well documented is considered (in the Audit Techniques Guide) a “quality” cost segregation study.

How do you determine your fee?

- Cost segregation engagements should be quoted on a fixed fee or hourly rate.
- If the provider is charging a contingency fee or an upfront fee, say “No Thanks”. The IRS ATG specifically states, “Examiners should closely scrutinize studies performed on contingency fees.”

How will the firm defend its work in the event of an audit – if at all?

- Is there an additional expense for this service?
- If a company does not offer audit defense as part of their services I would probably question why they don't. Are they not confident of their work? Are they outsourcing their work?

Does the firm perform site visits for all cost segregation projects?

- As stated in the Audit Techniques Guide Chapter #3. The detailed cost approach (Engineering Based Study) includes the following activities:

3) Inspect the facility to determine the nature of the project and its intended use.

4) Photograph specific property items for reference. Request if needed previous site photographs that illustrate the construction progress as well as the condition of the property before the project began.

Are you able to provide references that we may contact?

- Confirm with the referenced client that the company performed their services as described and if they would use them again in the future?

Do you outsource any of your work?

- Outsourcing is more common than you might think and begs the question; How do you control the quality and consistency of your work. How can an individual do quality control if they don't stay current by doing cost segregation projects on a regular basis themselves? This being said the evaluation of the production procedures and product is then left to an outside source.

If you are doing your research like most people do by using the web please keep in mind the following:

- * If an individual within a firm says they have 25+ years experience or the firm as a whole says they have 100+ years of combined experience in cost segregation than keep in mind that cost segregation as we know it today really didn't begin until 1997 when the Hospital Corp of America court case effectively reinstated a form of component depreciation for certain building support systems, such as the electrical and mechanical systems that directly serve tangible personal property. This ruling against the Service primarily concluded that the enactment of ACRS in 1981 did not redefine 1250 property to include property that had been 1245 under ITC rules. Experience in the actual performance of cost segregation studies since 1997 and the consistent and ongoing education related to the constant tax law changes affecting the cost segregation industry are a much better gauge of the qualifications of an individual and a firm.