SC&H GROUP

Expertise that Works

COST SEGREGATION ACCOUNTING ADVANTAGES FOR MULTI-STATE DISTRIBUTION CENTERS

Client Situation & Challenge

A multi-billion dollar European manufacturing company's distribution capabilities in the U.S. were starting to fall behind those of their competitors. The competition was in a position to respond faster to fulfillment requests, and several of the company's major clients were at risk as a result.

In an effort to enhance operations and regain competitive positions, U.S. distribution center enhancements were executed including extensive property renovations, and upgraded equipment. After completion, a cost segregation study was ordered as a means to preserve cash flow and defer Federal and state income taxes. The objective was to segregate the construction costs of the renovation, and the purchase price of the new equipment out of the building and into personal property tax categories. This would afford the company more options and flexibility in deciding when and where to allocate capital with increased cash flows to finance further distribution center improvements. Properly classifying all costs into the correct categories would help the company maximize depreciation deductions, recognize lower tax burdens, and increase after-tax cash flows. Yet, the challenge was that all the details and costs pertaining to the property renovation and equipment costs were not readily available. Uncovering the data and reclassifying the assets would require the advice of experienced cost segregation experts.

Cost-segregation studies require a detailed analysis of all project costs and documentation by specialists with in-depth knowledge of the current tax laws. After considering many national firms, the company turned to SC&H as the trusted advisors to work with their tax department to execute the studies.

Cost Segregation Expertise

The first matter of business was to review all of the tax depreciation schedules for each distribution center. From these, SC&H was able to determine which property renovations qualified for a shorter tax recovery period.

The next step was to identify all items associated with the distribution center renovations including the general contractor's application for payment, construction invoices, change orders, and mechanical, plumbing, and electrical drawings. SC&H uncovered that the construction items lacked the detail specific to each area of renovation. The contractor, as an example, had a total electrical cost of one million dollars in his contract that was not specific enough for cost segregation purposes.

Since the tax treatment for two identical assets may differ based upon several factors (use, manner of attachment, and function), an inspection of the facility was in order. This helps to fully understand an asset's use and condition, as well as to gather information that further supports the classification of capitalized costs into their appropriate tax class lives.

SC&H then conducted a detailed review of the construction drawings. Items supporting the renovations qualifying for shorter lives were identified. SC&H advisors calculated costs estimated the percentages of the applicable construction spend that would qualify under IRS regulations for inclusion in the reclassified costs.

Results Achieved

All told, SC&H reviewed $13 million in construction costs associated with distribution center renovations. The teams identified $3.7 million in real property that warranted reclassification from a 39-year useful life, down to 15, 7, and 5 year useful lives for tax purposes. This resulted in $600,000 of net present value savings. The study resulted in additional depreciation deductions of $2.5 million in the first 5 years.

SC&H Group's integrated approach saves both personal and real property if reviewed in conjunction with cost segregation studies. This assignment, and the order of magnitude of client savings realized, is fairly standard. SC&H worked with internal accounting at each distribution center to ensure all reporting structures were updated to continue capturing reclassifications that result in significant tax savings.

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