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Arcane Income Tax Tip by Patrick O Connor

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Sam sold 2 commercial properties in June 2008 and was discussing tax planning with his CPA and cost segregation provider. The sales price for the properties was $5.2 million and $3.3 million. Sam had owned both properties for about 8 years. The cost segregation specialist estimated Sam could save more than $175,000 in 2008 income taxes. This would be accomplished by using cost segregation and â€œcatching-upâ€• previously under-reported depreciation.

Sam has passive income from oil and gas investments and from his real estate. Sam is in the property management business and is actively involved in managing his real estate investments. Samâ€™s net income from his management company is about $400,000 per year. The fascinating question is, how does Sam reduce his income taxes by over $175,000 after he sold the properties?

Tax Rate Arbitrage

Sam is benefiting from tax rate arbitrage. The income tax rate for Sam on ordinary income is 35%. His capital gains rate is 15%. Sam did not obtain a cost segregation study when he purchased the properties 8 years ago. Therefore, he has been reporting too little depreciation and unknowingly paying excessive income taxes. By claiming the depreciation on his 2008 tax return, he is able to use the additional ("catch-up") depreciation to reduce ordinary income, just as if he had claimed the depreciation during the prior 8-year period.

The preliminary cost segregation analysis indicated Sam had understated real estate depreciation during the prior 8-year period by $885,000. The tax rate arbitrage between ordinary income tax rate (35%) and the capital gains rate (15%) is 20%. Sam can reduce his 2008 income taxes by $177,000 ($885,000 times 20%) by claiming the depreciation not used in prior years. (Precisely correct calculations are more complex but the end result is very similar.)

What is Cost Segregation?

Cost segregation is simply an accurate way to allocate the cost basis of real estate and establish a depreciation schedule. The real estate depreciation schedule is often established by allocating a portion of the cost basis to land and allocating the balance to a long term depreciation recovery period (27.5 or 39-yr straight-line depreciation). Cost segregation fine-tunes the depreciation schedule by identifying short-life items. These can generally be depreciated over 5, 7 or 15 years. In preparing a cost segregation report, an appraiser or engineer will visit the property and identify, quantify and evaluate the quality of various types of short-life property. After the site visit, the appraiser will literally establish a beginning cost basis for each of the short-life items, as of the acquisition date. In a typical engagement, there may be 35 to 50 types of short life property items depreciable 5, 7 or 15 years.

What are the Short-Life Items?

Some of the common short life items are carpet, vinyl tile, blinds, landscaping, fencing and paving. Others, more unassuming, are underground utility infrastructure, storm sewage, specialized plumbing and electrical, etc.

Cost Segregation Myth

Many real estate investors and even some tax return preparers believe cost segregation simply defers income taxes. Their concern is they will be creating an excessive tax bill when the property is sold. However, the concern is unfounded. Cost segregation provides a net reduction in income taxes (based on the difference between the ordinary income rate and the capital gains rate). While that the tax payer is deferring taxes at ordinary income tax rates, he is only increasing taxes, at the time of sale, at capital gains rates. The net benefit is roughly 20% of increased depreciation in total tax reduction.

Of course, using cost segregation when a property is sold does not include deferral benefits. However, it includes substantial tax reduction benefits based on the catch-up depreciation.

Unknown Tax Tip

Depreciation understated in prior years can be claimed in the current year without filing any amended income tax returns. In addition, the net depreciation not reported in previous years can be claimed in one year. This is a fairly recent development established in Rev. Proc 2001-19. Depreciation adjustments used to be divided evenly over 4 years.

Under-reported depreciation is reported in the current year ("Year of Change") using form 3115 (change of accounting method form). The 3115 form, for cost segregation purposes, has been designated by the IRS as an "automatic consent" change of accounting method.

Simple Example

Sam obtains cost segregation reports to document the 5, 7 and 15 year property in his recently sold properties. The cost segregation reports indicate Sam understated depreciation in prior years by $885,000. This additional depreciation reduces Samâ€™s ordinary income taxes and increases his capital gains taxes. Ordinary income taxes are reduced by $309,750 ($885,000 times 35%). Capital gains taxes are increased by $132,750 ($885,000 times 15%). Net tax savings are $177,000 ($309,750 less $132,750).

Is this Legal?

Absolutely, since Sam voluntarily made a loan to the government of $177,000. Sam loaned Uncle Sam the money by overstating his net income, because he was understating his real estate depreciation. Sam certainly would have never intentionally lent the US government money for 8 years at 0%. The only thing worse than making Uncle Sam a 0% loan is letting him keep the principal.

Why Didnâ€™t My CPA Recommend This?

Federal income tax law is complex; there are many nuances. It is accurate to say no single person is an expert on all aspects of US income tax law. Cost segregation has also changed substantially over the past 10 years. It used to cost $20,000+ for a simple cost segregation study. In addition to lower costs, the benefits of cost segregation have become better understood. However, there are still income tax return preparers who believe cost segregation simply defers payment of income taxes.

In addition, the writer believes remuneration for tax return preparers is ill conceived. They are paid a flat fee to complete the forms. Other than client retention, there is limited incentive for a tax return preparer to focus on tax reduction. The remuneration issue is compounded by the peak work load prior to the tax filing deadline. Clients want to visit with the tax return preparer when he is processing his peak load and is least able to give focused attention to individual clients.

Does This Make Sense for Me?

You need to answer a few questions to determine whether getting a cost segregation study will reduce your income taxes. The first question is whether you are paying income taxes. (It is hard to reduce taxes below $0.) The next issue is the type of income. Is it passive or ordinary. If it is ordinary income, can you claim the depreciation as someone who is â€œmaterially participatedâ€• in operating the real estate or as a real estate professional. Additional depreciation can definitely be used to offset passive income. Materially participated is a term of art. Consult your CPA or tax return preparer on this issue. There are also limitations related to your at risk basis. You can deduct depreciation to offset ordinary income if you are a real estate professional. In broad terms, this means your day job is related to the real estate business. This would include real estate brokers, mortgage brokers, title company staff, real estate attorneys and others.

The next step is to determine how much additional depreciation can be generated and the net consequences of the additional depreciation. An experienced cost segregation advisor should be able and willing to provide both a preliminary analysis of the additional depreciation, evaluate the income tax consequences, and evaluate the capital gains consequences. That will provide the information you need to make an informed decision.

Conclusion

The byzantine US Income Tax Code is too complex for any person to understand entirely. A lower tax rate and fewer deductions would benefit taxpayers and the economy. However, for now, the tax code is voluminous, has convoluted rules and tortuous logic. Legally reducing your income taxes is possible. However, it requires planning and a team effort.

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Oâ€™Connor & Associates is a national provider of commercial real estate consulting services including a cost segregation, a http://www.protest-brazoria-county-property-taxes-appraisals.com/Federal_Tax_Reduction/index.cfm>federal tax reduction ,due diligence, renovation upgrading cost analyses, tax return review and apartment inspections.

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