the property owner's guide to cost segregation

Learn how accelerated depreciation can lead to significant tax savings

engineered
TAX SERVICES

discovering hidden treasures for real estate investors

The old tax law met the new tax law December 26, 2017. One year later, every tax benefit afforded to real estate investors has changed significantly and in a very good way.

“The Property Owner’s Guide to Cost Segregation” was written to provide insight into the tax benefits available for real estate investors at a Federal, State and Local level and how these benefits can be used to preserve wealth for property owners and prompt you to ask your CPA what is the best way to use the old/new tax codes to maximize real estate return on investment.

As a leader in the tax reform field, Julio Gonzalez, National Tax Reform Expert and CEO of Engineered Tax Services Inc., and its team provides a range of specialty tax solutions designed to maximize return on investment for real estate owners, including cost segregation, federal & state energy incentives, the disposition of assets, and the proper handling of tangible property as they relate to recent federal tax changes. His team works with real estate investors and their CPAs to maximize ROI by using best in class tax advantages.

disclosure

preface

This book is written for professionals that currently own or seek to own properties and want to take full advantage of their rights to tax incentives. My role in this industry is to educate and produce the most valuable cost segregation studies for each property we survey. My team of directors, engineers and consultants provide first-hand expertise and have over 300 years of combined tax education and industry knowledge. As our nation continues to face a fast pace in economic growth, what I have discovered is that very few individuals have an in depth understanding of this particular benefit within the real estate commercial world.

In order to provide an upper hand on the techniques that can provide substantial benefits to a property owner, this book will highlight the basic knowledge required to understand the importance of a cost segregation study and all the other tax incentives vital to real estate investors. The objective of this book is to give insight, resources and additional opportunities to property owners by bringing to light how to utilizing their current assets at hand.

In preparation for this book, my team and I reviewed other cost segregations books currently in print. Many of them are valuable and worth reading; they provide valuable quantitative statistics, research, and case studies in a few instances. Many books present only one perspective, opinion, or angle on a topic or industry. By researching the best written books on cost segregations, speaking to top professionals in the field, and sharing our gained experience, we aim to provide the most thorough book on cost segregation.

We have conducted case studies including assets, for professional football stadiums, fuel stations, office buildings, medical facilities, warehouses, hotels, and many other commercial properties. Our team has provided our services to property owners with a single property to billionaire families who control over 200 properties in their portfolio and require an extensive cost segregation study.

Our focus and commitment is to our clients. Inn writing this book, our goal is and continues to be in providing the educational knowledge you seek on cost segregation.

Your dedicated partner,

Julio Gonzalez

Julio Gonzalez, National Tax Reform Expert
CEO, Engineered Tax Services

contents

chapter 1

Introduction to Cost Segregation

foreword

In 2013 when I entered the family office space by working directly for a Patriarch who made his money in real estate, I came to understand the importance of educational information not only for regular real estate investors, but even more so for the wealthiest of individuals and family offices. Even the most successful people financially can learn new ways to save money on taxes or to increase their investment returns. By understanding this need for education among the top 1%, I created first the Family Office Real Estate Institute, then The Family Office Guide to Commercial and Investment Real Estate, and now The Family Office Real Estate Magazine to provide just that.

Along the way, I have even shared direct information to Family Offices and their Patriarchs on various real estate strategies, and it was from this that I came to understand the real benefit and needed information on Cost Segregation.

I had shared an overview from Julio Gonzalez, whom I had met in my travels due to his expertise and stature in the community, and the response was pretty astonishing. The number of families wanting more information was substantive surrounding wishing to know more about cost segregation. It is because of that demand that I was ecstatic to know that Julio Gonzalez, CEO of Engineered Tax Services was putting out a book that would go into detail on cost segregation, its many benefits and how to maximize the opportunities that it creates.

Real Estate has created significant wealth for many people, in not only a primary area of wealth creation but also secondary areas of wealth creation. Real Estate can also be one of the most valuable tools for an individual or family office to create substantial wealth for future generations. Tax Savings for Real Estate – Wealth Creation and Preservation Through the Knowledge of Real Estate Taxation provides an in-depth, easy to understand roadmap to clearly understand how to maximize your real estate investments for generations to come. Julio provides his extension knowledge that not only he has, but also his organization Tax Engineered Services in a way can be used in practice.

From my time knowing Julio and seeing first-hand how his expertise has helped so many, it is no wonder he is an advisor to the White House on real estate and taxation and was able to play an integral role in helping shape our countries real estate tax laws coming into the 2018 tax year.

Of the books that are suggested through the Family Office Real Estate Institute, this is a must have for any real estate investor, and especially for family offices that are interested in maximizing their wealth creation and preservation in real estate.

DJ Van Keuren

The biggest tool in the real estate investor tax toolbox is cost segregation.

It is not the only tool just the best one. Cost segregation before tax reform was good. After tax reform, cost segregation became great! Let's dive into cost segregation and then we will go over many, many other tools for you the real estate investor.

As the real estate market continues to soar, property owners are educating themselves on tax tools like depreciation, in hopes of finding ways to help reduce their costs. Cost segregation increases cash flow in the form of a deferral by utilizing short class lives to accelerate depreciation on commercial real estate property. First of all, why is investing in Real Estate such a good investment. The answer is simple. It is one of the very few investments in the United States that you get to fully expense. If you buy an investment property for $1,000,000, you get to expense a $1,000,000. You can't expense a stock. You can't expense a bond. You can expense investment real estate. So in reality you are getting a 50% return already if your tax rate for both federal and state taxes is 50%. Amazing.

Now, in the United States tax code, you can depreciate your real estate investment over a 27.5 to 40 year period based on property type or you can do a cost segregation study to expense the building by components. In essence, a cost segregation study determines for the IRS the amount of the building that in non-structural in nature. This would be considered tangible property that under the new tax code can be expensed immediately. Talk about preserving wealth. You could buy a building, determine through a cost segregation study that 30% of the building is tangible property and take an immediate deduction on your tax returns of 30%. Sounds too good to be true but the reality is it true and it has been around for a long time. **Let's go into more detail now.....**

Every commercial property has value and over time that value lowers due to normal use and deterioration. A tax deduction called depreciation reflects this loss of value over time and allows a property owner to recover the cost of wear and tear. A cost segregation study is an engineered analysis, which will account for of all costs associated with a commercial property, to help classify certain components into personal property versus items in categories that impose between a 40 to 27.5-year depreciation. This process of accelerated depreciation, will provide the necessary tools to significantly decrease a property owner's income tax liability. Cost segregation is just one way to ensure all the necessary tax benefits are properly identified and applied; therefore, freeing available cash flow on a balance sheet. Under the current tax laws, this method differentiates real and personal property in an asset's accounting balance sheet. This process aids in future benefits via dispositions, repairs, routine maintenance and overall asset management. Additionally, the tax savings can be reinvested into the property and seen as net present value.

Whether newly constructed, purchased or renovated, the components of your building may be properly classified via this process.

Added Tax Benefits of Cost Segregation

- Identifying repairs & maintenances expenses
- Identifying disposition expenses
- Reduction in your current tax liability
- Immediate increase in cash flow
- Insurance savings
- Minimization of recapture upon sell of the asset

The chapters within this book will offer great insight into the added benefits of cost segregation and many other real estate tax benefits not name cost segregation. It is important to stay up to date with all federal government and IRS laws and regulations.

Mr. President Trump kept his tax returns confidential. Why? Why wouldn't he? People suspect he didn't pay taxes. My guess is that he preserved his wealth and mitigated tax by using cost segregation studies. Cost segregation studies allow real estate investors to expense a good portion of their real estate investment immediately. The study details for the IRS the percentage of the real estate property which is non-structural in nature. This typically equates to 30 to 50% of the building costs which under our new tax code can be immediately expensed.

Ok so we know President Trump bought a lot of property over the past few decades. Let's go over an example of how this would work. President Trump buys an Office Building. Let's say he acquires the building for $90,000,000. Now, President Trump orders a cost segregation study. The study determines that the non-structural components of this building equal $30,000,000 of the purchase price. What does this mean? Well, it means that $60,000,000 of the value is deemed structural in nature and that portion is depreciated (expensed) over 39 years. However.....and this is the magic...is that $30,000,000 is now expensed immediately. This is $30,000,000 in expenses that he will use to lower his tax payments for that year. If he buys more real estate then guess what....more expenses. So many expenses from buying so much real estate that it likely brought his taxable income down to zero.

He understood the power of real estate and "me too". I don't buy $90,000,000 buildings but the economics apply the same if I buy a million dollar apartment complex. That purchase and the cost segregation study will likely generate $300,000 in tax write offs for that year.

I could buy stock...but I can't expense that. Bonds? Can't expense. Funds? Can't expense. The gift of real estate. You buy it, you get to expense it, it generates income and hopefully appreciates in value. You combine investing in real estate with the power of expensing the building with a cost segregation study is magical. Who wouldn't do this. My guess is that this is exactly what Mr. President did. It sounds simple. And it is....really simple.

Does it mean that the President didn't pay taxes. He definitely did. Real estate taxes, payroll taxes, licenses and other related tangible taxes. He likely used the tax code to his advantage but his advantage likely created a ton of jobs and brought back buildings and communities that were in dire need for a boost. Take the Trump Hotel in DC. The old DC Post Office. The building sat vacant. A beautiful, historic building in decay. A building not generating taxes for DC and not generating income and jobs for the community. Walk in the hotel now. Stunning. Thousands of jobs created from one of the most beautiful hotels in our Country. The taxes it generates from property tax, sales tax, hotel tax, food tax and income tax are substantial. Sure President Trump used savvy tax laws to help him accomplish this and a cost segregation study to take the expenses up front. Would it look bad to the average person who would see a big write off on his tax return. Likely more than 50% of the US would feel that way. Was it ultimately amazing for the community and does it actually yield significant tax to the system with jobs to the area. 100%. Feels like an "Art of the Deal" type of plan. Definitely.

The nice lesson here. Buying real estate and taking advantage of a cost segregation study and all the other benefits of investing in real estate are not just available to the "Rich". They are available to all.

the history of cost segregation

In the past, a building was treated as a single asset where each of the internal components that made up the building, were all calculated as one single asset value that was depreciated over 39 years. This meant that over the term of 39 years, the tax deductions would remain exactly the same year to year. However, we all know that most components within a building do not last 39 years such: as carpeting, lighting, heating, cooling systems, landscaping and land improvements. It is tax inefficient to depreciate an asset over 39 years that will be disposed over a 5-year period or less. Treating the building under this traditional depreciation method makes it difficult to manage your cash flow.

In 1962, the Investment Tax Credit act was enacted to increase interest in investments and reduce recession and inflation. Since then, this legislation has been changed and re-interpreted many times.

monumental case

The Hospital Corporation of America v. Commissioner: The monumental case to provide the largest impact on cost segregation was in 1997, when court concluded that for certain assets the possibilities to accelerate the timing of depreciation shall be further expanded. After the ruling, with the accelerated method of utilizing 5, 7 or 15-year rates of depreciation, certain costs are now classified as personal property or land improvements. Without segregating costs, these assets are imposed to a 39-year or 27.5 –year depreciation rate for each expense, which result in a much higher tax liability.

Short-term asset segregation of building components that are non-structural in nature include, fixtures, flooring, cabinetry, internal piping, landscape, parking lots, land improvements, mechanical systems, lighting systems, special electrical work and building finishes. When a proprietor segregates these assets from the structural portions of the building, cost segregation can become a powerful tax- planning tool for maximizing tax deductions that lead to great wealth preservation by managing a property owners investment in the most tax efficient manner.

Today, property owners are recognizing additional tax benefits by applying cost segregation studies in different situations, including the purchase of a new property, new facility constructions, renovations, or expansions of existing buildings. Real estate companies, franchisers, business owners, and high net worth individuals are now using these studies with many properties within their portfolios.

Not all properties will qualify for depreciation deductions so it is important that all parties understand the process.

Studies with the highest yield in benefits are typically those properties that utilize land improvements and site renovations such as hospitals, hotels, manufacturing facilities, supermarkets and restaurants.

The IRS regulations relating to tangible property were issued in September 2013 and provided for additional write-offs for most taxpayers. It is important to have a team of specialists that can assist in creating required capitalization policies and identify expenses for repairs and maintenance to reduce tax liability and improve cash flow.

property sales and state tax

How a property is classified and the situation of the dwelling dictates how the cost segregation study will be formalized and how many credits or exemptions are found. The Internal Revenue Service has laws in place that allow buildings, land improvements, and tangible personal property items to be depreciated as the establishment goes through wear and tear. As buildings reach the point of needing improvements or new buildings are put into thought; qualified experts in design and construction play an important role in cost segregation. These qualified experts provide the correct auditing to utilize the appropriate rate of depreciation for each valid component within the building, therefore providing more property tax incentives.

Depending on the state of the property, the property may also qualify for state tax deductions or credits which can be identified with a thorough cost segregation study.

Whether a cost segregation study is formulated for a property in the early development stages or for a long standing historical property; this book will review many different aspects of cost segregation. By allowing the proprietor to expense repairs, maintenances, and dispositions as they improve the building, a cost segregation engineered tax study will provide the additional tax benefits. Additional benefits to conducting a study include: insurance savings, energy cost savings, disposition studies, fixed asset review, construction tax planning, preservation tax credits such as historical and new market, DEIRA reports to reduce insurance premiums, energy audits, benchmarking reports, and reserve studies.

Much of the content in the chapters of this book will offer immense awareness to those in the real estate industry and great insight into the next generation of cost segregation. It is important to stay up to date with all federal government and IRS laws and regulations.

chapter 2

Understanding the Law & Cost Segregation

With all the court rulings and legislative acts that have affected the Investment Tax Credit - cost segregation has become a niche incentive within real estate that causes a lot of questions and perplexity. To understand how cost segregation studies are conducted, an examination of IRS laws and techniques must be studied and enforced to produce the most incentivized result. Depending on the property type, the different types of assets at hand must be classified into the proper category to compute the depreciation and cost.

The Internal Revenue Code allows several different methods to calculate depreciation and provide tax incentives the applicable:

1. Depreciation method
2. Recovery period
3. Convention

Professional cost segregation engineers provide detailed studies on properties to support claims of depreciation that allow property owners to receive benefits that abide the precedent tax laws and case studies.

The U.S. Treasury Department has overseen the Internal Revenue Code in order to identify how the IRS has interpret these laws and how they have been applied to individual cases. Over the years, legislative regulations have been released that have the same authority as statutory law and provide operation rules specific for IRC provisions.

> **If a taxpayer feels that their individual case is an exception to the guidelines of the law, it is possible the matter may be taken to tax court and a judicial hearing can be appointed for the case.**

IRC Commissioners have released Interpretive Regulations that explain the IRS's views on various Internal Revenue Code sections. These regulations may be challenged if they do not withstand congressional objectives but still carry high authority within the system.

The Tax Court is overseen by the commissioner of the IRS and was created by the U.S. congress. It has 19 members appointed by the President of the United States. After Tax Court, if the case is still not resolved, then it may be taken into the hands of the federal court system. A very small amount of cases go to the Supreme Court System and rulings are based on related rulings, IRS documentation, and interpretation of the U.S. Constitutions or Laws. Litigation can be very costly to the average taxpayer so often times, small tax liabilities are not monumental enough to spend the money, time, and effort to take these cases into the courts.

internal revenue code regulations

The sections within the Internal Revenue Code for cost segregation and depreciation allowance are sections: 167(a) and 168.

They provide the filing guidelines for depreciation deductions and give a general understanding of what cost segregation entails. The shorter the recovery period for a certain asset, the larger the tax deduction will be for the property owner overall. With that in mind, it is beneficial for taxpayers to properly allocate assets and their costs by utilizing the accelerated depreciation techniques.

The system that most property owners utilize for cost segregation studies is the MACRS.

Within Modified Accelerated Cost Recovery System (MACRS) there are two methods to calculate depreciation:

1. General Depreciation System (GDS)
2. Alternative Depreciation System (ADS)

In order to decide which system to use, a distinction must be made between real property and personal property. These sections within the IRC are Sections 1245, 1250, 38 and 48.

real property

Real property encompasses the land and all structures attached to it (land, buildings, permanent structures, etc.) and is generally depreciated using 27.5 or 39 year recovery periods.

personal property

Things that are not permanent structures of your land or buildings that are located on the land (chain link fence, signage, parking lot lighting, etc.) can be depreciated using 5 or 7 year recovery periods.

Provisions 1250 and 1245 within the Investment Tax Credit have the purpose to provide the definitions of real or personal property. Provision 1250 is what defines real property including land, land improvements, residential and nonresidential buildings and structural components. Provision 1245 defines what is considered tangible personal property and other tangible property.

Section 48 of the Internal Revenue Code of 1954 was originally enacted to promote growth within the U.S. economy. This section allows a tax credit for properties and a business owner's properties that were placed in service during a taxable year. Furthermore, Section 38 continues to go in depth of what is considered eligible tangible property; this property is often called "Section 38 property" when classified. The ITC was repealed in 1986, then later reinstated. In 1997 when the IRS Tax Court made their decision of Hospital Corporation of American and Subsidiaries (HCA), the ITC once again was proposed as qualifying property for purposes of depreciation.

Apart from the Internal Revenue Code, cost segregation is also dependent on income tax regulations, case laws, revenue procedures, and congressional language. IRS Revenue Procedures provide technical guidance, explanations of the applicable deductions and information about classification for cost segregation purposes. Revenue Rulings are administrative guidelines and the interpretation of the law by the IRS Commissioner's. This model is provided for the IRS Private Letter Rulings (PLR) and are for taxpayers that may need further interpretation of the laws. The taxpayer can submit a written request for interpretation and based on the taxpayer's particular case, the IRS will provide an in depth written statement and accurate interpretation of the law. The taxpayer's private information is taken from the PLR, then it is presented on the IRS website under the Internal Revenue Ruling bulletin. Typically, Private Letter Rulings are not considered a precedent, but simply a generic interpretation.

Private Letter Rulings: All cost segregation specialists must be aware of these rulings and stay up to date on any changes that will benefit their client.

With these regulations, the situation of the property and type of business in question will dictate the depth of the information required in order to estimate the study. In addition, a detailed cost analysis of every unit within the asset is required and must be done by an independent specialist.

Through recent years, the process, application and value of cost segregation have steadily increased. The significant changes that have been made to these studies include applying:

- Energy tax deductions
- Dispositions for un-depreciated and retired assets per Treasury Regulation (TR) 1.1168(i)-8 MACRS
- Expense of un-depreciated basis of property subject to qualified repair per TR 1.162-4
- Expense un-depreciated basis subject to routine maintenance per TR 1.263;
- Manage and minimize recapture upon property sales
- Identify and recognize units of property and interdependent systems as defined under the recently issued T-Regs
- Bonus depreciation for reclassified assets

Even though the IRS accepts Cost Segregation, incomplete or poorly prepared documentation could cost a property owner unforeseen expenses not expected or necessary. It is important that a specialist with many years of experience that can analyze cost segregation cases is contracted, in case an audit arises. Along with thorough documentation, the most commendable cost segregation specialist will also know in-depth knowledge of all previous case laws. These specialists can therefore recognize any asset that may have had a previous case law or an amended regulation; in result, making that asset eligible to classify as a personal property asset. For new asset acquisitions, an experienced cost Segregation specialist can review the property's purchase contract to ensure that it does not bind an owner from formalizing a cost segregation study at a later date. All performed cost segregation studies should have a seamless reporting process in order to avoid any interruption of business to the property owner.

chapter 3

Types of Cost Segregation Studies

Many different case scenarios can utilize Cost Segregation. Taxpayers who own properties, purchase existing properties, and construct new properties can benefit from the tax laws that allow cost allocations. Typically, properties that are purchased, expanded, remodeled, or constructed after 1987 when the Investment Tax Credit was enacted, will benefit from a cost segregation analysis.

Generally, properties that are purchased, expanded, remodeled, or constructed after 1987 will benefit from a cost segregation analysis.

The highest yielding deductions and credits often come from properties valued at over $200,000 or that have large amounts of added features such as high-end finishes or components to operate.

The type of clients who seek cost segregation studies often include:

- Business owners of large manufacturing plants, hotels, restaurants, shopping centers or food facilities.
- Individuals that own large portfolios of investment properties such as multi-family homes or apartment buildings.
- Real estate companies that are often purchasing and selling multiple properties within the calendar year.
- Franchise owners with similar properties such a golf courses or assisted living facilities.

Depending on the type of property, the percentage rate of the building's cost that can be classified into shorter life assets will vary - generally 15 to 45 percent. The chart to the left provides these estimated percentage rates for examples of properties that benefit from cost segregation studies. Properties with more land have higher benefits of tax due to the personal property. Some examples include grocery stores with a lot of machinery; hospitals and medical clinics with labs and technical machinery; industrial manufacturing facilities with advanced equipment; theme parks with new land and ride constructions in mind; shopping centers with large parking areas and rain water drainage systems; apartment buildings in suburban areas with large areas for tenants to park, swimming pools on property, tennis courts and golf courses.

Property Type	Reclassification %
Apartment Building	20%-40%
Assisted Living Facility	22%-45%
Auto-Car Dealership	29%-35%
Bank	30%-45%
Conference Center	25%-35%
Fitness Center	22%-45%
Golf Course	28%-60%
Grocery Store	20%-45%
Hospital	28%-40%
Hotels	30%-50%
Leasehold Improvement	18%-40%
Manufacturing	30%-45%
Medical Office/Clinic	22%-35%
Mixed Use Properties	18%-30%
Office Building	20%-30%
Research Facility	22%-45%
Resort	25%-45%
Restaurant	20%-40%
Retail Strip Mall	18%-30%
Theme Park	16%-22%
Warehouse	22%-40%
Winery	18%-25%

case study

Engineered Tax Services performed a cost segregation engineering review of building components and site improvements on 21 two-story buildings situated on 8 acres in Dallas, Texas. The cost segregation benefit included a reclassification of 27.5-year depreciation class life assets into 5 and 15-year class lives. This resulted in a combined benefit of $1,835,135 on the purchase. This benefit clearly demonstrates that as a result of the final tangible property regulations (T-Regs), why cost segregation has become a powerful tax tool for real estate clients. Generally, an engineered cost segregation study will be required for any large sum of costs being allocated for a depreciation deduction. Once the property owner decides their current or future property is in need of a study, a cost segregation specialist will generally provide an estimated proposal. If the property has specialized assets or building components in place, an outside consultant may be needed for their expertise in that specific area

chapter 4

The Cost Segregation Procedure

There are many steps to be taken in conducting an accurate cost segregation case. A client who has decided to move forward with the decision to re- allocate their assets and determine if they qualify for a tax benefit will embark on a detailed documentation process of a Cost Segregation Study. This process includes specific documentation, site inspections, engineered reviews and analysis, allocation or classification of assets, computations, and a compilation of reports and forms that must be included in the documentation for the IRS.

For the purpose of having a set of guidelines in place, the IRS has developed the IRS Cost Segregation Audit Technique Guide (ATG).

CPAs and financial providers should use this ATG guide to assist in selecting a cost segregation provider.

To assist in this process, the IRS has put together an audit technique guide that outlines the steps that are required to ensure that a cost segregation study is properly performed.

This guide was released with the purpose of assisting the IRS examiners in the process of understanding cost segregation studies and what should be reviewed.

1. To start, the guide provides an introduction into cost segregation along with the laws and legal history of cost segregation that make the studies what they are today.
2. The next few chapters go into the specific elements of an engineered study and how to review and examine reports submitted by professionals.
3. The last three chapters provide guidance for very specific cases, important court decisions that are relevant and an appendix that explains technical processes that should be adhered to when conducting a cost segregation study.

Overall, the process requires general methodologies and much knowledge from experienced engineering professionals to have what the IRS considers a quality cost segregation study. These quality cost segregation studies are recommended to be conducted by accredited and licensed professionals, since they are required to provide detailed documents in classifying assets, determining costs, include any interviews, blueprints, or supporting documents, include relevant legal framework in regards to the classification used, contain detailed lists of assets and properly organized in their asset classification class, include thorough outline of all costs associated with the study, and provide up to date information of all parties involved in the study. However, the first step after the client seeks a cost segregation specialist will typically be to do appropriate research and documentation.

obtaining information

Collecting information from the client is important because it allows the hired specialist to generate an estimate of the benefits a study may yield for the client and how much time or cost the study will require. The type of information needed will vary depending on whether the property already exists or is to be constructed in the future. Examples of general information collected in the first meeting could be the description and purpose of the building, the square footage, tax information for previous years if applicable, current or future construction plans, and blueprints or property maps.

For new construction, the cost segregation professional may require:

- Land and property size
- A thorough list of projected costs including land development costs
- Construction schedules and payment requests
- Lists of equipment purchased or involved
- Applicable site inspections
- Relevant photographs of work in progress or completed assets
- Blueprints of prospect project
- Any contracts or contract payments

For existing buildings, the cost segregation professional will may require:

- Any previous purchase price allocations that separate each asset into the appropriate allocation and its value
- Property settlement statement
- Documents that will assist in calculating real property book value
- Blueprints or property maps
- Documentation that records or proves deterioration of assets
- Lists of equipment on property
- Past site inspections and photographs
- Any purchase/lease agreements or appraisals
- Schedules, change orders or documents for future renovation plans

Most cost segregation specialists have an organized plan in collecting and analyzing information.

It is critical that the client provide all requested documentation, as it allows the cost segregation professional to effectively maximize tax benefits and find all possible benefit options for the property in question.

site inspections

To hold up against an IRS audit, a qualified engineer should always perform the site visit. Once the initial information and estimates have been completed, the cost segregation specialist should visit the property in question to further assess and obtain pertinent data. The required prior information collected should give the specialists the background information needed for a general overview of the facility. It will also allow for all parties to have an approximate estimate of how long the inspection will take to complete. Depending on the size of the building to be studied, it could take up to 3 days to complete.

The best person to conduct the site inspection with the engineer is someone who has access to all the spaces within the building, such as a superintendent, maintenance team or engineering personnel.

Some of the items that may be needed during the site visit include a digital camera, property maps or blue prints of the building, instruments that will assist in measuring spaces, and something that can be used to take notes. Important things to note during a site inspection are the measurements, quality, type, and quantity of all components such as plumbing systems, parking lots, landscaping, signage, sidewalks, and mailboxes with photographic evidence. Sometimes a team of two specialists is necessary in order to take time-consuming data on fixtures that require more information such as; the type of material, the wattage, or if obtaining a measurement will be a two-person job. Often times the easiest way to do a site inspection is by separating the building into sections such as exteriors, interior rooms, storage spaces, and hallways or common areas. This part of the cost segregation study is generally easier to compute on a new building because the cost record of all components are readily available .Keep in mind to include all costs including construction costs and any fees acquired in the process. With all the data collected, a spreadsheet is the most practical way of organizing the information by asset class and cost.

engineered documentation

The next step for the cost segregation specialist is to take the data compiled and produce a comprehensive report for the cost segregation study. Depending on the information and property at hand, there are several methodologies that may be used to produce reliable studies. To date, the IRS does not have a standard or required procedure in compiling a cost segregation study. However, all reports must have the accurate classification of the property and the appropriate depreciation deductions for all components listed. Also, the more detailed and accurate the study, the faster the IRS service provider can review and provide the taxpayer with their deductions. The IRS guide on cost segregation numerates certain methodologies that are often utilized by specialists including, the detailed cost approach, the detailed cost estimate approach, the survey approach, the residual estimation approach, the sampling approach, and the experience approach.

the detailed cost approach

The detailed cost approach compiles costs from construction and accounting records to build a report. Since this method relies on true documentation and little estimates, it is typically the most time consuming but accurate method. Examples of the data utilized for this methodology include: contracts, job reports, blue prints, invoices, and any records that document the actual cost of a component. On a new construction the records needed for this method are more likely to be found, and this may be the best option.

the detailed cost estimate approach

A Detailed Cost Approach is generally used for new construction. Much like the detailed cost approach, the detailed cost estimate approach will also need a compiled list of documents; however, when a record is not found the specialist will do an estimate of the cost of the component to report. In order to find these estimates the specialist must find the cost from a reliable source and have the source referenced in the study. For this reason, it is important that the client provides all requested invoices in order to not depend on an estimate of a component.

This method is often utilized for the purchase of an existing property when records are not available.

the survey approach

For the survey approach, after the specialist has done a site inspection and has all the components of the property listed he/she will reach out to the contractor or subcontractors in written form and ask for the prices of each item. Depending how long ago the work was concluded will dictate how reliable the data of costs will be for each component.

residual estimation approach

The residual estimation approach is a method that determines the cost of shortlived assets, such as on a 5 or 7-year property. These costs are added together and then subtracted from the total project cost, while the remaining cost is assigned to the building itself or other long-lived assets.

This method may not be the most accurate, but it is helpful if there are time constraints on obtaining a cost segregation study.

sampling approach

By utilizing the sampling approach, costs and resources of the study will be greatly reduced but the accuracy is more likely to be flawed. This method is applied by performing a cost segregation study on a sample of a large portfolio of properties and based on those results, a standard model is developed for each facility type. The costs are then taken from the model and repositioned on a percentage basis.

The sampling approach works well with firms that have many properties with very similar or nearly identical blueprints, such as fast food chains or nursing facilities.

the experience approach

Often times a cost segregation specialist has so much experience at hand, that they can estimate all costs needed for the study by simply collecting data from the site visit. Although this method is allowed, the specialist must be able to properly allocate each part into its appropriate property class.

This method may be the least reliable methodology in preparing a cost segregation study.

chapter 5

Property Classifications

introducing to MACRS

Buildings put in service after 1970 utilized the ADR system to depreciate tangible assets. The Asset Depreciation Range system separated each asset depending on the nature or use. This system was put in place to simplify the process previously used to determine depreciation. The asset depreciation range allowed taxpayers a 20% flexibility above or below the IRS's guidelines on class life. The ADR system was still not detailed enough and continued to cause controversies. Due to these complications, the ACRS system or Accelerated Cost Recovery System was developed. This less intricate system was mandatory and gave the option of this recovery periods. Even so, depreciating assets still caused disagreements between taxpayers and the IRS. Therefore, the tax reform of 1986 paved way for the Modified Accelerated Cost Recovery System, also known as MACRS.

MACRS: This system is utilized and accepted by the IRS for purposes of depreciating eligible assets.

MACRS is primarily used for the purpose of income tax and provides a guideline in computing the depreciable life of assets into different classes. If applied correctly, a detailed asset review utilizing MACRS will provide additional write-offs and reduce tax liability while providing a safer tax filing position.

the evolution of MACRS

Asset Depreciation Range (ADR) → Accelerated Cost Recovery System (ACR) → Modified Accelerated Cost Recovery System (MACRS)

tangible personal property

The key to cost segregation and the MACRS approach is to identify real property from personal property. Tangible personal property is what is identified in order to capture the accelerated benefits of cost segregation. In essence, tangible personal property consists of structural components of buildings, while non-tangible property consists of the land, buildings or other inherently permanent structures.

Examples of Tangible Personal Property (Contained in or attached to a building):

- Display Racks, Shelving & Cabinets
- Neon & Other Signs
- Decorative Trim & Millwork
- Certain Air-conditioning Equipment (for a specific business activity)
- Machinery, Generators & Kitchen Equipment
- Decorative and Specific Business Activity Light Fixtures
- Carpeting
- Wall Coverings
- Window Treatments
- Accordion Doors & Partitions
- Interior Landscaping

not tangible personal property

- Land (Non-Depreciable)
- Buildings (27.5 or 39 Year Depreciable)
- Swimming Pools (Land Improvements_15 Year Depreciable)
- Paved Parking Areas (Land Improvements_15 Year Depreciable)
- Side-walks (Land Improvements_15 Year Depreciable)
- Docks (Land Improvements_15 Year Depreciable)
- Bridges (Land Improvements_15 Year Depreciable)
- Fences (Land Improvements_15 Year Depreciable)
- Exterior Landscaping (Land Improvements_15 Year Depreciable)

tax reform and the changes to depreciation

After tax reform, the structural value of a building is depreciated (expensed) over a 27.5 to 40 year period. The tangible property was, as shown above, typically depreciated at an accelerated period between 5 to 15 years. That was under the previous tax code. The new tax code allows you to expense the tangible portion of a building immediately. The only item you can't expense is the value associated with the land when buying real estate.

qualified restaurant property

Acquired and placed in service after 9/27/2017 - 12/31/2017 is allowed 80% bonus on new and used property recovered at 5/15 years but not the "Restaurant Property".

Note: If a purchase and contract was signed prior to 9/28/2017, then 0% bonus applies, and we still use the Closing Date for Places in Service. If signed and closed from 9/28/2017 - 12/31/2017, then 80% bonus applies on the 5- & 15-year property but not the "Restaurant Property," which is recovered at 39 years.

Note: If New Construction, same rules apply as listed in Note 1 above, except prior to 9/28/2017, 5- & 15-year property are eligible for 50% bonus.

Let's do an example. An investor buys a building for $2,000,000. The land value is $200,0000 so the balance, $1,800,000 is able to be expensed. Traditionally, based on the property type, the investor would expense the $1,800,000 over a 30 to 40 year period. The investor decides to get a cost segregation study to determine the amount of the property that is tangible assets, not related to the structure. The study determines that $800,000 of the $1,800,000 is tangible assets which includes finishes, flooring, landscaping, parking specialty electrical, and a whole list of other tangible assets.

Under the old rules, we would depreciate the $800,000 over a 5-to-15-year period. That is not bad, but under the new tax laws, the cost segregation study allows $640,000 to be expensed immediately under bonus depreciation rules. This is huge. Bonus depreciation previously was only allowed for new real estate investing. The new tax rules allow bonus depreciation for existing buildings acquired now. The results of the study are significant. The report also allows you to retire and expense structural assets as they are exhausted, which can also lower capital gains when selling the property.

these rules apply to

Net interest deduction limited to 30% of the business's adjusted taxable income. Disallowed interest can be carried forward indefinitely. Businesses with average annual gross receipts of $15 million or less are exempt from the limitation.

Real property trades or businesses can choose to exempt themselves. If they choose to take the exemption, they must use the Alternative Depreciation System (30 years for residential rental property; 40 years for nonresidential real property)

The Real Estate Roundtable reported in January of 2019 that the Treasury Department released final regulations on the new 20 percent deduction for pass-through business income (section 199A) on Friday afternoon. Treasury also released (a) proposed regulations under section 199A that address REIT dividends received indirectly by mutual fund shareholders, and (b) a revenue procedure that establishes a safe harbor for determining when rental real estate constitutes a trade or business for purposes of the new deduction: Section 199A Final Regulations (REG 107892-18) • Section 199A Proposed Regulations (REG 134652-18): https://lnkd.in/e6z_ine • Section 199A Rental Real Estate Trade or Business Safe Harbor Revenue Procedure (IRS Notice 2019-07).

In summary the new tax laws allow real estate investors a 20% deduction for pass-through income from a partnership, S corporation, or sole proprietorship. Deduction is also allowed for qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income. (NOTE: "Specified Service Trade of Businesses" which includes businesses like health, law, accounting, and investing, among others are eligible for the deduction if annual income is less than $315k married, $157,500 single and deduction is phased out between $315k-$415k married and $157,500-$207,500 for single filers.)

The deduction is limited to the lesser of: 50% of W-2 wages paid, OR the sum of 35% of W-2 wages paid plus 2.5% of the unadjusted basis.

We have an online calculator you can use to calculate both the 20% pass through estimates and interest deduction estimates.

These new rules are really helpful to any real estate investor and really expand the benefits associated with a cost segregation study.

* Bonus depreciation not available if electing to be an "electing real property trade or business" under Sec. 163(j). The limitation doesn't apply to nonresidential real estate, residential rental real estate, or QIP.

** Qualified improvement property was omitted from TJCA's 15 year property, so until technical correction, it is limited to nonresidential real property's 39 year class life. Definition: "Qualified improvement property" means any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Does not include expenditure attributable to (i) the enlargement of the building, (ii) any elevator or escalator, or (iii) the internal structural framework of the building.

*** "Section 179 property" means property (A) which is (i) tangible property (to which Sec. 168 applies) or (ii) computer software and to which Sec. 167 applies, (B) which is Sec. 1245 property or QIP ("any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service" but not "any improvement attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building") or any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: (i) roofs, (ii) heating, ventilation, and air-conditioning property, (iii) fire protection and alarm systems, and (iv) security systems, and (C) which is acquired by purchase for use in the active conduct of a trade or business. Note: The expanded language in red font above only applies for property placed in service in tax years after 2017.

**** 30 years is for property placed in service on or after Jan. 1, 2019; property placed in service prior to this date uses 40 years. The changes in depreciation are also impacted by the changes to real estate investors in regards to interest deductibility.

The changes in depreciation are also impacted by the changes to real estate investors in regards to interest deductibility.

old tax law

- Business interest fully deductible

new tax cuts & jobs act

- Imposes limitation on business interest (with exemptions for some small businesses)
- Real Estate companies may elect to maintain full deductibility of interest
- Election requires longer depreciation period for buildings (ADS Method) 30 years for residential and 40 years commercial
- Can't utilize Bonus Depreciation
- Can still do Cost Segregation! - Carves out and accelerates ADS 20yr site and 10yr building personal property

chapter 6

The Right and Wrong Property for Cost Segregation

the properties that make sense

All properties can benefit from a Cost Segregation Study, as long as they are investment properties, the only properties subject to depreciation. The exclusion would be permanent residence or properties that are owned and do not depreciate because of the ownership structure.

common misconception and bonus depreciation

Cost segregation is a benefit that is based on the amount of tax basis invested in real estate property. It is a common misconception that real estate properties under $1M have a smaller tax basis and do not benefit from a cost segregation study due to the associated fees – this is not always the case. Properties ranging from $500k and under to $50M or more have benefited from cost segregation. Reason being, the smaller properties benefit because of bonus depreciation. Bonus depreciation allows taxpayers to calculate and deduct 80% of qualifying property costs in the first year, in addition to regular depreciation for new construction and improvements.

A common misconception is that real estate properties under $1M have a smaller tax basis and would not benefit from cost segregation, believing the fees would outweigh the benefit. That is not always the case.

For example, a cost segregation study that classified 200k dollars of a newly constructed 500k property into personal property would allow for a $160k bonus depreciation benefit in the first year alone. Additionally, the study would identify the opportunity to capture added benefits, such as dispositions and repairs and maintenance expenditures. This would increase the benefit to where the fee would not be so outrageous that it would hinder the investment.

tenant improvements

The same circumstances apply even in a small tenant improvement with bonus depreciation and new assets. There is quite a bit that can be written off to validate the benefit from the study. At the very least, everyone should look at his or hers investment to see if it would be beneficial, no matter what the size. As a firm, Engineered Tax Services always offers a preliminary analysis to estimate what the benefit would be vs. the associated fee and determine if a study is in your best interest

common misconception and land improvements

Another misconception surrounds properties that do not have a lot of personal property in them and very little interior build out, such as industrial warehouses.

There is still a benefit because those properties generally have a lot of land improvements that qualify. They may also have certain portions of electrical, mechanical, and plumbing that can also qualify. This kind of study can pay greatly in the first year, and the ability to identify those dispositions, repairs and maintenance, and also minimize recapture through the proper retirement of assets are just as valuable.

recapture & cost segregation

Upon the sale of a business property, personal property and land improvements identified through cost segregation are disposed of at net tax book value. Subsequently, there are neither gains nor losses associated with the disposal of these corresponding assets. All resulting gains on the sale of the associated structure and land will be taxed at a preferential capital rate.

length of ownership and minimizing recapture

If a property is purchased with the intention to flip or own for a short period of time (less than a year), a cost segregation study may not be significant. However, many people in the industry feel that if you do not own an investment property for even 1-3 years, that it may not warrant a cost segregation study. It may still make sense in order to identify the opportunity to take deductions at ordinary tax rates. Depending on what the tax rate is, we can determine what the estimated benefit is during the time the property was held and how that will impact the recapture and the opportunity to lower the tax position through long-term gains vs. ordinary income tax.

recently sold properties

If a property has already been sold it may still be a good candidate for cost segregation. As long as you sold the building and have not filed the tax return, there is an opportunity to do a cost segregation and begin maximizing tax deductions at ordinary tax rates. Although the study may increase the gain, the gain may be at a much lower rate making it a beneficial investment.

In conclusion, if there is an investment property that is held for longer than one year, a cost segregation study should be considered. Always determine if a study makes sense by requesting a complimentary analysis to ensure it is an opportunity for good investing. It is also important to note that the fees are tax deductible.

chapter 7

The Cost Segregation Worksheet and Online Calculator

disposition defined

When you undertake demolition or renovate a building you may tear out lighting, HVAC units, other components, and dispose and retire from the building. As such, their book value can be treated as a business deduction. The tangible personal property within the structure allows for the remaining depreciable value to be written off when the asset is retired, provided the personal property is no longer in service and the purchase was not intended for demolish. This must be identified and valued prior to demolition.

Disposition occurs when an asset is permanently withdrawn from use when:

- Sold
- Exchanged
- Retired
- Physically abandoned
- Destroyed
- Transferred to supplies, scrap, or similar account

partial asset disposition

New partial disposition election allows taxpayers to treat the retirement of structural components and subcomponents of assets as a disposition on which gain or loss (usually loss) is recognized.

Dispositions and retirements need to be made in the year of disposition, otherwise they must remain on the books until they have run their course.

computing disposition

Any reasonable method may be used to calculate the remaining basis for disposition, including:

1. Discounting the cost of the replacement portion of the asset to its placed in service year cost using the Producer Product Index (PPI);
2. A pro rata allocation of the unadjusted depreciable basis of the asset is based on the replacement cost of the disposed portion of the asset and the replacement cost of the asset; and
3. A study allocating the cost of the asset to its individual components (Proposed Reg. §1.168(i)-8(f)(3)).

If a detailed asset report is unavailable, the producer product index can be used to identify and calculate a reasonable disposition amount.

Engineered Tax Services is proud to offer a comprehensive and detailed Asset Disposition Calculator, which uses the Producer Product Index (PPI) as a tool to calculate a reasonable disposition amount.

using the ppi to calculate partial asset dispositions

After registering on the Engineered Tax Services website, you will be given access to the PPI Index Disposition Calculator. The calculator provides some general guidance on applicability and use.

> **Producer Product Index (PPI) measures the industry level and tracks the prices for various types of building components.**

required data

Information required for disposition calculation

Cost Basis of Component
New Original

Cost Basis of Building Component
$ 0.00

Date of Purchase (Start Date)

Date of Replacement (End Date)

New: Is the cost of the asset recently added to the property?

Original: Is the original cost of the asset that was removed known? For example: if the roof was replaced in 2000 and again in 2015 and you want to take disposition for the roof added in 2000.

Information required for disposition calculation

This is the date the asset was added to the building. If you take a disposition write-off for an existing purchased asset, then use the original purchase date.

Cost Basis of Component

New Original

Cost Basis of Building Component

$ 0.00

Date of Purchase (Start Date)

Date of Replacement (End Date)

This calculator is designed to identify the value of specific assets that need to be removed for tax purposes. You must be specific about the asset in order to identify the value.

Year Original component installed (optional)

Use Purchase Date

Component Category

Appliances

Type of Component

Major Appliances, Residential

Condition of Component

Average

Average Useful Life of Component (Years)

12

Check this box to manually enter the Useful Life

Clear Submit

Information required for disposition calculation

This example reflects the information needed to calculate disposition for re-paving a parking lot. It shows the cost of paving is $26,500 in 2015 and is replacing a property purchased in 2013, but originally constructed in 2005 (optional data).

Cost Basis of Component

(•) New ( ) Original

Cost Basis of Building Component

$ 26,500.00

Date of Purchase (Start Date)

06/15/2013

Date of Replacement (End Date)

12/15/2015

Year Original component installed (optional)

2005

Component Category

Site Improvements

Type of Component

Paving, Asphalt

Condition of Component

Average

Average Useful Life of Component (Years)

15

[x] **Check this box to manually enter the Useful Life**

Clear Submit

Based on the information provided - the retirement loss to be realized is $21,976.15 and a full accumulated depritiation schedule is also provided.

Display Calculation for Component Condition: Manual

Condition: Manual

- **Manually Entered Useful Life:** 15
- **Component's Remaining Useful Life:** 13
- **Number of Years Used Prior to Retirement:** 2

- **PPI Index at Time of Purchase:** 196.4
- **PPI Index at Time of Replacement:** 196.7

- **Original Basis of Component:** $26,459.58
- **Claimed Depreciation:** $4,483.43
- **Retirement Loss of Component:** $21,976.15

However, the most detailed and precise method for determining disposition is via a detailed engineering study, or a detailed cost segregation study, which can be provided by Engineered Tax Services. A cost segregation study identifies and provides a detailed list of assets to easily identify and capture future disposition.

The detail in a cost segregation study provides:

- Immediate disposition adjustments based off of original, engineering based valuations for each asset.
- A worksheet for property owners and managers to quickly identify disposition each year to capture these write-offs and improve the ROI on building improvements.

The cost segregating approach to claiming dispositions is beneficial because under the new regulations, there is no look back available, such dispositions must be taken in a timely manner. The retirement of that asset also allows you to minimize recapture.

chapter 8

The Most Costly Mistakes in Cost Segregation

Content in this chapter contributed by Bonnie Buol Ruszczyk, president of BBR Marketing.

Performing the property due diligence is key to avoiding costly mistakes for financial advisors and their real estate clients.

As noted in Chapter 4, the IRS has offers an audit technique guide that outlines the steps that are required to ensure a cost segregation study is properly performed.

The primary goals of the ATG are to provide examiners with an understanding of:

1. Why cost segregation studies are performed for Federal income tax purposes
2. How cost segregation studies are prepared
3. What to look for in the review and examination of these studies
4. When certain issues identified in the cost segregation study need further examination

CPAs and financial providers should use the ATG guide when selecting a cost segregation provider like Engineered Tax Services. There are court cases outlined below where studies have been disallowed because the proper due diligence was done incorrectly, which set up a disallowance and tax preparer penalties.

choosing your specialist*

Two recent court cases have had a significant impact on the use of cost segregation studies in terms of reclassifying building components for accelerated depreciation.

CASE #1

In the most recent case, the U.S. Tax Court filed a memorandum opinion on March 12, 2012 denying AmeriSouth XXXII Ltd. over $1,000,000 of accelerated depreciation previously reclassified using a cost segregation study. This memorandum is significant and those in the accounting industry must take notice and exercise greater caution when hiring a qualified engineering firm to provide tax studies for their clients.

Ultimately, they need to be assured through their own due diligence that the selected engineering partner is able to justify the results and is prepared to support the reclassifications in the event of an audit.

*Contributing Author: Bonnie Buol Ruszczyk is President of BBR Marketing, a firm that provides marketing strategy, training and tactical implementation for professional services firms.

Accountants also have an ethical responsibility to advise their clients regarding firms that may inevitably place them at risk due to their methodology, experience or inability to defend their reports. The facts of the memorandum are as follows:

- AmeriSouth, a limited partnership, bought an apartment complex in 2003 for $10.25 million. AmeriSouth commissioned a cost-segregation study and then attempted to depreciate more than 1,000 building components over 5- or 15-year spans, instead of the 27.5 years applicable to rental real estate under MACRS. Using its cost-segregation method, AmeriSouth deducted $3,029,029 for depreciation in the years 2003–2005.

- The IRS audited the partnership under the Tax Equity and Fiscal Responsibility Act and disagreed with AmeriSouth's treatment of the components; it denied $1,079,751 in deductions for those years. The case ended up in Tax Court, where the IRS also argued that AmeriSouth was attempting to depreciate some assets it did not own.

- At about the same time as the case was tried, AmeriSouth sold the apartment complex and subsequently stopped responding to communications from the court, the IRS and even its own attorneys. The court allowed the attorneys to withdraw from the case. When AmeriSouth failed to file a post-trial brief, the court could have dismissed the case entirely, but instead it decided the case, deeming any factual matters not contested to be conceded by AmeriSouth.

- The court looked in depth at the components in each of the 12 categories AmeriSouth had identified for faster depreciation: site preparation and earthwork, water distribution system, sanitary-sewer system, gas line, site electric, special HVAC, special plumbing, special electric, finish carpentry, millwork, interior windows and mirrors and special painting.

- Based on its examination of the facts, the court sided with the IRS in all but a handful of instances, holding that most components were structural, integral to the buildings' operation and maintenance, and therefore depreciable over the life of the building.

This case was unique because the property in question was being sold around the time the case was tried and AmeriSouth reportedly stopped responding to all communications simultaneously. Consequently, AmeriSouth did not have the expertise or evidence to uphold its provided study.

If AmeriSouth had allowed itself to be properly represented, sufficient evidence could have been provided to refute the judge's position on many of these disallowances. Experts in the engineering tax community familiar with the Hospital Corporation of America v. Internal Revenue Code would have been able to successfully challenge many of the court's final disallowances of the reclassified components within the study. Unfortunately, several items in the report were clearly aggressive, and the report included assets not even owned by the property owner, such as site improvements owned by the public government. This tactic opened the floodgates to the court potentially disallowing the entire report.

Ultimately the court's decision was beneficial for the engineering tax industry. Certainly the articles subsequent to the memorandum have fueled great concern for the reliability of cost segregation studies. Fortunately, the legitimacy has not changed and these tax strategies are still one of the most viable tax treatments for real estate investors, when done properly. The memorandum, however, clearly demonstrates the necessity for the CPA community to have a Request for Proposal system in place in order to select a qualified engineering partner to issue specialty tax services to their firm's clients.

The RFP system for engineering tax services should include in its request:

- Verification of corporation engineering licenses
- Verification of employed professional engineers
- Verification of insurance coverages, including Errors & Omissions cover age for gross negligence
- Minimum of 10 references from CPA firms nationally that verify satisfied peer results
- Verification of licensed CPA and/or licensed attorneys for protection from IRS tax controversy
- Verification the engineering firm has successfully defended reports against IRS audits

Michael Daszkal, managing partner for Daszkal Bolton, a large regional Florida CPA firm, stated, “We as a firm go through a very through due diligence process when selecting outside consultants who provide specialty tax services for our clients. I anticipate that we as an industry will see more of these court cases until the CPA community as a whole does a better job of managing the RFP process for selecting specialty tax firm. We have a regimented process for selecting such firms that are approved for our partners to refer to our clients. Realizing that this is an unregulated industry and there are many new firms claiming expertise, we interviewed more than a dozen firms before making a final selection. We were able to verify their engineering licenses, the employment of professional engineers, insurance coverages, as well as peer references. We have been thrilled with the relationship and we are glad we as a firm went through such a rigorous RFP process prior to selecting a firm we felt comfortable referring to our clients.”

Allan Koltin, considered one of the most influential people in accounting by Accounting Today, added, “It is vital that CPA firms be aware that there are great differences in the quality of specialty tax firms and that an RFP process which is managed top down by each firm is critical to assure quality of service and mitigate future risk.”

At this time, we can only theorize as to the effect this current IRS memo will have on future inquiries. However, it would be reasonable to hope that those signing returns and advising clients properly investigate outside resources that provide such reports. If the IRS decides to intensify its evaluations of cost segregation reports, CPAs would be prudent to expect outside firms to note a going concern, provide audit defense, and comply with Circular 230 regulations and offer detailed architectural plans to support the claim.

CASE #2

The other recent Tax Court case provides an object lesson on the importance of CPAs taking extreme care in selecting specialty tax partners, when their clients are purchasing the assets of a business that includes real estate.

When a company acquires part or all of the assets of an existing trade or business, the purchaser s tax basis is determined by the amount paid for the assets. Both parties in the transaction generally must agree to an allocation of the purchase price among the assets purchased. In the case Peco Foods Inc. and Subsidiaries v. Commissioner, the Tax Court ruled that a taxpayer who purchased the assets of a business could not retroactively change a purchase price allocation agreed to in connection with the asset acquisition. The court held that even a properly completed cost segregation study could not be used to reclassify assets from real property to personal property after the purchaser and transferor had an enforceable asset allocation agreement in place.

Although the taxpayer in Peco Foods was prevented from using a cost segregation study, taxpayers may be able to draft a purchase agreement that permits the taxpayer to perform a fixed-asset review or cost segregation study after the purchase transaction has been completed.

Gary Boomer of Boomer Consulting established The Specialty Tax Circle to address all these issues related to providing quality services in this tax arena. Said Boomer, “We’ve teamed up with another firm, Engineered Tax Services to introduce The Specialty Tax Circle to help firms improve their growth and profitability by leveraging specialty tax services that address issues such as these.” This group brings together firm leaders who will share best practices and experiences dealing with tax issues that require special attention. “This is a great opportunity for our firms to focus on opportunities and share experiences and resources,” said Engineered Tax Services CEO, Julio Gonzalez. By creating this group, we are giving firms an opportunity to learn from each other and discover how not to repeat the mistakes that were made in the Hospital Corp and Peco Foods cases.”

Taken together, this pair of contentious IRS cases should instill a greater sense of vigilance among CPAs when researching a suitable specialty tax partner. The consequences of performing adequate due diligence in such cases can make an enormous difference in the final determination of allowable property classification and depreciation.

chapter 9

Cost Segregation Case Studies

case studies

We have created a series of successful case studies, each highlighting a different depreciation scenario of cost segregation. The various building types below represent the variety of depreciation found between different building types due to tax codes, amount of personal property, or difference in land improvements. These are not the only properties that qualify and only serve as a guideline. Every property should be evaluated on a case-by-case basis.

Bank Building

5-year: 19.06%
15-year: 21.55%

39-year: 40.61%
Basis: $800K

39-year commercial

A typical commercial property is subject to a 39-year depreciation schedule for new purchases, construction, renovations, and tenant improvements. A cost segregation study separates personal property and land improvements into 5, 7, and 15-year class lives. This accelerates depreciation & increases near term cash flow in the form of a deferral.

Apartment Building

5-year: 29.54%
15-year: 13.55%

27.5-year: 56.91%
Basis: $37M

27.5-year residential

Residential properties such as apartments and other multi-family buildings differ as they are subject to a 27.5-year class life. Typically, these facilities can expect to see a 20%-40% benefit in accelerated depreciation with a higher than average 5-year benefit.

Self-Storage Facility

5-year: 38.99%
15-year: 41.03%

39-year: 19.98%
Basis: $3.5M

5-year recovery

Self-storage facilities often capture a higher than normal 5-year depreciation benefit. This is due to the fact that metal framed panels with standing seam metal roof generally offer the ability to dismantle and move the business making much of the structure a 5-year asset. Additionally, site improvements including asphalt paving, sidewalks, curbing, and fencing, security lighting and underground utilities fall under a 15-year depreciation schedule.

Restaurant Building

5-year: 24.56%
15-year: 1.06%

15-year: 74.39%
Basis: $2.6M

15-year ruling

The 15-year recovery period has been made permanent for qualified leasehold improvements, restaurant, and retail property. In order for restaurants to qualify for the full 15-year recovery period, the buildings must be 50% dedicated to consumption and preparation of food and be placed in service after Jan. 1, 2009. However, from Oct. 23, 2004-Dec. 31, 2008, the full 15-year recovery period could only be applied to improvements.

Auto Dealership

5-year: 18.41%
15-year: 22.38%

39-year: 59.21%
Basis: $2.1M

land improvements

Auto dealership are ideally suited for the benefits of cost segregation studies. A majority of the facilities can obtain high benefits. From 15-year depreciation due to the large amount of land improvements, including parking lot lighting, storm water drainage, concrete curb and gutter, asphalt paving, and landscaping.

chapter 10

The Next Generation of Cost Segregation

As a result of the newly revised tangible property regulations (T-Regs) that were passed in late 2013 and early 2014, the next generation cost segregation study has become the most powerful tax tool for real estate clients.

This “next generation” cost segregation study has captured the attention of the CPA community because CPAs have always known that a dollar in their client’s hand today is worth more than the promise of a dollar tomorrow. The ability for CPAs to assist clients in reducing their tax liability was greatly improved in April 1999. At that time, the IRS issued a legal memorandum allowing taxpayers to segregate various building costs into shorter depreciable lives outside of the standard 39 or 27.5 year class life via a process called Cost Segregation. This was the genesis of the “old school” cost segregation study.

Throughout recent years, the process, application and value of cost segregation have steadily increased. How does the “old school” cost segregation study differ from the “next generation” version? A simple list below shows the differences:

An original cost segregation study looked at just the building depreciation. The final tangible regulations issued in 2013 introduced the next generation cost segregation study. This next generation study brought the added tax benefits of:

- **energy tax incentives**
- **repairs and maintenance**
- **asset disposition**

Old School

- Accelerated depreciation through identifying 1245 property vs. 1250 property, land improvements and tenant improvements.

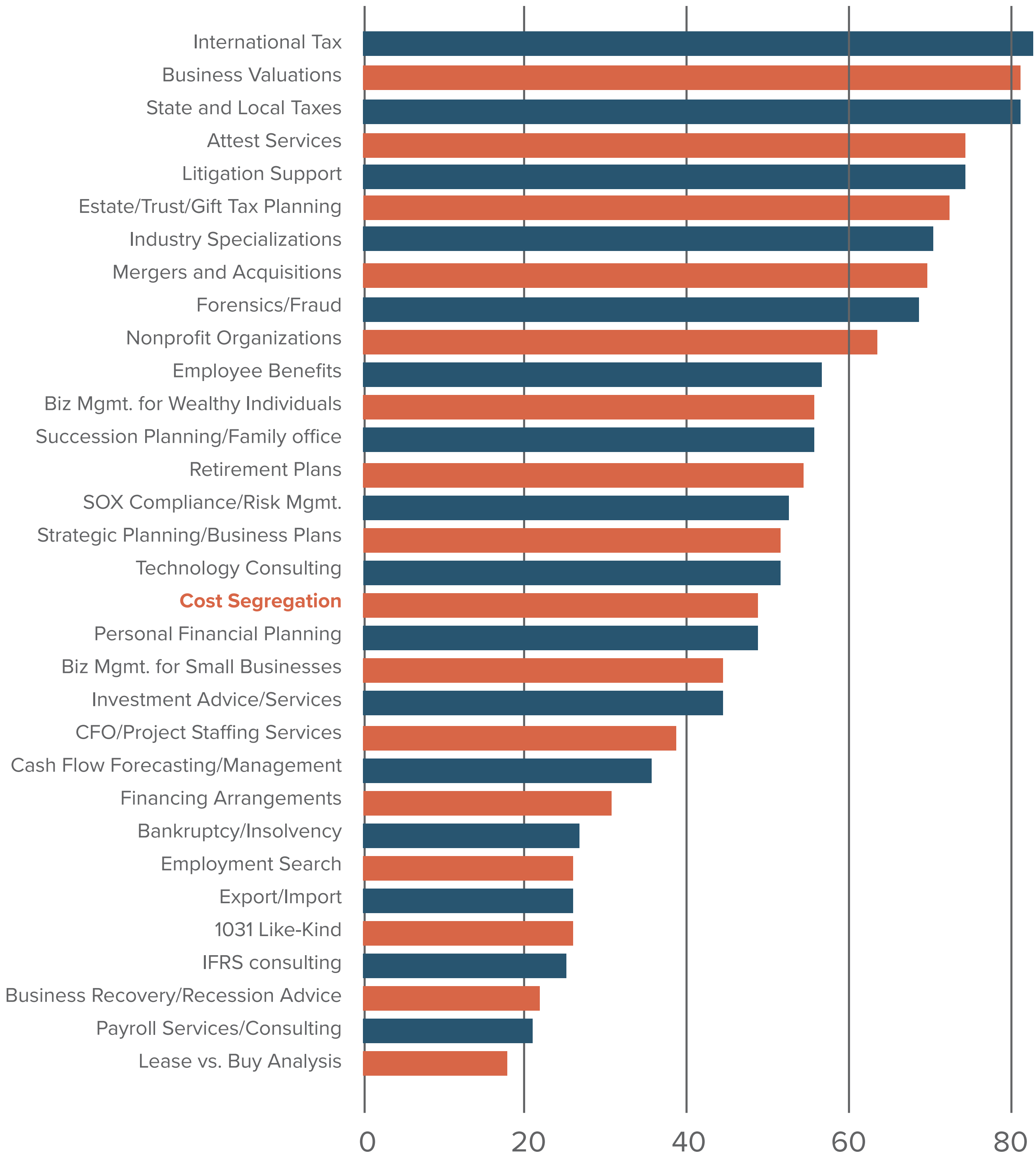
New Generation

- Accelerated depreciation
- Energy tax deduction (179D) for heating and cooling systems
- Energy tax deduction (179D) for lighting systems
- Energy tax deduction (179D) for building envelope
- Dispositions for undepreciated and retired assets per Treasury Regulation (TR) 1.1168(i)-8 MACRS, or modified accelerated cost recovery system
- Expense of undepreciated basis of property subject to qualified repair per TR 1.162-4
- Expense undepreciated basis subject to routine maintenance per TR 1.263(a) – 3(i)
- Manage and minimize recapture upon property sales
- Identify and recognize units of property and interdependent systems as defined under the recently issued T-Regs
- Bonus depreciation for reclassified assets

These differences reflect the value of cost segregation to CPAs and their clients as a top consulting service. The use of “next generation” cost segregation studies has helped many firms attract new clients, retain existing clients and secure consistent revenue growth and firm expansion.

top niche services

Percentage of firms increasing their business in these areas (of 77 firms responding)



importance of cost segregation cost studies

I asked Allan Koltin, CEO of Koltin Consulting, if he was surprised by the importance that CPA firms are placing on cost segregation consulting services. He responded, “In visiting my CPA clients over the past month, they are all indicating that the new regulation changes have allowed them to thrive in terms of using cost segregation studies to generate strong revenue while attracting new clients.”

For a more complete understanding, let’s go back to the genesis of the “old school” cost segregation. The 1999 IRS memorandums were significant because the building does not only consist of walls, roof and interior rooms, but also land improvements (storm sewers, curbs and sidewalks, parking lots, swimming pools, landscaping, etc.) and personal property (flooring, interior finishes, decorative lighting, kitchens, interior glass and electrical wiring for appliances, etc.). As I mentioned, the “old school” report helped clients accelerate depreciation of their buildings.

The memorandums were clear in that a typical property’s structure is subject to a 39-year recovery period, land improvements are subject to 15-year recovery period, and certain other building components qualify as personal property with a five- to seven-year recovery period. The IRS allows the componentization of buildings for accelerated tax depreciation through the process of a cost segregation study to identify land improvements and personal property that can be separately depreciated over the shorter recovery period. The average commercial building owner will realize approximately 25 to 35 percent of the total costs of their building as shorter class life depreciable assets. This can translate into major tax savings and increase cash flow for savvy real estate investors.

Cost segregation and the related tangible property studies are clearly mainstream in the accounting industry. It is typical to see a relevant consulting service being adopted by the five percent innovative CPA firms in the industry and then the trickle effect happens slowly as the other firms see the importance over a decade.

Older Properties

There are also great benefits for clients who have purchased buildings since 1986. The accelerated benefits are not lost for real estate owners who have purchased real estate in a previous tax period.

Once a taxpayer files two federal income tax returns using a specific depreciable or non-depreciable life for a particular asset, a specific accounting method has been adopted for that asset for federal income tax purposes. Prior to the issuance of Rev. Proc. 96-31—the predecessor of Rev. Proc. 97-37, Rev. Proc. 98-60 and now Rev. Proc. 99-49—there was no procedure for an automatic change of accounting method for an asset that erroneously was being depreciated over too long a life or not depreciated at all.

Since depreciation is a non-cash flow item, application of this Revenue Ruling could provide a significant impact on tax return. For example, a substantial tax benefit is achieved in the case were depreciation has not been taken on a building constructed for $8 million with eligible improvements of $2 million and placed in service on Jan. 1, 2000. The cumulative depreciation of $1,114,200 that was not taken previously can now be deducted in the first year of change. Additionally, the balance of the depreciable assets continues to be depreciated over their remaining life, providing an after tax present value benefit of $600,000.

automatic change of accounting method

Rev. Proc. 87-56 provides the taxpayer with general depreciation guidelines for use in both a cost segregation study and/or change of accounting method. Rev. Proc. 99-49 provides that a taxpayer may file for an automatic change of accounting method for an asset for which depreciation was not taken, or for which depreciation claimed was less than the allowable amount. The amount of "missed depreciation" from the date the asset was placed in service (the Section 481(a) adjustment) can be deducted in the first year of change.

The benefits of this procedure were solidified by the US Tax Court decision in Hospital Corporation of America. In a pro-taxpayer decision, the Tax Court narrowly defined what is considered "real property" for income tax purposes.

ever-increasing benefits

So now we have a historic background to the "old school" study, and we have a glimpse of the "next generation" study. Let's get into the specifics of the changing benefits of these engineering studies that are causing such a commotion with CPAs.

The new issuance of the T-Regs in regard to repair and maintenance expensing rules dictates the necessity for the full deconstruction of 1250 property with a proper cost segregation study to allow future retirement of assets.

The new issuance of these regulations for expensing versus capitalization shows that the IRS recognizes that property owners who make renovations to the structural 1250 assets of their facility must have a proper engineering study to allow the retirement expense for the abandoned property.

a look back

This logic also applies retrospectively. A quality engineering report must look at a building's assets that are no longer in service as determined through the review of the blueprints, tax schedules and an engineering site visit. An audit of a client's existing facility will allow a determination of whether assets within the building are currently on the client's depreciation schedule which should have been disposed of from renovations and/or tenant change-overs and the assets were disposed with no salvage value.

The next generation report should always include an engineering analysis that summarizes the remaining undepreciated basis of a building's components subject to expense as abandonment for disposition of MACRS property.

Asset	Service Date	Quantity	Price	Total	Un-depreciated Amount
Abandoned Tenant Reservations	2006	1	$2,745,550.20	$2,745,550.20	$1,518,631.81
Grand Total					**$1,518,631.81**

For manufacturing, warehousing, distribution, automated material handling, service industries or clients with similar activities, identifying "functionally independent" machinery or equipment used in the performance of their business activities, can make the difference between having to capitalize repairs to these systems. An engineering-based cost segregation study can identify these functionally independent systems and plant property. Once defined, the taxpayer can write off retired assets from their books in the year they were removed from the property.

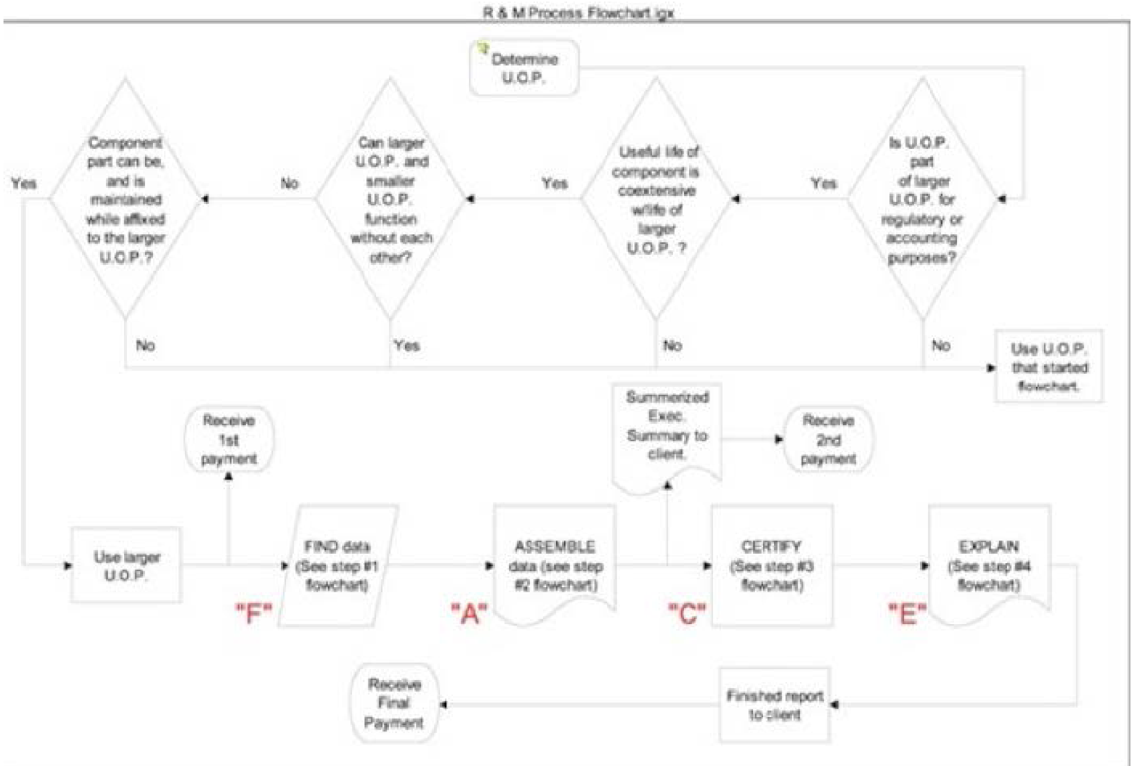
The purpose of conducting a detailed engineering cost segregation report on an existing facility should not only be to reclassify short-term class lives It also should now be detailed to include total deconstruction and unit price valuation of all structural property to take advantage of the 263a regulations, which allows a property owner to expense the retirement of 1245 structural property throughout the life of the ownership of such property. A proper IRS-compliant study will have an engineering-based unit price for each structural component that includes engineering expertise valuation of the condition of the component, replacement cost of the component removed and aging factors.

The next generation study must also include a detailed engineering analysis of the units of property, or UOPs, for the entire building to make a determination of building components that where placed into service and are deemed to be repairs and maintenance to be expensed under 263a guidance.

The chart on the following page shows a sample of the assets that would be typical in a new-generation report, where assets were actually maintaining normal operations within the facility, and without which the spaces would have been left inoperable. A physical engineering analysis would determine whether the building's assets were merely replacement of nonperforming assets still being depreciated. If the engineering inspection shows any assets capitalized were to serve to maintain the existing function of the facility, the remaining undepreciated balance would be depreciated. The sample chart below summarizes the engineering tax determination of remaining undepreciated basis subject to expense as qualified repair per Sec 162, Treasury Regulations 1.162-4.

Asset	Service Date	Qty	Price	Total	Un-depreciated Amount
Building Compressor	4/15/2009	1	$3,845.82	$3,845.82	$3,479.81
Air Compressor	5/27/2009	1	$3,449.26	$3,449.26	$3,128.93
7.5 Ton Compressor/ Condenser	5/05/2010	1	$5,146.44	$5,146.44	$4,799.76
3 Ton AC Roof Computer	3/22/2012	1	$4,980.00	$4,980.00	$4,878.91
15 Ton Trane W/TCI Communications	8/06/2012	1	$14,750.00	$14,750.00	$14,608.17
10 Ton Trane Condensing Unit	5/21/2008	1	$5,700.00	$5,700.00	$5,024.66
10 Ton Trane Condensing Unit	10/10/2008	1	$2,058.65	$2,058.65	$1,836.26
Compressor	9/16/2010	1	$4,591.14	$4,591.14	$4,321.62
Tandem Compressors	10/01/2010	1	$3,286.50	$3,286.50	$3,100.22
10 Ton Trane A/C Unite	8/03/2007	1	$5,500.00	$5,500.00	$4,741.22
10 Ton Trane Condensing Unite	2/11/2008	1	$5,300.00	$5,300.00	$4,636.89
Trane Condenser	4/13/2009	1	$4,366.00	$4,366.00	$3,950.49
Grand Total					**$58,506.94**

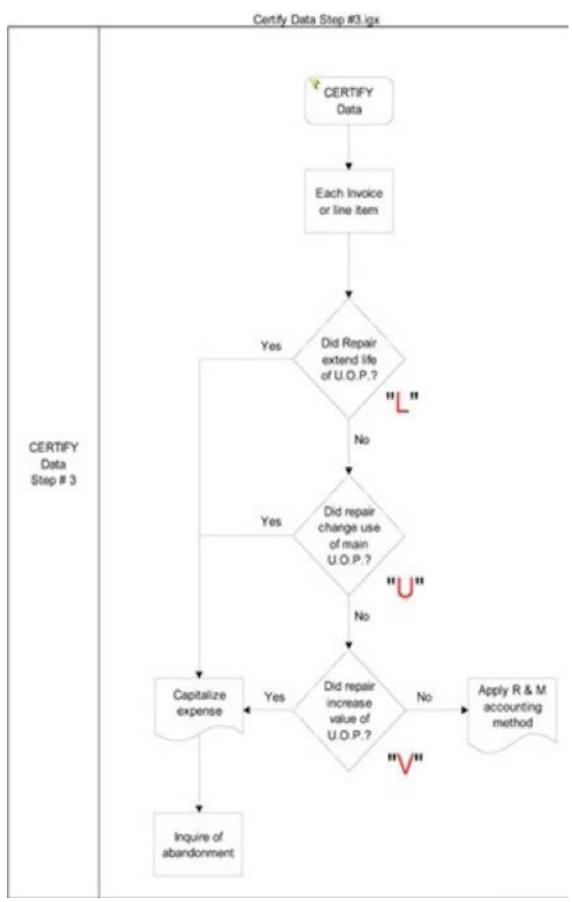
The engineering process to perform such an analysis is outlined in the following tables.



This engineering process is done under the newly defined IRS Unit of Property engineering division listed below:

Definition of Systems (UOP)

- Heating, ventilation and air conditioning, or HVAC, systems
- Plumbing systems
- Electrical systems
- Escalators
- Elevators
- Fire protection and alarm systems
- Security systems
- Gas distribution systems
- Any other structural components identified in the published guidelines (building envelope).



The next-generation report also needs to capture the remaining undepreciated basis subject to expense as qualified routine maintenance per Sec 263(a), Treasury Regulations 1.263(a) – 3(i). This is an often-overlooked engineering process that can yield significant tax deductions for the real estate client.

The next-generation study must also determine whether the real estate clients design include renovated energy efficient lighting, heating and cooling systems and/or building envelope into the structure. From 2006 through the end of 2016, each area of efficiency allowed the real estate client to deduct up to $0.60 per square foot in accelerated tax deductions. In a rehabilitation project components replaced will have a retirement expense consideration per the unit-of-property determination.

It is also very important to remember that giving the real estate client a detailed fixed asset accounting of their real estate investment, will allow for the proper retirement of the tangible personal property, thus eliminating recapture of such retired assets. This can be as big a tax benefit as all the other “next generation” benefits outlined.

One critical aspect of the new disposition rules is the fact that the look-back period expired in 2013. This was a key look-back deduction to clean up any real estate client’s fixed asset schedule for the components of their building.

Michael Daszkal, managing partner of the South Florida-based CPA firm Daszkal Bolton, said, “The new tangible regulations have bolstered the way we approach cost segregation studies, and the benefits of these combined engineering services have made cost segregation our number one consulting service in terms of revenue and new client attraction.”

It’s easy to see why. When combined, all these additional “next generation” benefits clearly demonstrate, why cost segregation remains a top consulting service for CPAs. As Allan Koltin concluded, “The CPA firms that miss these client opportunities will hurt their reputation and growth.”

chapter 11

Being Tax Efficient as a Real Estate Investor

Content in this chapter is contributed by Jim Sullivan, VP of Business Development for Forever Forests, LLC

Engineered Tax Services provides the independent engineering analysis required for energy tax credits and cost segregation studies. Combined, these services result in maximum efficiency and cost savings on the federal, state, local, and utility levels.

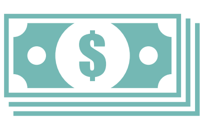
In the preceding chapters of this book, we have discuss cost segregation and how it evolves into the next generation of tax benefits. Ultimately, cost segregation is one aspect of tax efficiency that is related to real estate, but there is a host of other tax benefits associated with owning real estate that every investor should also be aware of.

As we have seen, real estate is the only investment class where the government allows a gain in equity through the use of historical tax credits, facade easements, air rights, TIFFS, energy tax credits, conservation easements, affordable tax credits, and many other incentives. The government provides this equity freely and the investor is then able to write off 100% of the building to minimize taxes and preserve wealth.

$10,000,000 building

example

A real estate investor buys a $10,000,000 property. The investor receives $3,000,000 in federal tax credits that he uses as his equity, securing 70% debt with no money out of pocket. The investor now does a cost segregation study and captures a $4,000,000 tax deduction in the first year alone. At a 50% tax rate, that is a $2,000,000 cash benefit on money saved. The investor also qualified for a much lower interest rate on the purchase since the property was energy efficient, which qualified for an additional tax deduction of $500,000 which is a $250,000 cash benefit.



$4,500,000 in tax deductions

Furthermore, the above investor also took a conservation easement on the land, promising the federal government he would conserve some of the acreage for wildlife. This netted the investor another $600,000 in cash.

In summary, the investor has a $10,000,000 building. No equity needed, provided by the government. The same property allowed him to take $4,500,000 in tax deductions (tax loss) to preserve $2,250,000 in cash and offset other taxes. It is easy for anyone to do this. Many simply don't have the awareness to do so, otherwise they would. Who wouldn't? How many real estate investors have tax advisors that would miss this? 90%? Maybe more? It comes down to a lack of awareness where these incentives are missed.

$2,250,000 in cash offset

As you can see, our tax code is structured to help people and businesses reduce tax liability so that they retain funds for proper business operations, driving revenue into our markets via wages and purchases.

other real estate tax credits & deductions

We have discussed cost segregation's impact on disposition of assets, repairs and maintenance expenses, and energy tax deductions. Clearly those are benefits to any real estate investor, but it is just a scratch on the surface. This section walks through a multitude of tax benefits that real estate investors utilize to maximize their wealth.

Energy Tax Incentives

Energy incentives were placed into service in 2006 by the government to inspire energy utilization and energy efficiency of buildings. It was designed to incentivize building owners to invest in energy saving components by shortening the payback period for those investment. Although we have discussed two key federal energy incentives in chapter 12, there is also a number of state and local utility incentives available to property owners. Each case must be looked at for state and local incentives in order to determine the benefits. Engineered Tax Services has a database that identifies those in detail and can provide that information upon request.

Historic Tax Credits

Another area where we find benefits is with income producing properties listed on the National Register of Historic Places. A Historic Tax Credit is essentially free equity that can be taken for improvements paid to restore these historic buildings. This federal income tax credit equates to 20% of the cost of rehabilitating historic buildings or 10% of the cost of rehabilitating non-historic buildings constructed before 1936. Meanwhile, the cost of the project must exceed the building's adjusted basis.

Cost segregation can be used to bring down the basis of a building so that the Historic Tax Credit can start with a lower threshold. For example, if a historic property was purchased for $1,000,000 and $200,000 is defined as personal property with a cost segregation study, then we can say the real basis for the property is $800,000. Once that $800,000 threshold is reached in terms of improvements, up to 20% of the associated costs can be taken under the Historic Tax Credit.

In the event that a property is sold and converted to cash, this credit is very impactful in terms of true equity for property investors.

The key is to maximizing these tax credits is to start with a cost segregation study. A cost segregation study allows you to accelerate the deductions of your building by breaking out personal property from structural property. The cost segregation study allows you to lower your basis to qualify credits at a reduced costs. For example, you buy a building for $1,000,000.00. The credits would kick in once you have exceeded $1,000,000.00 in renovations. If a cost segregation identifies $250,000 in personal property, 80% of which ($200,000) can be immediately expensed under the new bonus rules, the reset basis is now $800,000. Now the credits kick in much sooner.

Step 1 is powerful. Step 2 is to make sure your historic tax submission is approved prior to when renovations have commenced. The key for us is to make sure your submission goes through perfect on the first submission. Engineered Tax Services works with your accountant and architect to make sure you get the maximum credits which really can serve as your free equity into the project. We also work with you to make sure you maximize other state and local credits prior to construction. Many local governments give sales tax incentives, employment tax incentives and property tax incentives. The key is to secure theses in advance of acquisitions. These credits can be substantial. Sophisticated real estate investors have been using these tools for decades. We bring these services to mainstream USA so that every real estate investor has access to these tax benefits.

These benefits are certainly compounded if the property lies within an Opportunity Zone where gains can be trafessed in on a deferred tax basis and gain from the investment in the zone can be eliminated based on holding periods and correct structure compliance.

Facade Easement Credits

Similar to the Historic Tax Credit, buildings that qualify under the historic register may also benefit from the Facade Easement Credit. The tax credit is designed to preserve the historic character of a building's façade. In order to qualify, the building must be of historic value or be in a certified historic district. This ensures the property preserves its historic character while providing a tax deduction for the owner.

These types of benefits are typically negotiated upfront with the local government and are best explored as part of your due diligence when looking for investment opportunities. The rules for this credit are technical enough that you will want to seek a professionals help.

Air Rights

Air space refers to the space above the grounds surface; and more specifically, the space above a building from the roof up. This space is considered fillable, making it valuable equity for real estate investors who wish to purchase or sell a property that can be extended vertically. Additionally, rights to that air space may also be sold or purchased for further opportunity. Every property owner and investor should evaluate air space rights as part of their due diligence process in order to avoid any surprises that may inhibit future development.

Conservation Easements*

A conservation easement is a private action taken on private land, which provides for the preservation of the land by permanently restricting development, commercial and industrial uses, and certain other activities on a property.

With the proper application of a conservation easement, land owners can receive a deduction up to 50% of their adjusted gross income. Further, surplus conservation easement deductions can enjoy a carry forward life of up to 15 years.

In certain circumstance, farmers and ranchers can realize a deduction up to 100% of their Adjusted Gross Income. Additionally, these deductions are recognized in the majority of states that also collect income tax; some cities as well. If that were not enough, certain states like Colorado, Virginia, and North Carolina have at times offered tax credit incentives for land conservation, which in many cases may be taken in addition to the federal and state deductions. Land owners should always consult with a tax adviser to accurately depict the tax savings outcome.

*Contributing Author: Jim Sullivan is the VP of Business Development for Forever Forests, LLC, and national land conservation consulting firm with offices in GA, FL, and CA. Forever Forests is a leader in structuring creative land conservation projects. They employ an emphasis on the application of conservation easements to enhance and permanently protect private land holdings while helping owners receive all the economic benefits they deserve.

Affordable Low Income Tax Credits

The affordable low income tax credit was developed to encourage private sector residential developers to build affordable housing. Tax credits are given to builders, who in turn sell them to investors to raise money for low-income housing. As long as the building continues to qualify, the investors can benefit from tax credits for 10 years for each dollar invested. The property criteria must be residential real estate, meet low-income tenant eligibility, and be rent controlled.

Bifurcation & Depreciation Strategy

When entering funds into a real estate partnership, the focus is typically on preserving the tax-exempt status for the public investors. This focus on the tax exempt partner side of the arrangement can distract the typically smaller investor group, the taxable partners, from incorporating and maximizing their own tax opportunities into the partnership structure. Special tax allocations and accelerated depreciation deductions stemming from cost segregation studies are two examples of traditional tax savings strategies that are often overlooked or typically not thought to be beneficial due to the heavy concentration of tax exempt partners within the structure. With proper tax planning upfront, both the tax exempt and taxable partners can gain tremendous shifts up in the cap rate.

In general, the private tax paying investor group represents a smaller portion of traditional real estate investment groups. The cost segregation benefits this minority by generating greater depreciation deductions to reduce the tax on their rental income and, in some cases, reduce the tax on other income if they are considered active real estate investors. Tax-exempt partners, on the other hand, generally do not benefit from depreciation deductions. Thus, in some cases, the differing status of the two groups can present a prime opportunity to specially allocate the tax-exempt partners' share of depreciation deductions to the taxable partners. By doing this intelligently, the tax exempt partners can also greatly benefit due to the fact that this would dramatically reduce any back end recapture to the tax exempt entity upon the sale of the asset, which dramatically improves their return position.

Even though the investors within each fund have different tax structures and tax needs, the goal of enhancing each investor's rate of return can be accomplished through sophisticated tax planning strategies. If properly structured, the tax exempt and taxable partners may both benefit from special tax allocations to produce significant tax efficiencies.

Tax Efficient Real Estate Investing		
	Fund with Tax Efficiency/Bifurcation	Fund with Non-Tax Efficiency
Portfolio Size	$100,000,000.00	$100,000,000.00
Cost Segregation Depreciation		
5 year property: 22%	$22,000,000.00	$22,000,000.00
15 year property: 11%	$11,000,000.00	$11,000,000.00
39 year property: balance	$67,000,000.00	$67,000,000.00
1st Year Depreciation		
Bifurcated to FO	$18,551,920.00	$4,526,920.00
179	$500,000.00	$ -
179D	$2,111,000.00	$ -
Charitable Tax Credits, Others	$1,487,521.00	$ -
Total 1st Year Deductions	**$22,650,441.00**	**$4,526,920.00**
Difference in Benefit	$18,123,521.00	
Tax Rate (Federal/State) 50%	$0.50	
Cash Benefit to FO	**$9,061,760.50**	**$4,526,920.00**
Family Office Investment	$10,000,000.00	
Debt	$50,000,000.00	
Institutional	$40,000,000.00	
Immediate Return Day 1 FO	**90.62%**	**4.53%**

Fannie Mae & Freddie Mac. Loan Energy Discount Programs

As a way to incentivize multifamily investors to save energy or water through property improvements, Fannie Mae and Freddie Mac have developed a Green Advantage program. This program offers a reduced interest rate loan program for new acquisition, refinance, or properties that are already green certified. By committing to reduce energy or water consumption by at least 15%, you may get better pricing and more funding to make the enhancements to the property.

Brownfield Cleanup Program

A brownfield site is any real property where a contaminant is present at levels exceeding the soil cleanup objectives or other health-based or environmental standards. The goal of the Brownfield Cleanup Program (BCP) is to encourage private-sector cleanups of brownfields and to promote their redevelopment as a means to revitalize economically blighted communities. The BCP is intended to remove some of the barriers to, and provide tax incentives for, the redevelopment of urban brownfields. This tax incentives allow for the environmental cleanup costs of eligible properties to be fully deductible at the year incurred. Meanwhile, previously filed tax returns may then be amended to include deductions for past clean up expenditures.

DEIRA – Insurance Replacement Appraisal

An insurance appraisal is a replacement cost analysis which provides an accurate estimate of the amount of insurance required to replace each structure exactly as it stands on the day the report was prepared. Most property owners, managers, boards, and insurance agents believe that obtaining an insurance appraisal for their property is one of the best decisions they have ever made. It takes the guesswork out of a property valuation by providing a detailed analysis of the actual cost to rebuild or repair an insured property, reducing premiums and obtaining better terms, conditions, and coverage for the property owner.

Charitable Credits

Although a taxpayer may want to demolish an existing property, it may hold many items that can be recycled and reused by another organization such as Habitat for Humanity. There are several charitable organizations across the country that accept used materials from investment properties such as cabinets, appliances, doors, light fixtures, siding, roofing windows, flooring, etc. The process of deconstruction and subsequent removal of charitable materials from investment prosperities

The following steps are necessary for the charitable contribution process:

- A licensed engineer will inspect the property prior to demolition to determine all the materials that would be eligible for donation. They will then, calculate the remaining tax value of assets being removed that will have no charitable value but will qualify as a partial disposition expense.
- Have your contractor add about 5% additional labor to provide deconstruction of charitable assets within your facility
- The taxpayer will need the donated materials valuation form 8283 from the engineer and must attach it with the appraisal to the tax return as support for the charitable deduction. Engineered Tax Services also provides the taxpayer with a partial disposition report to maximize the benefit.

All of the tax advantages listed in this section are available to real estate developers and investors. When combined, these smart real estate investments serve as a valuable tax tool for wealth preservation.

Tax Efficiency Applications Due Diligence	Applicable Yes or No	Projected Tax Cash Benefits to Investor	Comments	Score
Cost Segregation	Yes	$2,971,815.00	Fund Uses Cost Segregation	10
Energy: 45L/179D/State & Utility Incentives	Yes	$476,000.000		10
Historic Credits (Federal/State)	NA	$0		0
Façades Easements	NA	$0		0
Charitable Contribution - Value Add	Yes	$869,464.00		7
Façade Easements	Yes	$487,887.00		6
Research & Development Design Credits	Yes	$115,000.00		5
Historic Easements	No	$0		0
New Market Tax Credits	No	$0		0
TIFFs	Yes	$685,125.00		6
Air Rights	No	$0		0
Conservation Easements	Yes	$825,000.00		7
Affordable Tax Credits	NA	$0		0
Bifurcation Strategies	NA	$0		0
Lean Energy Discount Programs	NA	$0		0
Solar Credits	Yes	545,555		5
Mortgage Mitigation Credits	Yes	$447,000.00		9
Brownfield Credits	Yes	1245111		9
State Mitigation Credits	No	0		0
704 Dispositions	NA	0		0
• Dispositions	Yes	$1,325,469.00		9
• Asset Retirement	Yes	$85,415.00		6
• Sales Allocation Management	Yes	$385,000.00	Based on holding period	8
• Disguised Sales Arrangements	Yes	TBD	Based on Buyer/Seller agreement	2
• 1031/1033 Delaware Statutory Trusts	TBD	0		0
721 Exchange	NA	0		0
DST Exchange	NA	0		0
Qualified Improvement Deduction Analysis	Yes	558111		9
Corporate Tax Structure	Yes	LLC	Poor	1
Rebranding Deduction Analysis	No	0		0
Tax Benefits to Investor	**Tax Cash Benefit**	**$11,021,952.00**	**Investor SCOE**	**109**
			Investor Grade	Excellent
			Risk Factor	0.87
			Capital Investment	$10,5000,000.00
			Tax Benefit	104.97%
			Investment Decision Calculation	$9,589,098.24
			Investment Decision	**Yes**

You invest. Your investment has losses. Sometimes the losses are considered active which means you can take the losses against active income. That is great. Sometimes losses are passive and you can only use them to offset passive income. This is ok if you have passive losses.

At year end, you can invest into opportunities that can create year end losses to help lower your tax liabilities. If you are active in real estate you can buy a property before year end and do a cost segregation study which will allow you to deduct a good portion of the investment immediately which can typically create losses. Potentially lots of losses. This is great if they are active losses you can use to offset ordinary income. The rules to be active in real estate are quite strict. I will outline them shortly. Alternatively you can invest in oil and gas exploration. Most the exploration costs are expensed immediately and the participation is active in the first year. Solar investments are also attractive. You get a 30% credit upfront and you get to depreciate the balance of the investment year 1. If you invest alone, you have a much lower threshold to be considered active. There are many other alternative investments that can help you arbitrage your tax liability at year end including movie credits, Opportunity Zones, easements and charitable donations.

So let's get to the rules!!!

Here are the general rules, as follows, per the IRS:

You materially participated in a trade or business activity for a tax year if you satisfy any of the following tests.

1. You participated in the activity for more than 500 hours.
2. Your participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who didn't own any interest in the activity.

3. You participated in the activity for more than 100 hours during the tax year, and you participated at least as much as any other individual (including individuals who didn't own any interest in the activity) for the year.

4. The activity is a significant participation activity, and you participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year and in which you didn't materially participate under any of the material participation tests, other than this test. See Significant Participation Passive Activities , under Recharacterization of Passive Income, later.

5. You materially participated in the activity (other than by meeting this fifth test) for any 5 (whether or not consecutive) of the 10 immediately preceding tax years.

6. The activity is a personal service activity in which you materially participated for any 3 (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital isn't a material income-producing factor.

7. Based on all the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis during the year.

You didn't materially participate in the activity under test (7) if you participated in the activity for 100 hours or less during the year. Your participation in managing the activity doesn't count in determining whether you materially participated under this test if:

- Any person other than you received compensation for managing the activity, or
- Any individual spent more hours during the tax year managing the activity than you did (regardless of whether the individual was compensated for the management services).

Stricter rules for real estate are:

(7)Special rules for taxpayers in real property business

(A)In general, if this paragraph applies to any taxpayer for a taxable year—

(i)paragraph (2) shall not apply to any rental real estate activity of such taxpayer for such taxable year, and

(ii)this section shall be applied as if each interest of the taxpayer in rental real estate were a separate activity.

Notwithstanding clause (ii), a taxpayer may elect to treat all interests in rental real estate as one activity. Nothing in the preceding provisions of this subparagraph shall be construed as affecting the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner.

(B)Taxpayers to whom paragraph applies, this paragraph shall apply to a taxpayer for a taxable year if—

(i)more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

(ii)such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. In the case of a joint return, the requirements of the preceding sentence are satisfied

In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements. For purposes of the preceding sentence, activities in which a spouse materially participates shall be determined under subsection (h).

(C)Real property trade or business For purposes of this paragraph, the term “real property trade or business” means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

chapter 12

How Cost Segregation Impacts the Federal Energy Tax Benefits

Opportunities to identify and maximize the return on investment can be found during all phases of the property ownership and investment cycle:

Recon
- Due Diligence
- PCA/PNA
- Environmental
- Energy Audits

Operation
- Cost Segregation
- Improvements
- Value Add
- Disposition Credits

Acquisitions
- Green Investments
- Property Financing
- Tax Credits
- Energy Incentives

Dispositions
- Valuation Analysis
- Sale Allocations
- 1031 Exchange
- Max Wealth Preservation!

Another way cost segregation studies may benefit a property owner is by utilizing the detailed classification analysis to identify energy tax deductions and credits within the permitted tax laws. These energy tax incentives can be based on new, old, or renovated residential and commercial buildings, as long as they meet the guideline. The categories included in these incentives could be lighting, heating, cooling, ventilation and hot water systems, and the building envelope itself. Your cost segregation team of specialists should also specialize in these energy certification processes required by the IRS. The certification calculates the tax deduction achieved from the installation of energy efficient assets.

45L energy efficient home credit

This energy tax credit equates to up to $5,000 per unit for energy efficient residential or multifamily properties. Both new construction, as well as renovations qualify if the efficiency levels are met. The credit can then be taken by the contractor or developer of these properties completed within the past three years.

Properties that may qualify for the credit include:

- Single-family homes
- Multifamily properties
- Apartments
- Units within an apartment building or condominium,
- Warehouses

Also, the property can be either the principal place of residence or a vacation home. Manufactured homes meeting the criteria may also benefit from the 45L tax credit.

179D commercial building energy tax deduction

When a new or existing commercial building is constructed or renovated since January 1, 2006, the building owner may be eligible for a Federal Tax Deduction range from $0.50/sq. ft. to $5/sq. ft. Most new construction and renovations comply with the requirements. The benefits are for the certification of new energy efficient lighting, HVAC and systems put into the building envelope, such as new wall insulation, roof insulation, and windows. The IRS requires an independent energy study by a licensed engineering firm.

A 20,000 square foot newly constructed commercial building qualifies for up to $5 per square foot under the latest 179D energy tax deduction for the installation of qualifying energy efficient assets placed in service during the taxable year.

The IRC Section 179D deduction is $100,000. This is an “other deduction” with an associated asset basis reduction and immediate write-off in the current year.

energy reduction requirements

- The dwelling must show at least a 25% reduction in heating and cooling energy consumption compared to other units constructed in accordance with the standards set forth in the 2006 International Energy Conservation Code (IECC)
- At least 10 percent of the energy savings associated with heating and cooling must be derived from attributes associated with the building envelope (roof, walls, windows, etc.).

variables

Although only the dwelling unit's heating and cooling systems energy consumption are used to determine the requirements for the tax credit, many other factors play a key role. These factors include: insulation, internal heat gains from lights and appliances, window coverings, exterior building color, mechanical ventilation, size of windows, exterior shading, climate zone, duct location, and unit's air tightness, just to name a few.

With all these variables, it can be difficult to establish the right measures to put in place without a pre-model assessment by a certified rater. Although raters can model the dwelling units and help identify what measure are needed to qualify, an official determination cannot be achieved until an onsite visit is conducted to determine the air tightness of the unit and duct work. Also, note that if a multi- family building receives certification for all its units, the same building plan may not pass in another location due to climate, building orientation, window directions, proximity to adjacent buildings and landscape shading.

The best practice to achieve the consumption requirement is to use the pre-model consumption rate along with general assumptions and worst-case variables to determine what changes, if any, are needed. There are numerous low cost changes that can be made prior to construction to provide a buffer in the event that onsite testing yields less than expected results.

Additional Energy Saving Opportunities

- 1603 - Alternative Energy Cash Grants
- Benchmarking
- Local Utility Rebate Certifications
- 45L Energy Tax Credits
- Renewable Electricity Production Tax Credit (PTC)
- Federal Tribal Energy Program
- U.S. Department of Treasury - Renewable Energy Grants
- High Energy Cost Grant Program
- USDA - REAP Grants
- Federal Loan Program - CREBs
- Qualified Energy Conservation Bonds (QECBs)

key criteria

Raters are often asked how efficient does heating and air conditioning need to be in order to achieve the 50% reduction in energy consumption to qualify for the tax credit. Since all building systems contribute to efficiency, there is no minimum requirement for each specific system as long as the combined systems reach the 50% reduction. Since different systems impact efficiencies more than others, we have put together a list of key criteria, their importance, and what specifications are key to reducing energy consumption by 50%.

key criteria by component

The following list identifies key criteria, their importance, and what specifications are key to reducing energy consumption by 50%. View the column to the left.

Mechanical Specifications

Heating	Avoid	Good	Best	Efficiency
Gas heat - forced air			x	90-96
Hydronic with gas central boiler			x	85-95
Heat pump without elec. heat strip		x		HSPF:8-9
Electric Heat - forced air & radiant	x			100
PTAC & heat pump with elec. heat strip	x			100
Cooling				
Air conditioner - Split System			x	SEER: 14-16
Heat pump - Split System			x	SEER: 14-16
Through-wall A/C & heat pump		x		SEER: 13-14
Packaged A/C & heat pump		x		SEER: 11-14
Window A/C	x			SEER: 11-14
Hot Water				
Gas			x	EF: .57-.65
Integrated gas		x		EF: .57-.65
Electric	x			EF: .92-.98

Insulation Specifications

Insulation Location	Importance	Insulation R-value
Flat ceilings (w/attic above)	High	38-50
Sloped/cathedral ceilings	High	38-50
Floor over garage	High	38-45
Cantilevered floor	High	38-45
Foundation walls	High	7.5-10
Exterior frame walls	Medium	19-23
Rigid Foam Exterior	Medium	5-7.5
Rim/Band joists	Medium	13-19
Floor over unconditioned basement	Medium	19-38
Under-slab insulation	Medium	7.5-10
Ducts in attic or crawl space	Medium	6-10
Slab perimeter insulation	Low	5-10

Windows and Doors

Windows & Patio Doors	U-Value	SHGC	R-Value
Northern states	.26-.31	.30-.35	
Southern states	.31-.40	.23-.30	
Doors			
Northern states			6-12
Southern states			3-6

Additional Key Items				
Item	Not Important	Neutral	Helpful	Very Important
Mechanical ventilation for indoor air Quality – same daily runtime				x
Ventilation for cooling to reduce usage of A/C – i.e. economizer, whole house fan				x
All ducts in conditioned space				x
Sealed & insulated ducts that are outside conditioned space				x
Unit air leakage below 7 ACH @ 50 pascals				x
Avoiding high and cathedral ceilings				x
Siding and roof are light in color (southern states)				x
Window coverings and blinds				x
Energy recovery ventilator if mechanical ventilation is present			x	
Reducing total window area			x	
Landscape shading			x	
Use of ceiling fans			x	
CFL and LED lighting			x	
Efficient washer/dryer		x		
Efficient dishwasher & refrigerator		x		
Insulation levels of interior walls	x			
Lighting & HVAC exclusively serving common areas	x			
Low flow toilets	x			

These green energy studies greatly improve the payback period for these types of investments and the IRS allows specialized service providers to go back to any projects that were conducted in previous years to quantify these tax benefits and bring clients through the current tax return. Energy efficiency and related cost savings tops the agenda for governments and businesses in the United States. Driving these concerns for them are the fluctuating demand, constrained supply, volatile commodity prices, changing regulatory environments, and the complex tax structure of today's energy industry.

chapter 13

Home Office Deductions

In preparing proactive tax plans for my clients, the Home Office Deduction is one that I always consider. If the IRS allows you to take a deduction for bills you already pay each month like utilities and a mortgage, why not claim the tax deduction and save some money? The Home Office Deduction is not a huge deduction like some of the other chapters in this book (ex. Cost Segregation, Conservation Easement, Energy Credits, etc.) but most business owners can arrange their operations to claim it. Small tax savings each year can really add up.

Additionally, a few years ago, the IRS came up with a Simplified Method that eliminates most of the record keeping requirements and the depreciation recapture provision. Later in this chapter I will show you how to compute both the traditional and the Simplified Home Office Deductions.

Finally, since daycare businesses represent a small segment of all businesses, specific requirements of daycares have purposely been omitted. If you own a daycare,we recommend that you engage a competent tax preparer or study IRS Publication 587.

who may claim the home office deduction?

The Home Office Deduction is most commonly claimed by small business owners reporting their income and expenses on Schedule C. Form 8829, Expenses for Business Use of Your Home, is filed in association with Schedule C. However, the Home Office Deduction may also be claimed by farmers filing Schedule F, partners receiving a Schedule K-1 (1065), and employees who are not provided a place to work by their employers.

(Please note that Form 8829 is not used to claim the Home Office Deduction for farmers, partners and employees, but rather a worksheet similar to Form 8829 is prepared.) Also, remember that the IRS requires the business portion of a home to meet the Exclusive and Regular Use Tests.

misconceptions and benefits

It is a common misconception that by claiming the Home Office Deduction a taxpayer is waving a red flag and increasing his chance of an audit. I know two CPAs in our town that will not claim the Home Office Deduction for any of their clients. Years ago, I picked up a new client because his CPA of many years wouldn't listen to him and did not allow him to claim the Home Office Deduction on his tax return. All I can say is that some tax professionals get their required annual continuing education from IRS seminars or from speakers who were trained by the IRS. I have insisted that my business owners who qualify claim the Home Office Deduction for decades and not one has been audited yet! Since my clients haven't been audited it can't be a red flag.

The simple benefit of the Home Office Deduction is being able to get a tax break for several items you already purchased. Over time the Home Office Deduction can amount to tens of thousands of dollars in tax savings if claimed every year.

The tax code already allows homeowners to deduct their mortgage interest and real estate taxes as itemized deductions on Schedule A. However, claiming them on Form 8829 brings the deduction before Adjusted Gross Income (AGI), which is better, since many federal deductions are benchmarked to AGI, and most states start with AGI in computing state income taxes.

limitations of the home office deduction

The Home Office Deduction is a legitimate business expense, which reduces taxable income and associated taxes. Decades ago, IRS audits and statistical analysis revealed that the Home Office Deduction was perceived as a generous tax deduction that too many people were claiming that did not qualify. This lead to restrictions to the deduction and clearer definitions as to what may be deducted and who qualifies.

IRS Publication 587, page 3, sets forth the primary requirements to qualify for this deduction as exclusive and regular business use. Additionally, an employee must meet two additional requirements. The employee's home office must be for the convenience of the employer and the employer may not rent any part of the home from the employee.

Finally, one limitation or fact against the Home Office Deduction is the fact that when you sell your home, the business depreciation you claimed in prior years must be "recaptured" and claimed at income, which of course results in additional tax owed in the year of a home sale.

computing the simplified method

The Simplified Method was first authorized by the IRS for tax year 2013. The exclusive use and business purpose requirements are the same as for the original home office deduction, but the record keeping requirements are greatly streamlined. Only the allowable square footage needs to be measured. The square feet of the business use of the home is multiplied by $5 to arrive at the Home Office Deduction using the Simplified Method. The total square feet claimed cannot exceed 300 which limits the deduction to $1,500 per year.

Other benefits of the Simplified Method are:

1) Schedule A deductions for mortgage interest and real estate taxes are not reduced (as they would be using the normal computation of the Home Office Deduction),
2) there is no recapture of depreciation when the house is sold, and
3) as mentioned before, the calculation and recordkeeping requirements are significantly reduced.

Restrictions of the Simplified Method include:

1) the annual limit of $1,500 per year is often less than what could otherwise be claimed, and
2) the unused deduction in a current year may not be carried forward to future tax years (as is allowed by the traditional Home Office Deduction).

Example: a woman sells beauty products for a well-known MLM company. Her Schedule C net income for the year is $10,000. She uses a 15' x 20' bedroom exclusively for business. Her Home Office Deduction using the Simplified Method would be $1,500, which reduces her taxable net income to $8,500, saving her $375 in federal income taxes (at 25%) and about $230 in self-employment taxes (at 15.3%). Depending on her state of residence, she would also save state taxes on the $1,500 claimed using the Simplified Method. In MO, she would save an additional $90 (at 6%) for total tax savings of $695 on a $1,500 deduction that was easy to compute which did not require an additional expenditure of cash.

computing the standard home office deduction

Computing the greatest deduction for the benefit of the taxpayer is a complex process and I have seen many computations by tax preparers that were not correct.

Mistake #1 – Failure to deduct the value of the land.

Accounting theory has long held that land is not subject to depreciation. Therefore, the tax code requires that the value of the land be deducted from the total cost of a home before it is depreciated. In the case of a newly constructed home the homeowner usually purchases the lot first and then hires a contractor. The owner knows what he paid for the lot and he knows what he paid to the contractor, attorney, surveyor, etc. The total of all these expenditures represents the total cost of his home. This total cost must be reduced by the cost of the lot (land) to arrive at the depreciable cost of the home. Previously owned homes present a challenge in determining a separate value for the land. Perhaps you could ask your realtor how much your land is worth without your home.

Mistake #2 – Not claiming depreciation expense.

Many people (and even some tax preparers) believe that computing and taking a deduction for depreciation is optional. They assume that if they don't take it, they won't have to pay tax on depreciation recapture when they sell the house. However, that is not the case. The goofy IRS code states that depreciation recapture must be computed and related taxes paid on depreciation, which was "allowed or allowable." "Allowed" means that depreciation was actually claimed previously as an expense. "Allowable" means that depreciation expense could have been taken in a prior year, but was not. Technically, recapture of depreciation reduces the cost basis on an asset (in this context, a home) usually resulting in a taxable gain. Although most gains on home sales are not taxable (because of exclusions added to the tax code), recapture of depreciation on a home office results in a taxable event because the portion of the home used for business is considered business property, since it was used exclusively for business.

Mistake #3 – Computing the business use percentage incorrectly.

Many tax preparers ask their clients for the size of the room they use for business and total square feet of their home. Many realtors compute the total square feet of a home by measuring it from the outside because they want the house they are selling to sound as big as possible. However, included in that computation are things that can be excluded from the total area of the home, like the width of walls and insulation, hallways, stairways, closets, and bathrooms.

The best way for a business owner to compute the total living area of his home is to measure the square footage of every room. Since the formula to compute the business percentage of a home is to divide the business use (numerator) by the total living space (denominator), reducing the denominator will increase the business use percentage.

Example

A business owner uses a 10'x15' room (150 sq. ft.) exclusively for business. The total square footage of his home measured from the outside is 1,500 square feet. Now he measures the square footage of each room (excluding bathrooms, hallways, etc.) and arrives at 1,200 in total living space. If he had used the original 1,500 square feet for the total his business use for the home Office Deduction would be 10% Computing the more accurate number takes a little more time but results in a larger deduction; business use is 12.5%.

Home Office Deduction

Outside Square Footage Percentage Deduction	Actual Livable Square Footage Percentage Deduction
10%	**12.5%**

computing the basis of the home

In the real world, computing the basis of a home is often an educated guess (relying on the owner s memory), especially if the home has been owned for a couple decades. Obtaining the closing statement for the purchase of the home is usually a good place to start. It lists the contract sales price and several other items charged to the purchaser. Many of the fees listed on the closing statement are forgotten but they increase the basis of the home. Things like recording fees and title search are not deductible as Itemized Deductions, but they do increase the basis of the home just purchased.

Many lenders require the use of an escrow agent to collect premium, interest, taxes and insurance from the purchaser and to remit the respective items when due. Therefore, it is not uncommon for the closing statement to show a prepayment of up to a year for estimated taxes and insurance. Prepayments of taxes and insurance to escrow (listed on a closing statement) do not increase the basis of a home. Annual payments of mortgage interest and real estate taxes are deductible as Itemized Deductions and homeowner s insurance is considered a nondeductible, personal expense.

Once we have the original cost and closing costs, now we get to add the value of permanent improvements. The IRS treats major improvements as increases in basis, but not repairs and maintenance, which are required for general upkeep of any building.

allowable deductions

The following are expenses involved with living in a home and the business portion can be claimed via the Home Office Deduction:

- Utilities (include: electricity, water, sewer, natural gas, propane, heating oil, trash service, security system monitoring)
- Homeowners' or renters' insurance
- Repairs and maintenance (includes items such as: repairs to the home or appliances, snow removal, tree removal, carpet cleaning, HVAC maintenance, calling a plumber to fix a leaky sink or remove roots from your sewer line, having a maid service clean the house, hiring an electrician to install a light fixture, light bulbs. However, lawn care is specifically excluded by the IRS as pertaining to the "whole house." That makes no sense as does much of the tax code.)
- Homeowners' association dues and Condo fees
- Mortgage interest (The amount claimed as a home office deduction reduces the amount that can be claimed as an itemized deduction.)
- Real estate taxes (The amount claimed as a home office deduction reduces the amount that can be claimed as an itemized deduction.)
- Rent (Some people rent rather than own a home. Instead of claiming mortgage interest and real estate taxes, they can claim their rent as part of their total Home Office Deduction.)

the computation of the home office deduction

The actual computation of the Home Office Deduction will be performed automatically by any tax software. We are hopeful that this chapter has helped you understand the numerous items that can be deducted and where to enter them on Form 8829 or the Home Office Deduction Worksheet.

Below, are the fields that need to be entered for your tax software to do its job and compute the Home Office Deductions These entries follow Form 8829:

- Measure the portion of your home used exclusively for business.
- Measure the total living area of your home. (See mistake #3 above.)
- Compute the business portion of your home by dividing Step 1 by Step 2.
- Compute net income before the Home Office Deduction (Schedule C, line 29).
- Enter the amount of mortgage interest for the year.
- Enter the amount of real estate taxes for the year.
- Enter the amount of homeowner s insurance for the year.
- Enter the amount of rent paid for the year.
- Enter the amount for repairs and maintenance for the year.
- Enter the amount of utilities paid for the year.
- Enter other expenses like association dues or condo fees.

don’t forget the 100% deductions

Although these last three sections may not seem related to the computation of the Home Office Deduction, they should be understood and considered as ways to increase allowable expenses and thereby reduce income taxes. The 100% Deduction section reminds business owners not to prorate deductions that should be deducted in total. The next section handles converting personally owned assets to business use because this allowable strategy and legitimate deduction is widely unknown to business owners. The new $2,500 threshold might have an application regarding the Home Office Deduction, such as computing home repairs, but is included because it is a new development and could benefit any business owner or real estate investor.

Let's assume that a business owner converts a spare bedroom for business purposes and that the room is 10% of the total. All the items that are purchased to furnish the "new" business office are deductible at 100%. They do not have to be prorated using the Home Office Deduction. These items are often overlooked by most business owners.

These items may include such things as:

- The cost of paint for the new office.
- A rug or carpet for the office.
- Cell phone (Initially, the IRS required complex calculations of business vs. personal use. However, when they became ubiquitous, Congress responded to the public and removed that requirement. Remember, if the cell phone plan includes the wife and two teens, only the husband's portion of the cell bill can be deducted at 100%).
- Internet (If you use your cell phone to Google things on the internet and your main reason to have hardwired internet service is for your business, then it can be deducted 100% as a business deduction directly on Schedule C. If not, it can be prorated at a greater percentage than the Home Office Deduction.)
- Furniture purchased for the office, such as:
    - » Desk
    - » Chair
    - » Bookcase
    - » Computer hutch
    - » Printer table
    - » A sofa or easy chair to take a break and read technical documents
- Decorations, wall hangings, draperies, etc. used in office
    - » Objects of art or inspiration
    - » Framed artwork or diplomas
    - » Sound system if music inspires you or makes you peaceful
- Technology purchased for the business used in the office often include:
    - » Computer
    - » Monitors
    - » Keyboard
    - » Mouse
    - » Printer
    - » Scanner
    - » Switches and routers
    - » Computer cables
    - » Peripheral equipment
    - » Office supplies
    - » Paper
    - » Toner and printer ink cartridges

Expense vs. Capitalization

Everything that costs less than $2,500 can be expenses as repair or supplies and does not have to be set up as an asset

chapter 14

The Section 721 Real Estate Exchange

Real estate investors who wish to defer capital gains taxes while increasing diversification in real estate, should consider utilizing a 721 Exchange. Section 721 of the Internal Revenue Code allows an investor to exchange property held for investment or business purposes for shares in a Real Estate Investment Trust (REIT) or an Operating Partnership without triggering a taxable event.

The transaction provides investors with a way of increasing liquidity and diversification of their real estate investments, while deferring very costly capital gains and depreciation recapture taxes that may result from the sale of properties.

Many tax professionals and real estate investors may be keenly aware of the 1031 Exchange program utilized by REITs as a method of acquiring properties from investors who are interested in selling their real estate investments. They must also find a replacement property as part of a 1031 exchange otherwise, pay hefty capital gains taxes and depreciation recapture taxes. These tax professionals and investors are also aware that most of the time the REITs have many property and investment restrictions, as well as high costs.

Section 721 of the Internal Revenue Code provides investors who are interested in selling their investment real estate to do so without having to find a replacement property. The code allows real estate investors to capture these tax benefits even if the real estate has already been sold by contributing the funds from the sale of the real estate, as they would the property directly into a 721 Operating Company and receiving Operating Partnership Units.

This transaction is called a 721 Exchange and provides many benefits that will be discussed in this chapter. The Section 721 Exchange has been titled by Real estate Weekly as "one of real estate's best-kept secrets." It should be recognized as a popular investment tool for real estate investors who wish to accomplish any of the following or all three - tax-deferral, estate planning, and diversification. It is important to remember that the Internal Revenue Code Section 721 is a complex tax code as is the Section 1031, and therefore all investors should consult their tax and/or legal professionals before making any type of investment decision.

what is section 721?

A 721 Structure allows an investor to exchange property held for investment or business purposes for shares in a REIT or Operating Partnership.

Section 721 of the Internal Revenue Code allows an investor to exchange property held for investment or business purposes for shares in either a REIT or an Operating Partnership without triggering a taxable event. This Section 721 financial structure is also referred to as a 721 Structure, as property or funds from the sale of property (such as 1031 sale of real estate) can be put in an Operating Partnership which can remain in the Operating Partnership or eventually be transferred tax free to a REIT.

Operating Partnerships are formed to aggregate real estate property and proceeds from the sale of real estate property, and either retain the assets and/or eventually roll the assets into a REIT if the Partnership desires.

The Section 721 is a method to acquire property from investors who are interested in selling their investment real estate, and do not want to find a replacement property as part of a 1031 exchange, nor pay capital gains taxes. Rather than exchanging property for another property, an investor can utilize Section 721 to contribute /relinquish property monies directly to the Operating Partnership in exchange for Operating Partnership Units. This transaction is often called a "721 Structured Exchange."

Investors seeking to defer capital gains taxes while increasing diversification in real estate, should consider utilizing a 721 Exchange.

the benefits of the section 721 exchange

In a typical property sale, the seller would pay taxes on the capital gains realized, as well as the depreciation that was utilized to defer taxes on the property's income. The capital gains and depreciation recapture taxes could exceed 20- 40% of the gains realized upon sale; leaving the investor with less capital for reinvestment (financial benefits comparison is provided at the end of this chapter and although the example uses a $100-Million property sale, the 721 Exchange can be accomplished with proper guidance with any size income generating or business property). A 721 Exchange allows investors to avoid taxes and keep their wealth working in a tax-deferred exchange of their investment property for shares in an Operating Partnership.

The 721 Exchange enables an investor to achieve diversification across geography, industry, tenant, and asset class in an Operating Partnership structure. As a shareholder in the Operating Partnership, the individual investor participates in a diversified portfolio of real estate and is no longer concentrated and dependent on one asset to provide cash flow and appreciation. The Operating Partnership can provide the same ongoing benefits of real estate ownership including income, depreciation tax shelter, principal pay down, and appreciation. The Operating Partnership can continue to make acquisitions on an ongoing basis. This allows the investor to benefit from future buying opportunities in the Operating Partnership without triggering any capital gains or depreciation recapture tax events

A 721 Exchange allows investors to avoid taxes and keep their wealth working in a tax-deferred exchange of their investment property for shares in an Operating Partnership.

specific investor benefits

Consistent Income: Operating Partnerships can issue dividends or distributions so that the investor has cash flow similar to when they owned their contributed property.

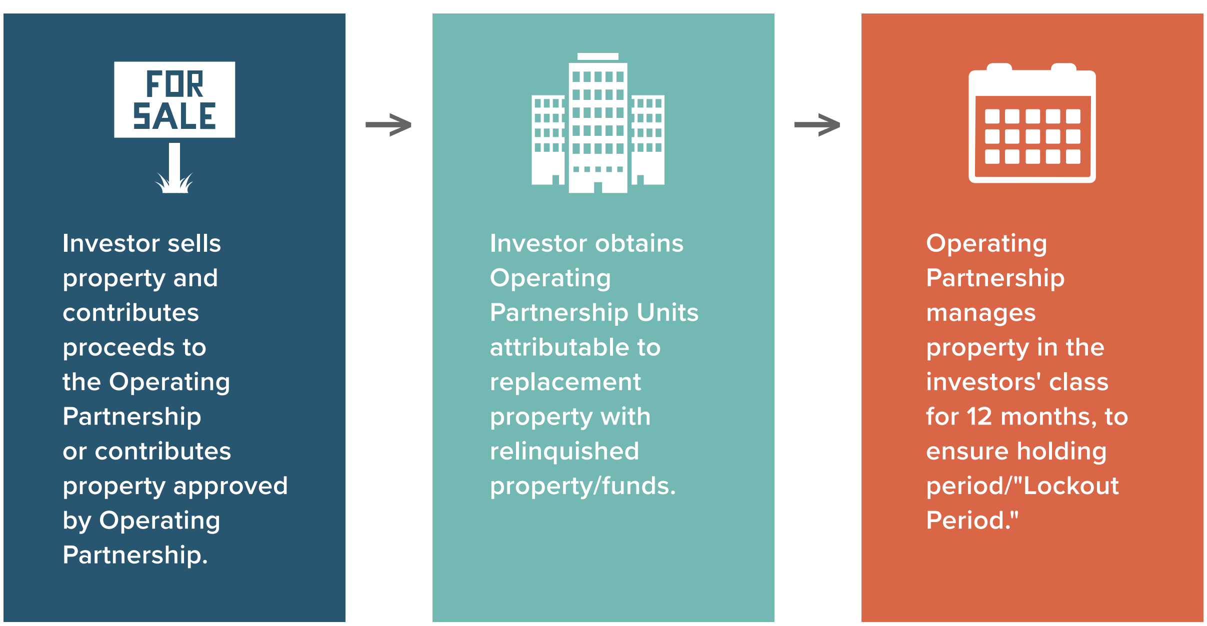
Tax Deferral: Contributing property or cash from the sale of real estate into the Operating Partnership provides for a deferral of any taxable income from the sale/transfer of the underlying real estate.

Tax Safety on Sale of a Portfolio Asset: On the sale of Operating Partnership property, partnership accounting and management fees generate sufficient expenses to offset any gains investors would be allocated, but the lockout period and indemnification provisions normally offset risk of gains.

Portfolio Diversification: Investor owns part of an ongoing Operating Partnership with diversified real estate projects.

Passive: The 721 Exchange allows investors to trade an actively managed real estate asset for a portfolio of real estate assets that are actively managed by the principals of an Operating Partnership, which focuses operations on real estate development / investment / mortgages. This structure allows individual investors to access and rely upon expertise provided by institutional asset management firms for all decisions regarding the real estate portfolio. The Operating Partnerships are passive investments, structured to provide acquisitions, property management, dispositions, investor communication, and the distribution of investors income produced from the portfolio.

The Transaction Flow of the 721 Exchange



Estate Planning: The 721 Exchange often is utilized as an estate planning tool to prepare an investors real estate assets to be passed down to heirs. When direct real estate assets are passed to heirs they are often difficult to quickly liquidate and equally divide among heirs. Conflict may arise as to how or when assets are to be sold, and this can create other asset issues for the heirs. The 721 Exchange provides a tailored solution that allows the estate to be prepared for easy transfer, while deferring the capital gains taxes that have built over the years. Before death and the passing down of the estate to heirs, the individual investor continues to receive dividend income. Instead of individual real estate assets, the heirs can receive easily divisible shares in the Operating Partnership that can be much more easily liquidated upon passing of the estate. Heirs who do not want or need funds may continue to hold shares in the Operating Company and receive dividends. Regardless of the decision of the heirs, heirs receive a step up in basis that permanently removes all capital gains and depreciation recapture taxes deferred in the estate. Beyond the estate planning benefits, the divisibility and liquidity of Operating Partnership shares allows investors to easily sell some of their shares if they are in need of capital.

Flexibility: Most often, in order for an investor to contribute a property to a REIT through an UPREIT transaction, the property must meet the REIT's stringent investment criteria. However, with some well-designed Operating Partnerships, the Operating Partnership can structure the Operating Partnership as it sees fit. In order to entice the most number of like-minded investors. By utilizing a 721 Exchange, an individual investor can exchange a property that does not meet the Operating Partnerships criteria for a fractional interest in a high-quality property or portfolio.

financial benefits

Cost/Revenue Benefits from a 721 Exchange		
1031/721 vs. Sold Property Cost/Revenue Benefits	1031/721 Transfer	Sold Property
Fair Market Value (FMB) of property	$100,000,000.00	$100,000,000.00
Fee to transfer FMV of property (1.5%)	$1,500,000.00	-
Fee to sell property at FMV (4%)	$0	$4,000,000.00
Closing Costs to sell property (5%)	$0	$5,000,000.00
Property Value Net of Transfer/Selling Fees	**$98,500,000.00**	**$91,000,000.00**
IRC 721 Capital Gains Deferment (IRS & State)	$0	-
Capital Gains 28.5% (IRS & State) NOTE A	$0	$14,250,000.00
IRC 721 Depreciation Recapture (IRS & State)	$0	-
Depreciation Recapture 28.5% (IRS & State) NOTE B	$0	$21,375,000.00
Net Property Value	**$98,500,000.00** NOTE D	**$55,375,000.00**
Dividend payouts in Partnership TIC NOTE C	$5,910,000.00	
Partnership TIC Annual Fees NOTE E		
Management Fee (1%) NOTE F	$985,000.00	
Property Management Fee (3%)	$2,995,000.00	

GENERAL NOTE: The above calculations are for illustrative purposes. The fees stay constant, the values will change for each property.

NOTE A: For the purposes of this comparison, we assume a Capital Gain of $50,000,000 or 50% of FMV

NOTE B: For the purposes of this comparison, we will assume a Depreciation Recapture of $75,000,000 or 75% of FMV

NOTE C: Each property in the TIC will have its own Revenue Stream. For the purposes of this property we use 5% annually

NOTE D: The owner of the sold property will find another property which will incur fees, expenses and revenue stream.

NOTE E: All fees are tax deductible to the owners of the Partnership TIC

NOTE F: This fee is used for our outside Legal, CPA and Tax Preparation (TIC & Personal Reporting)

chapter 15

Cost Segregation: Frequently Asked Questions

frequently asked questions

Q: What is a cost segregation study?

A: The IRS requires an investment property to be depreciated (expensed/ amortized) over either a 27.5 period for rental properties or 39 year period for non-rental properties. An independent engineering report, permissible by the IRS breaks down the building into detailed components with their associated values. This report shows the IRS in detail, the value of individual components within the building (concrete, masonry, steel, finishes, equipment, furnishings, plumbing, HVAC, electrical, land improvements, and other related components) that may exhaust over a much shorter period versus the 27.5 or 39 years standard amortization. The report basically allows the property owner to expense 20% to 45% of the building immediately versus over the 39 years. The IRS allows these studies for new buildings and any buildings owned less than 15 years with proper documentation. These reports can help with writing off a tremendous amount of the investment immediately on new properties or allow a property owner to go back up to 15 years to generate significant tax deductions for under amortizing their building. Provide acquisitions, property management, dispositions, investor communication, and the distribution of investors income produced from the portfolio.

Q: When should a cost segregation study be done?

A: A cost segregation study is best done when a property is purchased, constructed, or remodeled after December 31, 1986 and if the owner will be paying property taxes for a few years.

Q: How long does it take to complete a cost segregation study?

A: All properties and cases are different. However, a cost segregation study will typically take between 4 to 6 weeks to ensure a quality cost segregation study.

Q: What is the cost of a cost segregation study?

A: The estimate of the cost segregation is typically done after the property in question has been surveyed. The more important question is to ensure that your cost segregation specialist is qualified to conduct an engineered study.

Q: What is a quality cost segregation study?

A: The IRS defines a quality cost segregation study as “a study that is both accurate and well-documented in the process of classifying, explaining the rationale, and substantiating the cost basis of each asset, while reconciling total allocated costs to total actual costs.”

Q: Can a cost segregation study be performed on buildings in the past?

A: Yes. Property owners can prepare a cost segregation look-back study on their current property and re-calculate the depreciation for the previous tax years based on their reclassified asset costs.

Q: When is a cost segregation study not a good option?

A: In order to take the full advantages of performing a cost segregation study on your property, it is recommended to own the property for at least two years or more. If your property is losing money, then it is not recommended to perform a cost segregation study. Also, not all commercial properties will qualify for a study. Price valuation is an important factor on whether a study is necessary for the owner or not. Savings must be very significant compared to the costs acquired in performing the study.

Q: What if the IRS does not accept the reports?

A: We provide a guarantee on our reports. Additionally, due to our diligence, expertise and licensing, we are able to insure our reports. We also get more mileage out of each report in terms of energy and insurance benefits. The key to our reports is to yield as much benefit as possible in the areas of tax, energy and insurance while having the product exceed IRS guidelines and produce the highest reclassification.

Q: What if you already work with a different cost segregation company?

A: The difference is in the quality, data and procedures followed and detailed in our report yield more mileage. We are the only legitimate licensed engineering firm in the industry that has professionally licensed engineers on staff with mechanical and structural expertise. Our firm can break down 39 and 27.5-year property in detail. This allows you to better manage all assets from a tax perspective in terms of leases, abandonment and sale.

Q: What if you're concerned about the tax consequences of a study?

A: We take the marriage of accounting and engineering very seriously and have built our firm on that foundation. In addition to our licensed engineers, we have a tax expert on staff that worked with the IRS for 33 years and performed tax controversy work for Deloitte for several years.

Q: What if you considered cost segregation studies in the past, but they were too expensive, with too little guidance for an accepted study?

A: Times have changed. You can now consider a study with confidence. The fees have gone down for superior savings, the IRS has published effective rules and a one-year catch up is permitted. Now is the perfect time to review your opportunities.

Q: What if your other cost segregation firm is cheaper?

A: Our fees are very competitive. However, be wary of firms that do not charge market price for a highly specialized service. Firms without tax experts to consult and collaborate on engineering studies raise red flags with the IRS because it reflects a lack of expertise in cost estimation.

Q: How much money can a cost segregation study save me?

A: Typically, a building will yield 25-30% of the total cost that can be segregated into land improvements and personal property.

Q: Doesn't my accountant already do cost segregation for me?

A: The IRS recommends using a third party for cost segregation studies, since the expertise of an engineer is required for the study.

Q: If a condominium complex is a short-term vacation rental, can I still do a cost segregation study?

A: Yes. However, short-term rentals vs long-term rentals depreciate differently. Although a condominium is considered a residential property and typically depreciates over 27.5 years, short-term rentals typically depreciate over 39 years. Dwelling units rented for a duration of 30 days or less are considered transient (hotel, motel, rooming houses, etc.). If 20% or more of the units, in the entire building meet this definition, the entire property is depreciated using 39 years.

about engineered tax services

about the author

Julio Gonzalez
Founder & CEO

Mr. Julio P. Gonzalez founded the Gonzalez Family Office and is the CEO and Founder of Engineered Tax Services, Inc. Engineered Tax Services is the country's largest specialty tax engineering firm which specializes in the preservation of wealth and United States' job creation through IRS engineering-based services to include research and development manufacturing tax credit and grant studies, energy tax incentives studies, cost segregation deprecation studies for buildings, Opportunity Zone studies, real estate state and local incentive studies and alternative tax optimization studies.

Mr. Gonzalez started Engineered Tax Services in 2001 to bring specialized engineering tax studies to mainstream America, which have historically only available to the Fortune 500 and public companies through then the Big 8 National Accounting Firms. Engineered Tax Services has 26 offices nationally and is headquartered in West Palm Beach, Florida.

In addition to Engineered Tax Services, Mr. Gonzalez started several other family operational companies including his family office, Gonzalez Family Office (GFO), Calle Gato Ocho (CGO), Engineered Tax Exchange (ETE) and Engineered Family Office (EFO). Gonzalez Family Office manages the Gonzalez family capital by investing primarily in real estate, private equity, and venture capital. CGO owns and operates direct real estate investments in multi-family housing and office/mixed-use real estate for the Gonzalez family.

Mr. Gonzalez works weekly in Washington D.C. to work with the administration, Congress and Senate to advise on tax reform and is the go-to tax expert representing many national organizations and associations. He is a regular public speaker on a national level regarding tax reform and tax sophistication for wealth preservation.

CONTACT
jgonzalez@engineeredtaxservices.com | 1-800-236-6519
engineeredtaxservices.com

our history

Engineered Tax Services, Inc. was founded by Julio P. Gonzalez in 2001. Julio saw the need for a company that could provide services to CPA firms, business owners, and commercial property owners to utilize specialty tax incentives previously available only to Big 4 accounting firms and Top 100 corporations. His vision encompassed a way to allow clients the utilization of tax incentives that could increase cash flow, expand service offerings, retain competitive advantage, and provide all of these consultative services under one roof. Even better, his vision was to create a company that provided a valuable service both to its clients and their surrounding community.

Engineered Tax Services, Inc. is a licensed engineering firm that focuses on federal, state, and local tax benefits. Under Gonzalez's guidance and true insight into how the industry is shaping, Engineered Tax Services is one of the largest, fastest growing, and most innovative engineering, energy, and specialty tax credit services firms in the country.

services

- Cost Segregation
- Research & Development Tax Services
- Energy Tax Certifications
- Construction Tax Planning
- Disposition
- IC-DISC
- Historic Tax Credits
- Sales Tax Credits
- Tax Controversy Studies
- DEIRA
- Fixed Asset Review
- Historic Valuation

bonus page
opportunity zone

opportunity zone | tax credit case study

Purchase Price of Building | $1,000,000

Est. Cost of Improvements | $10,000,000

Cost Segregation Study (Pre-Construction value $285,000)

$3,150,000 in immediate tax deductions in Post-Construction Cost Segregation Study

	Eligible Tax Credits
Historic Tax Credits - Federal	$1,800,000
Historic Tax Credits - State/Local	$2,000,000
New Market Tax Credits	$500,000
Brownfield Grant	$480,000
Loss Development Rights	$380,000
Solar Tax Credits	$250,000
Facade Easements	$520,000
Cell Tower Income	$500,000
Property Tax Abatement	$1,200,000
TIFFS	$480,000
Energy-Efficient Tax Credits	$112,000
Design Tax Credits	$84,000
Additional S.A.L.T. Credits	Negotiable State by State
Total	**$8,591,000**

Disclaimer

Tax credits and savings list above in this case study are estimates only, and there is no assurance that your tax savings will match the figures presented, which is given as an example.

Your reliance on the figures we present is at your own risk. Any tax credit savings are Not to be interpreted as common, typical, expected, or normal for the average property investment.

opportunity zones overview

In the Tax Cuts and Jobs Act of 2017, Opportunity Zones were established by Congress to encourage long-term investments in low-in-come urban and rural communities nationwide. The governor of each state was allowed to nominate certain areas for the IRS so that they would be certified to receive investment from Qualified Opportunity Funds (QOF).

To create incentives to spur this economic development, Opportunity Zones were created to provide tax benefits to investors. First, investors can defer tax on any prior gains until the earlier of the date on which, an investment is sold or exchanged, or December 31, 2026, as long as the gain is reinvested in a Qualified Opportunity Fund. Second, if the investor holds the investment in the Opportunity Fund for at least ten years, the investor would be eligible for an increase in basis equal to the fair market value of the investment on the date that the investment is sold or exchanged.

To become a Qualified Opportunity Fund, an eligible taxpayer self-certifies. (Thus, no approval or action by the IRS is required.) To self-certify, a taxpayer merely completes a form provided by the IRS and attaches that form to the taxpayer's federal income tax return for the taxable year. (The return must be filed timely, taking extensions into account.)

To establish a Qualified Opportunity Fund, an investment vehicle is set up as either a partnership or corporation for the purpose of in-vesting in a eligible property, located in an Opportunity Zone that utilizes the investor's gains from a prior investment in order to fund the Opportunity Fund.

The creators of this program claim that employment in these areas should increase as well as spurred growth and reduced poverty, but the results will only be available once the program is used over the next 3 to 5 years since inception.

The fundamentals for the Opportunity Zones are to help investors, through tax incentives, to transform areas that are declining or already have failed to thrive and create economic hubs. This is not the first time that such programs have been designed to spur economic development in targeted areas. Timothy Weaver, professor of Urban Policy and Politics at the State University of New York at Albany, writes: "Numerous efforts have been made to create similar programs in similar zones, both in the U.S. and the U.K. After reviewing these programs, on the whole, scholars reached the strikingly similar conclusion that the programs did not work, at least not as was hoped."

Unlike the SEC or FINRA, who put parameters on who can raise money or sell securities, the government has set no limitation on who can start and operate an Opportunity Zone Fund. This may lead to many people selling the sizzle and the tax benefits of the program, rather than the real estate investment itself.

With over 8500 Opportunity Zones, investment opportunities should exist in secondary and tertiary markets, as well as major markets, but stringent due diligence will need to done to ensure the location is ideal. One will need to take a good, hard look at a market demand analysis and ask questions such as: Is the population in that area shrinking or growing? What is the current income like in that area? Is it close to public transportation? Is the "wave" of gentrification coming that way? These are just a few of the questions outside the investment you should look at, and if your operator can not provide this information, then one should start looking elsewhere. This type of non-market information happens quite a bit when the market is doing very well, and people are hopping into the market to become "the next big developer." This could easily happen with Opportunity Zone properties.

Location, location, location is still the most important thing to consider in any real estate investment. For example, if one would look in Nevada for an opportunity zone, one of the best places to invest would be the old part of Las Vegas, which has already begun to gentrify with the help of the Zappos CEO Tony Hsieh, who has been pouring money into that area since well before the Opportunity Zone program came about.

Because the location is close enough to the central part of the city, and the gentrification process had already begun before the announcement of the Opportunity Zone program.

To many, the Opportunity Zone is being considered the next best investment opportunity, but the fundamentals still need to be followed. You still need to make sure you dig deeper into the real estate opportunity. What is the demand for the property type? What kind of property type is best for the location? What is the experience of the developer? What is the track record of the developer? How much is the operator putting in of their own money and what is their plan to protect the downside if the area doesn't take off as they think it? Regardless of the tax benefits, investors still have to have an excellent investment opportunity that is being managed by a proven operator, focusing on the fundamentals of real estate investing.

DJ Van Keuren

engineered
TAX SERVICES

www.engineeredtaxservices.com