Tax Planning Ideas:
Introduction to Cost Segregation and the Impacts of Tax Reform

ABOUT KBKG

- Established in 1999 with offices across the U.S. , including Pasadena, New York, Chicago, Dallas/Ft. Worth, and Atlanta.
- Provide turn-key tax solutions to CPAs and businesses.
- R&D Tax Credits, R&D Audit Defense, Cost Segregation, Energy Tax Incentives, Repair vs. Capitalization Studies, Transfer Pricing, IC-DISC Export Incentives.
- Performed thousands of tax projects resulting in hundreds of millions of dollars in benefits for our clients.
- Our team is a diverse mix of tax professionals, attorneys, engineers, and economists from various disciplines. This combination of talent allows us to focus on our areas of service and maximize results for our clients.
- A preferred provider for thousands of CPAs across the country.

TODAY'S PRESENTERS

Amar Patel

Principal – Cost Segregation

WHAT IS COST SEGREGATION?

Primary goal: Identify all property-related costs that can be depreciated faster (typically with a 5, 7 or 15 years tax life)

- Taking tax deductions earlier increases cash flow
- Creates a time value of money benefit by having cash now and not later

Secondary goal: Establish the depreciable tax value for each major building component that is likely to be replaced in the future

- Examples include the roof, windows, doors, bathroom fixtures, HVAC, etc.
- Tax preparer's need this information to claim a "retirement loss" or "partial disposition" deduction for the remaining depreciation left on that component.

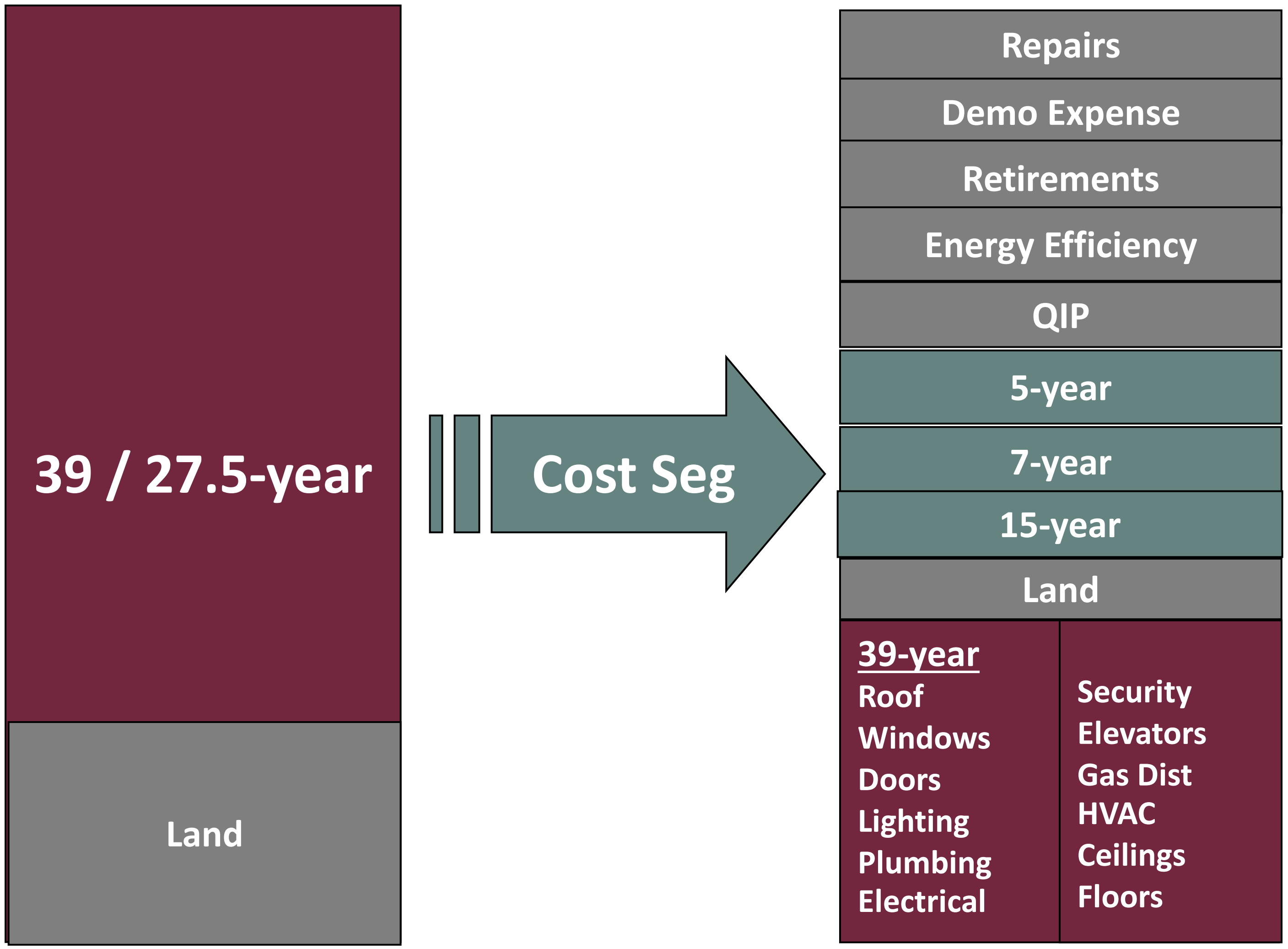
KBKG ENHANCED COST SEGREGATION STUDIES

APPLIES TO:

- Acquired Property
- New Construction
- Remodeled Property
- Build-outs/Tenant Improvements

MAKES SENSE:

- Building > $750,000 (less land)
- Acquired, constructed or remodeled in last 20 years



ANY TYPE OF PROPERTY MAY BE ELIGIBLE FOR A STUDY

Building Type	Average Re-Allocation
Apartment Buildings	20-35%
Retail Stores	20-40%
Restaurants	20-45%
Office Buildings	10-25%
Manufacturing Facilities	20-60%
R&D	30-60%
Wineries	20-45%
Grocery Stores	25-45%
Hotels	25-45%
Warehousing	10-25%

Other Projects Include:

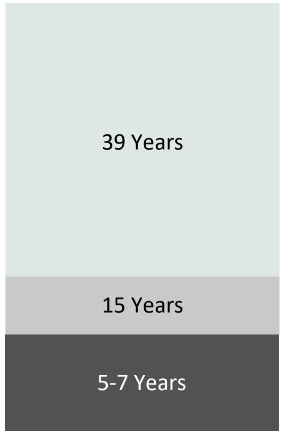
- Shopping Malls
- Self-Storage Facilities
- Sports Facilities
- Golf Courses & Ranges
- Auto Dealerships
- Gas Stations
- Healthcare Facilities
- Medical Centers
- Industrial Buildings
- Distribution Centers
- Auto Service Centers
- And more…

EXAMPLE: OFFICE BUILDING, CURRENT YEAR ACQUISITION

- $5 million office building
- Without cost segregation costs are depreciated straight line over 39 years

With a Cost Segregation Study

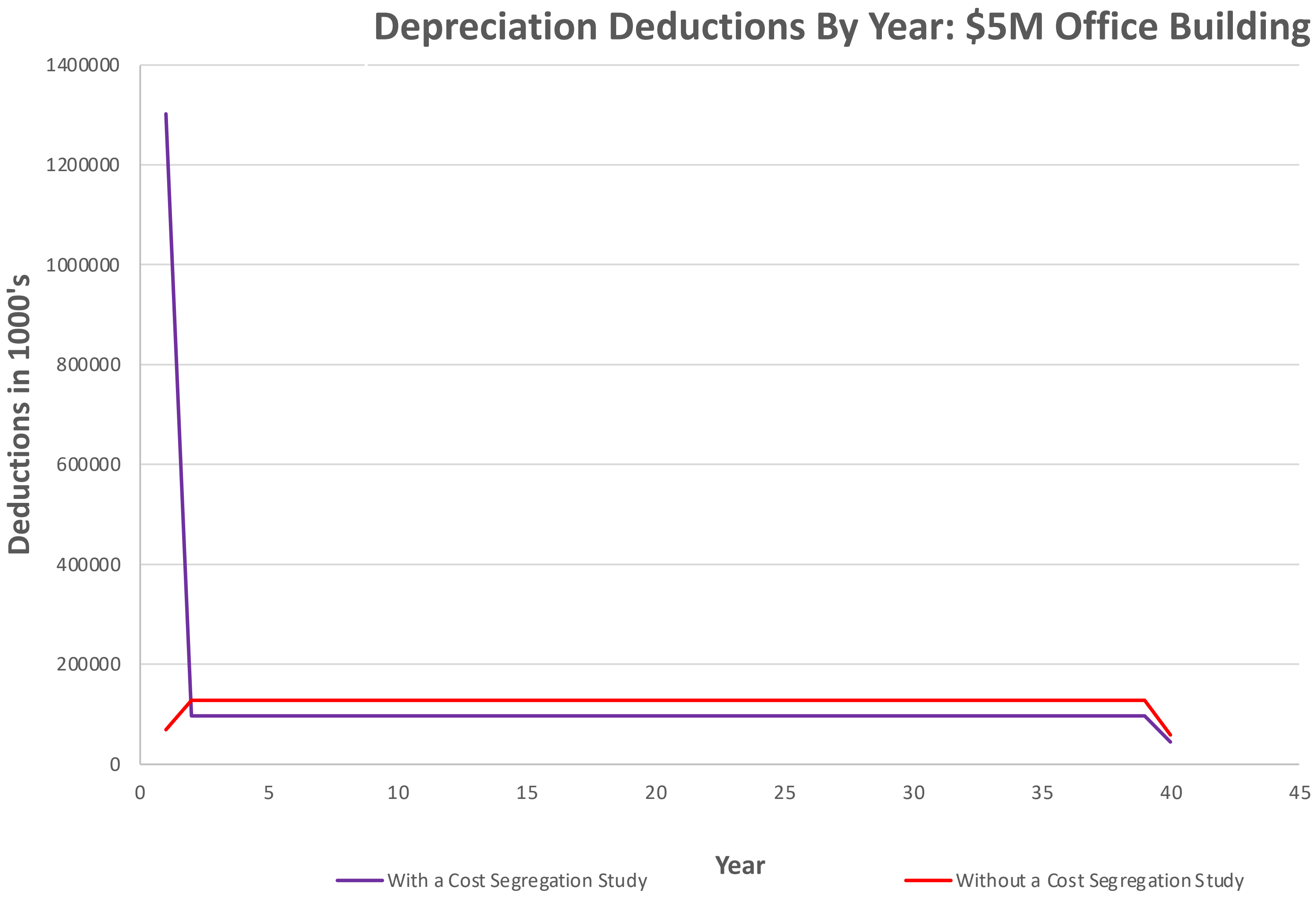
$5 million recovered over asset class lives



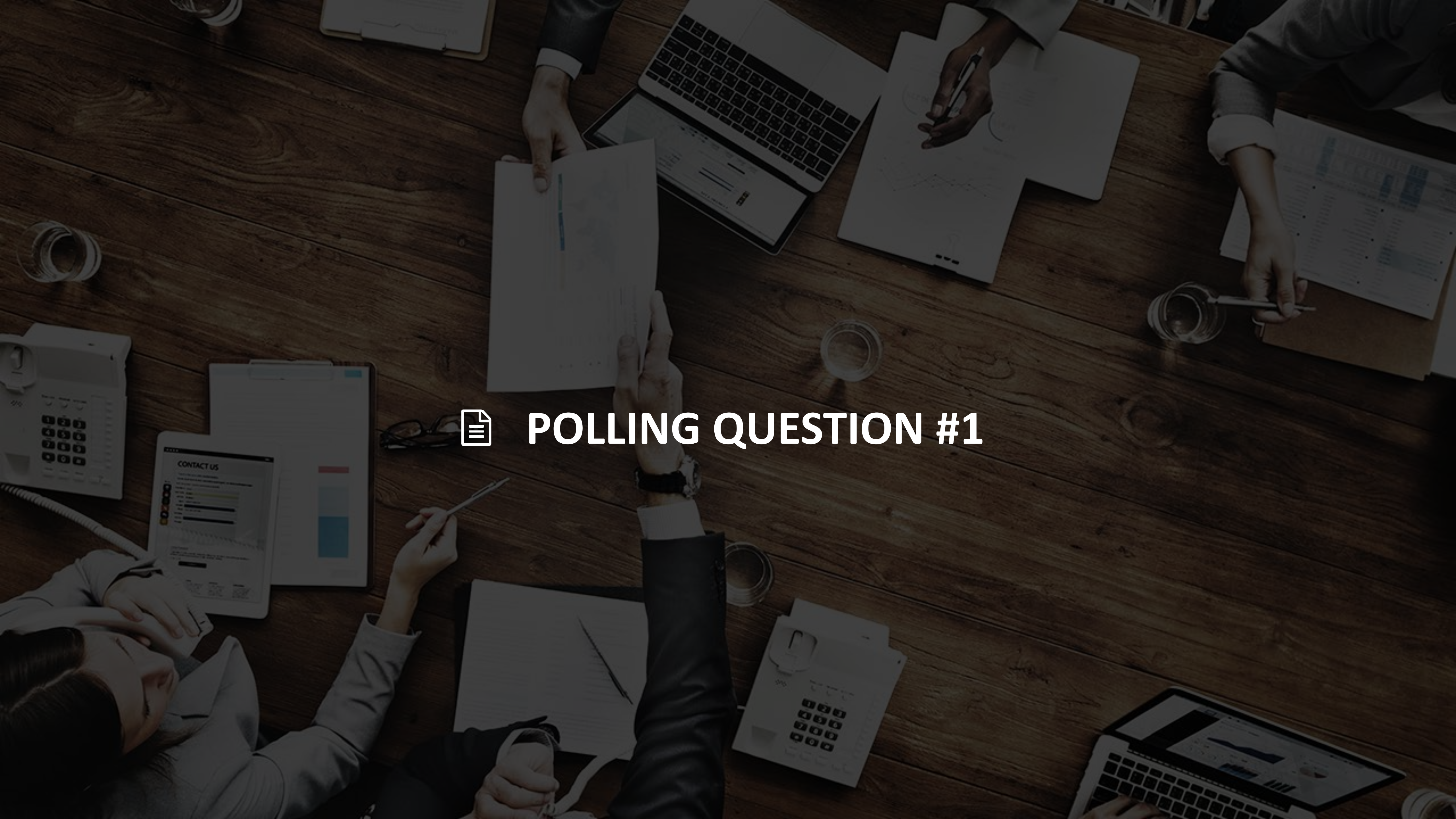
Of $5 Million:
$750,000 = 5- or 7-year property
$500,000 = 15-year property
$3,750,000 = 39-year

Increased Depreciation Deductions in the Year 1: $1,200,000
Cash Tax Savings: $420,000
Projected NPV Benefit (8% disc. Rate): $310,000

BENEFIT: ACCELERATED DEPRECIATION DEDUCTIONS



POLLING QUESTION #1



COST SEGREGATION – TAX PLANNING TOOL

One of the most common tax planning tools for anyone with real estate

- Performed in year purchased – simply report the allocations on depreciation schedule

Can be done anytime after the building is purchased

- No amended tax returns
- File a Form 3115 and claim any missed deductions in year performed.
- Allows tax preparers to plan when to use deductions

Modified Rule of Thumb:

Use online software for residential buildings with basis > $150k

- https://www.kbkg.com/residential-costsegregator

TAX CONSIDERATIONS

- Unused deductions carry forward
- When building is sold, the taxpayer must recapture depreciation taken on personal property
  - Personal Property (Sec 1245) recapture is at ordinary tax rates.
  - This is why the hold period should be > 3 years
- Passive activity rules can offset benefit of a cost segregation
- 1031 exchange ("Like-Kind Exchange") rules need to be considered

RECAPTURE

When building is sold, taxpayer must recapture depreciation taken on personal property

- Personal Property (Sec 1245) is recaptured at ordinary tax rates so best to hold > 3 years
- 1245 property may lose value quicker than 1250 property upon sale – may mitigate 1245 recapture
- Disposed components are not recaptured

TAX REFORM – 1031 EXCHANGE "LIKE-KIND EXCHANGE

1031 Exchanges

- Cost segregation can still be beneficial on both sides of a real estate exchange

- Bonus depreciation would apply to the "excess basis" in the new property

Example: A property is sold in a 1031 exchange for $1M. There was $700K of depreciation leftover at the time of sale (aka "carryover basis"). <u>Not eligible for bonus.</u> Gain =$300K

The new property is purchased in a 1031 exchange for $1.5M. Defer Gain by reducing basis by $300K, New basis $1.2M of which $700K is carryover and only the **excess basis of <u>$500K</u>** ($1.5M - $1M) **is eligible for bonus** depreciation.

PARTIAL DISPOSITIONS

Current regulations allow you to take a loss deduction when you remove components from your building!

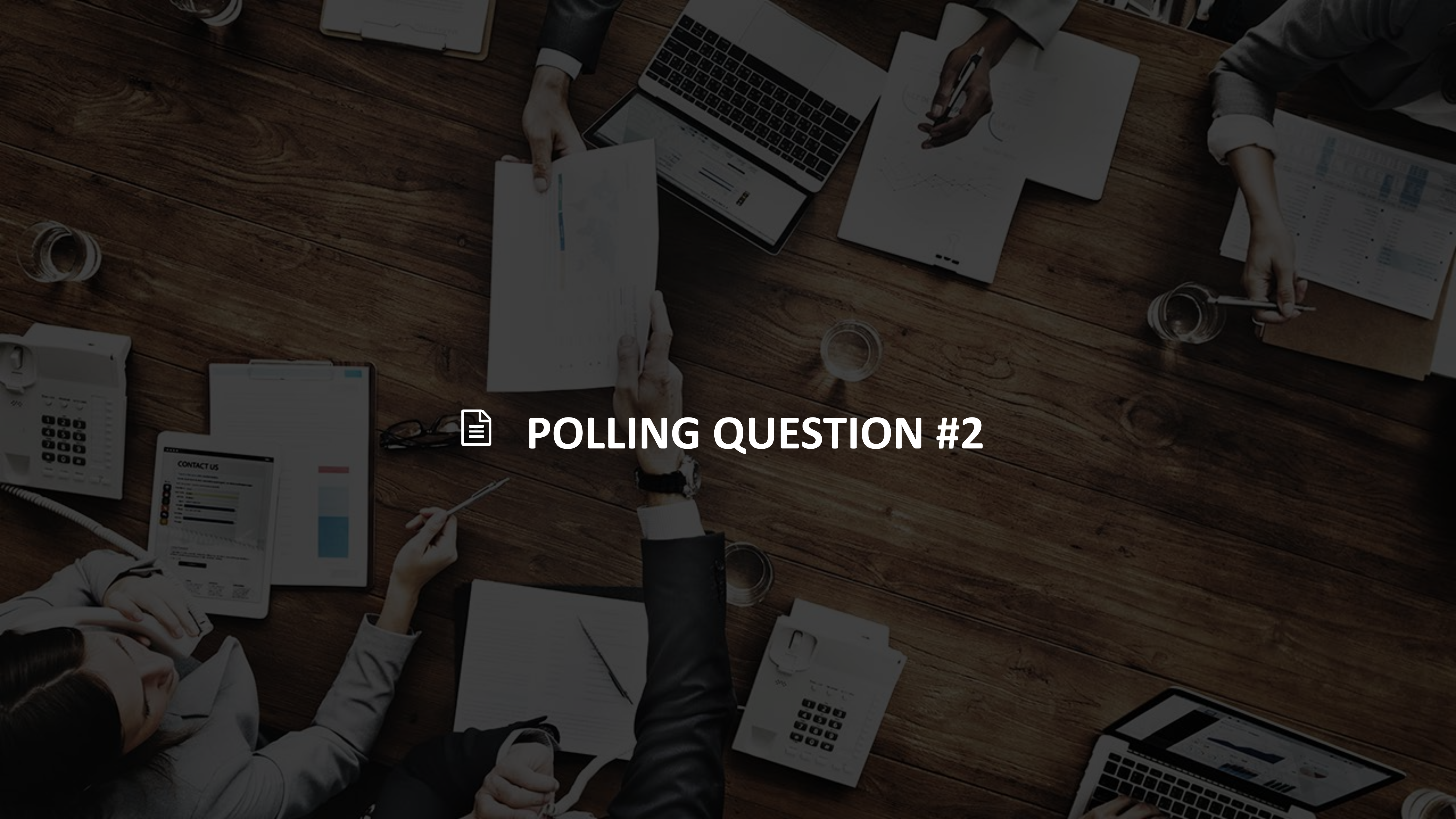
Example: If you pay $200,000 for all new windows in your building, you need to capitalize that amount

- Depreciate that $200,000 over 39 years
- Figure out how much the old windows were not written off and claim all that as an immediate deduction!

- Can be done on a go forward basis only, not retroactive.

Online Partial Disposition Calculator

- http://kbkg.com/solutions/partial-disposition-calculator



POLLING QUESTION #2

TAX REFORM – BONUS DEPRECIATION

100% bonus rate applies to assets acquired post 9/27/17 thru 2022

- Rate phases down 20% each year after that
- Bonus is now available for **used property**

Cost Seg Studies - personal property and land improvements are fully depreciated even for acquired buildings

Limitation on Business Interest Expense :

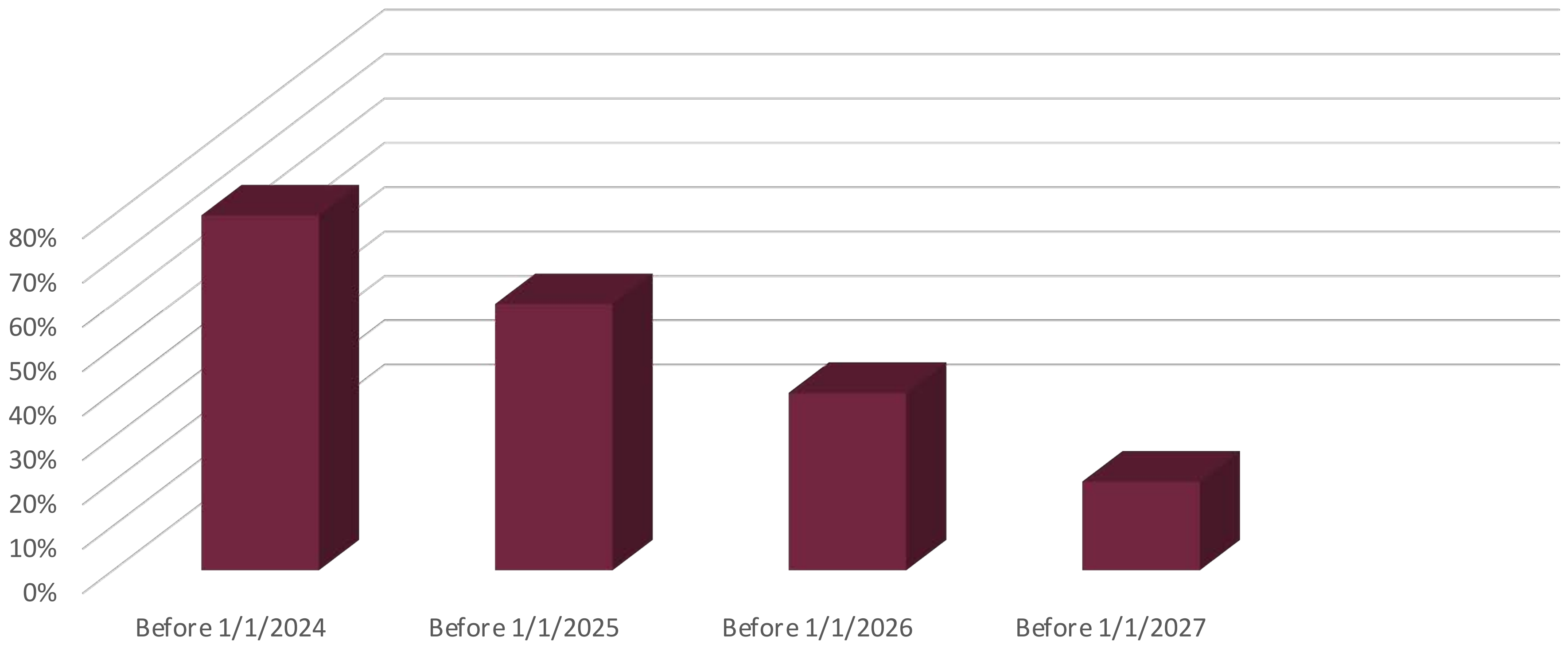
Real Property Trade or Business 163(j) >$25M revenue

- Election to deduct all their interest
    - ADS required on **real property only**
    - 40-years on commercial buildings, 30-years on residential rental, **20-years on QIP**
- ADS **NOT** required on personal property and land improvements
- Not applicable to businesses with less than $25M in revenue (avg. last 3 years)

TAX REFORM – BONUS DEPRECIATION

100% bonus depreciation is applicable for assets **acquired and placed in service** after 9/27/17 and prior to 1/1/23

Phase down through 2026



Bonus Depreciation

Section 754 Elections

- Step up is bonus eligible if new partner had no prior depreciable interest in the property.

- If taxpayer owning existing depreciable interest acquires additional depreciable interest in same property, additional interest **IS** bonus eligible.

Step-Up Upon Death

- Step-up on death specifically **excluded** from bonus depreciation
  - Property received by decedent **NOT** eligible for bonus depreciation

TAX REFORM – BONUS DEPRECIATION

Qualified Improvement Property is defined as:

- Sec. 1250 **INTERIOR** improvements to non-residential property
- Made by taxpayer **AFTER** the building was originally placed in service
- **NON-STRUCTURAL** in nature
- **NOT ELEVATOR** or escalator
- **NOT EXPANSION** of the building

Qualified Improvement Property *history*:

39yr w/ Bonus → 39yr w/o Bonus → 15yr w/ Bonus

1/1/2016 to 12/31/2017 – QIP 39yr, 50% bonus eligible

9/27/2017 to 12/31/2017 – QIP 39yr, 100% bonus eligible (if acquired & PIS during period)

1/1/2018 to 12/31/2019 – QIP 39yr, not bonus eligible (**PER TCJA**)

1/1/2018 to 12/31/2022 – QIP 15yr, 100% bonus eligible (**CORRECTED BY CARES ACT**)

TAX REFORM – BONUS DEPRECIATION

Following property is SPECIFICALLY EXCLUDED from bonus applicability

- Property **REQUIRED** to be depreciated under the alternative depreciation system (ADS)
    - Used predominately outside of the U.S.
    - Tax-exempt use property
    - Tax-exempt bond financed property

TAX REFORM – BONUS DEPRECIATION

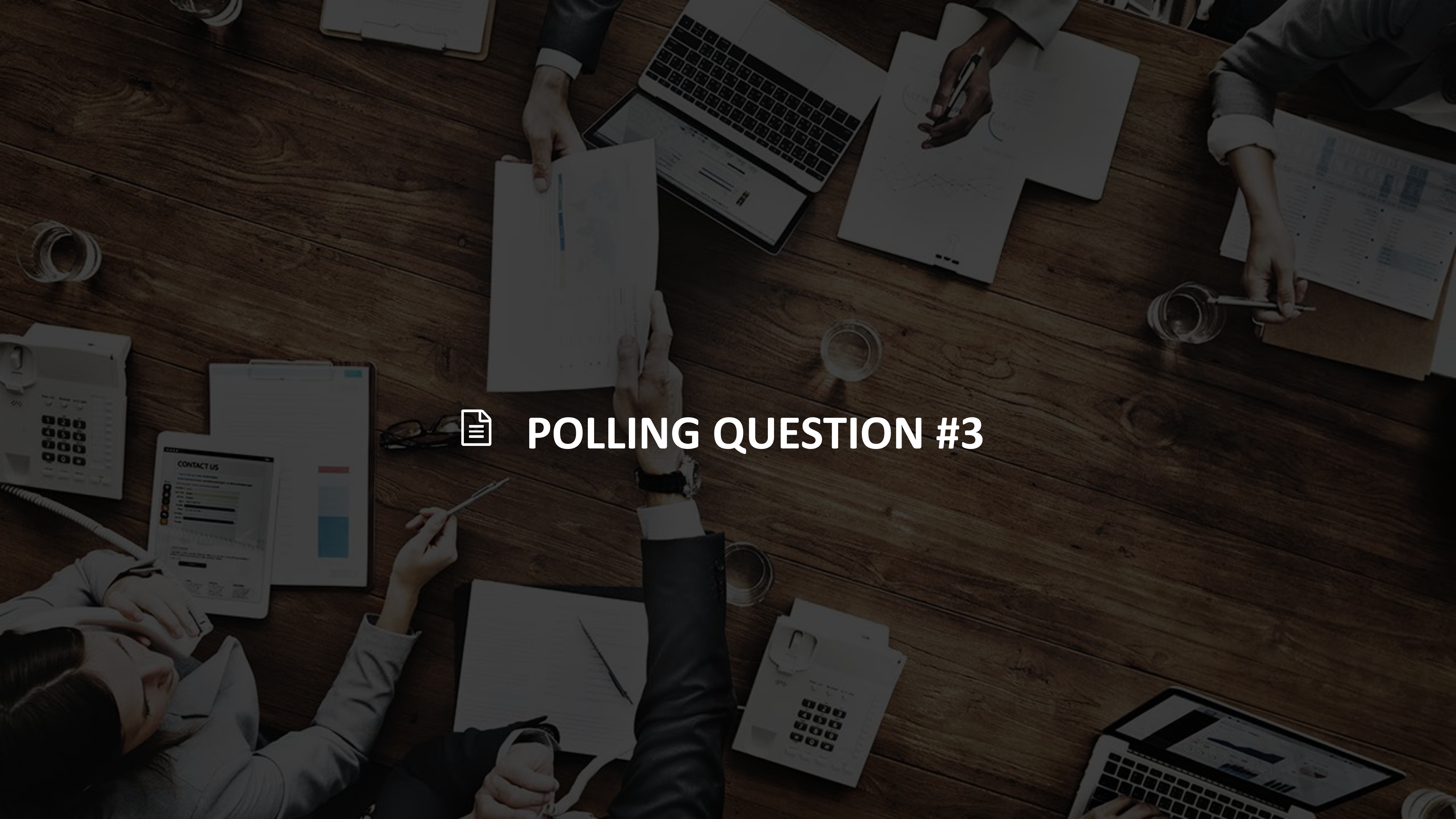
Property of a Specified Type – SPECIFICALLY EXCLUDED from bonus applicability

- Property used in a trade or business that has floor plan financing (e.g., automobile dealerships) = **NO BONUS**
- Taxpayers leasing property to these businesses provided the lessor is not described in Sec. 168(k)(9)(A) *(utilities)* = **BONUS ELIGIBLE**
    - Good news for lessors or real estate holding companies that lease the property to operating entity

TAX REFORM – BONUS DEPRECIATION

Placed in Service Requirements

- In order to qualify for 100% bonus depreciation, the property must be placed in service after 9/27/17 and before 1/1/23
- For new construction buildings, we generally look to the date the **certificate of occupancy** was issued
- For acquired property, we look to the **"ready and available"** standard



POLLING QUESTION #3

Other Considerations

How long does a study usually take?

- Typically between 30 – 60 days ***from the time all information is received***
- Plan ahead for tax deadlines. If needed for March 15 deadline, advise client to engage as early as possible (November/December)
- Provide free cost / benefit analysis during proposal phase

How much does a study typically cost? *$4K – 16K*

- Depends on the size and type of building
- Depends on additional renovation costs on top of the building acquisition
- Do renovations span multiple tax years?
- Smaller Residential Properties under $650K is basis – use self service software tool - ***$450 / report***
- Our team will identify whether green energy savings are applicable to building (179D and 45L)

KBKG ADVANTAGE – COST SEGREGATION PROCESS

All projects performed under supervision of Certified member of ASCSP (American Society of Cost Segregation Professionals)

- Most certified ASCSP members on staff of any cost segregation firm
- Free Cost / benefit analysis of subject property
- Review of relevant construction documentation (if available)
  - Perform Site Inspection
  - Reverse Engineer Construction Cost using IRS approved cost estimation techniques
- Prepare IRS audit-ready deliverable (Stamped by ASCSP member)
- Tax software integration deliverable – Work with CPA to ensure results are presented on Tax Return
- Free audit support

TAX REFORM – 179 EXPENSING

- Sec. 179 allows businesses to deduct the purchase of qualifying equipment and software
- **2022 Deduction Limit = $1,080,000** (raised from $510K in 2017)
- **2022 Spending Cap = $2,700,000** (beyond the cap a dollar for dollar reduction in the deduction)
- New items (**roofs, HVAC, fire protection & alarm systems, security systems**) can be expensed under Sec. 179. You'll find these noted in our cost segregation studies.
    - Only for commercial buildings (not residential)
    - Only for improvements made **after** the building was first placed in service (originally placed in service by any taxpayer)

KBKG Example: Client purchased existing 10-year old building in 2022 for $4M. Before placing it in service, they put in a new roof, HVAC, fire protection, and security system for $500K. All 179 eligible.

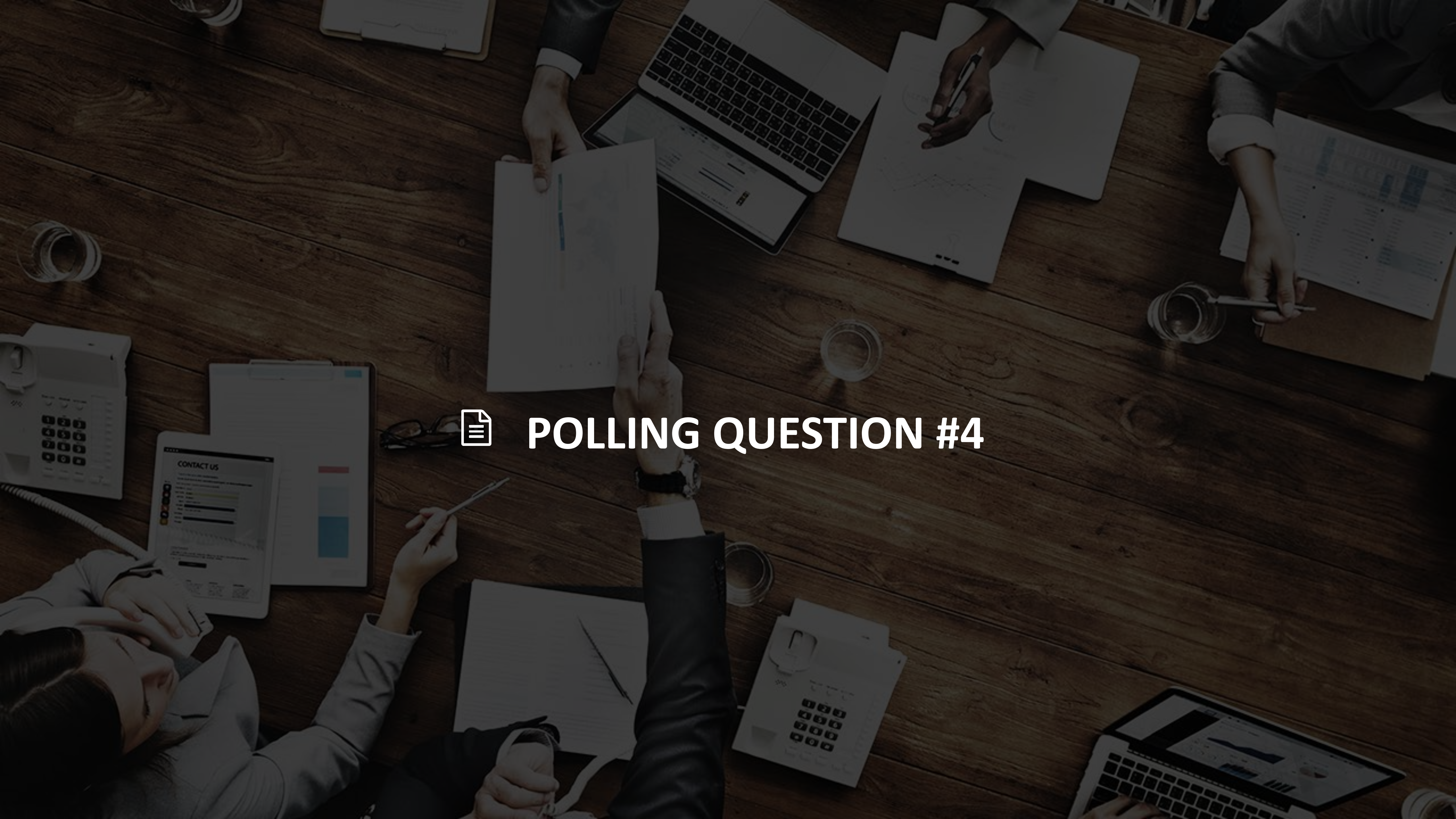
TAX REFORM – 179 EXPENSING

179 Expensing **now includes** personal property **used for furnishing lodging**, such as furniture and appliances in hotels, apartment buildings, student housing, etc.

KBKG Insight: There's no benefit taking 179 expense on tangible personal with 100% bonus depreciation

- Taxpayers should therefore consider utilizing 179 expensing on items not otherwise eligible for bonus depreciation, such as roofs and HVAC equipment. This would avoid hitting the 179 max of $2.7M.
- Please note, this makes them subject to recapture.

POLLING QUESTION #4



COST SEGREGATION FOR SMALLER RESIDENTIAL PROPERTY

- Residential properties up to 6 units
- Depreciable tax basis of $650,000 or less (purchase price less land).
- Including rental homes, condos, and townhomes
- Relies on information provided by the building owner, empirical construction data, and proprietary algorithms written by the KBKG Cost Segregation Engineering team.
- Provides a detailed cost breakdown for the property categorized by tax life

Free trial for 1st time users

KBKG.com/Residential-CostSegregator

Demo: https://www.youtube.com/watch?v=soCReXNAT6s&t=12s

Q&A

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