

Passive Activity and Cost Segregation

How does a Cost Segregation Study provide tax benefits?

A Cost Segregation Study is a detailed study of your commercial property which allows you to reclassify specific real property assets into tangible personal property assets and accelerate the depreciation. The reclassification of tangible personal property from real property and the difference in the depreciation allowed may provide significant tax benefits. Because past years' depreciation expense was understated, taxable earnings were overstated, which allows the property owner to harvest overpaid taxes in the current tax year.

Performing a Cost Segregation study may be particularly beneficial for businesses following the enactment of the Tax Cuts and Jobs Act, the sweeping federal tax reform law passed in December 2017. The new law expanded the concept of bonus depreciation, which allows businesses to depreciate a certain percentage of the cost of business property during its first year in service. Traditionally, bonus depreciation was only available for new property, and businesses could only depreciate up to 50 percent of the cost of the property as of 2017.

However, the Tax Cuts and Jobs Act extended bonus depreciation to used property and allowed businesses to depreciate 100 percent of the cost through tax year 2022. Businesses will be able to depreciate the following amounts in subsequent years: 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026. This significantly expands the number of assets that qualify for bonus depreciation and the amounts that businesses can depreciate during the asset's first year in service. As a result, businesses are now able to capture substantially more tax savings through depreciation deductions by taking advantage of bonus depreciation.

Commercial buildings are full of assets that may qualify for expanded bonus depreciation. By consulting professionals with tax and engineering expertise to conduct a Cost Segregation study, commercial building owners can identify these assets—which must have been placed into service after September 27, 2017—and claim accelerated deductions through bonus depreciation.

What is Passive Activity and how does it cause problems for LLC's looking to take advantage of Cost Segregation?

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Passive Activity Limitations to Cost Segregation

However, many real estate owners trying to take advantage of the significant tax benefits from Cost Segregation do not realize that they are subject to passive activity losses, which eliminate the potential benefits of Cost Segregation. Proper tax planning and a clear understanding of Cost Segregation applications are vital to obtaining maximum tax benefits.

For real estate investors, a passive activity is one in which the owner of the real estate does not materially participate in the profession of real estate investments. In fact, any rental activity is a passive activity whether or not the taxpayer materially participates.

The biggest problem arises when a taxpayer has placed real estate in a Limited Liability Company (LLC). In this situation, the taxpayer is either leasing the property to a third party or using the property as part of their own business operation. This set-up will likely render the rental of the property as a passive activity. The problem arises when the investor creates additional depreciation resulting in passive activity loss. Depreciation deductions are limited to the amount of rental income (passive income) and cannot be used to reduce ordinary income. If passive income is not available, the passive loss is carried forward to the following tax year.

For real estate investors with passive investments, Pre-tax planning is crucial in evaluating the potential benefits derived from a Cost Segregation Study.

How can owner-occupied buildings capture the benefits of Cost Segregation if the building is in a separate LLC?

A potential passive activity loss can be overcome in a few ways, but owner-occupied properties can immediately benefit without any additional legal work or entity creation. The IRS has allowed certain taxpayers to treat multiple entities as one "economic unit", subject to a few stipulations. Generally speaking, an owner occupied property will qualify under the IRS criteria.

For example, if a doctor has a practice operating under an S-corporation and owns the building under a separate LLC, often the strategy has been to have the LLC break even each year by paying the necessary rent from the S-Corporation to the LLC to cover all expenses. By electing to treat the 2 entities as one economic unit, the passive activity rules are eliminated and all income or losses are considered active and become fully deductible in the year incurred.

In utilizing cost segregation, the LLC would likely have large losses for 1-5 years relating primarily to depreciation that could be fully deducted when grouped with the operational unit, therefore eliminating passive loss limitations and ultimately enabling the taxpayer to immediately benefit from cost segregation.

IRS Guidance

IRS Treasury Reg §1.469-4 offers the guidelines as to what may qualify as an "appropriate economic unit":

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Generally, “one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.”

There is also a “facts and circumstance” test that should be performed in determining appropriateness of grouping activities. “Except as otherwise provided in this section, whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends upon all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469:

- (i) Similarities and differences in types of trades or businesses;
 - (ii) The extent of common control;
 - (iii) The extent of common ownership;
 - (iv) Geographical location; and
- Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).”

The most effective tax experts understand the intricacies of current IRS rules and can work within regulations to obtain the maximum deductions. Performing a Cost Segregation Study is a highly specialized process that can result in significant tax benefits, but only when used in conjunction with an understanding of specific conditions within a business entity that may impact the company’s long-term savings.

Contact CRG for more information:

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