

Cost Segregation

How to get a larger up front tax deduction...

In real estate investment there are four components that make up a return: Cash Flow, Equity Build-Up, Appreciation, and favorable Tax Treatment. In this article we are going to talk about the tax component.

Primarily there are two tax considerations. One capital gains, the other depreciation.

Capital gains: On the federal level when you sell your gains, if the property is held for over a year, under current tax rates, you will be taxed at 15% vs. your marginal rate, say perhaps 35%. On a \$200,000 gain that's a \$40,000 difference! And even then that tax may be deferred if you opt for a tax-free exchange. (See article Volume 1 on our web site www.balfourcommercial.com).

Depreciation: It comes as no surprise that every year you have to pay taxes on your real estate investments. You have to report all your rents. Subtract all your expenses. Then pay the appropriate tax. The tax benefit is that in addition to your cash expenses you get to deduct a non-cash expense called depreciation. This is a pre-determined amount prescribed by the IRS and greatly reduces your net operating income and thus your tax. In effect some of your cash flow is not taxed in the current year. In the example below, a \$500,000 commercial property consisting of \$100,000 of land and \$400,000 building improvements the traditional depreciation prescribed is \$10,256. At a 35% tax rate that provides a \$3,590 tax savings.

COST SEGREGATION - FIRST YEAR SAVINGS

	<u>Traditional</u>		<u>Cost Segregation</u>		
	<u>Value</u>		<u>Dep.</u>	<u>Value</u>	<u>Dep.</u>
Valuation	500,000		500,000		
Land	<u>100,000</u>		<u>100,000</u>		No depreciation on land
Building	400,000	10,256	300,000	7,692	Commercial buildings - 39 yrs, Apartments 27.5
			30,000	20,000	3yr personal property, double declining
			25,000	10,000	5yr personal property, double declining
			45,000	4,500	15 yr personal property, 150 declining balance
		<u>\$10,256</u>	vs.	<u>\$ 42,192</u>	Depreciable amount
					35% tax rate
		\$3,590	vs.	\$ 14,767	First Year Tax Savings

Cost Segregation. A more aggressive approach that could potentially give you \$42,192 in depreciation write-offs, thus a \$14,767 first year tax savings is through an approach called Cost Segregation. Here, with proper documentation, instead of just breaking down the property into two categories building and land, the IRS lets you further break down the building component into building and personal property. The benefits are two fold. First the property components are written off with much shorter depreciable lives (years). The second is that the depreciation deduction can be accelerated, in some cases up to double that of the straight-line amount.

It is true that the IRS will want you to adjust annually for the accelerated depreciation and the more you write off annually will increase your gain down the road when you sell. Even so you get the tax-free use of the money till then and capital gains treatment vs. ordinary income. We at Magnusson Balfour encourage you to ask your accountant how this may benefit you and would love to assist you in finding or selling your investment properties.

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Perhaps the owner has become complacent, there are technological advances that weren't kept up with, the industry has become saturated with competition, the management has risen to their point of incompetence (the Peter Principle), or some aspect of the business has not been paid attention to, marketing, finance, production, human resources, etc. This type of business is where the turn around specialist flourishes. They find the problem and fix it. They often tend not to care about leaving their personal mark and often don't particularly care what industry it is in. They are bottom line driven and like to use their business skills in producing new and quick results through the people and systems in place added to their business savvy and/or capital.

The title of this article is "*Business Cycles – Where do I want to enter?*" I'm hopeful you can now see why businesses for sale don't come in "one size fits all." Aside from the industry the business is in, it's different strokes for different folks. We at Magnusson Balfour would be pleased to discuss which phase would best fit your comfort level.

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