EPISODE 882

[INTRODUCTION]

[0:00:00.0] ANNOUNCER Welcome to the Real Estate Syndication Show. Whether you are a seasoned investor or building a new real estate business, this is the show for you. Whitney Sewell talks to top experts in the business. Our goal is to help you master real estate syndication.

And now your host, Whitney Sewell.

[INTERVIEW]

[0:00:24.3] WS: Stop, you're throwing money into the dumpster. Have you thought about that? This is your daily Real Estate Syndication Show. Today, our guest, Frank Giudici is going to tell us how to keep from throwing that money into the dumpster. Welcome to the show, Frank.

[0:00:39.5] FG: Excellent, thank you so much for having me again, Whitney. I appreciate the opportunity.

[0:00:44.1] WS: Yeah. Frank is Bedford Cost Segregation's business development director and is here to discuss the partial asset disposition election as it pertains to commercial real estate. He's a repeat guest. We did a show as WS606 which we talked about details of cost segregation, I would encourage you to go back and listen to, that was June 18th of last year.

Prior to joining Bedford team, one of the largest independent owned cost segregation providers in the country, Frank spent 15 years in the construction management industry with two top-ranked builders both nationally and internationally.

A civil engineer by degree, Frank served as both a project engineer and procurement manager for a large-scale commercial construction across US including high-rise multifamily, nano tech manufacturing. Frank, welcome again to the show, you definitely have an expertise that anyone in this business needs to be knowledgeable in or at least know enough to know that they need to speak to someone like yourself or have someone like yourself on their team so they can get these benefits and make sure they're not throwing money into the dumpster, I know this happens often and people just don't realize, right? They just don't know but you're going to help us to do that so I want us to really jump right in, obviously we're short on time as we talk about the details of tax.

Let's jump right in and explain a little bit about what partial asset dispositions are. What is that? I know many people listening think, "What is he talking about? I haven't heard of that before."

[0:02:09.3] FG: Yeah, it's obviously a mouthful. The bottom line is this, in 2014, the IRS came out with what was called the final disposition regs and I don't want to get too much into the weeds but the bottom line is, this provided people an opportunity to basically write off the amount of depreciation left in assets that were being disposed of, hence, partial asset disposition — assets being disposed of as part of renovation projects. Think about this, when you buy a property, the depreciation clocks starts all over back at zero, okay? You, let's use the multifamily world because that's where you reside, right, Whitney?

In the multifamily world, all residential use commercial real estate depreciates over 27 and a half years. If year two, you decide to do significant renovation work to your properties, all of – let's use the example, you're going to go through and redo all the bathrooms, okay? All the units of a given property; you're going to gut renovate all the bathrooms.

Think about technically, even though those bathrooms could be 50 years old, you bought them, you bought that property two years ago. You've only been depreciating the assets within that bathroom envelope of every unit for two years. So — 27 and a half minus two, you're left with 25 and a half years of depreciation left.

If you're stripping out all of the assets of every bathroom and every unit and you're throwing it into the dumpster, many people don't realize that there's depreciation left in those assets that you can write off as a loss in the current tax year.

All of that money is going into the dumpster and the client never thinks to mention to their CPA and the CPA never thinks to ask the client about the extent of renovations that were performed and what type of value was left in those assets that were being thrown out.

The Bedford Cost Segregation team specializes in type of an analysis so that we can prepare people upfront and we can do the proper things in the beginning to allow people like you in the multifamily world and in fact, I know as your cost segregator, we've done cost seg studies in advance, knowing that there could be partial asset dispositions on your property in later years.

Your cost seg provider needs to be your resource partner and he needs to make, he or she needs to make sure that they set you up correctly from the beginning because there's different levels of detail and cost seg studies. By having conversations upfront, we can set you up to be able to claim these moneys that you're otherwise throwing into your dumpster.

[0:05:05.7] WS: Yeah, I think most people think, "Well, I'm just throwing these things away" whether it's toilets or sinks or whatever it may be. Roofing, we think that there's any value there to be had, right? We're getting rid of it so we can create value, you don't think about the tax benefits potentially there that we're throwing away.

[0:05:23.2] FG: Yeah, that's – I want to just touch quickly on the three key fiscal benefits of educating yourself and being aware of this opportunity. Again, everything is facts and circumstances, especially with the IRS.

There's a bunch of things that have to be checked off in order for you to be able to claim this what's called partial asset disposition election. But, the three key fiscal benefits are first, well, let's face it, it's a loss, right? The more losses you can generate in the current tax year, the better, right?

Losses offset taxable income. Now, all of a sudden, your taxable income is reduced to zero and you're not paying any taxes on your taxable income, what a beautiful world. That's key fiscal benefit number one.

Number two, if these assets that are being pulled out are eligible for partial asset disposition, then you have the ability to write-off the demolition contractor, the removal cost to get those assets out. That can be written off in its entirety as a partial asset disposition and that removal demolition contractor cost doesn't have to be capitalized. There's an additional loss for the current tax year, great.

Then lastly, this is the one that people don't think about, there's something called ghost assets. When people have major renovations done and the assets are stripped out of the building and permanently removed and hold offsite, people don't realize that unless you reconcile, you're starting depreciable basis of that property.

Even though those assets are in the local landfill, they're still depreciating on your books as if they were still in your building. A lot of people, when they do these significant improvements, they just give the improvements to their CPA and the CPA adds another line item on to the depreciation schedule improvements 2021: X hundreds of thousands of dollars.

They don't think about the assets that those improvements replaced. By properly reconciling that starting depreciable basis of the property and instead of that being a one-million-dollar depreciable basis, you've just stripped out $200,000 worth of assets in bathrooms so now it gets reconciled as 800,000.

For the rest of the 27 and a half years that you're depreciating that one million dollars, you're now depreciating at 800,000 instead of a million. Why am I telling you all this? Well, in the commercial real estate world, when you sell that property, the IRS is going to look at the amount of depreciation you've claimed from the day you put it in the service to the day you sold it.

You will get taxed in the form of what's called a depreciation recapture tax. If you don't reconcile your depreciable basis from the time that you took out the existing assets and put the new in, you're going to be paying a depreciation or capture tax that's higher because you never reconciled your original starting depreciable basis by saying, “Hey, MR. and Ms. CPA, I removed X hundreds of thousands of dollars in assets, that starting depreciable basis needs to be reduced.”

Those are the three key fiscal benefits, it's one in the beginning, current losses in the current tax year and then two, it's on the tail end of the life cycle of your property. When you go to sell it, you're going to actually pay less in depreciation recapture taxes because you reconciled your books from the beginning. This is huge. Those are the key fiscal benefits.

[0:09:00.0] WS: Yeah, so many great big benefits there, just goes to show me again time and time again why just our team is so important, right? Just so we have an expert like you on our team and then also, I can just see like you mentioned like they hand in these receipts to their CPA or whatever they say we spend this much on these items and they're leaving so much money there, right?

I can see why too, even that CPA in this business needs to be knowledgeable about these things to a great extent. You don't want to be their first client hopefully that's done a cost segregation on a property, right? I worked with an individual like yourself. Could you just speak just a second Frank, to that relationship?

You provide these reports and then we want our CPA to know how to utilize that. Is that something you're willing to – you're able to work with someone's CPA a little bit to say, "Hey, this is what you need to be thinking about or this is what these reports do" those things?

[0:09:50.7] FG: Yeah, listen, this is why I – as you're aware, my first episode Cost Seg providers are not all created equal, okay? Bedford is our know-how in the industry and the sheer number of people that we have covering the entire country is really unmatched and we want to be your resource partner because if the proper questions do not get asked in the beginning, had we just done a normal baseline cost segregation study on your latest acquisitions, Whitney.

We would have never been able to claim those partial asset dispositions, two, three, four, five 10 years down the line. You have to set yourself up right from the beginning and unless you're having the right types of conversations, that's not going to happen.

Bedford uses that same philosophy with CPA's, right? We obviously have clients but the clients have CPA's. CPA's come in all ranges of experience and familiarity with cost segregation and partial asset disposition and tangible property regulations.

There's a bunch of stuff out there and so Bedford actually has our own in-house tax team that can literally walk through any CPA's who are unfamiliar on how to get the cost seg study results to translate to the actual client's tax returns.

It's a great question and that's one of the things that Bedford kind of stands out from a lot of the rest is that we're here to be an educator or resource partner and to make sure that your CPA feels comfortable with the process as well.

[0:11:20.2] WS: I want to add one thing too — we closed on 45 million to 50 million dollars in real estate like within the last two weeks of last year, right? One was like, two or three days before the end of the year and then another one, just a day or two before Christmas.

Having somebody like Frank on our team, we were having those conversations and working through cost seg stuff long before we ever closed on those projects so we could still provide as much value as possible to our investors through tax savings and appreciation.

That's why we got to keep that line open to someone like Frank and our CPA and those tax experts because I am no tax expert, that's for sure. That's why I want people like these on our team that are.

Frank, are there some factors though that need to be met so we're eligible for these things?

[0:12:03.8] FG: Yeah, absolutely. This is where a lot of people get tripped up, CPA's get tripped up, cost segregation providers get tripped up and again, you need to protect yourself. Not all cost seg providers are created equal especially when it comes to tangible property regulations and partial asset dispositions.

I know this all sounds like a mouthful but bottom line is, you need to make sure you're vetting your cost seg provider and understand that they have the qualifications and people in place to properly do these types of studies.

I'm going to hit on the five key factors that you need to make sure have been done or are legitimate in your given situation to be able to claim this partial asset disposition election. Number one is, assets cannot be acquired and disposed of in the same tax year. I can't tell you how many people I speak to, who they say, "Oh yeah, we did part. Yeah, we took advantage of partial asset dispositions. My cost seg provider, we had big plans from the beginning before we bought this multifamily property that we were going to tear out all the bathrooms and all the kitchens upon acquisition and we were going to write off all of it as partial asset dispositions" and I'll ask, "Well, when did you acquire the property?"

"Oh, we acquired it in February of 2020." "Okay and when did you do your interior renovations?" "Oh, we did is as soon as we closed on the property starting in March." We can't do it. Okay, so the IRS doesn't want people buying property with the intent, right? The keyword is intent, they don't want people buying property with the intent to gut renovate and totally abuse this partial asset disposition election. That's not the point.

The point of the partial asset disposition election is a year minimum or years down the line, the property owner decides that they want to do renovations and therefore, there's that ability to write off the losses of what's left in depreciation of what's being replaced. They key is, you can't buy a property and renovate it in the same year and expect to claim partial asset dispositions. That's a huge no-no and I will tell you, there are cost seg providers out there that they just look right past it because the better the results look on their study, the client's happy and the client doesn't know any better.

The CPA is not asking questions or is not up to speed. That's number one, okay? You have to have your property placed in service. General rule of thumb for at least a year before you go and start doing these types of dispositions to be able to be eligible for this partial asset disposition election.

[0:14:48.6] WS: It's not the calendar year, it's like 365 days.

[0:14:52.5] FG: Yeah, listen you can't – like you just mentioned. You just closed on two properties in December of 2020. You can't turn around and start doing a planned renovation in January of 2021. That's just wrong, okay? Because obviously the IRS knows that if you bought a building and within a month you are doing major renovations, they know that you went in to buying that property with the intent to do those renovations.

The whole point is, this is how the IRS looks at it. If you buy an asset, a building with the intent to do significant renovations then technically, the things that you're going to be replacing to put those new improvements into place should have zero-dollar value because you bought the property knowing that all of those bathrooms and all of those kitchens meant nothing to you. You had zero-dollar value because you're planning on replacing it anyway. It makes sense, okay? You have to play by the rules, so that's number one.

[0:15:48.6] WS: Yeah, and we want to be careful about that because often, we are planning to renovate.

[0:15:52.1] FG: Listen, this is one of the biggest hiccups in the multifamily syndication world, okay? Everybody is looking for properties, class-C, class-B and their immediate plan is to update certain units to get the rents to go up and put in that. You have to play it right, okay? You can get yourself in trouble. Number two, 75% or more of the existing building's exterior walls must remain in place as either exterior or interior walls of the final improvement project.

You can't just go to a building and demolish 50% of the walls and build out the other, replace that 50% of walls with a whole new design and expect to write off the depreciable basis left in that 50% of walls you basically tore down. This goes back to the Section 280 demolition rules. You have to maintain 75% or more of the exterior walls as part of the final finished renovation project. Also, you have to maintain 75% or more of the interior structural framework.

To also be able to claim this partial asset disposition election, okay? I want to keep moving but that's key. 75% or more of the exterior walls and interior structural framework must remain in place. Three, the renovation project must not be a repair. It has to be deemed an improvement. Repairs are expansible, okay? You can't claim partial asset disposition on something that you repaired because you expensed it versus an improvement, which is capitalized.

That's number three, you can't claim partial assets. You have mentioned roof, a lot of times roofs get counted as repairs. You are able to just literally expense the total cost of repairing your roof. You can't write off; you can't claim partial asset disposition on a roof repair. Repairs are out. Repairs are a whole other tax strategy that we can talk about in a third episode. Number four, I believe we're on number four. Partial asset dispositions must be taken advantage of in the tax year that they actually were disposed of and took place.

Unlike cost segregation, where we can do what's called look back studies, we can, the general rule of thumb for cost segregation is whether you built it, you bought it or you renovated it, we have the ability to do cost segregation study today on a property that was purchased, built new or renovated up to 20 years ago, okay? We can catch up the missed accelerated depreciation deductions and you get to claim it in the current tax year. This is not the same with partial asset disposition.

If you did dispositions in the 2020 tax year, you have to claim those partial asset dispositions on your 2020 taxes. If you think you can go and just wait until 2021, you've removed yourself from eligibility, okay? It's out, done and then lastly number five — and this is where going back to the relationship of having a cost seg provider who ask questions about what your future plans are possibly with a given property to be able to set you up correctly —

For the most part, if you do not have a detailed cost segregation study performed on the original asset prior to doing dispositions you will almost always not be able to be eligible. Think about this Whitney, when you do a cost segregation study, most people think personal property and land improvements. That's the name of the game with cost segregation. How much tangible personal property, five and seven-year items and how much 1250 land improvements, 15-year items can I segregate from my acquisition?

Great but in the partial asset disposition world and a lot of times in the cost seg world, we're only focusing on the personal property and the land improvements but if you plan for years down the line to do significant renovations and you think it's worthwhile to take advantage of the partial asset disposition election, you need to make sure your cost seg provider breaks down the same amount of detail that they did for your personal property and land improvements.

They need to convert that same level of detail to the 1250 real property. All the 27 and a half and 39-year assets that can't be segregated as part of the cost seg study, all need to be itemized and broken out in the same granularity as the personal property and land improvements because this is a baseline, right? If you don't have a baseline for all your 27 and a half and 39-year assets, when you call us to come back after you do significant improvements, how are we going to know what was ever in place five, six, 10 years ago to be able to justify what the value in a partial asset disposition world, is going to achieve?

It's very important to get a detailed, which is a different level of cost seg study, you have to have a detailed cost seg study perform prior to doing any dispositions. For those of you out there who have acquisitions and you think that you're going to do significant renovations down the line, get a cost segregation study — a detailed cost segregation study performed before.

[0:21:32.4] WS: Frank, well unfortunately we're running very low on time and I'm sure we'll have you back in the future and we'll talk maybe a little more about this and some other things but quickly two last questions. Any predictions that you have that maybe of tax implications or changes that are going to happen say over the next year or so with cost seg or just partialized to disposition, anything like that that our operators that are listening or even passive investors need to know about or expect that may happen?

[0:22:00.3] FG: Yeah, you know what? The American Society of Cost Segregation Professionals, which really to me is the crème de la crème of cost seg providers and really people should be using as a resource as their vetting. We've had some pretty renowned speakers and people come in lately because this is a popular question and we feel like the cost seg industry is going to be pretty well unharmed by this latest Biden administration and the tax reform that continuous to be touted.

I think at a minimum, nothing will happen until the 2022 tax year and even at that, I still think cost segregation is going to exist. It's going to still have the same level of value add. It may not be as potent because let's face it, 100% bonus depreciation is pretty amazing. That may not be around in 2022 but again, at the end of the day even without bonus depreciation, cost segregation is still a key value add and ultimately, let's face it.

Be smart about it, take advantage while the rules are in place and seem to be in place for at least 2021. Take advantage, don't take the risk of something changing in 2022 and you're losing out. That's the best I can give you. I don't have the crystal ball unfortunately.

[0:23:16.3] WS: No, that is all we needed and thank you for that. Frank, how do you like to give back?

[0:23:19.6] FG: My wife and I are – we got sucked into the adopting of pets and so we actually do a lot of giving back to the local pet shelters, adoption centers and stuff like that. We always go on a massive BJ's wholesale run and load up on supplies to drop off at the local shelters around where we live in upstate New York. That's kind of how we give back from a charitable standpoint.

[0:23:43.8] WS: Frank, always a pleasure to catch up and thank you just for your willingness to share with our listeners on this especially this partialized to disposition where many may not have heard of that and it is something you need to know and we need to be talking to your tax expert about, no doubt about it. About your specific situations and properties that you have so you don't miss out. Like you said, you can't claim it years later down the road so be sure you're looking into that. Also Frank, how can obviously the listeners get in touch with you and learn more about you?

[0:24:11.3] FG: What I would suggest is go to Bedford's website, www.bedfordteam.com and then from there, you can find me and all of my contact information. I'll be uploading a couple of videos here to give more of a personal side about me and you can get to know me a little better behind the scenes and by all means, education is key in this world. Please reach out, email, phone call, ask any questions, I'm more than happy to be an educator, a resource partner to help you strategically plan going forward.

[0:24:42.4] WS: Thanks Frank, that's a wrap. Thank you very much.

[END OF INTERVIEW]

[0:24:46.2] WS: Don't go yet, thank you for listening to today's episode. I would love it if you would go to iTunes right now and leave a rating and written review. I want to hear your feedback. It makes a big difference in getting the podcast out there. You can also go to the Real Estate Syndication Show on Facebook so you can connect with me and we can also receive feedback and your questions there that you want me to answer on the show.

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[OUTRO]

[0:25:26.5] ANNOUNCER: Thank you for listening to the Real Estate Syndication Show, brought to you by Life Bridge Capital. Life Bridge Capital works with investors nationwide to invest in real estate while also donating 50% of its profits to assist parents who are committing to adoption. Life Bridge Capital, making a difference one investor and one child at a time. Connect online at www.LifeBridgeCapital.com for free material and videos to further your success.

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