EPISODE 1183

[INTRODUCTION]

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Whitney Sewell (WS): This is your Daily Real Estate Syndication Show and I'm your host, Whitney Sewell. Today is a Highlights show that's packed with value from different guests around a specific topic.

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[INTERVIEW 1]

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WS: Our guest is Bill Smith. Thanks for being here, Bill.

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Bill Smith (BS): Thank you for having me, Whitney.

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WS: I'm honored to have Bill here. He's an expert in his field and we can learn a lot from him. He's the National Sales Director for ELB Consulting, Inc. He works with commercial real estate owners and investors to reduce their federal tax burden and improve their cash flow for future investments. After spending twenty-plus years in executive sales, marketing, and management positions for both Fortune 500 and entrepreneurial firms in real estate, finance, technology, and services, Bill teamed with ELB, a specialty tax solutions business in 2013. They utilize a proprietary engineering methodology to maximize the allowable IRS tax deductions and provide bulletproof protection in the event of an IRS audit. Bill, thanks again for being here. Bulletproof protection, we all want that, especially in the event of an IRS audit. I want you to tell the readers a little more about who you are in case they haven't heard of you, what you do, and then we're going to get into this thing called cost seg. Elaborate on who you are and then we will get into that.

0:01:31
BS: I'm a Regional Director and National Director for ELB Consulting. I've been doing this for a number of years. I'm the product expert for our firm. Cost segregation, for those people who haven't heard of that in the past, some know what that is or have heard of it, have some general understanding or maybe a misunderstanding, which I find quite a lot when I'm talking to people, don't know what it is. Cost segregation is a method to dissect the building down to

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all its component parts and short life them into ways to accelerate the depreciation. I like to say optimizing the depreciation schedule. You can get in there, optimize the depreciation schedule, which creates those tax deductions, which in turn creates cash flow. The real goal for cost segregation is cash flow.

I've had clients that want it for strictly tax deductions. They got a high tax liability and they say, "Bill, help me out." They say when I'm done, "I didn't pay taxes." They were very happy. Many firms and many people like it for not paying the taxes to free up cash flow to then buy more properties, which that's what your readers want. They're looking to buy more properties and they're buying syndications. The syndicators are using this as we know. Also, some people are buying a small apartment complex. They're starting out two or three rental homes, a lake home they're renting. That's where the real benefits lie and breaking down the components for tax strategy.

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WS: I look forward to getting in more depth about cost seg and why we need to know what this is. When does it make sense to have a segregation study done? Maybe you can elaborate on what that is a little bit, even more, in-depth to the actual study itself.

0:03:20
BS: I will get into that in some more detail. When does it make sense to be done? There's some debate about that. A lot of people will say it's good to do it when you purchase the property or when you build a property. Some CPAs even have a misunderstanding because we were providing information and a report that the CPAs use to mitigate the tax liability. We don't do it, we just provide the details for the CPA. The best time to do it is now. You could have bought a property five or ten years ago and we can do a look back study. You've been doing straight-line depreciation on these past five or ten years and it was a large enough property. There was enough meat on the bone, so to speak. We can do a look back study, catch up on what you've taken a straight line to accelerate all the current properties, and then you get a lump sum of deductions in the current tax year.

People said, "If I get $1 million in tax deductions, that's more than I can use this year. I've only got up $300,000 tax liability on my properties." It carries forward. You never lose it. It's not a use it or lose it. If you've got excess depreciation, you can certainly use that. It's good to do it in the year that you buy it. It goes into service, but you can always do it where you can do a look back. Another point is if you've had a property for a while, you did significant improvements, capital improvements. If you're putting $1 million into a property upgrade or repurpose, then there's a cost seg on those improvements. You may or may not have done it on the property originally. If not, we can go back into the original property from five years ago,

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and then the improvements, this particular expense, and then put those in the right tax buckets and apply those for the CPA to mitigate tax liability.

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WS: Is there any time that we wouldn't need to do a cost seg study or wouldn't want to?

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BS: If someone's flipping property, some of your readers will say, "I'm buying a property, I'm going to upgrade it and I'm going to turn it over in a few years." You have to need to hold a period because the IRS will have a recapture rate and they don't want you to double-dip. If you took excessive deductions in this first couple of years, then sold it, then they're going to have a recapture rate. Recapture is the spread on the gain on sale and your basis value. If you depreciate, you reduce your basis value. On that spread of basis value to your acquisition price, you're going to pay ordinary income tax and you pay capital gains on the capital gains rate, which is lower. Some people choose not to do it when they don't have more than a five-year hold period. Some do though. They may not know, but because of the cash flow strategy, you're going to have to recapture anyway. They will do it if they're using the cash for more properties. If you're not using it to keep your investments going, then it doesn't make sense. I would suggest someone not do it. The only time that it makes sense not to do it is if the property is too small.

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WS: Does it cost anything if I called or connected with you and said, "I gave you the details about a property," and you did say, "No, that's not probably a property that would be worthwhile doing a cost seg on?"

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BS: No, it doesn't cost you anything. Our firm, like pretty much every other firm, some do charge for a proposal. We do what's called a feasibility analysis. It's the terminology in the industry. It's a fancy word for proposal. What our firm does, and some use a quick model and some numbers, but we will be going to evaluate that property and identify a conservative projection of tax benefit, cash flow and an optimistic benefit. We'll give you a range of where it's going to fall. You can look at that. We can have a conversation about those benefits if it doesn't make sense. We can talk to your CPA and tax professionals like, "Do you need it?" Let's say you have carried forward losses for something else and you're not paying taxes. That's the other thing. If you don't have a tax liability, it doesn't make sense to do it. Going back to that last question, that's one thing I left out. If you're not paying taxes, good for you and it won't help you.

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WS: What size of the property should we start to consider a cost segregation study for?

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BS: There are a lot of these investor boards and things out there and people are arguing. There's a lot of argument over that. We can do property as low as $300,000. You're looking at a warehouse, there are not a lot of special-purpose components. It's the special purpose components, mechanical, electrical, plumbing, flooring, lighting, and all the specialty items that make a big difference. If it was a small doctor's office in a smaller community in a place like Raleigh, Roanoke, or somewhere like that, doctor's offices are $800,000 to $1 million. You've got a lot of specialty components like built-in cabinets, specialty lighting, specialty flooring. There's an opportunity to go down as low as $300,000 but typically, $1 million is a cut-off.

The larger the property, the greater the benefit. We look at it and say what makes sense for a property is a cost-benefit analysis. We'll say, "Here's the price. Here's your net present value on a cash flow, the cash you're not paying the IRS. Does that make sense?" Most firms will provide some level of evaluation like that. The higher, the better. There is a discussion about single-family rental homes and we do a lot of those. We will sometimes do a desktop version. We'll have the appraisal and we will have the closing statement. We will ask the homeowner or the owner to take some additional pictures because they probably have pictures for renting but they don't have pictures of the mechanical systems and the breaker box and stuff that get cost seg people excited.

We had done those on some rental properties when they're large enough. There are also automated models out there. There are several of those. We have a division that has one of those. We create an automated model. That will support properties up to $1 million and it doesn't have to be just residential. We can do any number of properties on our platform. It's a modeling platform based on the 14,000-plus studies we've done to date. It supports properties under $1 million. One of the things I want to mention about that is I've had people call us where that makes sense for a $600,000 or $700,000 property. On the flip side, I should have fully engineered and instead of paying $1,000 for that without an offense, or on a residential it's $400, you want the asset detail. There are benefits to that. Having the asset detail in some properties provides value and that gives you future value for the cost. It depends. Under $1 million, you may want a fully engineered report and sometimes you don't. It depends on the investor's goals in what they're going to do with the property.

[INTERVIEW 2]

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WS: Our guest is Frank Guidici. Thanks for being on the show, Frank.

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Frank Guidici (FG): A pleasure to be invited. Thank you so much, Whitney, for all that you do.

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WS: Frank, what are some of those common misnomers that we need to keep in mind?

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FG: The number one that I find is people have this mindset that if you don't have a cost segregation study performed in the year in which the property was placed in service. When I say placed in service, that typically means when somebody takes title after acquisition. They take the title of the property or they build it new and they get their certificate of occupancy. That's kind of the in-service state, right? When does that property start to generate income? You'll hear me use the word commercial property a couple of times, and I don't want people to get mixed up. Commercial property is any real estate that generates income. It's not just property of commercial use. Commercial property can be commercial use or residential use. So I just want to clear that up.

But, again, the number one misnomer is that if you don't have that cost segregation study performed in that year that you file it on your depreciation schedule for your taxes, then you've missed out. The simple truth is this is the one thing I ask people to keep in mind when it comes to cost segregation. The general rule of thumb is whether you built it brand new, ground-up construction, or you acquired it, or you significantly renovated a building in your portfolio over the past 15 years, so dating back to the early 2000s. Any one of those three options; significant renovation, acquisition, new build construction. Over the past 15 years, you have had the ability. You are a potential candidate to have a cost segregation study done.

The IRS allows us to be retroactive, so we can literally go back into someone's portfolio of properties, commercial real estate that they put into service in the early 2000s. We can do this study in the present day, right here, 2020, and we can catch up on the missed depreciation deductions they hadn't been claiming over the past 15 years, and they can claim them in the current tax year, so probably a good tidbit. For people who haven't filed their 2019 taxes, they have the ability to have a study performed right now, May of 2020, and they can utilize the results of that study with their 2019 tax return and benefit from those missed depreciation deductions they haven't been claiming over the past 15 years.

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WS: I think a lot of people get into real estate, and they may own property for years and they don't even know this is something they should do. It's not in their wheelhouse yet.

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FG: That's a great point, Whitney, and a lot of them will realize that the loophole was created for cost segregation as part of Reagan's Tax Reform Act of 1986. Technically, cost segregation has been happening for properties that were placed in service on January 1st, 1987 all the way to the present day. But it really wasn't until the fall of 2004 that the IRS released the audit technique guideline for cost segregation, which is when this industry really blew up. I mean, in the fall of 2004, when the IRS released their kind of stamp of approval on the cost segregation industry, that's when you started seeing cost seg providers pop up left and right.

Again, the general rule of thumb, 15 years you still have the ability to have a cost segregation study performed and to receive that cash flow, because that's what it's doing. Cost segregation is a tax deferral strategy. It's the time value of money. The more deductions you have now to offset income in the present tax year is more cash flow in your pocket. It's less money you're paying Uncle Sam. It's more money in your pocket that you can invest elsewhere.

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WS: That sounds good to me. I wanted to highlight one thing. I know you highlighted it, just the definition of commercial real estate when you're talking about it right now. But I wanted to clarify. Somebody has, say, a portfolio of 10 single-family homes. Can they also do a cost seg as opposed to somebody that has, say, a triplex or a 50-unit?

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FG: Absolutely, yup. Again, where it gets a little tricky is people who own vacation homes and they Airbnb the vacation home for a certain amount of time throughout the year and they try to have a cost segregation study done on the months that it's actually being rented. I don't want to get into the weeds. That gets a little hairy. But for the most part, if it's a property that's not a personal residence and you're using it to basically generate income, whether it's of residential use or commercial use, you have the ability to perform cost segregation.

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WS: All right. What's another misnomer that we should be aware of?

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FG: Yeah. The other big one is, "Well, geez, Frank. If I do a cost seg study on a property that dates back to the early 2000s, I'm going to have to amend all my tax returns, going back 15 years." False. The IRS does not require you to amend all your previous years' tax returns. There's a form called Form 3115, and that's a change in accounting methods that gets filed with your current year's taxes. That basically alerts the IRS that you are taking a particular property or multiple properties within your portfolio, and you are changing the depreciable cycle of those properties. Therefore, I know I'm getting technical, but a score of 481(a) needs to be made up for. That's that cash flow that I was talking about, the catch-up depreciation that

you've been missing out on over the past 15 years. You get to catch up on that 481(a) adjustment which is populated within this Form 3115 change in accounting methods.

Again, you're not required to amend all your previous tax returns. It's one form that needs to be filled out. Now, what I will tell people is I keep saying a form that makes people think it's a singular page. That's false. This is about a 15-page document, 12 to 15- page document on each property, and it does come at an extra additional charge. Many cost seg providers are able to provide this Form 3115. Sometimes, CPAs are able to do it as well, but there's a special tax software that's required to be able to produce this.

The only caveat to doing a cost seg study on a property that was placed in service over a year ago is you have to file that Form 3115, but that's a heck of a lot better than having to amend all your previous years' tax returns.

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WS: For sure. No doubt about it. Any other misnomers that we need to know about?

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FG: You know what? I'm going to just touch upon two more and I'll be quick because there are two other important topics I also want to touch upon. The other misnomer is that my CPA does this for me. This is how I describe it to people. If it's a CPA who's progressive and one of the Big 4, Big 8, whatever you want to call it, yes, those types of CPAs have independent departments within their overall firm that specialize in cost segregation. But many CPAs don't have those capabilities or in-house services, because it does require staff with engineering principles and construction principles to be able to generate these studies in order for them to be defensible to the IRS in case of an audit.

What I tell people is, yes, your CPA does do what I call a low-hanging fruit cost segregation study. If you took your building and you flipped it upside down, all the stuff that would fall to the ceiling is what your CPA traditionally does. That's what they segregate. It's called the FFE, furnishings, fixtures, and equipment. If you own multifamilies, many times a CPA will segregate the appliances, right? You've got the stove or the oven and the refrigerator and the dishwasher. All that stuff, low-hanging fruit we call it.

But if you really want to take advantage of cost segregation, you need to have a professional provide it, and this is where I'll insert the company pitch, Bedford Cost Segregation. This is what we do. If you really want to take advantage of cost segregation, there's much more than just appliances in a given commercial real estate that can benefit from cost segregation. This is where a lot of CPAs draw the line in the sand that they cannot provide that type of backup or

justification. Again, leave it to the professionals to go in and do electrical loading analyses. There's a bunch of stuff that can also be peeled out and really benefit from cash flow.

Then lastly, a lot of people have this mindset that when they're doing a renovation project, this stuff that they are disposing of to make way for the new improvements. You're redoing your bathroom. You're redoing your kitchen. You're sprucing up your commercial real estate. Inevitably, whenever you're doing renovations, you're disposing of older assets. So people don't realize that when they're stripping those assets out of their commercial real estate and they're putting it into the dumpster which is heading to the landfill, they are literally shoveling cash into that dumpster. There is something called partial asset disposition that you can have incorporated into your cost segregation study that you're able to claim the depreciable value still left in assets that you're demolishing as part of your renovation project.

I'm not going to get into the weeds. There's a bunch of caveats that have to be met to be able to qualify for this partial asset disposition, but it's something that you have to talk to a cost seg professional about. It's very important. There could be valuable losses that you're shoveling into the dumpster and not claiming on your tax returns.

[END OF INTERVIEW]

[OUTRO]

00:19:53
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