# COST SEGREGATION STUDIES

WHEN ARE THEY BENEFICIAL? AND STRATEGIES ON HOW TO QUALIFY EVEN WHEN YOU HAVE A MANAGEMENT COMPANY.


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# Detailed Report on Cost Segregation Studies

Cost segregation is a strategic tax planning tool that involves a detailed analysis of property assets. It reclassifies components of the property (like electrical installations, plumbing, or landscaping) into categories that allow for a quicker depreciation rate. This accelerated depreciation means larger tax deductions in the early years of property ownership.

## Eligibility Criteria

Suitable for owners of both commercial and residential properties. The key condition is that the property must have been purchased, constructed, or renovated within the last 24 months.

## Benefits of Cost Segregation:

### Accelerated Depreciation

By segregating costs, certain parts of your property can be depreciated over a shorter period (5, 7, or 15 years) instead of the standard 27.5 or 39 years. This front-loading of depreciation expenses leads to substantial tax savings in the initial years.

### Cash Flow Boost

These immediate tax savings translate directly into improved cash flow, providing more capital for investments or property improvements.

# Consequences

## Depreciation Recapture

If the property is sold within five years, some of the accelerated depreciation may be recaptured, meaning you'll owe taxes on a portion of the depreciation claimed. This is often at a 25% rate but can vary based on your tax bracket.

# Who Qualifies

## Property Owner Requirement

This strategy is available to anyone owning eligible property, regardless of whether they are individual investors, corporations, or real estate investment trusts.

# Understanding Losses and Income Limits

## Passive Activity Loss Rules

Generally, losses from passive activities like real estate investments can only offset passive income. The $25,000 allowance for lower-income earners is a special exception but phases out as income increases. <u>Therefore, a Cost Segregation Study is usually only beneficial to someone who "Materially Participates" in the management of their real estate property or someone who has made the election as a "Real Estate Professional".</u>

# Real Estate Professional Election vs. Material Participation

## Real Estate Professional Election

This election allows real estate professionals to deduct losses from their real estate activities against other forms of income, effectively bypassing the passive activity loss rules.

### Irrevocability

Once made, this election is binding for five years, requiring careful consideration before opting in.

### Qualification Requirements

1. **More than 50% of Personal Services in Real Property Business:** The taxpayer must spend more than half of their working hours in real property businesses in which they materially participate.
2. **Minimum 750-Hour Requirement:** The taxpayer needs to spend at least 750 hours during the tax year in real property businesses they materially participate in.

### Election Process

To make this election, taxpayers must declare their status on their tax returns and provide evidence of meeting both criteria.

### Record-Keeping for Proof

**Time Logs:** Keep a detailed log of all time spent in real property businesses, including dates, hours, and descriptions of activities.
**Documentation of Activities:** Maintain records of services performed in each real property trade or business. This can include contracts, emails, or statements of work.
**Comparison with Other Personal Services:** Evidence showing that time spent in real property businesses exceeds time spent in other personal service activities.

# Material Participation

The IRS's seven tests for material participation ensure that the taxpayer is genuinely and regularly involved in the operation of the activity.

## In-Depth Understanding

Material Participation is a criterion used by the IRS to determine if a taxpayer is sufficiently involved in a business or income-producing activity, particularly in real estate.

## Qualification Tests

There are seven tests to establish material participation. A taxpayer must meet any one of these:

1. 500-Hour Test: Participation in the activity for more than 500 hours during the year.
2. Substantial Participation Test: Participation is over 100 hours and is not less than the participation of any other individual.
3. 100-Hour Plus Participation Test: Participation for more than 100 hours in the activity, and this participation is at least as much as any other individual.
4. Significant Participation Activities (SPA) Test: Participation in multiple activities, each over 100 hours, with a total exceeding 500 hours.
5. Material Participation in Five of Ten Previous Years: Material participation in the activity for any five of the prior ten tax years.
6. Personal Service Activity Test: Material participation in a personal service activity for any three prior tax years.
7. Regular, Continuous, and Substantial Test: Based on all facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis.

## Proof of Participation:

Keeping detailed records is crucial. This includes logs of hours spent, dates of participation, and a description of activities. These records should be contemporaneous to strengthen their validity.

## Best Practices for Both Strategies

**Consistent Record-Keeping:** Maintain detailed, organized, and consistent records throughout the year. Digital tools or apps can be particularly useful for tracking time and activities.
**Seek Professional Advice:** Due to the complexity of these rules and the need for accurate record-keeping, consulting with a tax professional or accountant is highly recommended. They can provide guidance on meeting IRS requirements and optimizing tax benefits.

### Conclusion

Material participation and the real estate professional election are powerful tools for real estate investors to maximize their tax benefits. Understanding the qualifications, maintaining meticulous records, and navigating the complexities of these strategies can lead to significant tax advantages.

# Short-Term Rentals and Material Participation

## Material Participation Usually Achieved

Owners of short-term rentals often meet the material participation tests due to the high level of involvement required in these operations.

## Beneficial Outcomes

This active involvement typically qualifies these owners for immediate loss deductions, enhancing the tax benefits.

# Short-Term Rentals with a Management Company

## Impact on Qualification

### Understanding the Challenge

**Primary Concern:** Using a management company for a short-term rental often raises the question of whether the property owner is sufficiently involved to meet the IRS's material participation standards.

**Key Issue:** The IRS scrutinizes the nature and extent of the owner's involvement in the operation and decision-making process of the rental activity, especially when a third party (like a management company) is involved.

## Strategies to Qualify for Material Participation

### Active Involvement in Decision-Making

**Examples:** Regularly making decisions regarding property pricing, guest acceptance, or maintenance issues.

**Proof:** Documenting communications or decision records that demonstrate your involvement.

### Supervising the Management Company

**Approach:** Actively overseeing the management company's work, including reviewing performance, making key decisions, and being involved in strategic planning.

**Evidence:** Maintaining logs of meetings, decisions made, and strategies discussed with the management company.

### Direct Engagement with Guests:

**Actions:** Handling some direct interactions with guests, such as addressing special requests, complaints, or feedback.

**Record-Keeping:** Keeping a record of these interactions, possibly through emails, messages, or notes.

### Involvement in Improvements and Maintenance:

**Participation:** Directly managing or supervising property improvements, renovations, or significant maintenance tasks.
**Documentation:** Retaining invoices, contracts, and correspondence related to these activities, as well as a log of time spent.

### Marketing and Promotion Efforts:

**Activity:** Engaging in marketing efforts for the property, such as social media promotion, listings management, or creating marketing materials.
**Proof:** Documenting these activities and the time spent on them.

## Best Practices for Documentation

**Contemporaneous Logs:** Keep a detailed diary or logbook of your activities related to the property, including dates, hours spent, and the nature of the work.
**Correspondence Records:** Save emails, messages, and notes from discussions with the management company and guests.
**Invoices and Contracts:** Retain all paperwork related to property improvements, maintenance, and marketing efforts.

## Overcoming IRS Scrutiny

**Demonstrating Substantial Involvement:** Your records should clearly show that your involvement goes beyond merely hiring a management company and includes active and regular decision-making and supervision.
**IRS's "Material Participation" Tests:** Aim to meet one of the seven material participation tests set by the IRS, focusing on the hours and nature of your participation.

### Conclusion

Successfully qualifying for material participation in a short-term rental managed by a third party requires proactive involvement and meticulous record-keeping. Property owners must demonstrate that they are not merely passive investors but are actively engaged in the significant aspects of the rental business.

# Example

FIXED ASSET AND TANGIBLE PERSONAL PROPERTY SUMMARY
AND DEPRECIATION SCHEDULE

| Description | Date Placed in Service | Amount | Asset Class | GDS Life | ADS Life | Method | IRC Section | Convention | Current Year Depreciation Calendar Year 2023 |
|---|---|---|---|---|---|---|---|---|---|
| 5 Year Property | | | | | | | | | |
| Flooring | 10/24/2023 | $ 15,311 | 57.0 | 5 | 9 | 200DB | 1245 | MQ | $ 12,402 |
| Wall Coverings & Blinds | 10/24/2023 | 3,223 | 57.0 | 5 | 9 | 200DB | 1245 | MQ | 2,611 |
| Shelving / Paneling | 10/24/2023 | 2,577 | 57.0 | 5 | 9 | 200DB | 1245 | MQ | 2,087 |
| Data / TV Equipment | 10/24/2023 | 1,807 | 57.0 | 5 | 9 | 200DB | 1245 | MQ | 1,464 |
| Appliances | 10/24/2023 | 26,092 | 57.0 | 5 | 9 | 200DB | 1245 | MQ | 21,135 |
| Special Plumbing & Sinks | 10/24/2023 | 15,965 | 57.0 | 5 | 9 | 200DB | 1245 | MQ | 12,932 |
| Electrical for Personal Property | 10/24/2023 | 4,779 | 57.0 | 5 | 9 | 200DB | 1245 | MQ | 3,871 |
| Counters & Cabinets | 10/24/2023 | 26,659 | 57.0 | 5 | 9 | 200DB | 1245 | MQ | 21,594 |
| | | $ 96,413 | | | | | | | $ 78,096 |
| 7 Year Property | | | | | | | | | |
| Telephone / Communications Equipment | 10/24/2023 | 537 | 0.11 | 7 | 10 | 200DB | 1245 | MQ | 433 |
| | | $ 537 | | | | | | | $ 433 |
| 15 Year Property | | | | | | | | | |
| Exterior Lighting | 10/24/2023 | 1,360 | 00.3 | 15 | 20 | 150DB | 1250 | MQ | 1,091 |
| Landscaping | 10/24/2023 | 1,935 | 00.3 | 15 | 20 | 150DB | 1250 | MQ | 1,553 |
| Land Improvements | 10/24/2023 | 1,148 | 00.3 | 15 | 20 | 150DB | 1250 | MQ | 921 |
| | | $ 4,443 | | | | | | | $ 3,565 |
| 39 Year Property | | | | | | | | | |
| Building | 10/24/2023 | 123,746 | | 39 | 40 | SL | 1250 | MM | 662 |
| Plumbing | 10/24/2023 | 23,992 | | 39 | 40 | SL | 1250 | MM | 128 |
| Heating, Ventilating, Air Conditioning | 10/24/2023 | 27,530 | | 39 | 40 | SL | 1250 | MM | 147 |
| Electrical Distribution System | 10/24/2023 | 14,816 | | 39 | 40 | SL | 1250 | MM | 79 |
| Roof | 10/24/2023 | 11,914 | | 39 | 40 | SL | 1250 | MM | 64 |
| Interior Finishes | 10/24/2023 | 115,617 | | 39 | 40 | SL | 1250 | MM | 619 |
| | | $ 317,615 | | | | | | | $ 1,699 |
| Tie to Cost Seg | | $ 419,008 | | | | | | | $ 83,793 |
| Total Excluded Costs | | 179,992 | | | | | | | |
| Total Amount | | $ 599,000 | | | | | | | |

**In this example we can see how the 5-year assets, 7-year assets, and the 15-year assets, can be accelerated in depreciation. In this case where the property was purchased at $599,000, we will be able to take a deduction of $101,393 resulting in <u>tax savings of $25,348.25.</u>**

The amount or percentage of accelerated depreciation will depend on the year in which you are taking the deduction.

H.R. 1, the “Tax Cuts and Jobs Act,” includes 100% first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023, Thus, the phase-down of the 50% allowance for property placed in service after Dec. 31, 2017, is repealed. The additional first-year depreciation deduction is allowed for new and used property. (The Pre-Act law phase-down of bonus depreciation applies to property acquired before Sept. 28, 2017 and placed in service after Sept. 27, 2017.) The first-year bonus depreciation deduction phases down, as follows:

- 80% for property placed in service after Dec. 31, 2022, and before Jan. 1, 2024.
- 60% for property placed in service after Dec. 31, 2023, and before Jan. 1, 2025.
- 40% for property placed in service after Dec. 31, 2024, and before Jan. 1, 2026.
- 20% for property placed in service after Dec. 31, 2025, and before Jan. 1, 2027.

# Conclusion and Recommendations

Cost segregation studies offer a potent tax-saving strategy for property owners, especially when combined with other real estate tax considerations like material participation and the real estate professional election. Short-term rentals often provide additional advantages due to the high level of involvement they require. However, incorporating a management company necessitates careful analysis to ensure eligibility for these benefits. Each situation is unique, so it's advisable to consult with a tax professional to tailor these strategies to your specific circumstances.