Season 1 – Episode 3: Unraveling the Tax Code: Understanding Cost Segregation Studies and the Grouping Election

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we're talking about a topic that can save you a significant amount of money if you're a real estate investor or business owner. That topic is Cost Segregation Studies and how you can utilize a specific treasury regulation to maximize its benefit. So let's dive in.

Cost segregation is a tax planning strategy that allows companies and individuals who have constructed, purchased, expanded or remodeled any kind of real estate to increase cash flow by accelerating depreciation, deductions and deferring federal and state income taxes. In essence, it's about identifying building components that can be reclassified from real property to personal property. This results in a shortened depreciation period for those properties, typically from 39 years for commercial property or 27 and a half years for residential properties to five, seven, or 15 year assets. Basically, what is happening is that when you purchase property, the property has, in addition to the land and structure, carpeting, cabinetry, sinks, faucets, fixtures, driveway, landscaping, fencing, et cetera.

Typically, what we see on our new client’s tax returns are a building and land allocation only. Now, technically, this is incorrect. As well as costing the client upfront cost savings, the IRS expects an allocation. What a cost segregation study does is give you a solid allocation of the various building components situated on and in the purchase property. This, of course, results in a shorter depreciation period, which will result in larger annual tax deductions, improving your bottom line. But how does this work in practice?

Well, let's take a real-world example. Say a Doctor's S-Corporation, just purchased a commercial building via a separate LLC. Our doctor decided to buy the building where they could have their office and possibly lease out additional space to other businesses. They bought the building inside a separate LLC for liability reasons. This is an appropriate way to structure this type of transaction.

The doctor's S-Corporation runs their practice, and the LLC owns and rents the building. If any liability exposure occurs through the S-Corporation. For example, as long as the S-Corporation is run separately from the doctor personally and from the LLC, the liability exposure will remain solely in the S-Corporation. Meaning the doctor could lose their practice without losing their building. If, on the other hand, the building was owned inside the corporation, which is not advisable due to negative tax effects, which is outside the scope of this episode. The practice in the building could also be lost due to a liability issue incurred in the doctor's medical practice. Now the question is how can they maximize their tax savings from the cost segregation study? To take advantage of the cost segregation study, they would hire a cost segregation specialist. This specialist performs an in-depth study analyzing various aspects of the building, like electrical installations, plumbing, mechanical components and even the type of materials used in construction.

The specialist will then prepare a report, reclassifying as many components as possible into shorter lived asset categories. These include categories like land improvements, personal property and other assets. The doctor can now depreciate these assets over a much shorter time period, or possibly immediately by using bonus depreciation rules, which is only available for assets that have a life less than 20 years, which this of course, results in substantial tax savings. To be clear on our specific fact pattern, where the doctors

LLC rents out the space of the Doctor's S-Corp, they must make a grouping election under Treasury Regulation 1-469(4)(c) on the first return where the activities exist. The grouping election under Reg. 1-469(4)(c) relates to the IRS's passive activity loss rules. In general. These rules were designed to limit the ability of taxpayers, especially those with higher income, to use losses from what the IRS defines as passive activities to offset income gained from non-passive activities.

A passive activity is any rental activity or business in which you do not materially participate. Material participation is generally determined based on the number of hours you spend on the activity, with the threshold being 500 hours in a year. The LLC in our example, would be considered a per se passive activity and the Doctor's S-Corp would be a business in which the doctor materially participates. Now getting to the heart of the matter grouping activities under 1-469(4)(c). Here's where we determine how the LLC and the S-Corp can be bundled for the purposes of applying passive activity rules. One or more trades or business activities or rental activities might be treated as a single activity if they form what is known as an appropriate economic unit. But what defines an appropriate economic unit? This isn't black and white. It's determined by the specific circumstances surrounding your activities.

You're allowed to use any reasonable method to apply these facts and circumstances when grouping activities, but there are, however, some key factors that hold the most weight. These include similarities and differences in types of trades for businesses, the extent of common control and ownership, geographical location and interdependencies between the activities. For our example, the LLC and the S-Corp would be an appropriate economic unit. By making the grouping election, the doctor can treat both activities as one economic unit. Since the doctor materially participates in this grouped activity. The losses from the real estate activity. The LLC can be treated as non-passive and can offset the income from the doctor's practice with large depreciation deductions stemming from a cost segregation study.

This election is extremely powerful and must be made as mentioned on the first return. Where these circumstances exist, a failure to make the election is treated as if you are making the election to not group the activities, and not making the election will limit the ability to deduct current losses, essentially mitigating the current tax benefit of the cost segregation study.

By strategically grouping activities and reclassifying components for faster depreciation, our doctor is able to improve their cash flow and lower their tax liability? Remember, this strategy isn't just for doctors with separate ownership entities. If you're a business owner with real estate investments or assets, you may also stand to benefit. However, the rules are complex, and it's crucial to have a skilled CPA to help you navigate them.

That's all for this episode of Tax Blueprints of Rohr CPAs podcast. You can find us online at rohrcpas.com/podcast and don't forget to subscribe on Apple Podcasts or Spotify. If you enjoy the show, please consider rating or reviewing us wherever you listen. I'm your host, Daniel Rohr. Thanks for listening.