"You don't have to fear tax time or feel hopeless about the checks you'll write to the government each year. This is a brilliant tool that will help you keep more of your hard-earned money!"

—**ELIZABETH BENTON,** BESTSELLING AUTHOR AND HOST OF THE *PRIMAL POTENTIAL PODCAST*

# THE BOOK ON ADVANCED TAX STRATEGIES

## Cracking the Code for Savvy Real Estate Investors

Volume 2, Advanced

AMANDA HAN AND
MATTHEW MACFARLAND
CERTIFIED PUBLIC ACCOUNTANTS

BiggerPockets® PUBLISHING

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# *Praise for the Series*

## THE BOOK ON TAX STRATEGIES FOR THE SAVVY REAL ESTATE INVESTOR

## THE BOOK ON ADVANCED TAX STRATEGIES: CRACKING THE CODE FOR SAVVY REAL ESTATE INVESTORS

"There's a saying: It's not how much you make, it's how much you keep—and there are few places where this is more applicable than real estate investing. In this book, Amanda and Matt explain the tax benefits of real estate in a way that even the most novice investor can understand, and they give both new and seasoned investors alike the tools necessary to put these strategies to work to start saving money immediately. This book is a must for any investor's bookshelf."

**—J Scott, Author of *The Book on Flipping Houses* and co-host of *The BiggerPockets Business Podcast***

"You can't even get your CPA to listen to your voicemail message for the cost of this book!"

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“Matt and Amanda are top-notch professionals with whom I have been associated for many years. Their clientele demands answers to the most current changes in the tax code, and their new book gives all of us a big advantage in creating strategies that will save us money and help keep our wealth!”

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“The only certain things in life are death and taxes. Thankfully, Amanda and Matt have made the latter much less of a sure thing! This book has a down-to-earth yet informative style that makes it fun and easy to read, while also helping to save real estate investors BIG money.”

**—Brandon Turner, Bestselling author of *The Book on Rental Property Investing* and co-host of *The BiggerPockets Podcast***

“If you want to learn how to embrace the tax code and make it work for you instead of against you, this book is a must read. With *The Book on Advanced Tax Strategies*, you don't have to fear tax time or feel hopeless about the checks you'll write to the government each year. This is a brilliant tool that will help you keep more of your hard-earned money!”

**—Elizabeth Benton, Business owner, podcaster, and bestselling author**

“Matt and Amanda knocked this one out of the park! [They] lay out a... clear understanding of the rules of self-directed investing, whether in an IRA or in a Solo(k). The book goes deep into the upside of tax-free and tax-deferred retirement savings as they illustrate the financial benefits. Want to invest your retirement funds outside of Wall Street? Read this book first!”

**—Kaaren Hall, CEO of uDirect IRA Services, LLC**

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Amanda Han and Matthew MacFarland

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# CHAPTER 2
# THE DO'S AND DON'TS OF ACCELERATED DEPRECIATION

*"Never put off till tomorrow what may be done day after tomorrow just as well."*

—**MARK TWAIN**

Meghan has been working at Dot-Tech as a software engineer for close to eight years. In fact, she was one of the first ten employees to join the company. Over the past eight years, the company has grown from a start-up firm with fewer than a dozen employees to a now-recognizable household brand with close to 100 employees and five different offices across the United States. As one of the key employees in the company, Meghan often spends many overtime hours at work. Thankfully, her husband James has a more flexible job as a marketing consultant, so he is able to help out quite a bit at home and with the kids when needed.

To help retain its employees, Dot-Tech has been issuing restricted stock units (RSUs) over the past several years. Previously, none of the restricted stock units really had had an effect on Meghan's taxes in any way, but this will be the year that a large chunk of Meghan's restricted stock units will vest. Meghan doesn't know too much about how RSUs will impact her taxes, but she has heard horror stories from some of her friends in the tech space who had received RSUs in the past. Her friend Rachel said that when the stocks vested, she ended up paying over 45 percent taxes on the fair market value of those stocks.

Meghan and James do not want to lose close to half of their windfall to taxes; instead, they want to get into real estate investing with this money. James's parents were successful real estate investors. Growing up, James and his siblings were able to spend a lot of time with their parents, who had the flexibility and financial freedom to do so. Now that they have grandkids, James's parents have been able to set aside some money for the grandkids' future college education. These financial benefits were the fruits of their labor from many years as real estate investors.

Because they knew the freedom and financial security that can be achieved with real estate investing, Meghan and James made the decision to use her RSUs from work to kick-start their investing venture. With the success of Dot-Tech, it looks like the fair market value of Meghan's restricted stock units will be close to $500,000. That's a good chunk of money to get them well on their way to real estate investing.

However, if Meghan's friend Rachel is correct, then Meghan could lose close to half of the RSU value to taxes. Assuming there will be taxes of 45 percent, the cash that Meghan and James will have after paying taxes on the $500,000 and selling the RSUs will only be $275,000. This just does not sit well with the couple. They know that there has to be a better solution for this. After all, hadn't they heard that there were many tax loopholes for real estate investors? Since they plan on investing in real estate, maybe some of the real estate strategies can help them reduce their upcoming tax bill.

James has always prepared their taxes in the past. Things were simple enough with Meghan's W-2, his sole proprietorship consulting income, and the interest and taxes on their primary home. From time to time, they would make some charitable donations, but other than that, taxes have been fairly straightforward for them. But this year will be different. How will the RSUs be taxed? Will they be able to use their real estate investing plan to reduce the taxes on the RSUs? As much as James wants to tackle this himself and search online for answers, he knows this is too risky a task to take on by himself. He doesn't want to step over a quarter to pick up a nickel.

They decide to do some research and find Mark, a reputable CPA who specializes in working with real estate investors. To their surprise, even though their main concern is the large tax bill on the upcoming RSUs, Mark starts the meeting by asking Meghan and James to elaborate on their overall financial goals and their plans with respect to real estate investing.

Meghan begins by telling Mark that James is expected to make around $100,000 of consulting income this year. Her annual salary will still be the usual $200,000, similar to previous years. Her RSUs will vest this year, and the estimated value of those will be around $500,000. Their plan, if possible, is to sell the stocks immediately upon vesting and turn them into cash of $500,000. They will then use that money to purchase a rental duplex for $500,000. Because James is self-employed, he will then reduce his consulting time and focus solely on real estate in order to qualify as a real estate professional for tax purposes. Although they do not need the cash flow from the rental for living expenses, they want to use real estate to build cash flow and for appreciation so that they could be financially free—just as James's parents were. The only problem, Meghan says, is that it looks like they will first need to pay $225,000 in taxes and can only use the remaining money to start their real estate investing venture.

Mark leans back in his chair, and a big grin appears on his face. According to Mark, it is possible to protect some of the RSU income from taxes. It is also possible to use rental real estate to create cash flow without paying a ton in taxes on the rental income. These goals could be accomplished with the following steps:

1. Sell the RSUs once they vest.
2. Use the cash from the RSUs as a down payment on rental properties.
3. Use leverage from banks, in addition to the down payment, to purchase rental real estate.
4. Maximize rental expenses to offset rental income.
5. Use accelerated depreciation to create a large tax loss.

Mark explains how the RSUs will impact Meghan and James's taxes. First, restricted stock units are taxable as part of W-2 wages in the year of vesting. The amount in taxable income is generally the fair market value of the stock at the time of vesting. As such, since the fair market value of Meghan's RSUs will be $500,000 at the time of vesting, Meghan's W-2 this year will increase by $500,000. The goal, then, is to use rental properties to reduce taxes on this additional $500,000 of income.

Instead of Meghan and James using the cash from the RSU sale to buy an all-cash property, Mark encourages them to consider using leverage to invest in real estate. Leverage allows them to use borrowed money, purchase more investment properties, and grow their real estate at a faster pace. In this case, leverage means using the traditional route of bank financing—saving up money for a down payment and then getting a loan from the bank to purchase a property. Instead of using all of their funds to purchase a duplex with all cash, it could make more sense to purchase three duplexes for a total of $1,500,000 with just some of their funds as a down payment and taking on a loan for the remainder. Even though this could result in less cash flow, it could also result in higher appreciation to have three properties—rather than getting all their cash tied up in one property.

On the tax side, it makes sense to use leverage to purchase multiple properties instead of buying an all-cash property to maximize tax savings using depreciation.

## Common Depreciation Myths Revealed

Depreciation can be an investor's best friend when it comes to tax savings. Depreciation is an annual income tax deduction in which the IRS allows an investor to write off the decrease in the property cost each year. We take a tax deduction on our rental properties when we may not have suffered any actual loss on the property—also commonly referred to as a "paper loss." Depreciation, under the IRS definition, is "a tax deduction that allows a taxpayer to recover the cost of a property over time. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property."

The IRS dictates the depreciation lives for different types of assets. Residential rental buildings, for example, are generally depreciated over 27.5 years. Land, on the other hand, is not depreciable. For example, if Meghan and James purchased a duplex for $500,000 that was made up of $75,000 of land and $425,000 of building, the depreciation on that rental property would be $15,455 per year. Assuming a federal and state tax rate of 45 percent, this could save them close to $7,000 in taxes each year.

$425,000 ÷ 27.5 years = $15,455 depreciation per year

Mark suggests that Meghan and James consider purchasing not just one property but three duplex rentals because—by using leverage to purchase more rentals—they increase cash flow and appreciation as well as the annual tax savings. If Meghan and James purchase three duplex rentals for a total purchase price of $1,500,000, this can mean tax deductions of $46,365 from depreciation alone.

$15,455 × 3 = $46,365 depreciation each year

An important thing to understand about depreciation is that the amount you write off is not dependent on how much money you put down to purchase the property. Rather, it is based on the purchase price of the property. For example, on a $500,000 property, you take the same depreciation expense whether you put 20 percent down or if you put zero money down. This means that it is possible to use depreciation to get tax write-offs, even if you paid no cash out of pocket. Meghan and James's money could either be used to purchase one property to depreciate or to purchase three properties to depreciate. Same out-of-pocket amount, but a much larger depreciation write-off once leverage is added to the equation.

Another important item to note is that depreciation is available as a write-off regardless of whether the property actually increases or decreases in value. Even if a $500,000 property declined in value at the end of Year One and is now only worth $450,000, you are still able to write off your depreciation based on what you purchased it for.

Everything sounds good so far to Meghan and James. They love the idea of using leverage to purchase more rentals to increase cash flow and for appreciation purposes. With Meghan's high W-2 income, they do not see a problem with obtaining bank financing at low interest rates that will allow them to still cash flow the properties. However, even with leverage and the acquisition of three properties, the estimated depreciation deduction is only roughly $46,000. That hardly puts a dent in the taxes they are projecting of $225,000.

The next step, Mark says, is to use a cost segregation study to accelerate the depreciation expense and use that to reduce their anticipated large tax bill. Meghan and James have heard of the term *cost segregation* but are not too familiar with the concept. Based on the limited information they have read about cost segregation online, it seems to be used for large properties, such as apartment buildings or commercial shopping centers. This is the first time they've been told it might help benefit smaller investors such as themselves. They are eager to hear Mark explain the ins and outs of how this can help them.

## What Is Cost Segregation?

Cost segregation is a valuable tax strategy for real estate investors that is designed to accelerate depreciation expense into current years rather than waiting to take it slowly over time. It is important to note that cost segregation does not mean you received any *extra* depreciation; it simply means that you are speeding it up and receiving the tax benefit today rather than waiting to receive it over 27.5 years.

We discussed previously that the IRS has a set of rules with respect to the calculation of depreciation. For residential rental real estate buildings, a rule for length of time (usually called the depreciation period) is typically over 27.5 years. With respect to rental real estate, there are more depreciable assets within the building other than just the building itself. Examples of other commonly found depreciable assets on rentals can include flooring, appliances, roof, cabinets, countertops, fixtures, drywall, plumbing, and HVAC. Each of these assets can have different depreciation periods and most are less than 27.5 years.

In essence, cost segregation is an analysis done to accelerate the depreciation on the building. Rather than depreciating the entire amount as "building" over 27.5 years, cost segregation breaks out the components of that building into smaller assets. Once these components are broken out (for example, cabinets, countertops, appliances), they can result in a larger tax deduction in the current years. The depreciation on items such as sidewalks, parking lots, specialty plumbing and electrical, and carpet can then be accelerated over 5 to 15 years instead of 27.5 years. From a tax perspective, cost segregation can create a faster—hence larger—depreciation write-off today. That's why cost segregation is often referred to as "component depreciation" and "accelerated depreciation."

Believe it or not, cost segregation can significantly increase the tax deduction on a rental property. Depending on the underlying property, it may be possible to create depreciation deductions of up to 20 percent to 40 percent of the purchase price of the real estate. If Meghan and James were to invest in $1,500,000 of rentals and implement a cost segregation study that showed accelerated depreciation to be roughly 35 percent of purchase price, that could mean up to $500,000 of depreciation in the first year. This could completely wipe out the taxes from Meghan's RSUs from work and save them $225,000 in income taxes.

Cost segregation sounds like exactly what Meghan and James are looking for. They both had hoped that real estate investing could help them lower their taxes, but they never expected it to wipe out their entire tax bill from the stock windfall.

## Common Questions Regarding Cost Segregation

### How is a cost segregation done, and can I do it myself?

We have come across investors who have tried the do-it-yourself (DIY) method when it comes to cost segregation. There are also some off-the-shelf software programs that claim they can be used to calculate cost segregation benefits. So, can an investor perform a cost segregation on their own? Sure. Is it recommended? No.

To do a cost segregation, you would need to carefully examine and apply the IRS depreciation policies on land, land improvements, and various classes of personal depreciable property. There are differences between Section 1245 property and Section 1250 property, to name a few. In addition, the IRS has defined thirteen principal elements of a qualified cost segregation. Those elements are:

1. Preparation by someone experienced and with the expertise
2. Detailed description of the cost segregation methodology
3. Use of appropriate documentation
4. Interviews conducted with appropriate parties
5. Use of a common nomenclature
6. Use of a standard numbering system
7. Explanation of the legal analysis
8. Determination of unit costs and engineering "take-offs"
9. Organization of assets into lists or groups
10. Reconciliation of final allocated costs to total the actual costs
11. Explanation of the treatment of indirect costs
12. Identification and listing of section 1245 property
13. Consideration of a variety of related aspects (for example, sampling techniques, change in accounting)

As you can see, it is more involved than simply breaking out the cost of dishwashers and sinks. Unless you are well versed in the thirteen elements above, we would not recommend taking the DIY approach to a cost segregation; it should be done by a reputable engineering or consulting firm. There is a set of specific rules and guidelines that must be followed in order to break out the components of a building and accurately split out the property for depreciation calculation. Doing it yourself can be complicated, time-consuming, and most of all . . . risky. Our recommendation is to leave this to the professionals and hire a cost segregation firm.

### Aren't cost segregation studies very expensive?

This is a concern we have heard from time to time. As with most investment decisions, there is a cost/benefit analysis that should be done in order to determine whether this strategy makes sense for a given investor in a given year. It may work for you but not your investor friend. It may have been a bad strategy for you last year but a great strategy for you this year. It all depends on the facts and circumstances of each case. However, if a 20 percent to 40 percent write-off in the first five years can save you tens to hundreds of thousands of dollars in taxes, then it very well could make sense to incur the cost to get the analysis done.

### When is a cost segregation study done?

First, accelerated depreciation can be taken at any time on a rental property you own. It does not need to be taken in the year you first purchase the property, or in the first year the property is placed into service. It doesn't need to be done in Year Two, or Three, or Four . . . you get the idea. Essentially, cost segregation can be done at any time during your rental holding period.

Investors are often under the impression that cost segregation must be done before the end of the tax year. Although most tax strategies do need to be implemented before the end of the year in order to reduce taxes for that year, that rule actually does not apply to cost segregations. In fact, we often recommend that clients wait until the tax return is being prepared before making a decision on whether a cost segregation would make sense for that year. For example, if I am expecting to pay taxes at 37 percent, I may want to get a cost segregation done to reduce my taxes. What if, though, by the time I prepare my actual tax return, it turns out that I actually ended up in the 10 percent bracket? I may want to forgo cost segregation for now and reconsider it as a strategy for a future year.