Creative Real Estate *strategies*

Thinking outside of the bowl

Dynamic Duos

Throughout history, there have been numerous “Dynamic Duos.” Batman and Robin. Laurel and Hardy (for us oldsters). R2D2 and C3PO. John Wayne and anyone. And of course, the greatest dynamic duo of all times, peanut butter and jelly. But there is another Dynamic Duo that more real estate brokers are beginning to use that can accumulate more wealth for their clients…cost segregation and Section 453.

Here is how the Dynamic Duo works. Depreciation is a huge opportunity when owning income-producing real estate. Depreciation can be used to shelter income from the operations of income-producing property and can help minimize taxes. What if there was a way to increase depreciation, which in turn would shelter more income and reduce taxes even more. That’s a good thing, right? Absolutely and that’s exactly what cost segregation does.

So what is the first half of the Dynamic Duo, cost segregation? Cost segregation is an engineered based study approved by Congress on each of the assets in a real estate transaction. This could be a lighting fixture to wiring in a wall. Whenever possible, those assets can be depreciated faster, which in return creates more depreciation, which will shelter more income and reduce taxes and keeps more money in the property owners’ pocket.

A cost segregation study can increase the rate of return, which could assist the property owner in making the property more attractive to buyers. At the same time, the seller benefits from accelerated depreciation, which again shelters more income and reduces taxes, so everyone wins using a cost segregation study. That’s the good news, but now there may be less than good news.

As you know, when selling a property, depreciation recapture is brought back for tax purposes. Having said that, you can transact a 1031exchange and defer the depreciation and accelerated depreciation, but the accelerated depreciation will count against the depreciation opportunities on the new replacement property. But don’t worry. There is still good news. If there wasn’t, there wouldn’t be a good reason to write this article.

The seller still has opportunities to defer the accelerated depreciation, and that’s why Section 453 is the second half of the Dynamic Duo. Just call me Batman. Or John Wayne. Either works. What if you could use cost segregation to shelter income and then defer accelerated depreciation recapture for as long as you would like.

Section 453 can be a great opportunity when the property owner wants to sell and retire or wants to buy more real estate. If he wants to retire, Section 453 can help him sell and retire and defer the capital gains tax, state tax, depreciation and accelerated depreciation and the Obamacare tax on the gain of his sales proceeds and provide him with a larger lifetime retirement income than if he paid taxes first. So he sheltered more income, reduced his taxes, and deferred his taxes on the sale, and that deferral can be passed on to his heirs. The Dynamic Duo helped him accumulate more wealth for retirement and for his heirs. John Wayne is looking pretty good right about now.

Now let's change gears and assume that the property owner wants to sell and buy more real estate. Our Section 453 may be a better option than a 1031 exchange. There are several reasons, but let's focus on accelerated depreciation. When transacting a 1031, you may not get a new depreciation schedule on the replacement property. For example, say you have depreciated your $4 million property at 80% and now transact a 1031 exchange and buy a $5 million replacement property. The new depreciation schedule will be 20% of the remaining unused depreciation plus the additional $1 million increase in the basis of the new property. You can still use cost segregation, but the benefits will be somewhat limited.

However, using Section 453, you can buy another property at any time in the future and get a new depreciation schedule regardless of the new basis of the new property. If you buy a $3 million property, great. If you buy a $5 million property, you still get a full depreciation schedule. So a new cost segregation study will allow you the full benefits of accelerated depreciation when using Section 453.

The bottom line is that using the Dynamic Duo; you can shelter more income, reduce taxes, and then defer the accelerated depreciation as well as other taxes when selling. This is a great opportunity for brokers to help their clients accumulate more wealth by keeping more of their hard-earned proceeds in their pockets and deferring their tax liability, which can create great leverage for their clients. So give us a call and let us start working for the benefit of your clients today. Happy selling.