General Tax Information

Your Legally Mine Asset Protection plan is designed primarily to ensure that your assets remain safe. We also strive to minimize any increased filing burdens that may result from your new structure. It is important to know, however, what your new filing obligations are, how to meet them, and how to use your new structure to reduce your overall tax burden.

IMPORTANT!!! - The following is a list of entity types and their tax requirements:

C-Corporation (including LLC taxed this way)	IRS Form 1120, due by **March 15th**
S-Corporation (including LLC taxed this way)	IRS Form 1120S, due by **March 15th**
LLCs with more than one owner (taxed as Partnership)	IRS Form 1065, due by **March 15th**
Limited Partnerships (aka FLPs or LPs)	IRS Form 1065, due by **March 15th**
Sole Proprietorships (including SMLLC taxed this way)	Schedule C on your Form 1040, **April 18th**
Single Member, disregarded LLCs	No return required

**State forms may also be required, depending on where the entity was formed and/or domesticated. Speak with a Legally Mine representative, or with your CPA, to determine whether state filings are required.

Many tax savings mechanisms are available to you through your new entities. Information about some of these mechanisms is included in your binder. For information about the tax savings opportunities listed below, speak with your CPA and/or a Legally Mine Representative.

Tax Savings Strategies:
Income Shifting
Rental of your primary residence - IRS Code 280A(g)
Medical expense accounts (such as Health savings accounts or Flexible spending accounts)
Travel expenses
Vehicle Expenses
Education Expenses
Startup expenses (such as the state fees and costs paid to Legally Mine)
Management, Rental, and Lease agreements (to create income that can be shifted out to other entities)
FICA/FUTA reduction through an S-Corp
Reduction of the new 3.8% Health Care Tax on rental and investment income
Etc...

P.O. Box 1629 ♦ Orem, UT 84059 ♦ Toll Free 855.361.2686 ♦ Fax 888.801.6454 ♦ www.LegallyMine.com

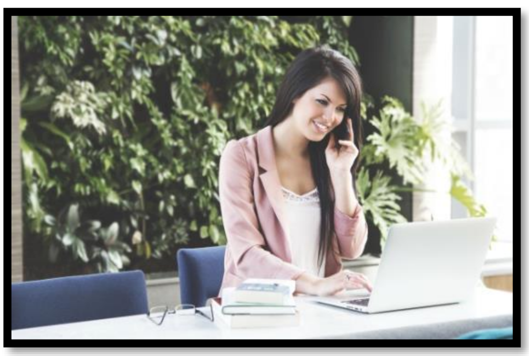
Income Shifting Information

What is Income Shifting? Income shifting is moving taxable money from one individual at a higher tax bracket to another individual taxed at a lower income tax bracket. The amount of income multiplied by the difference in tax brackets is the resulting amount of tax savings. Example: John and Jane make $300,000 per year. Their tax bracket is 33%. They have two children in college, costing them $15,000 per year per child in after-tax dollars. Instead of giving that money to their children, they can shift it to them. Each child reflects $15,000 of income on his or her tax return. John and Jane then report $270,000 on their joint tax return. The resulting savings are roughly $9,900 ($30,000 x .33)), not taking into consideration self-employment tax.

There are two forms of Income Shifting: Earned and Unearned.

Earned Income Shifting

What is Earned Income Shifting? Earned income shifting is simply hiring an individual you are financially supporting to provide services to a business for which services the business can then pay the individual out of the corporate account. There are many ways to justify earned income (meaning the individual is paid through a 1099 or a W-2). A dental practice could pay the dentist's children for use of their photos on his or her website. A doctor's office could pay the doctor's children for shredding the papers for the office. A child could do administrative work, provide tech support or website design, or do advertising (social media, blogging, etc.) for the professional office. The possibilities are almost endless, but the wage must be reasonable (no $100,000 salaries for shredding paper part time). Keep in mind that you can pay a dependant earned income of approximately $600 if paid using IRS tax Form 1099, or $12,000 if paid on IRS tax Form W-2.per year without that individual needing to file a tax return.



What are my kids' filing requirements? Your children, or the individual you are financially supporting, will have to file their own income tax returns for the income they have earned for services provided and will be taxed at their tax rate. If they have elected to have federal or state taxes withheld from their paycheck, they will want to file as a tax refund is the only way to receive a refund on the taxes paid if any is owed.

What are the tax rates for my kids? This chart shows the income tax rate for 2021 of a single individual:

Taxable Income	Tax Rate
$0—$9,950	10% of taxable income
$9,951 to $40,525	$932.50 plus 12% of the amount over $9,951
$40,526 to $86,375	$5,226.25 plus 22% of the amount over $40,525
$86,376 to $164,925	$18,713.75 plus 24% of the amount over $86,375
$164,926 to $209,425	$46,643.75 plus 32% of the amount over $164,925
$209, 426 to $523,600	$120,910.25 plus 35% of the amount over $209,425
$523, 600 or more	$121,505.25 plus 37% of the amount over $523,600

Am I required to treat the individual hired for income shifting as an employee? If you hire the individual or child as a W-2, then yes you will need to treat them as you treat any other employee. For example, if you make all employees clock in and out each day, that individual or child must also clock in and out. Maintaining payroll documentation and other records to prove that the children, or other individual, is a bona fide employee is recommended. As mentioned above, ensure that the individual or child is paid a reasonable, and consistent, salary for the work they are performing for your business.

If the child or individual is contracted as an independent contractor and paid through a 1099, then that individual or child has more autonomy and is not considered an employee. For example, if you hire your child to mow the lawn and provide upkeep to the landscaping of the business, then you could pay the individual as a 1099 independent contractor and provide him or her with minimal guidance on how the work is to be accomplished, essentially paying a lump sum once the work is completed.

What about FICA and FUTA (Self-employment) taxes? If your business is a corporation, or a partnership that contains non-parent partners, FICA and FUTA taxes are required to be paid on the individual or child's wages. However, FICA and FUTA taxes would have to be paid if you hired someone for similar work anyway, so this really is a wash for the business.[1]

If you operate either as a sole proprietorship or a husband-wife partnership with no other partners, services provided by your child under the age of 18 are not considered employment for FICA. If your child is under 18 in this scenario, you, as the business owner, are not required to pay FICA and FUTA taxes on the child's wages and FUTA is not imposed if your child is under age 21.[2]

[1] For more information on hiring your kids please refer to the IRS guidelines on hiring family at https://www.irs.gov/businesses/small-businesses-self-employed/family-help.
[2] Id.

Unearned Income Shifting

What is Unearned Income Shifting? Unearned income is income distributed to people through their ownership interests in an income producing company (such as a limited partnership interest in a family limited partnership) or other interest-producing investment or account. By having an ownership interest in the income producing business or asset, the individual or child has a right to receive a distribution of that income.

How can I make a Distribution? In order to shift income through a distribution of profit, the business entity (FLP or otherwise) has to have income after all expenses have been met. There are several ways to generate income: interest from investment accounts owned by the FLP (management or consulting fees paid to the FLP for managing accounts and investments), rental income from houses owned under an LLC, management fees paid to the management LLC, etc. Income, after all expenses are paid, can then be paid out to the partners for their share of the profits in the company.

How are Profits allocated? How much of a percentage in the company should I give? Tax is attributed to an individual's ownership percentage in the business entity. If the business has $100,000 per year of income and you want to shift $30,000 per year to a child as unearned income, the child would normally need a 30% limited partner interest (or membership interest for an LLC) in the business.

Are there any tax implications to gifting my children ownership in an income producing entity? Keep in mind that transferring ownership percentages could be a taxable event if the value transferred (in the form of ownership percentages) exceeds $28,000 per individual per year ($15,000 from each parent). More value can be transferred if parents want to tap into their estate tax exemption amount early. Tapping into that amount requires filing a special gift tax return.

What is the "Kiddie Tax" and how does it limit my ability to use unearned income shifting? The IRS has limited the amount that a minor or dependent can receive under unearned income shifting. Passive income, or unearned income, is limited for dependents or individuals under 19 years of age to around $2,100 per year[3] for these individuals taxed at their individual income tax bracket. It is also limited for full time students under the age of 24 if they are still claimed as dependents on their parents' return. Otherwise, any unearned income above $2,100 is taxed at the parents' rate. For individuals 24 years of age and older, there are no restrictions, so long as they are not claimed as dependents.

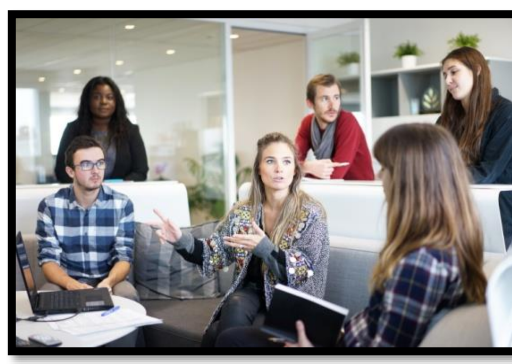
[3] For 2016, the first $1050 of unearned income is tax-free for dependents under their standard deduction. The second $1050 is taxed at 10%. Anything over $2100 is subject to the parents' tax rate.

280A(g) Information

Internal Revenue Code 280A(g)[4] allows you to rent out your entire home for up to 14 days per year without reporting that income on your individual federal income tax return. You can rent the home to anyone for any reason. The business can then pay you for use of your home, take the cost as a tax deductible business expense, and the income is then, in essence, shifted to you tax free. On the receiving end of 280A(g) (the income paid to you), it is very straight forward: You receive the money and do not have to report it on your tax return. On the business deduction side, though, there are some important considerations that you will want to look at:

1) How much can you charge for rental of your home? The reasonable daily rental value for a meeting space is usually about $1,000 per day. If you want to get a more exact number, you can check with local hotels or event centers in your area to see what they charge for a meeting room. Is your home comparable to a Hilton? A Ritz Carlton? Something more or less expensive? For larger events, like an office party or promotional event, you can likely charge more, depending on the size of your home and the nature of the event. Again, you would want to contact a local venue to determine what you would have to pay to rent a space similar to your home.

2) What is a justifiable business expense for rental of my home? There is a broad spectrum of potentially allowable business expenses. The expense needs to be reasonable and to be primarily for business purposes. For example, your business could hold employee trainings in your home, or sponsor a continuing education class in your residence.



Likewise, you could host an office Christmas party or employee appreciation party at your home. The business could pay for those expenses as well.

Depending on your circumstances, you may also host business meetings in your home. If you host a business meeting in your home, just make sure the meeting is documented and that there is a valid business purpose for holding the meeting. It is also best to have at least one other person involved in the meeting other than you and your spouse and/or child (business associate, accountant, etc.). One business might reasonably hold 12 to 14 meetings a year at your home, especially if you don't have an otherwise workable meeting space at your office. If you have multiple businesses, you could spread meetings out between various businesses.

Keep in mind that the IRS has not issued a clear statement on what is allowable and what is not, so you will just need to make sure that everything you do is documented and justified. Use of your home does not trigger an audit, but some deductions may be disallowed in a random audit if proper records are not kept.

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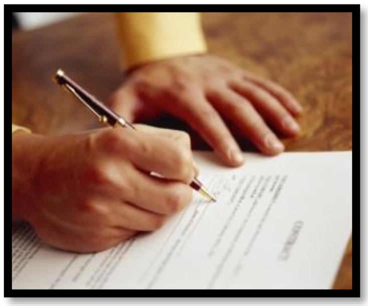
[4] *See* http://www.law.cornell.edu/uscode/text/26/280A for the text of the provision (scroll down to the bottom).



3) How do I document the 280A(g) deduction? Documentation is not overly complicated. You just need to ensure your company books are kept properly. The business should write checks to you each time it uses your home. All receipts need to be kept for additional expenditures, such as food. For meetings held in your home, fill out a meetings and minutes form each time you hold a meeting and make note of business items that were discussed. For promotional events or office parties, photos, a guest book, food receipts, or other items that would prove the event took place would be appropriate.

4) Can I use 280A(g) for other properties other than my primary residence, such as my vacation home? Yes, you can as long as the other property constitutes a residence under IRS guidelines. The IRS allows individuals to use more than one dwelling as a personal residence. Under IRS Tax Topic 415 the IRS has defined the use of a dwelling unit as a residence if "you use it for personal purposes during the tax year for more than the greater of:

1. 14 days, or
2. 10% of the total days you rent it to others at a fair rental price.[5]

Under the same IRS document, the IRS acknowledge it is possible that an individual could use more than one dwelling unit as a personal residence during the year. The Tax Topic further states that if you use a dwelling unit as a personal residence and rent it for fewer than 15 days, the taxpayer should not report any of the rental income. The downside to this is that you are also unable to deduct any expenses as rental expenses under this scenario, so be sure to determine what strategy is going to provide you the best savings.

5) Is my business required to report the payment to me? Maybe. Rental amounts paid in excess of $600 to individuals must be reported to the recipient and IRS through Form 1099-Misc.[6] Do not let this concern you! Even if you are required to receive a 1099 Misc. from your corporation, taxes on this payment can be avoided by reporting on Schedule E, Form 1040 as follows:

Rental Income Received	$15,000
Less: Amount Tax-Free under Section 280A(g)	(15,000)
Taxable Amount	$0

Remember, both 280A(g) and Tax Topic 415 expressly allow that any residence that receives rental income under 14 days out of the year receives nontaxable income. By writing the above statement on your Schedule E, Form 1040, you are merely accounting for the funds the corporation has reported to have paid to you and avoiding any discrepancies between what your company reports and what you declare.

For additional questions, information, or an appointment with your accountant, please contact one of Legally Mine's tax specialists.

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[2] IRS Tax Topic 415 (https://www.irs.gov/taxtopics/tc415.html).

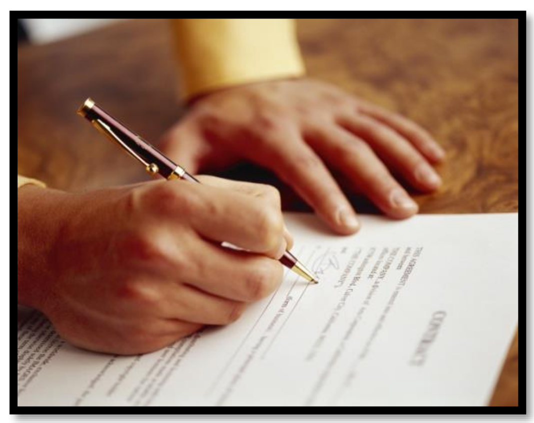
[3] *See* https://www.irs.gov/pub/irs-pdf/i1099msc.pdf

Entity Cash Flow and Taxation Information

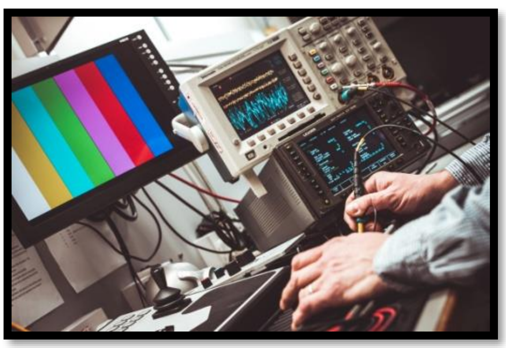
Proper cash flow between your entities is an important part of maintaining your asset protection plan. As a general rule, any entity with more than one owner will need at least one bank account and will need to file a tax return. The following list provides an overview of your multi-member entities and outlines the cash flow, taxation, and deductions associated with each one:

Your Business/Practice - (usually an LLC taxed as an S-Corp) - This entity is usually your main source of income. Because of that, this entity typically claims the bulk of your deductions. This entity also allows you to use tax saving strategies such as shareholder distributions, income shifting (through paying wages to your children or others), the home office deduction, and the 280A(g) home rental deduction. This entity will maintain a bank account, usually a checking account. That account should only hold amounts sufficient to cover regular operating expenses for one to two months. Any excess income or funds should be transferred either into an account in your safe asset FLP (for safe keeping) or as distributions to you as the owner. This entity's checking account will also be the source of any payments made to you as a part of the home office deduction or the 280A(g) home rental deduction. LLCs taxed as an S-Corp are required to file a Form 1120s with the IRS each year. This form is an informational return only; this entity will not be paying taxes. Any net taxable income it produces will be passed through to your ordinary income tax rate.

Asset Management LLC - (usually taxed as a partnership) - This is your primary asset protection entity. It serves as the general partner for any FLPs, owns any High Risk Asset LLCs, and owns your Property LLCs or Land Trusts for your real estate (except your primary residence). Your Asset Management, LLC will need a bank account, usually a simple checking account with at least enough funds to cover any bank fees. The source of this entity's income may include rent from any rental properties you own, management fees for its services to your other entities, and any other income generated by entities it owns or manages. This income may be used to pay for the costs and maintenance of any of the properties or entities owned or controlled by the Asset Management, LLC. Any excess income may be distributed to the members of the Asset Management, LLC or it may be contributed to the Safe Asset, FLP for safe keeping. The Asset Management, LLC's income may also be used to take advantage of tax savings strategies, including income shifting and the 280A(g) rental deduction. It may be possible to take advantage of these strategies even if the Asset Management, LLC is not producing income. LLCs taxed as partnerships are required to file a Form 1065 with the IRS each year. This form is an informational return only; this entity will not be paying taxes. Any net taxable income it produces will be taxed on your personal 1040 at your personal rate.



Safe Asset FLP - (taxed as a partnership) - This entity holds your "safe" assets, such savings accounts, gold and silver coins or bullion, investment or brokerage accounts, artwork, jewelry, and other similar property. You will continue to have at least one checking account in your personal name (or the name of your family trust), which you will use to pay your regular monthly expenses (utilities, groceries, etc.). Anything beyond that amount should be transferred to an account held by your Safe Asset FLP. This may be a savings account, money market account, checking account, or any other suitable account. If the FLP will be holding excess funds from your practice, a separate account should be kept within the FLP for that purpose. You can move money in and out of this FLP without any problem so long as you keep a good record of the cash flow. This can be done on Quickbooks, Quicken, or some other program or spreadsheet. This entity's income will derive from the assets it holds. This income can include interest on bank accounts, dividends from stocks, or the net proceeds from the sale of an investment. It can also produce income through a contractual agreement with your practice for holding accounts. Any income may be used to take deductions, including family travel expenses related to some business purpose, meetings in your home, or income shifting. Partnerships are required to file a Form 1065 with the IRS each year. This form is an informational return only; this entity will not be paying taxes. Any net taxable income it produces will be taxed on your personal 1040 at your personal rate.



Equipment FLP - This entity will hold your business/practice equipment. It will need at least one bank account, usually a checking account. The account will receive funds from leasing your equipment to your practice and will be used to pay for deductible expenses (purchase of new equipment; equipment maintenance; sales tax, if applicable in your state; income shifting, and so forth). Your practice will pay this equipment FLP according to the lease agreement you have in place. That lease amount is a deductible business expense for your practice and will be the FLP's primary source of income. This income will be offset by the deductible expenses mentioned above. Partnerships are required to file a Form 1065 with the IRS each year. This form is an informational return only; this entity will not be paying taxes. Any net taxable income it produces will be taxed on your personal 1040 at your personal rate.

If you have any additional questions regarding the deductions and tax savings strategies referenced above, please refer to our tax information sheets or contact us for additional assistance.

Entity	Purpose	Tax Form
Business/Practice	Typically claims bulk of tax deductions through the business	1040, 1065, 1120 or 1120S
Asset Management LLC	Primary asset protection vehicle	1065
Safe Asset FLP	Holds “safe” or low risk assets	1065
Equipment FLP	Holds business/ practice equipment	1065

Understanding the Home Office Deduction

The 1997 Taxpayer Relief Act allowed taxpayers to get a deduction for their home offices. It created deductions for the business portion of mortgage interest, property taxes, utilities, homeowner's insurance, repairs, pest control, and depreciation or rent as well as eliminating travel time. There are two ways to claim a home office deduction: (1) Claim your home office as your principal place of business; or (2) Have your corporation claim a home office deduction. A vehicle deduction can also be applied for home offices.

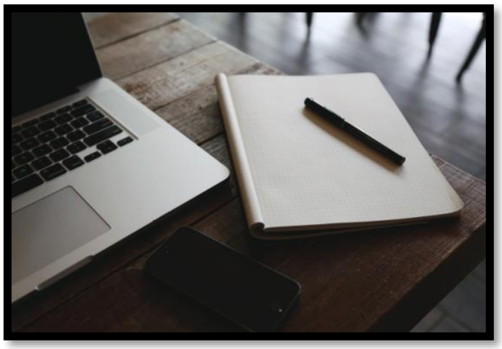
1. Claim Your Home Office as Your Principal Place of Business

Requirements to Claim this Deduction

To qualify for this deduction, there are two basic requirements. First, make sure your home office is your **principal place of business.** Second, ensure you have **regular and exclusive use** of your home office.

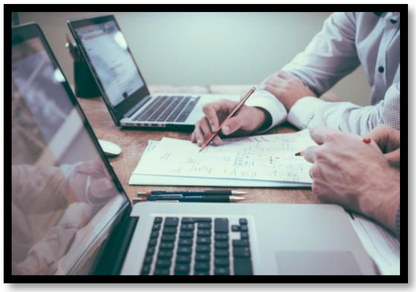
- ***Principal Place of Business:*** To qualify as the principal place of business, you must use your home office for substantial and regular business. For example, meeting with clients, customers, patients, etc., in your home office during normal business hours would qualify under this deduction. Even if you do business at another location, you can still claim a deduction for the part of your home used exclusively for business.

- ***Regular and Exclusive Use:*** Regular use means ten hours or more per week[7], which should be documented ninety days every year. Exclusive use means you cannot use the home office for any personal use; it must be dedicated to business use only. These business activities can be administration or management, such as billing customers, clients, or patients; keeping books and records; ordering supplies; setting up appointments; forwarding orders or writing reports.



We suggest documenting your regular use of the home office at least 90 days each year. One idea is to have a journal next to your desk in your office which you use to record the hours and tasks you did that day. We also suggest taking photographs of your work area to prove you have an office in your home. While neither is necessarily required, providing documentation will help to prove that you have used your home office and qualify for the deduction. Remember, the more documentation you have, the easier any future audits will be.

[7] Green v. Commr., 78 T.C. 428 (1982).



There are two accounting methods to taking the home office deduction: the Simplified Option (Worksheet in Schedule C Instructions) **and the Standard Method** (IRS Form 8829).[8] **Below is a chart comparing the use of both sources of accounting. You will want to work with your CPA to find which system will work best for you.** Under either method the deduction cannot exceed gross income from business use of home less business expenses.

Simplified Method	Standard Method
Deduction for home office use of a portion of a residence allowed only if that portion is **exclusively** used on a **regular basis** for business purposes	Same
Allowable square footage of home used for business (not to exceed 300 square feet)	Percentage of home used for business
Standard $5 per square foot used to determine home business deduction	Actual expenses determined and records maintained
Home-related itemized deductions claimed in full on Schedule A	Home-related itemized deductions apportioned between Schedule A and business schedule (Sch. C or Sch. F)
No depreciation deduction	Depreciation deduction for portion of home used for business
No recapture of depreciation upon sale of home	Recapture of depreciation on gain upon sale of home
Deduction cannot exceed gross income from business use of home minus business expenses	Same
Amount in excess of gross income limitation may **not** be carried over	Amount in excess of gross income limitation may be carried over
Loss carryover from use of regular method in prior year may **not** be claimed	Loss carryover from use of regular method in prior year may be claimed if gross income test is met in current year

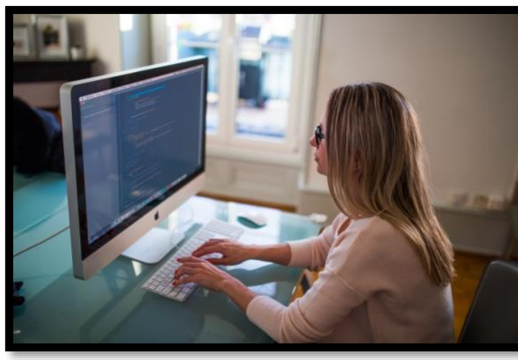
[8] For a more in-depth explanation of tax deductions for your home office, go to IRS Publication 587, *Business Use of Your Home*, provided at this website: http://www.irs.gov/publications/p587/index.html

2. Have Your Corporation Claim a Home Office Deduction

While you can always claim the home office deduction on your personal filing, a more tax efficient way to claim the deduction is through a business or practice. The IRS allows employers to reimburse employees[9] for many costs incurred by the employee including, among others, business expenses, depreciation, interest, and taxes. [10]

There are **three steps** to legally have your business or practice claim the deduction. These steps are as follows:

1. Have your business tell you in writing that you need to find an office for the business's convenience. This letter should be on the company letterhead and should specify the items reimbursable by the company. [11]
2. Complete IRS Form 8829 on or before December 31; fill it out as if you were personally going to claim a deduction for your home office.
3. Submit your completed IRS Form 8829 on or before December 31 to your corporation. Then, have your corporation reimburse the deduction amount shown on the Form. This amount is a deduction on the books for the corporation. You will receive this reimbursement tax-free.



If you are going to take the home office deduction as a reimbursement, you will not be able to use the simplified method to estimate your costs, but will have to be reimbursed under the standard method of calculating costs.

Benefits of Your Corporation Claiming the Deduction

There are several benefits to having an active business take the home office deduction rather than taking the home office deduction on your personal filing.

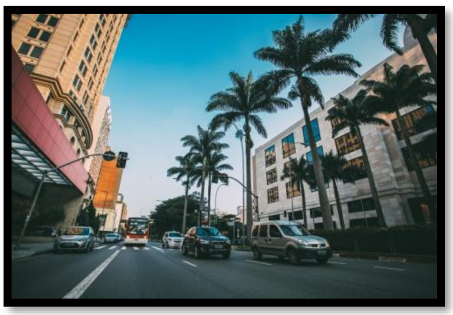
- **Avoid** (1) miscellaneous deductions category, where the total of these miscellaneous deductions gets reduced by the two percent of adjusted gross income floor,
- **Avoid** (2) losing the home office deduction to alternative minimum tax, and **Avoid** (3) the no-renting-to-your-employer rule.
- **Prevail** by getting total home-office deduction at corporate level.
- **Avoid** reporting your home-office deduction on your personal return, as it will be reported as tax deductible business expenses on your corporate return.

[9] The authorization to reimburse employees is found in IRS Regulation 1.62-2(d)(1).
[10] IRC Chapter 1, subchapter B Part VI
[11] Page 15 of IRS Publication 15, (Circular E), *Employer's Tax Guide*. Expense reimbursements do not have to be included in an employee's wages if the business has an "accountable" plan. The IRS requires three things to be considered an accountable plan: 1. Business connection (i.e. that the expense was incurred in the performance of services for the employee to the employer), 2. Substantiation (that the employee substantiates the expense incurred within a reasonable period of time after paid or incurred), and 3. Returning excess amounts (That amounts paid by the employer to the employee that are in excess of what was spent are returned to the employer).

Note for Regular Employees of a Corporation: If you are an employee, once you pass the two requirements above, you can qualify if your home office meets the following requirements: (1) It is for business use only; (2) It is for the convenience of employer; (3) It is not rented out to your employer for use of the home office.

Vehicle Deduction[12]

You can deduct the cost of transportation and cost of driving or maintaining your vehicle when in use for your business. Normally, the cost of commuting from work and home is not a deductible expense. However, when the home office deduction is taken by either means discussed above, the commute is then considered getting from one workplace to another in course of business when traveling within the area of the regular place of business.[13]



Transportation expenses includes ordinary cost of the following:

- Visiting clients
- Going to business meetings away from your regular workplace
- Getting from one workplace to another in course of business when traveling within area of tax home (which means regular place of business)
- Getting from your home to a temporary workplace when you have more than one regular place of work.

[12] For more details on the vehicle deductions and travel expenses, go to IRS Publication 463, *Travel, Entertainment, Gift, and Car Expenses*, provided at this website: http://www.irs.gov/publications/p463/ch04.html

[13] https://www.irs.gov/publications/p463/ch04.html "...Daily transportation expenses can be deducted if: (1) you have one or more regular work locations away from your residence or (2) your residence is your principal place of business and you incur expenses going between the residence and another work location…"

Cost Segregation

What is it? Cost segregation is a tax-planning tool that allows you to accelerate your depreciation expense on investment real estate, creating a larger deduction which directly lowers your taxable income. This engineering-based process identifies costs that can legally be depreciated faster than the standard 27.5 years for residential properties, or 39 years for commercial real estate.

Under normal circumstances when property is depreciated, the property is broken down into two different categories: the land, which is not depreciable, and the building. Cost segregation further divides the separate property as follows:

1. 5-year property,
2. 7-year property,
3. 15-year property, and
4. 27.5-years to 39-year property.

How does it work? With cost segregation, real property is reclassified to both real and personal property. Any land improvement costs will be depreciated over 15 years and any personal property costs (e.g.: carpet, window coverings, countertops, etc.) will be itemized and depreciated over 5 to 7 years. Separating the assets creates a larger upfront depreciation deduction, which can be applied to lower your overall tax liability.

Why would I want to use this strategy? By front loading your depreciation expense, cost segregation allows you to get cash out of your property quicker. This is cash that you can then use for current investments, rather than having it stuck in the property to be depreciated out later.

I've had this investment property for a long time. Can I still use this strategy? If you have held the property for some time, you can still take advantage of cost segregation as the IRS allows you to "catch-up" on the deductions you could have already been taking. This allows for even greater year one savings as you catch up on previous years' depreciation.

From an accounting perspective, you would file a change in the method of account on Form 3115 based on the results gained from the cost segregation study. This change of accounting will create a one-time lump sum deduction, referred to as a Section 481(a) adjustment, in the year you change your accounting method for the property. The idea for this adjustment is to correct the depreciation not taken in previous years. Ultimately this adjustment provides you with more cash in hand by catching up to the depreciation schedule you would have received had you conducted the cost segregation study at an earlier date.

How do I implement this strategy? The IRS requires an engineering-based inspection and written report on the property, called a Cost Segregation Study, in order to take advantage of cost segregation. This written report is what allows you to take the accelerated depreciation on the property.

How does the new tax bill affect cost segregation? The Tax Cuts and Jobs Act raised bonus depreciation from 50 percent to 100 percent. The new bill also allows bonus depreciation on qualifying used property. These changes increased the value of cost segregation compared to previous years.

Rental Loss Issues

Typically, income and losses generated by properties are considered passive income. This means that any losses or deductions generated by these properties, including those that come from the advanced depreciation created by the cost segregation study, can only be deducted against other passive income. However, there are ways to overcome the passive loss issues and use your rental losses immediately, rather than spreading those losses over many years:

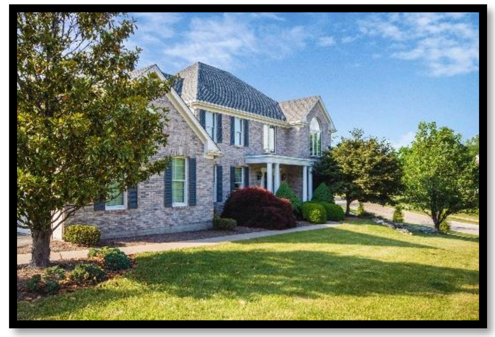
1. If you or your spouse qualify as a real estate professional, and you or your spouse materially participate in the rental, then the income/losses from the rental properties becomes active income and you can deduct the segregated depreciation against other active income. [14]
2. If you actively participate in the rental activity, and your adjusted gross income is under $150,000, you can use up to $25,000 of your losses. [15]
3. If you have passive income, such as rental income, you can deduct your passive losses against those passive gains. [16]

Components

When the cost segregation study is utilized, repairs to the property, as well as improvements to the building, become easier to account for in depreciation moving forward. When you replace or improve a component of the property that has the cost segregation study in place, you can easily assign a value to the old component and write off its undepreciated basis.[17] This cost study component write-off usually results in larger write-offs than you would get from the IRS regulations that contain the formulas to use for writing off old components.

Can this strategy effect the property at inheritance? When an individual dies, the property owned by that individual gets passed to their inheritors, at which point the inheritors receive a "stepped-up" basis in the property. Without going into too much detail, this means that the effective value of the property is the fair market value of the property at the time of the inheritance, rather than at the time the deceased original owner purchased the property. If the inheritor sells the property, the capital gains would be calculated by the gains

[14] IRC Section 469(c)(7).
[15] IRC Section 469(i).
[16] IRC Section 469(d)(1).
[17] Reg. Sections 1.168(i)-8(b), 1.263(a)-3.



above the stepped-up basis, rather than the gains above the original basis, or the original value of the property when purchased by the original owner. In community property states, this stepped-up basis also occurs for property owned by two spouses as community property when only one spouse dies.[18]

When the property is inherited and receives a step-up in basis any possibility of depreciation recapture is erased. Depreciation of the property begins fresh for the inheritor, allowing the inheritor to repeat cost segregation to accelerate the deprecation of the property – as previously explained.

Possible Downsides to Cost Segregation

1031 Exchange issues
The tax bill enacted in December of 2017 removed the ability to apply a 1031 exchange to anything other than real estate. This means If you end up doing a 1031 exchange for your property, with a cost segregation study in place, you'll have taxable gain attached to everything that is not a 27.5-year or 39-year property. Again, this is only an issue if you attempt to do a 1031 exchange on that property.

Ordinary Gain on Sale
Upon sale of the property as a whole, the 5- to 7-year property is considered as tangible personal property. The depreciation recapture on tangible personal property creates ordinary gain, or rather is taxed at ordinary income tax rates.

Cost of the Study

Care should be taken to ensure the cost of performing the cost segregation study does not exceed the projected tax benefits of the advanced depreciation itself. Since the study is an engineering-based study, you and your accountant may need to get outside help to perform the study, and third-party groups may increase the cost to you to use this strategy. Be aware of these third-party costs, and how these costs affect the overall effectiveness of the strategy.

[18] IRC Section 1014(b)(6)