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Cost Segregation & Tax Benefits in Real Estate

How depreciation can enhance after-tax returns and improve cash flow efficiency

One of the distinguishing characteristics of real estate investing is the ability to generate income while also benefiting from tax advantages.

Among these, depreciation — and specifically cost segregation — can have a meaningful impact on after-tax returns.

While often viewed as a technical topic, the underlying concept is straightforward: certain portions of a property can be depreciated more quickly, reducing taxable income in the early years of an investment.

Understanding Depreciation

When an investor acquires a property, the value of that asset is typically depreciated over time for tax purposes.

For residential real estate, this depreciation is generally spread over 27.5 years.

Depreciation is a non-cash expense, meaning it reduces taxable income without affecting the actual cash flow generated by the property.

As a result, investors may receive income distributions while reporting lower taxable income.

What Cost Segregation Does

Cost segregation accelerates this process.



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Instead of depreciating the entire property evenly over 27.5 years, a cost segregation study identifies components of the property that can be depreciated over shorter timeframes — often 5, 7, or 15 years.

These components may include:

- Interior finishes
- Certain building systems
- Site improvements

By reallocating portions of the asset into shorter depreciation schedules, more depreciation is recognized earlier in the investment.

The Impact on Taxable Income

Accelerated depreciation can significantly reduce taxable income in the early years of an investment.

In some cases, this may result in:

- Lower current tax liability
- The ability to offset other passive income
- Increased after-tax cash flow

This does not change the underlying economics of the investment, but it can meaningfully improve how those returns are realized after taxes.

Timing and Front-Loading Benefits

One of the key aspects of cost segregation is timing.

Rather than spreading depreciation evenly over decades, a larger portion is recognized in the early years of ownership.

This front-loading of tax benefits can be particularly valuable when combined with:

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- Initial investment capital
- Early-stage distributions
- Portfolio growth strategies

In effect, it allows investors to retain more of their cash flow in the near term.

Interaction with Investment Strategy

Tax efficiency is most effective when it aligns with the broader investment strategy.

For example:

- Cash-flowing investments benefit from reduced taxable income
- Refinancing events may return capital without triggering taxable gains
- Reinvestment strategies can be supported by improved after-tax liquidity

When these elements work together, the result is not simply higher returns, but more efficient capital deployment over time.

Important Considerations

While cost segregation can provide meaningful benefits, there are several factors to consider:

- **Depreciation is a timing difference**
Accelerated depreciation today may result in lower depreciation in later years
- **Recapture upon sale**
A portion of the depreciation may be subject to recapture when the asset is sold
- **Tax treatment varies by investor**
Individual outcomes depend on specific tax circumstances

For these reasons, tax strategy should be evaluated in coordination with qualified advisors.



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How We Think About It

We view tax efficiency as an important component of overall investment performance, but not the primary driver.

The starting point remains:

- Strong underlying assets
- Durable cash flow
- Disciplined execution

When those fundamentals are in place, tools like cost segregation can enhance outcomes by improving after-tax efficiency and increasing near-term liquidity.

This aligns with a broader objective of building sustainable, cash-flowing portfolios over time.

Final Considerations

Cost segregation is one of several mechanisms that can improve the efficiency of real estate investments.

While it does not change the underlying performance of an asset, it can meaningfully affect how and when returns are realized.

For investors focused on income and long-term portfolio growth, understanding these dynamics can be an important part of evaluating opportunities.