CAPITAL SQUARE

DEPRECIATION, COST SEGREGATION & BONUS DEPRECIATION

BACKGROUND ON DEPRECIATION

BACKGROUND

Real estate owners are allowed a deduction called “depreciation” that reduces taxable income from the property. The depreciation deduction is intended to compensate property owners for wear, tear and obsolescence. The deduction increases the after-tax returns from real estate and is not available for financial assets, such as stocks and bonds.

COMPUTATION OF DEPRECIATION

The Tax Reform Act of 1986 introduced the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, a class life is assigned to each asset class, as follows:

Asset Class	Class Life
Nonresidential Real Property	39 years
Residential Real Property	27.5 years
Land Improvements	15 years
Personal Property (Affixed to Real Property)	7 and 5 years

The owner’s basis in the property (typically cost) is recovered over the assigned class life of the asset. Residential property has a 27.5 year recovery life, which means that the owner is allowed an annual depreciation deduction computed as follows:

Residential Real Property

cost basis x 1/27.5 per year

= 3.63% depreciation deduction per year

Nonresidential property has a 39-year recovery life, which means that the owner is allowed an annual depreciation deduction computed as follows:

Nonresidential Real Property

cost basis x 1/39 per year

= 2.56% depreciation deduction per year

EXAMPLE

Assume a property owner has a $1.1 million cost basis in real estate with a $100,000 land value. The first step is to exclude the $100,000 land value because land is not depreciable (land does not wear out). If the property is residential, the owner is entitled to $36,300 per year in depreciation deductions. If the property is nonresidential, the owner is entitled to $25,600 per year in depreciation deductions. This means that 100% of the property's cost basis (excluding land value) is recovered over the assigned life for the asset:

$36,300 per year x 27.5 years = $1 million, the original cost basis and
25,600 per year x 39 years = $1 million, the original cost basis

NON-CASH DEDUCTION

Depreciation is a "non-cash" tax deduction. Most tax deductions, such as taxes, insurance, maintenance and repairs, require a cash payment to obtain the deduction. However, depreciation is a non-cash deduction, computed based on the cost (purchase price) for the property.

DEPRECIATION DEDUCTIONS INCREASE RETURNS FROM REAL ESTATE

Depreciation deductions increase after-tax returns for real estate investments by generating additional cash flow. Financial assets, such as stock and bonds, do not qualify for depreciation deductions. Also, residential property is recovered (depreciated) more quickly than nonresidential property. This added tax benefit encourages tax sensitive investors to focus on residential property.

INTRODUCTION TO COST SEGREGATION

INTRODUCTION

Cost segregation is a tax-planning tool used to accelerate depreciation deductions by allocating costs to shorter-lived assets and assets that qualify for bonus depreciation.

HOW DOES COST SEGREGATION WORK

The property owner engages a qualified engineering firm to allocate their cost basis (typically purchase price) for the property into the class lives shown above. The goal is to increase the allocation to the following shorter-lived assets that will accelerate depreciation deductions or qualify for bonus depreciation:

Land Improvements	15 years
Personal Property (affixed to real property)	7 and 5 years

CONCLUSION

Allocating to shorter-lived assets with a cost segregation study can dramatically accelerate (increase) depreciation deductions. This will increase after-tax returns for real estate investments by generating additional cash flow.

INTRODUCTION TO BONUS DEPRECIATION

INTRODUCTION

Bonus depreciation accelerates depreciation deductions. Assets with a MACRS recovery life of 20 years or less qualify for bonus depreciation.

100% BONUS DEPRECIATION

The Tax Cuts & Jobs Act of 2017 increased the bonus depreciation percentage to 100% for assets placed in service before January 1, 2023 and 80% starting on January 1, 2023.

SECTION 1031 EXCHANGES

Cost segregation does not limit Section 1031 exchanges. The cost segregation study only impacts depreciation deductions, not the qualification of “like kind” property as required by Section 1031.

EXAMPLE

Assume a property owner has a $1.1 million cost basis in real estate with a $100,000 land value. The first step is to exclude the $100,000 land value because land is not depreciable (land does not wear out). Assume a property owner has a $1 million cost basis in depreciable real estate. If the property is residential, the owner is entitled to $36,300 per year in depreciation deductions. If the property is nonresidential, the owner is entitled to $25,600 per year in depreciation deductions.

Using cost segregation: if during 2022, the owner is able to allocate $400,000 of cost basis to assets with a recovery life of 20 years or less, the depreciation deductions would be accelerated as follows:

$421,818 = $400,000 bonus depreciation plus $21,818 ($600,000 x 1/27.5 years = $21,818) – residential

$415,384 = $400,000 bonus depreciation plus $15,384 ($600,000 x 1/39 years = $15,384) – nonresidential

Residential: $421,818 with bonus depreciation; $36,300 without bonus depreciation

Nonresidential: $415,384 with bonus depreciation; $25,600 without bonus depreciation

Using cost segregation in this manner can dramatically accelerate (increase) depreciation deductions. This will increase after-tax returns for real estate investments.

STRATEGY FOR BOOT

DEPRECIATION DEDUCTIONS REDUCE TAXABLE INCOME

Depreciation deductions reduce taxable income from real estate. In addition, depreciation deductions can be used to offset taxable income from other real estate. This is true of standard MACRS depreciation and bonus depreciation.

BONUS DEPRECIATION DEDUCTIONS REDUCE SECTION 1031 BOOT

In addition, depreciation deductions can be used to offset taxable boot in a Section 1031 exchange. Under Section 1031, any cash received or reduction in liabilities in the exchange will be taxable. Bonus depreciation deductions can be used to offset Section 1031 boot. In this way, taxpayers can use bonus depreciation to cash out of an exchange or reduce liabilities without gain recognition. This is an excellent strategy for exchangers who would like to cash out of an exchange or deleverage.

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