CAPITAL SQUARE

WHY YOU SHOULD BE CALCULATING TAX-EQUIVALENT YIELD

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COMPARING APPLES TO APPLES: WHY YOU SHOULD BE CALCULATING TAX-EQUIVALENT YIELD

TAKEAWAYS

- Depreciation is a powerful tool for real estate investors to shelter significant amounts of property income from taxation.
- Tax-equivalent yield answers the question, “What yield would I need from a fully taxable investment to equate to the after-tax yield of this tax-sheltered investment?” This analysis provides an apples-to-apples comparison of investment options.
- Many real estate investors find they can achieve yields that are similar on a tax equivalent basis to riskier strategies in equities or high yield bonds, but with an investment in high-quality, necessity-based real estate assets.

The ability to shelter cash flows from taxes is often cited as one of the greatest benefits of investing in real estate. Despite this popular perception, real estate tax shelters are often poorly understood. Even if investors do understand the functioning of a tax shelter, they may not have a clear idea of how to assess the benefit that it provides.

The following article offers an overview of one of the most valuable tax shelters in real estate – depreciation – and describes how investors can assess the value provided by depreciation through the use of a tax-equivalent yield.

DEPRECIATION CAN SHELTER MUCH OF THE CASH FLOWS OF A REAL ESTATE INVESTMENT

Depreciation is the concept of deducting the cost of a long-lived asset over the course of its life. In real estate, this means that rather than considering the cost of a property to be an expense in the year it is purchased, the property is gradually expensed over its useful life. (The IRS considers the "useful life" to be 27.5 years for residential assets and 39 years for commercial assets.) These depreciation deductions are a "non-cash expense," meaning real estate owners are able to deduct depreciation expenses from their taxable income, thereby decreasing taxable earnings, even though they did not actually have a cash outflow for the expense.

To illustrate why depreciation creates a tax shelter, let's take a very simplified example: A property owner finishes the year with $2,000 in operating revenues and $1,000 in operating expenses, leaving her with $1,000 in operating income at her property. However, she also has $1,000 in depreciation deductions for the year. This non-cash expense is deducted from the $1,000 in operating income, leaving the investor with $0 in taxable earnings. Although the investor in this example realized $1,000 in cash income at the property, the tax shelter provided by depreciation was able to fully shelter this income, leaving this investor with zero income taxes due. This stylized example shows the value of tax shelters to a real estate investment.

COST SEGREGATION STUDIES ALLOW INVESTORS TO INCREASE UPFRONT DEPRECATION DEDUCTIONS

Cost segregation studies are an analysis of a physical property, performed by engineers and accountants, used to increase the depreciation deductions in the early years of property ownership. The study examines the value of property improvements – depreciated over 27.5 or 39 years – and reallocates relevant portions of the asset value to personal property or land improvements, which are depreciated over shorter time periods (e.g., 5-year, 7-year or 15-year depreciation schedules). With shorter depreciation recovery periods, the reallocated property value creates larger depreciation deductions in the early years.

Increasing the depreciation deduction at a property through cost segregation studies means adding to the value of the tax shelter in the initial years of a property investment. For many real estate investments, depreciation deductions as outlined in a cost segregation study will provide the primary deduction used to mostly or fully shelter taxable income in the first year or several years of an investor's ownership of a real estate asset.

ASSESSING THE VALUE OF DEPRECIATION DEDUCTIONS WITH THE TAX-EQUIVALENT YIELDS

Depreciation deductions provide a tax shelter that adds to the value of a real estate investment. But how does a prospective investor conceptualize and quantify the value of the tax shelter? How does the investor compare a tax-sheltered real estate investment with competing investments that do not offer a similar tax shelter? This is where the concept of the tax-equivalent yield comes into play.

The tax-equivalent yield is a return metric that answers the question: “What yield would I need from a fully taxable investment to equate to the after-tax yield of this tax-sheltered investment?” For example, for an investor with a 40% marginal tax rate, a 6.0% fully tax-sheltered yield would equate to a 10.0% tax equivalent yield:

10% tax equivalent yield * (1 – 40% tax rate) = 6.0% tax sheltered yield

Said another way, after paying income taxes, a 10.0% yield on a fully taxable investment would be needed to equate to a 6.0% tax sheltered yield after accounting for the benefits of depreciation: 10.0% is the tax equivalent yield of a 6.0% fully tax-sheltered yield (using the figures in this example).

Capital Square encourages our investors to look at the tax equivalent yield of their real estate investments. This metric provides an apples-to-apples comparison of the tax-sheltered cash distributions (i.e., yields) of their real estate assets as compared with other fully taxable investment income, such as stock dividends or bond interest. The tax equivalent yield of a fully tax-sheltered real estate investment is often similar to or greater than the yields of riskier strategies in equities or high yield bonds.

Through the benefit of tax shelters provided by real estate, many investors are able to achieve these high tax-equivalent yields while placing their money in a necessity-based asset such as Capital Square’s top-quality housing solutions. We believe that investors need to be fully equipped to assess the benefits of real estate tax shelters to make an informed investment decision.

ABOUT CAPITAL SQUARE

Capital Square is a national real estate firm specializing in tax-advantaged real estate investments, including Delaware statutory trusts (DSTs) for Section 1031 exchanges, qualified opportunity zone funds, development funds and a real estate investment trust (REIT). As a vertically integrated company, Capital Square has also become an active developer of mixed-use multifamily and build-for-rent properties in the southeastern U.S. as well as a dedicated property manager through Capital Square Living, which launched in 2023. Since 2012, Capital Square has completed more than $7.5 billion in transaction volume. Capital Square's related entities provide a range of services, including due diligence, acquisition, loan sourcing, property/asset management and disposition, for a growing number of high-net-worth investors, private equity firms, family offices and institutional investors nationwide. Since 2017, Capital Square has been recognized every year by Inc. 5000 as one of the fastest growing companies in the nation. In 2017, 2018, 2020 and 2023 the company was also ranked on Richmond BizSense's list of fastest growing companies in central Virginia. In addition, Capital Square was named a "Top Workplace" by the Richmond Times in 2023. To learn more, visit www.CapitalSq.com.

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