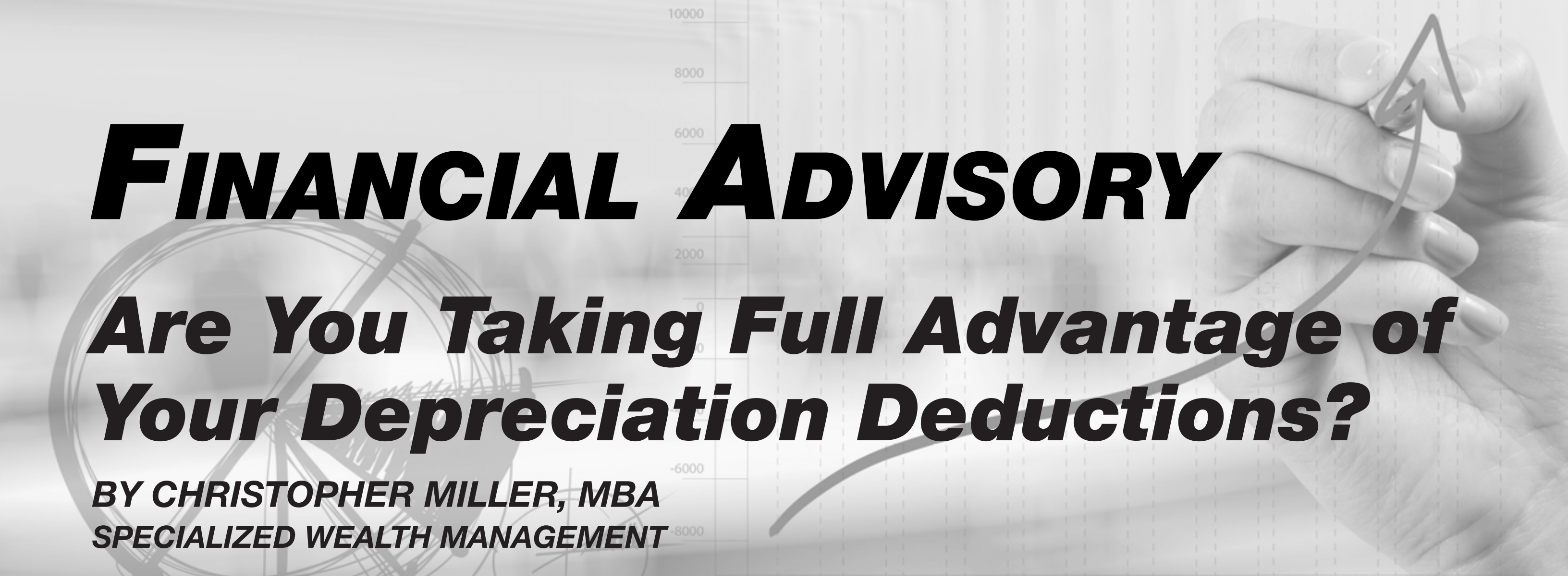

Financial Advisory

Are You Taking Full Advantage of Your Depreciation Deductions?

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We all know that tax deferral (with the potential to make the savings permanent) of some income through depreciation deduction is one of the big benefits of owning investment real estate. This month, I will discuss ways that you can maximize your tax benefits by using this accounting tool. After all: who doesn't want more savings?

HOW DOES DEPRECIATION WORK?

By using the depreciation deduction, an investor can write off a portion of his "basis" every year and use that to offset taxable income from the property. How do I calculate my benefits? Let's walk through the process:

START WITH THE % IMPROVEMENTS (AND DON'T USE THE TAX BILL!)

Let's say that I'm thinking about buying 4 apartment units for $1.4 million and would like to estimate my annual depreciation benefits. Per IRS rules, I can depreciate only the improved portion of the property since the agency doesn't believe that land depreciates. So – we need to determine what percentage of my $1.4 million cost is represented by the property's improvements.

Some investors will remember that their property tax bill contains information about % land vs. improvements value and will be tempted to use this as a guide: Don't do this! Why not?

First, you will likely be shortchanging yourself: A quick review of some of my properties show that the county assessors say my improvement values range from 22% to 45%. So, if I bulldozed that 22% property; the raw land would be worth 78% of what it is now? That does not sound right to me.

Next, the county assessor charges tax based on the entire value of your property rather than just the improved value. Since it doesn't mean anything to their wallet, they really don't care about getting the % land to improvements ratio correct.

Lastly, due to the reason above, the IRS likely won't even recognize the tax bill as a valid guide for determining your depreciation. So – it's possible to get in trouble with the IRS by taking less deductions – who knew?

If I wrote off 22% of that $1.4 million property every year, that would give me a $11,200 tax deduction every year. If I, instead, write off 80% of the property: my annual deduction will grow to $40,727. That is quite a jump and is good motivation to get this estimation right.

This estimation is best left to a discussion between you and your CPA. (And – as a real estate investor – if you don't use a professional tax preparer, you should hire one). When I'm doing "back of the envelope" calculations on properties, I will use 80%.

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DEPRECIATION DIFFERENCE – RESIDENTIAL VS. COMMERCIAL PROPERTIES

Once you have settled on your percentage estimate to use for improvements, you then need to divide that amount by the proper time period for your property type. The IRS says that residential properties (including apartments) can be deprecated over 27 ½ years, while commercial properties are depreciated over 39 years. Using the $1.4 million value estimate and 80% improvements ratio above, a commercial (NNN Leased) property will generate an annual $28,718 deduction vs. the $40,727 from the apartments. This is something to be aware of when evaluating acquisitions.

YOUR BENEFITS ROLL OVER

When an investor first buys a property, it is not uncommon for his depreciation deduction to exceed his annual taxable income from the property. When this happens, he will effectively owe zero tax on income from his building. Additionally, unused depreciation deductions may be "carried over" and applied to other properties or some other forms of passive income. Any unused depreciation is carried over on your tax returns in perpetuity until it can be used.

GET MORE DEPRECIATION THROUGH A 1031 EXCHANGE

As I have written about recently, a property sale and 1031 Exchange could be an opportunity to gain more depreciation deductions. Let's say that I owned a single-family house here in Southern California and have been renting it out for the last 30 years. This means that I no longer receive a depreciation deduction from the property. If I sold it for $700,000 and assumed a $700,000 loan to buy the hypothetical $1.4 million 4-unit property, the IRS would call this "buying $700,000 of new basis." Using the calculations above, this will give us a ($700,000 x 80%) / 27.5 = $20,636 depreciation deduction every year. Quite a nice improvement over zero!

Depreciation is a wonderful tax tool for us real estate investors. We all enjoy a bit more money in our pockets, and I hope this article has given you some ideas on keeping more of what you have earned. My office number is (877) 313-1868.

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