FINANCIAL ADVISORY

Accelerate Your Real Estate Benefits With Accelerated Depreciation

BY CHRISTOPHER MILLER, MBA
SPECIALIZED WEALTH MANAGEMENT

Most of my clients are buying income producing real estate and, at the same time, buying what the IRS calls more depreciable basis that can better defer (potentially forever) taxes on their real estate income. Many of my clients receive a "Cost segregation study" with their investments. This study, completed by a tax professional, identifies parts of a property that are eligible for "accelerated depreciation." For example, an apartment property can be depreciated over 27.5 s – but some of it's value may qualify for "accelerated depreciation" taken over 5 years. If $100,000 of value is depreciated over 5 years, that is $20,000 / year vs. $3,636 / year over 27.5 years. Just as more cash flow sooner is preferable to an investment owner; more tax savings is something smart investors chase as well.

HOW DEPRECIATION WORKS

Where to find Accelerated Depreciation – Apartments

Apartment properties, of course, are usually depreciated over 27.5 -Years. Some parts of the real estate, however, can't be reasonably expected to last that long. Carpeting, cabinets, laminate flooring, heating and air conditioning equipment, and other appliances are such features. If the value of such items is judged by a professional to represent 10% of your total improvements value, than this is 10% of your depreciation that can be taken much sooner – for more tax savings today.

INDUSTRIAL FIXTURES

We recently had an automotive repair facility as an offering. Commercial (non-residential) properties have a longer depreciable life than apartments – 39 -Years. This means that $100,000 of improvements value will yield an annual deduction of $2,564. This property features numerous automotive lifts, electrical upgrades, and paint emission control boots that are permanently installed in the property. Our clients are expected to take advantage of accelerated depreciation that will allow them to deduct the value of these improvements (10% of the property value) over two -Years!

CONVENIENCE STORES & GAS STATIONS

A special feature of the Trump tax cuts gave some

Christopher Miller is a Managing Director with Specialized Wealth Management and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator and as an advisor helping clients through over five hundred twenty five 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998. Call him toll-free at (877) 313 – 1868.

very valuable benefits to the owners of gas stations. The longest depreciation schedule for them is over 15 years, but a proper cost-segregation study can divide portions of the property into depreciable parts with 15--Year, 7--Year and 5--Year lives.

Gas station owners can additionally take advantage of "bonus depreciation" by using the modified accelerated cost recovery system. (MACRS). Under this rule, a purchaser of a gas station can deduct 60% of his depreciable value in year one! The remaining 40% can, with a proper cost segregation study and the input of tax professionals, be divided among those 15, 7 and 5 -Year time periods.

Let's say an investor bought a gas station for $10 million on January 1 of 2023, (This makes the math easy,) and that the property is leased long-term to an operator. He is just the landlord – he isn't involved with the business. He and his CPA have agreed that 80% is a good estimation of his improvements value, or $8 million, with 20% representing land value. His cost segregation study estimates that 60% of his improvements value is "15 -Year property," while 15% is 7 -Year property and 25% is 5 -Year property.

60% of our investor's $8,000,000 basis, or $4,800,000, can be deducted from his 2023 taxes when he files in April. The $4,800,000 is likely much more than the annual rent he receives from one gas station, so he can apply the excess deductions to income from the rest of his real estate portfolio. If he effectively defers (potentially forever) all his income from 2023 and still has depreciation left over – he can roll that unused savings forward as "carry forward basis."

There is still more depreciation savings! The 40% ($3,200,000) remaining will be divided into 60% ($1,920,000) 15-year property, 15% ($480,000) 7-year property and 25% ($800,000) 5-year property. His annual depreciation deductions (after the 60% above, and unused savings will be carried forward), will be $348,571 for the first 5 years, $188,571 for the next 2, then $120,000 until the property is fully depreciated after year 15.

DOES THAT DEPRECIATION SAVINGS NEED TO BE PAID BACK?

If you sell the gas station in the future, and choose not to do a 1031 exchange, then yes – you will need to pay capital gains tax on the sale and pay a tax (recapture in tax terms) on your accumulated depreciation – all the depreciation you have taken. Depreciation recapture rates are currently 25% to the IRS and 9.3% (or more, depending on your tax bracket,) to California. (Or the state you live in.)

The depreciation bill will never have to be paid if you continue to do 1031 Exchanges for the rest of your life. This is a strategy that my investors use to generate income for today, grow their wealth for the future, and pass on a maximum amount to their heirs. When they die, through what's called a stepped-up-basis, all their deferred capital gains and accumulated depreciation throughout the years will disappear. Their heirs will "start fresh" with a brand new basis – which they can start depreciating to start the savings again.

I wanted this article to illustrate the large savings that can be had through cost-segregation studies. I'm not sure that owning a gas station is right for everyone – but the exaggerated depreciation benefits made this an easy example to use and understand.

Are you using cost segregation to maximize your depreciation benefits? It may be worth considering. If you have any questions, my toll-free office number is (877) 313-1868.

Securities offered through Emerson Equity LLC, member FINRA/SIPC. Emerson Equity LLC and Specialized Wealth Management are not affiliated. All investing involves risk. Always discuss potential investments with your tax and/or investment professional prior to investing.