Using Depreciation to Cut Your Tax Bill

By Darcy Bolton, Attorney

Depreciation Write Offs

One of the most important benefits of investing in real estate is that the profits are granted very generous tax treatment by the IRS. Among the many advantages of owning property is the option of taking substantial depreciation on a property and to deduct it as an expense. Many times, particularly in the early years of ownership, the depreciation allowance will wipe out all the cash flow profit and no tax will be due.

What is Depreciation?

If a company buys a printing press or a large cutting tool we all know that it will be worth less after a year than it was when it was new. Although the same machine is sitting in the same place, working as well as it ever did, the value is less and the decrease in value is called depreciation. The reduction in value is a real loss to the business and the IRS allows the business to count depreciation loss as an expense and subtract the loss from the business profits. Buildings break down, rot and wear out too, and every year there are technical advances that make the existing real estate less desirable. Investors are allowed to take depreciation on their income property. We can treat the amount of allowed depreciation as any other expense and subtract it from our income for the purpose of determining taxable income. That results in a significantly reduced tax. The result is that often the real estate investor pays no tax at all. Machines and equipment have a real decline in value as they age. Businesses that invest in equipment have an actual loss of value and an actual depreciation expense.

The generous tax break is created because real estate usually increases in value as time passes. When values go up, real estate investors have no depreciation in value, have no loss at all, but they are allowed to take depreciation against their cash income from the property.

In a remarkable distortion of the real world of investing, the IRS allows investors to file a statement of loss to the IRS while banking their cash flow profit!

New Depreciation Rules

Depreciation used to be a real bonanza for high income taxpayers. The IRS has gradually tightened up the rules and significantly reduced the tax benefits. But the rules are still very generous for real estate investors.

Under the old rules, all a taxpayer's income and all his losses went into one pot. He paid taxes on his total gain or loss. The effect was that high income individuals could buy real estate and use the depreciation to offset their income from the practice of medicine or law or any other source. People with the highest incomes often paid no taxes at all.

That generous tax law worked caused a very real hardship on investors whose primary income was from real estate investment. The tax dodgers didn't care how much they paid for the properties they bought because the more they paid the higher the depreciation loss and the less tax they paid. They didn't care how much repairs cost or how much the properties lost because the more they lost the less tax they paid.

Investors that were primarily in the real estate business had a hard time competing with them. They couldn't pay the high prices for properties or pay for the elaborate upgrades and improvements that the big tax dodgers were offering to their tenants because their investments weren't being subsidized by the IRS.

The Tax Reform Act of 1986 cut that out. Now everyone's income is divided into three boxes and everyone pays tax separately on the taxable income in each box. Very little mixing of the profits and losses allowed between the categories of income. Now a high earner has to pay his tax on his earnings without considering any real estate write offs. For example, the tax has to be paid on passive investment income, such as interest, without subtracting depreciation losses on real estate from the interest income.
But real estate investors can still take depreciation write offs against their real estate income.

Accelerated Depreciation
Prior to the 1986 change in the tax law, real property could be depreciated using an accelerated method. A taxpayer chose to depreciate his property at a very high rate in the early years but in exchange had to live with a very low rate later. Successful investors would buy a large property and take the maximum allowable depreciation to reduce the tax liability from the strong cash flow they had from their other properties.
That's fine. That ploy got them through the first year with a reduced tax liability. When the second year rolled around they had the same cash flow from the older properties plus the additional cash flow from the last purchase and a reduced depreciation allowance to shelter it, so they were headed for an even larger the tax bite.
The only thing to do to avoid paying the tax was to buy larger property. And the next year ..... you can guess, more of the same. Following their business plan, every year they had more and more cash flow and every year less and less depreciation to shelter it. It added up to an every enlarging tax burden. It was like a huge Ponzi scheme with the IRS. A lot of investors went broke trying to stay ahead of their ever growing tax liability.

Declining Straight Line Depreciation
After 1986 the new law requires the use of straight line deprecation. For residential property, you must use a life of not less than 27.5 years. While you can elect to use a longer life, most people use the 27.5 year life to get the maximum allowable depreciation.
The expected life of an apartment property is arbitrarily set by the IRS at 27.5 years. Considering almost all properties last well beyond this term, and some last several hundred years, a 27.5 year depreciation rate is quite generous. Using the IRS mandated rate of 27.65 years for the building creates an annual rate of depreciation of 3.636 % per year.
As you deduct the depreciation each year, you must subtract the amount of depreciation from the amount you paid for the property to arrive at a new tax basis for the property. Tax basis in a property is the undepreciated value of the property that the IRS uses for tax purposes. It has no utility outside of calculating taxes due.

Calculating the Amount of Depreciation
Since the land never wears out and never becomes obsolete, depreciation is taken only on the improvements to the land which is primarily the buildings.

Separating the Building Value from the Purchase Price
To determine the depreciation on a particular property you need to find the value of the building first. When you purchase a property you pay one price for the land and the building. They are not sold separately.

One way to determine the value of the building is ask the seller to set separate values for land and building in the sales agreement. Another way is to ask your insurance agent to give you the value they are using for the building. Another way is to get comparative values of vacant land in the area and subtract the land value from the total purchase price to find the value of the building.
In many states the property tax assessor sets a separate value on the land and the building. This method usually results in a much larger portion of the price being allocated to the land which reduces the building value and the depreciation.

QUESTION: We purchased a property for $550,000 with 20% down and financed the balance at 6.5%. The first year the net cash flow after all expenses is $12,500. What is the taxable income?
ANSWER: Without taking depreciation the taxable income is $12,500. Financing, amount put down, amount owed and rate of interest do not enter into this calculation and will be ignored.
The next thing to do is find the value of the building without the land. We will use the county assessor's values of $225,000 for the land and $325,000 for the building. Multiplying the value of the building, ($325,000), times 3.64% (the IRS allowable rate of depreciation), gives us the depreciation, which is $11,830.
Subtracting the depreciation, ($11,830), from the cash flow, ($12,500) gives us the taxable income after depreciation, $670. Therefore, while you received cash of $12,500, you will only pay tax on an income of $670. $670 is below the minimum income for tax purposes, so no tax is due.

Calculating Depreciation in Later Years
In the above example the depreciation was $11,830 for the first year of ownership. At the end of the first year the undepreciated value of the building will be $325,000 - $11,830 = $313,170.
The second year the depreciation will be ($313,170 X .03636) = $11,399. The undepreciated building value will be ($313,170 - $11,387) = $301,771.
And so on, year by year declaring 3.64% of the remaining value of the building is depreciation, and counting it as an expense.
It is interesting to note that the building is never completely depreciated. The property basis is less and less so the depreciation is less and less. As it approaches a zero basis the depreciation declines to a few pennies per year, but it's never zero.

Distinguishing Undepreciated Building Value and Property Basis
We saw above that the building was valued at $350,000 at purchase, then $313,170, then $301,771 as depreciation was taken in subsequent years. The only reason to calculate the undepreciated value of the building is to use the new value to determine the next year's depreciation.
Property basis is needed to calculate recapture for Federal tax when the property is sold. The property basis is the reduced building due to depreciation + the original value of the land.
The purchase price was $550,000 so that is the tax basis at the time of purchase. The second year the property basis will be $550,000 - $11,830 (depreciation taken), = $538,170. The next year the tax basis is ($538,170 - $11,387) = $526,783.

Recapture On Sale

A wise man one said, "When it seems too good to be true, it probably is". Depreciation is not a free ride and not a total avoidance of tax.
If you hold the property more than one year and sell it, the difference between the original purchase and sale price is a profit, and it is treated as a capital gain, subject to a very reduced 15% Federal capital gains tax.
Unfortunately, every time you depreciate a property, you reduce its basis for tax purposes. The difference between the depreciated tax basis and the original purchase price is treated as recaptured income and subject to an ordinary income tax rate of about 25%.

EXAMPLE: Let us assume that in the above example our investor, who purchased his apartment property for $550,000 depreciated it down to $500,000 over a few years and then sold it for $650,000.
The difference between what he paid and what he sold it for, ($650,000 - $550,000 = $100,000), will be assessed at a capital Federal capital gains rate of about 15%, depending on some other facts. His Federal capital gains tax will be 15% of $100,000 or $15,000.
He took $50,000 in depreciation which he recovered in the sale price. He is assessed for tax at a recapture rate on that portion at 25%. In this case the tax is 25% of $50,000 or $12,500. In addition he has to pay whatever State taxes are assessed.
One way to avoid paying any tax on the sale is to enter into a 1031 tax postponed exchange also referred to as a 1031 exchange after the section of the IRS code that permits it and sets the rules for it to qualify.

Tax Loss Carry Forward
In the early years of ownership the rent may relatively low, so the cash flow is low, and depreciation is at a maximum. Especially if you bought with a small down payment, interest payments are going to be high so cash flow is going to be at its lowest. At that stage, depreciation often exceeds the whole taxable income.
It may happen that one year there are large expenses or a drop in income. As a result cash flow is reduced. That year not all of the allowable depreciation needs to be used to wipe out the taxable income. After taking into account depreciation, there may even be a net loss for tax purposes.
If the whole amount of the loss, including depreciation expense, is not used in any year, it can be carried forward, often for many years, and used in future years, as is required, to reduce the tax on cash flow income, future profits from real estate or other passive activities.

Accelerated Depreciation on Personal Property
The Greeks adopted a convention that land and buildings were "real", therefore "real property" and everything else was "personal property". When an investor buys an apartment property it may come with a lot of what is classified as "personal property". Some items of personal property commonly found in apartment properties are carpet, computers, desks, appliances, fire safety equipment and gardening machines.
The IRS has a separate accelerated depreciation schedule for these more expendable items. The allowable life is from five years to seven years and the allowable depreciation is 15% to 20% per year.

Investors who want to get some extra depreciation can break these items out from the purchase price, set separate values on them, and take the accelerated depreciation allowance on those items.

Cautionary Note

Since issues involving real estate can get quite technical, it is always recommended that you consult a tax professional. The examples included in this article have not included any estimates for state or local income taxes. The state taxes could have a material impact on the outcome of any transaction and should be reviewed carefully.

This article is intended for general information. Readers are cautioned that tax law changes very rapidly, and information in this article may be obsolete or not be applicable to a particular taxpayers situation. Readers are urged to consult their tax professional before making any decision that may have tax consequences.

The foregoing is an excerpt from a book called Make a Fortune in Real Estate written by Darcy Bolton, a California Real estate attorney and very successful investor. Mr. Bolton has taken more then 400 real estate cases to court. He also has more than 50 years experience in real estate investing owning and managing over 100 units.

The book may be purchased by sending a check for $19.99 + $2.25 shipping to APMA, 36 Springacre, Irvine, CA 92614. California residents add 8% tax.