Understanding Depreciation

The Depreciation Expense and Depreciation Recapture

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Important Note! This presentation can be downloaded at nexusREA.com/tools

The Real Estate Depreciation Expense

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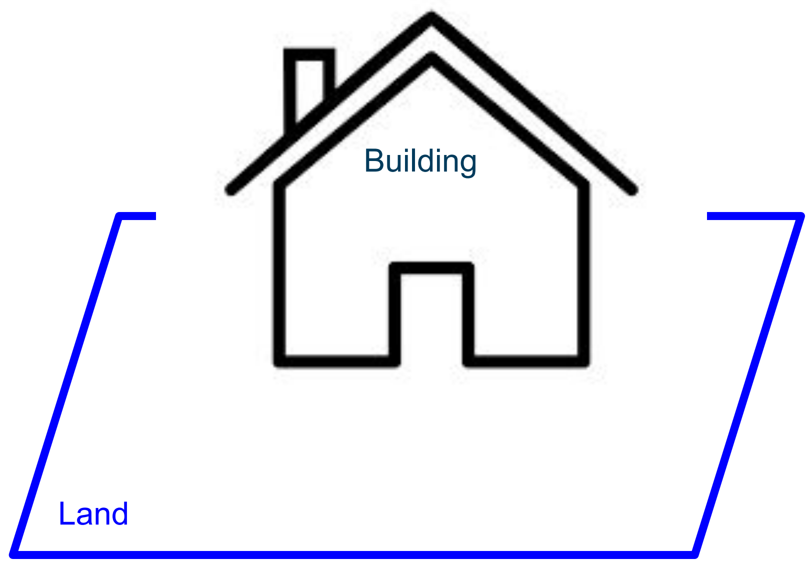
Depreciation is the process used to deduct the costs of buying and improving a rental property over a period of time.

It is <u>one of the biggest and most important deductions</u> for rental real estate investors because it reduces taxable income but not cash flow.

Depreciation essentially creates a tax deductible expense at the end of each year… just like RE taxes, mortgage interest and operating expenses.



Depreciation

Depreciation in a Nutshell

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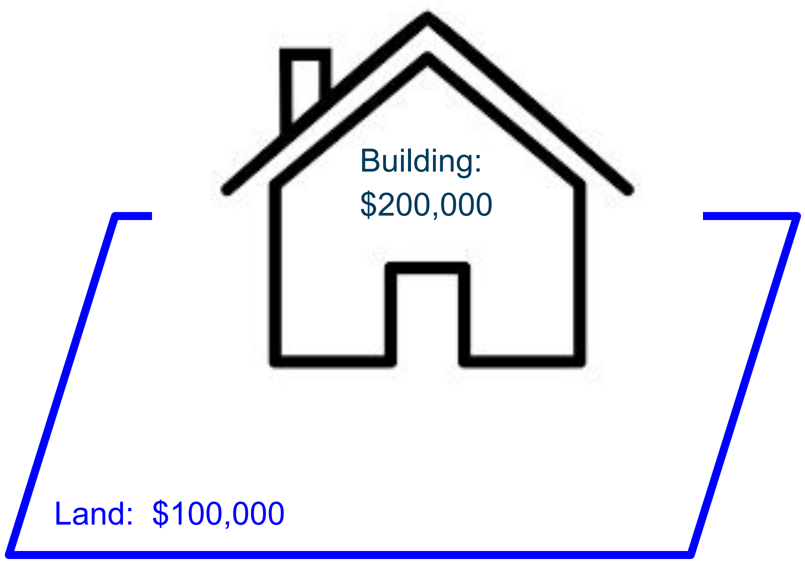
Take a property valued at $300,000. Assume ⅔ of the value is in the Building, and ⅓ is in the Land*******.

The IRS allows allows investors to depreciate the Building over 27.5 years (for residential), creating an annual tax deductible expense.

- $200,000 Building value / 27.5 years = $7,273 depreciation expense
- Assume a 24% federal tax bracket
- $7,273 x 24% = $1,746 post-tax benefit (Fed)

Total Value: $300,000



**** See "Improvement Ratio" slide later in presentation for how to find this*

Improvement Ratio: Finding Land/Building Value

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How do we know how much of a properties value is in the land and in the building?
This is called the “improvement ratio”

There are 3 primary methods, with county assessed value being the most predominant. Regardless of which method you use, make sure to document your approach and your findings.

1. County Assessed Value (available on county assessor websites)

   Google “[your county] county assessor”… (e.g. “arapahoe county assessor”)

2. Buyer/Seller Appraisals
3. Replacement Cost and Land Sale Comps

PIN:	031070155
AIN:	1973-01-4-23-013
Situs Address:	725 Ursula St
Situs City:	Aurora
	*Photo Sketch
	View Parcel Map
Neighborhood:	Hoffman Town Nbhd
Neighborhood Code:	218.00
Acreage:	0.1840
Land Use:	Single Family
Legal Desc:	Lot 13 Blk 57 Hoffman Town 5th Flg

	Total	**Building**	**Land**
2020 Appraised Value	279,200	188,700	90,500
2020 Assessed Value	19,963	13,492	6,471
		2019 Mill Levy:	103.562

Using the actual example above, the total assessed value is $19,963 and the Building portion is $13,492

13,492 / 19,963 = 68% of value is in the Building

If we purchased the property for $300,000, the “depreciable cost basis” would be $300,000 x 68% = $204,000

$204,000 / 27.5 years = $7,418 annual depreciation expense

Depreciation Recapture

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Depreciation Recapture

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The downside of depreciation is depreciation recapture upon sale of the property.

Depreciation recapture is the portion of our gain attributable to the depreciation we took on your property during prior years of ownership, also known as <u>accumulated depreciation</u>.

Depreciation recapture is taxed as ordinary income up to a maximum rate of 25% (federally). State taxes vary.

We can avoid this recapture, as well as capital gains taxes INDEFINITELY by always rolling the sale into another property via a 1031 Exchange.

Establishing the Cost Basis

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In our example, the depreciable cost basis is $200,000. This would give us $7,273 annual depreciation expense. After one year of ownership, this would reduce our cost basis to $192,727. After two years, it would reduce our cost basis to $185,454. And after 27.5 years of ownership, our cost basis would effectively be reduced to zero unless we made capital improvements along the way.

Real estate depreciation affects the cost basis of our investment. Specifically, as we take depreciation deductions over time, they **DECREASE our cost basis**.

Our **cost basis is INCREASED** by any capital improvements we make to the property. This includes anything that substantially increases the value of the property. If we put a new roof on a property, for example, or if we renovate a kitchen, it's a capital improvement. Capital improvements do not include routine maintenance or repairs that are necessary to keep the property in good working order.

Raise Basis (good for taxes):
Capital Improvements

Lower Basis (bad for taxes):
Depreciation

Establishing Taxable Gain on a Sale

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If we sold this property after 2 years, our taxable gain would be:

Purchase Price: **$300,000**
Sell Price: **$350,000**

<u>Initial Basis: $305,000</u>
$300,000 *Purch Price*
$5,000 *Closing Costs*

<u>Minus Depreciation: $14,546</u>
$7,272 x 2 years

<u>Plus Capital Improvements: $6,000</u>
Replaced the deck

Adjusted Basis (*for taxes… upon sale*)
Initial Basis - Depreciation + Capital Improvements =
$305,000 - $14,546 + $6,000 = $296,454

Taxable Gain
Sell Price - Adjusted Basis =
$350,000 - $296,454 = **<u>$53,546</u>**
<u>(Of this, $14,546 is taxed at 25%, the remainder at long-term Cap Gains ~15%)</u>

Raise Basis:
$6,000

Lower Basis:
$14,546

Adjusted Basis

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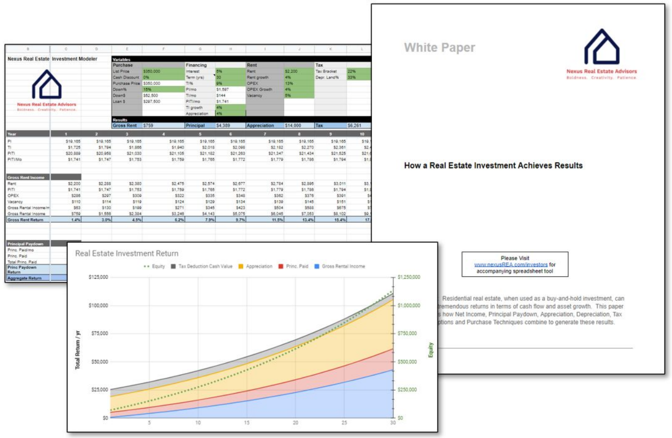

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About Nexus

The power of experience.

As both your advisor and Realtor®, Nexus takes the mystery and challenge out of real estate investing, helping build residential income real estate into your wealth and retirement strategy.

Nexus was created by the founder of Echo Summit Property Management, one of Colorado's largest and most respected management companies (acquired in 2019). After managing nearly 10,000 properties across the Front Range over a decade, we know the winners and losers, often down to the street-level. We also have a proven personal track record of building significant wealth with residential RE investments.

We are experts in purchasing… from identification to negotiation to inspection to close. Nexus also has access to best-of-breed technologies, vendors and ecosystem partners to ensure a smooth experience every step of the way.

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Thank You!

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