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InCommercial Property Group

Whitepaper

Tax Efficient Investing

Maximizing the Efficiency of Depreciation

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INTRODUCTION

Continuing in the path of 2022 and 2023, 2024 is anticipated to be a difficult time to be an investor in any asset class. Inflation, the great destroyer of wealth, is receeding with prices still high along with uncertain economic conditions. Taxes, always a concern for the sophisticated investor, seem only set to rise. That challenging backdrop is met with potentially falling corporate profits, stock market volatility and declining rental rates in many markets.

To excel in 2024, an investor will have to make smart choices to invest in assets that produce durable income, backed by strong companies in resilient industries while being mindful of how to protect those gains from today's challenges – including dilution from rising taxes.

DEPRECIATION GENERALLY

Real property includes both land and the things we do to improve the land, such as the construction of infrastructure, parking lots, buildings, etc. While the tax law recognize that land may appreciate in value – something most real estate investors are familiar with and have long enjoyed, the law also assumes that improvements (buildings, etc.) depreciate – we consume them, they age and become obsolete. While the assumption that real property improvements depreciate might not always hold true in actuality, it is an established principle in federal income tax laws.

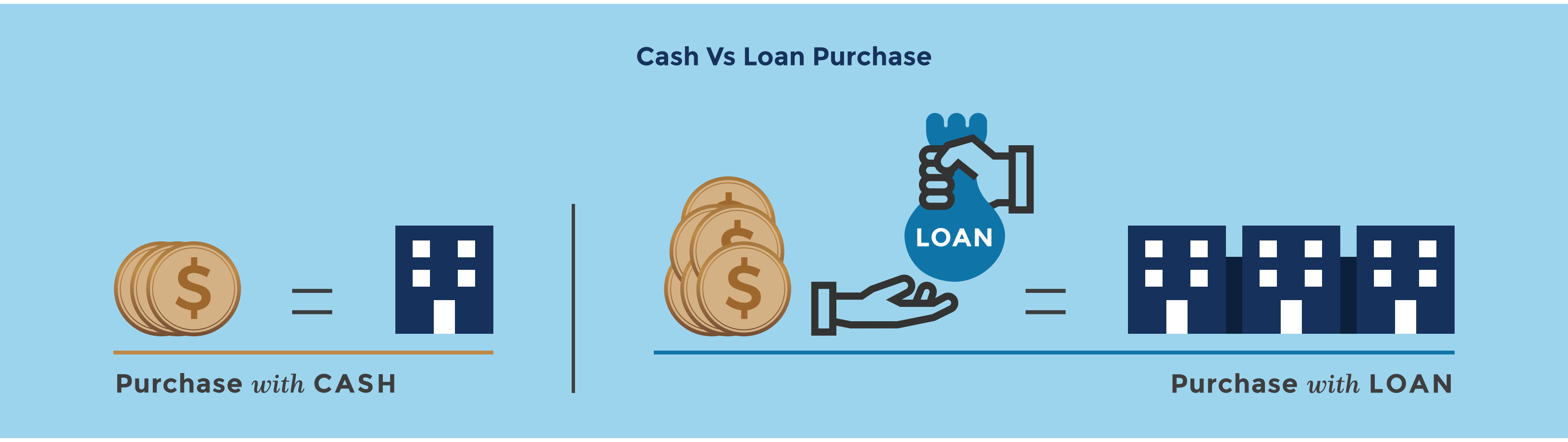
These competing processes – the appreciation of land versus the depreciation of improvements, is what often results in real estate investors achieving long term gains with low effective tax rates. The income derived from the property over many years is offset by depreciation expenses that effectively reduce the tax burden of their investment – an impact that compounds over time to create a net benefit to investors that few asset classes can match.

Importantly, appreciation and depreciation do not involve cash, they are paper gains and losses. While the laws do not (yet) tax unrealized appreciation, they do allow the real estate investor to depreciate a portion of the improvements each year, offsetting the income produced by the property.

Depreciation schedules have been set for most property types, broadly classifying residential rental properties (excluding land) as having a 27.5-year useful life and commercial rental properties (also excluding land) as having a useful life of 39 years. Thus, the amount of depreciation an investor can claim each year is most simply the amount of improvement cost (purchase price less land) divided by the useful life each year the investment is held until the entire improvement cost has been depreciated to zero.

LEVERAGED DEPRECIATION

Depreciation, as powerful as it is, becomes even more impactful with leverage. Most real estate is purchased with some form of loan in place – an investor buys property with a greater value than their cash on hand by borrowing additional funds from a lender. The amount borrowed and the increased value because of the amount borrowed, generally increases the investor's cost basis in the property. If an investor buys property with greater value, the investor typically has more improvements that can be depreciated and thus more income that can be offset.



BONUS DEPRECIATION

In 2024, an investor can elect to take bonus deprecation of 60% of the improvement cost of certain real property acquired with a scheduled depreciation period of 20 years or less along with certain other property. Otherwise eligible properties acquired in 2025 will only be eligible for 40% bonus depreciation and the benefit continues to phase out annually (20% in 2026) through December 31st, 2026, when it will drop to zero unless otherwise extended by Congress.

Without making some other elections, most real property will not qualify for bonus depreciation because the scheduled depreciation is greater than 20 years – this is where cost segregation studies are often employed with significant impact as some percentage of every property will have a shorter useful life than the entire property (e.g., site improvements are typically 15-year assets – which include improvements like sidewalks, roads, sewers, fences, landscaping, etc.).

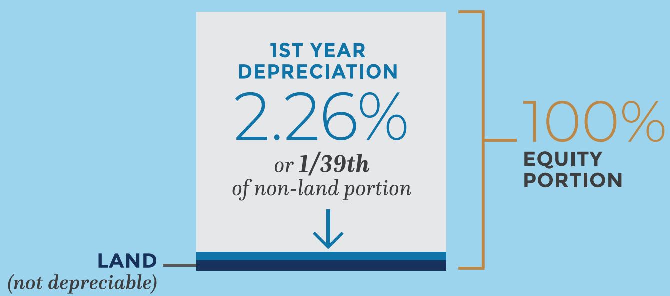
A relatively small percentage of real estate has been granted a depreciation schedule shorter than 20 years and are therefore able to take 60% bonus depreciation (excluding land) without completing a cost segregation study, if acquired in 2024. Retail Motor Fuel Outlets (gas stations) are one such property class that has a 15-year depreciation schedule and therefore qualifies without the need of further engineering studies or analysis, as provided for in Internal Revenue Code (IRC) Section 168(e)(3)(E)(iii) (See Footnote on page 5).

BRINGING EVERYTHING TOGETHER

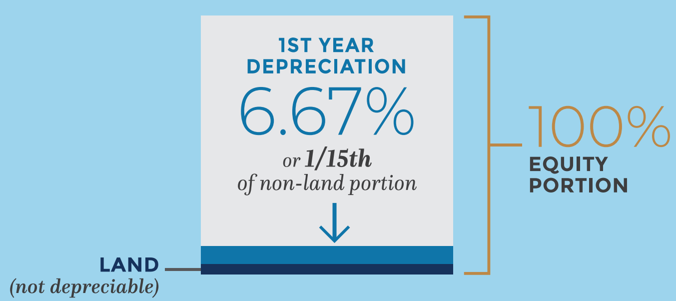
In 2024, a sophisticated investor can invest in gas stations, take on leverage, bonus depreciate the non-land portion 60% in the first year and claim depreciation expenses greater than the amount of cash used to acquire the property.

Comparing Depreciation Scenarios
More Money and More Property allows for More Tax Losses

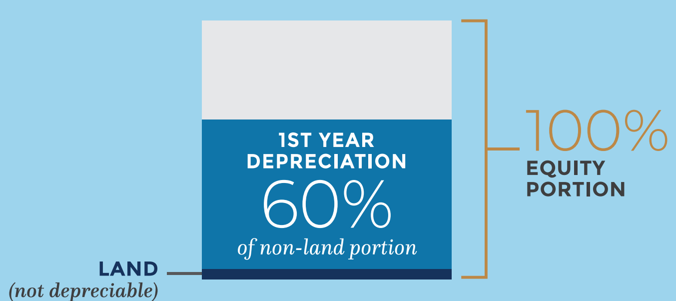
Scenario 1[1]
Commercial Property with Straight Line Depreciation



Scenario 2[1]
Motor Fuel Retail Outlet

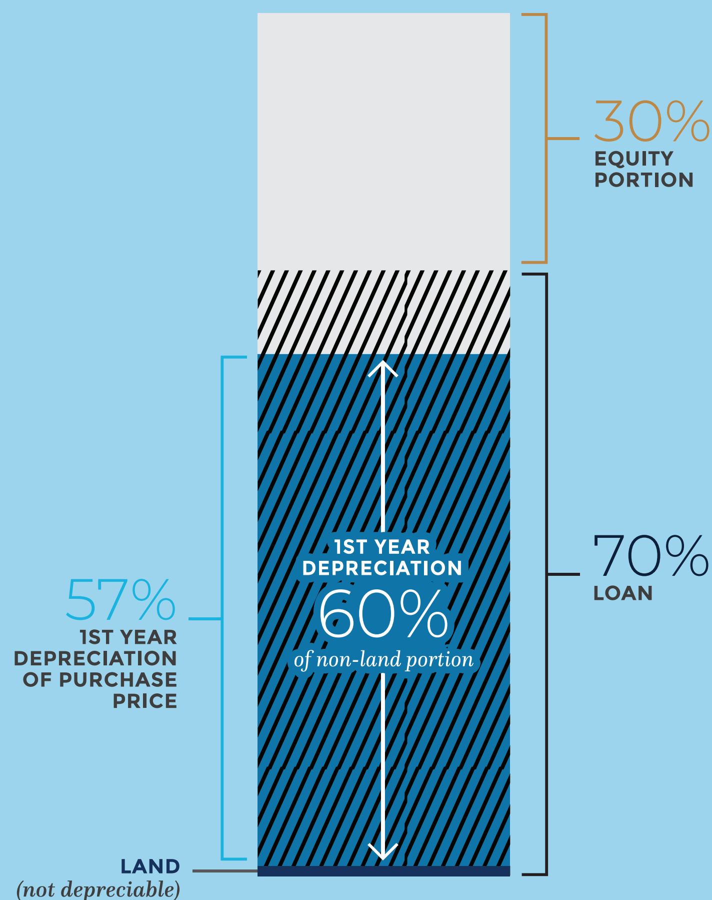


Scenario 3[1]
Motor Fuel Retail Outlet electing Bonus Depreciation



Assume $100 Equity	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Purchase Price	$ 100.00	$ 100.00	$ 100.00	$ 333.33
Land Value	$ 5.00	$ 5.00	$ 5.00	$ 16.67
1st Year Depreciation	$ 2.44	$ 6.33	$ 57.00	$ 190.00

Scenario 4[2]
Applying Leverage to a Motor Fuel Retail Outlet electing Bonus Depreciation



1 *The figure includes a 5% adjustment for land values. A higher land value will result in lower depreciation expense.*
2 *The figures represented require some assumptions about land values and loan amounts – in the scenario shown, we assume a 5% Land Value and a 70% Loan to Value loan. The resulting ratio of equity to first year depreciation is 30% to 57% for a first year loss multiple of 1.71:1 – this assumes no acquisition related expenses or other costs that would reduce the impacts.*

APPLICATIONS [3]

Since the depreciation in this case is so much greater than a property will reasonably be expected to generate in cash flow over a typical investment horizon of 5-10 years, the investor would ideally be able to use these dramatic depreciation expenses to offset income from other sources – the question then becomes what income can investor offset?

Buckets of income used for determining federal income tax liability include the following:

1. Active 2. Passive 3. Portfolio

Failed 1031 Exchange

An investor that is unable to complete an orderly 1031 exchange would, in many cases. have passive income that is either section 1231 (capital gains) or section 1250 (recapture) – both of which can often be offset by depreciation expenses. An investor with a failed 1031 exchange should consult with their tax preparer to determine how the gains from sale will be characterized and if this strategy may be applicable.

Real Estate Investors

Income or loss from rental real estate is, for most investors, a passive activity. Investors with large portfolios of rental real estate, particularly real estate that has been owned for a long time and has significant unrealized potential gains, likely generate significant passive income that is currently being taxed as ordinary income.

Investors should be encouraged to review Form 8582 which will report the Passive Activity Income or Loss from their tax return. If Line 3 is positive, the investor has passive income that should be investigated further.

Form **8582**

Department of the Treasury
Internal Revenue Service

Passive Activity Loss Limitations

See separate instructions.
Attach to Form 1040, 1040-SR, or 1041.
Go to *www.irs.gov/Form8582* for instructions and the latest information.

OMB No. 1545-1008
2022
Attachment Sequence No. **858**

Name(s) shown on return | **Identifying number**

Part I **2022 Passive Activity Loss**
Caution: Complete Parts IV and V before completing Part I.

Rental Real Estate Activities With Active Participation (For the definition of active participation, see ***Special Allowance for Rental Real Estate Activities*** in the instructions.)

1a	Activities with net income (enter the amount from Part IV, column (a)) . . .	**1a**			
b	Activities with net loss (enter the amount from Part IV, column (b))	**1b**	( )		
c	Prior years' unallowed losses (enter the amount from Part IV, column (c)) . .	**1c**	( )		
d	Combine lines 1a, 1b, and 1c			**1d**	

All Other Passive Activities

2a	Activities with net income (enter the amount from Part V, column (a)) . . .	**2a**			
b	Activities with net loss (enter the amount from Part V, column (b))	**2b**	( )		
c	Prior years' unallowed losses (enter the amount from Part V, column (c)) . .	**2c**	( )		
d	Combine lines 2a, 2b, and 2c			**2d**	
3	Combine lines 1d and 2d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c or 2c. Report the losses on the forms and schedules normally used			**3**	

3 *We can't provide tax advice as we are neither tax professionals, nor familiar with any investor's particular set of facts and circumstances. Every investor should have their own, independent, competent tax representation.*

Real Estate Professionals

Some investors may be real estate professionals, as defined in the Internal Revenue Code, in which case it may be possible for them to either invest as active participants in real estate, which would otherwise be considered passive activity, or aggregate all their real estate activities to claim active status. This can be particularly powerful for some investors but requires careful consideration and consultation with competent tax representation.

Passive Business Owners

Some investors may own businesses in which they are no longer active and consequently, the income derived from those businesses may be considered passive income. As indicated above, this determination must be made with careful consideration and consultation with competent tax representation.

Footnote:

IRC Sec. 168(e)(3)(E)(iii) provides that a retail motor fuels outlet is 15-year property even though food or other convenience items are sold at the outlet. Depreciable real property qualifies as a retail motor fuels outlet if (1) 50% or more of the gross revenue from the property is from petroleum sales or (2) 50% or more of the property's floor is devoted to petroleum marketing sales. A facility that is no more than 1,400 square feet in size is exempted from the 50% tests. Under IRC Sec. 168(g)(3)(B) , the recovery period is 20 years under the alternative depreciation system of IRC Sec. 168(g) . Rev. Rul. 97-29 held that a retail motor fuels outlet qualifies as 15-year property whether or not the taxpayer-owner is also the operator.

Disclaimer:

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