# 1031 Exchange FOCUS

*SECTION 1031 OF THE INTERNAL REVENUE CODE IS ONE OF THE GREATEST WEALTH BUILDING TOOLS AVAILABLE TO INVESTORS*

## > Calculating Depreciation

*Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property.*

Depreciation is a method for matching the costs of acquiring property over the properties' estimated economic life.

The IRS requires that most properties be depreciated via the 'straight-line' depreciation method. Using the straight-line method, residential income properties are depreciated over 27.5 years. Commercial properties are depreciated over 39 years.

**Depreciation Calculations**

It is important to note that land is not depreciable. In order to properly calculate depreciation, the value of land must be excluded. For example, a $1MM duplex with land worth $300,000 has $700,000 worth of depreciable real estate.

Using the straight-line depreciation method, the annual depreciation amount is approximately $25,500 ($700,000/27.5)

NOTE: The IRS will typically not challenge the assessment of the land value if it reasonable. A tax advisor, attorney or real estate agent should be able to provide guidance for what is reasonable based on the location and type of land.

**Depreciation Benefits**

Deprecation is an 'intangible expense' that will reduce the reportable taxable income from the property. This is good, because the end result is more money in our pocket and less tax to the IRS. Here's how it works:

The yearly rental income from the example duplex is $36,000. At the end of the year, this will have to be reported to the IRS. However, the IRS does not tax the entire $36,000. The taxable income from the property is calculated as follows:

Rental Income

(Expenses)

<u>(Deprecation)</u>

Taxable Rental Income

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If the expenses of operating and managing the duplex are $5,000 for the year, the taxable rental income is calculated as follows:

| | |
|---|---|
| Rental Income | $36,000 |
| (Expenses) | ($5,000) |
| (Deprecation) | ($25,500) |
| Taxable Rental Income | $5,500 |

NOTE: Please always seek the guidance of a tax advisor. It may be beneficial for some property owners to depreciate certain items on the property (fences, fixtures, etc) at different depreciation schedules, which is allowed via cost segmentation.

**Depreciation Tax**

Upon the sale of an investment property, the IRS requires the payment of a depreciation recapture tax. The tax rate is currently set at 25%. In the example above, if the duplex was owned for 10 years, the entire depreciation taken on the property would amount to $255,000 ($25,500 x 10). The IRS requires a recapture tax on that entire amount. Hence, the sale of the duplex will result in a $63,750 deprecation recapture tax (255,000 x 25%). This is in addition to state and federal capital gains taxes.

The deprecation recapture tax as well as any associated capital gains taxes can be deferred in full via a 1031 Exchange.

**Conclusion**

Of all the benefits of owning real estate, depreciation may be one of the most important. The tax advantage depreciation offers is powerful. The IRS will always assume that depreciation is taken and will hold an investor liable for the deprecation recapture tax – even if the investor failed to take advantage of the depreciation. Bottom line: make sure you are taking advantage of this powerful tool.



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