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Maximizing Depreciation Deductions for Business Real Estate

Over the Winter, rising mortgage interest rates may have slowed the real estate market but Spring is the time when buying and selling activity begins to heat up again. When buying business real estate for your own occupancy or for rental to others, you should act to maximize the depreciation tax deductions that you can claim for the property. The following are a few ideas we hope will help.

Depreciation is one of the largest deductions available to offset your income and it is often overlooked or is not utilized to its full potential.

Separating Improvements from Land

Not all of the purchase price of acquiring real estate is depreciable. While the cost of improvements to land is depreciable, the cost of land itself is not. As such, you will want to identify and document, at the time of purchase, the portion of your overall acquisition cost allocable to improvements. To do this, you should either retain a qualified real estate appraiser to make an allocation between land and improvements based on a detailed written analysis, or, if you have sufficient valuation expertise and knowledge of the locality, write your own detailed analysis and allocation. We would be glad to review the analysis to determine whether it would be respected by the tax law. In addition, you should know that the cost of improvements includes not only the cost of buildings, but also the cost of items such as landscaping and roads, and even some costs of grading and clearing. We can guide you in identifying which of these land related costs are, in fact, costs of improvements, and should be reflected in the assets that qualify for depreciation tax deductions.

Converting Land into a deductible Asset

While land is not depreciable, there are methods to obtain tax deductions for your land cost. One way to do this is to enter into a long-term lease of the land rather than purchase it. If you lease the land, the rents you pay under what is called a "ground lease" are deductible.

Acquisition of an Interest in Land Known as an "Estate-For-Years"

With an estate-for-years, you would own the land for a period of years, while an individual or entity unrelated to you would own the interest in land that begins when your estate-for-years ends. As the owner of the estate-for-years, you would be allowed to "amortize", that is deduct ratably, the cost of the estate-for-years over its duration. Thus, for example, if your estate-for-years is for 25 years, you would be allowed to deduct each year 1/25th of the cost of the estate-for-years. We can assist in identifying which individuals or entities qualify as unrelated, and review the feasibility of an estate-for-years as applied to a specific acquisition.

Cost Segregation

A common technique to maximizing depreciation deductions is separating personal property from buildings. In general, business buildings must be depreciated over a period of 39 years, and residential rental real estate over a period of 27.5 years. An immediate write-off is available, but only for smaller taxpayers, for certain building improvements. In contrast, most personal property (furniture, equipment, etc.) is depreciable over much shorter periods. Generally, these periods have been 5 or 7 years, but under current tax law, in most cases, 100% of the cost of items of personal property can be deducted in the year in which the items are placed in service. Accordingly, if a specific item is classified as personal property rather than as a part of a building, the depreciation deductions for that item will generally be available sooner and in economic terms, have a greater "present value" to the property owner.

As such, just as it is advantageous to properly allocate between improvements and land, it is important to identify and document, at the time that you acquire real estate, the items that are personal property and the items that are building parts.

For many items, the difference is based on general knowledge: a desk is personal property, but a load bearing concrete wall is part of a building.

However, for many items such as lighting fixtures, signs, floor coverings, wall coverings, plumbing, electrical systems and heating and cooling systems, the distinctions are governed by complex tax rules that can involve projections as to the future use of the items, and may even require consultation with engineers or other construction experts.

Further, after the personal property and building items are separately identified, they must be separately valued, either by an appraisal, a breakdown of construction costs or both.

This alert covers only some of the tax rules available to maximize depreciation deductions for business real estate that could potentially benefit you, your family, and your business. Please contact us if you have questions, want more information, or would like us to help in a specific business real estate acquisition that delivers the best tax results for you.

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