

# Tax Efficiency in DST Investing

## Cost Segregation, Bonus Depreciation, and After-Tax Return Enhancement

- AN EDUCATIONAL OVERVIEW

### How Depreciation Offsets Income Tax

Depreciation is a non-cash deduction that allows real estate investors to recover the cost of income-producing property over time. From a tax perspective, this deduction reduces the investor's taxable income dollar-for-dollar. An investor in the 37% federal tax bracket who recognizes \$100,000 of depreciation reduces their federal income tax liability by \$37,000 — with no corresponding reduction in the cash received from the investment.

Because depreciation is a paper loss rather than an economic one, it is widely regarded as one of the most powerful wealth-preservation tools available to real estate investors. For investors participating in a Delaware Statutory Trust (DST), depreciation from the underlying property flows through to each investor in proportion to their ownership interest.

### Depreciable Life: Multi-Family vs. Commercial Real Estate

Not all real estate assets are depreciated on the same schedule. The IRS assigns different **recovery periods** — the length of time over which an asset's cost may be deducted — based on the nature of the property and its components.

**Residential rental property (multifamily):** Depreciated over **27.5 years** on a straight-line basis. A \$1,000,000 depreciable basis generates approximately **\$36,364 per year**.

**Commercial real estate (office, retail, industrial):** Depreciated over **39 years** on a straight-line basis. The same \$1,000,000 basis generates only approximately **\$25,641 per year** — approximately 30% less annually.

This structural difference creates a meaningful annual advantage for multifamily investors seeking to shelter distribution income from taxation. That tax benefit can be amplified considerably through a technique known as cost segregation.

### Cost Segregation: Accelerating Depreciation Through Component Classification

A cost segregation study is an engineering-based analysis that identifies and reclassifies structural components of a real property investment into shorter depreciable lives — typically 5-year, 7-year, or 15-year property — rather than depreciating the entire structure as a single long-lived asset.

Components that commonly qualify for shorter recovery periods include specialty flooring, cabinetry, land improvements, specialty electrical systems, and certain HVAC components.

By reallocating a portion of the building basis to these shorter-lived asset classes, investors can accelerate a substantial portion of depreciation into the early years of ownership. This improves the present value of the tax benefit and can significantly enhance after-tax returns throughout the investment hold period.

## Bonus Depreciation: Capturing the Full Benefit in Year One

Bonus depreciation is a federal tax provision that allows investors to deduct the **full cost of qualifying property in the year it is placed in service (defined as the point of investment by the DST)**, rather than over the applicable recovery period. Under current tax law, personal property and qualified improvement property with a recovery period of 20 years or less may be eligible for bonus depreciation.

When combined with cost segregation, bonus depreciation allows investors to recognize potentially substantial depreciation deductions in Year 1 of an investment — rather than spreading those deductions over 5, 15, or 27.5 years. This front-loading can have a transformative effect on after-tax yield, particularly when the Year 1 deductions are sufficient to shelter multiple years of taxable cash distributions from the investment.

Depreciation deductions that exceed an investor’s income in a given year may generally be carried forward to offset future income, extending the tax benefit beyond the initial year. The precise availability of these deductions depends on each investor’s tax circumstances, passive activity rules, at-risk limitations, and applicable law at the time of the investment.

## Illustrative Example: A Multifamily DST Investment with Cost Segregation

The following example demonstrates how cost segregation and bonus depreciation may interact with a typical multifamily DST investment to generate meaningful tax efficiency. All figures are hypothetical and provided for educational purposes only.

### Investment Assumptions

Parameter	Assumption
Total DST Investment Basis	\$2,000,000
First Mortgage Allocation (50% LTV)	\$1,000,000
Cash Equity Investment	\$1,000,000
Cash-on-Cash Distribution Rate <sup>1</sup>	4.50%
Annual Cash Distribution	\$45,000
Land Allocation (Non-Depreciable)	7% / \$140,000
Depreciable Building Basis	93% / \$1,860,000

<sup>1</sup> There is no guarantee that a DST will pay a distribution or continue to pay a distribution at its stated rate. This example is for illustration purposes only and does not indicate a DST will achieve its objectives.

### Cost Segregation Allocation

Engineering-based cost segregation study provided by a third-party that allocates the \$1,860,000 depreciable basis across the following asset classifications:

Asset Classification	Recovery Period	Allocation	Dollar Amount
Personal Property	5-Year	22%	\$409,200
Land Improvements	15-Year	5%	\$93,000
Building Structure	27.5-Year	73%	\$1,357,800
<b>Total Depreciable Basis</b>		<b>100%</b>	<b>\$1,860,000</b>

### Year 1 Bonus Depreciation

Applying the bonus depreciation election to 5-year and 15-year property identified in the cost segregation study yields the following Year 1 deduction:

Category	Amount	Basis for Election
5-Year Property	\$409,200	100% Bonus Eligible
15-Year Property	\$93,000	100% Bonus Eligible
<b>Total Year 1 Bonus Depreciation</b>	<b>\$502,200</b>	<b>25.1% of Total Investment Basis</b>

### After-Tax Return Analysis

At a 4.50% cash-on-cash distribution rate, the \$1,000,000 cash equity investment generates **\$45,000 per year** in pre-tax cash distributions. Without depreciation offset, an investor in the top federal income tax bracket (37%) would owe meaningful income tax on those distributions each year.

The \$502,200 of Year 1 bonus depreciation illustrated above is sufficient to shelter the \$45,000 annual distribution for approximately **11 years** — with no income tax owed on distributions received during that period, assuming the investor can fully utilize the deductions in the year generated or carry them forward against future income from the investment.

The 27.5-year building component — representing 73% of depreciable basis, or \$1,357,800 — continues to generate annual straight-line depreciation of approximately \$49,375 per year throughout the hold period, providing ongoing income offset well beyond Year 1.

This illustration does not account for potential additional tax benefits associated with the deferral of capital gain taxes from the exchanged property, which may further enhance after-tax economics for investors utilizing a 1031 exchange into the DST.

**TAX EQUIVALENCY: ILLUSTRATIVE GROSS YIELD REQUIRED WITHOUT DEPRECIATION OFFSET**

For an investor who cannot benefit from depreciation offsets, the equivalent pre-tax yield required to match the after-tax economic benefit of a 4.50% distribution sheltered by bonus depreciation would be approximately **7.8% for an investor in the top federal and Georgia state tax brackets**, or approximately **9.2% for an investor in the top federal and California state tax brackets**. These figures underscore how meaningfully depreciation can enhance effective after-tax returns relative to a nominal pre-tax yield.

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**IMPORTANT DISCLOSURE**

This document is provided for educational and informational purposes only and does not constitute tax, legal, or investment advice. The illustration assumes a 7% allocation of purchase price to non-depreciable land and that the investor has sufficient tax basis in the replacement property (including exchange basis carried over, if applicable) to utilize bonus depreciation deductions. The tax equivalency illustration assumes a top federal income tax rate of 37%, a top Georgia state rate of 5.19%, and a top California state rate of 13.3%.

Depreciation allocations, bonus depreciation eligibility, passive activity loss limitations, at-risk rules, and basis limitations vary by investor. Actual results will depend on individual tax circumstances, timing of placement in service, applicable tax law, and IRS guidance in effect at the time the property is placed in service. Investors should consult their own qualified tax advisor to evaluate the impact of any DST investment on their specific situation.