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Whitepaper

Tax Efficient Investing

Maximizing the Efficiency of Depreciation

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.

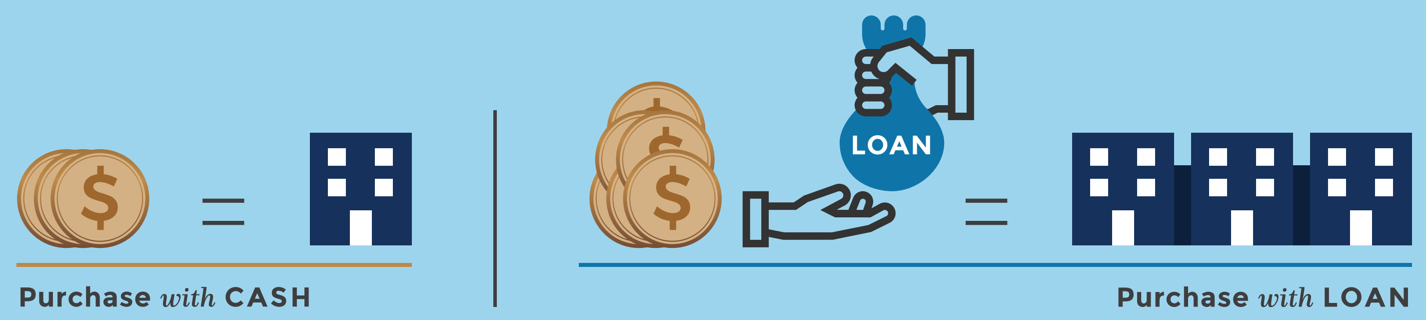
Importantly, appreciation and depreciation do not involve cash, they are paper gains and losses. While the laws do not (yet) tax unrealized appreciation, they do allow the real estate investor to depreciate a portion of the improvements each year, offsetting the income produced by the property.

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.

Cash Vs Loan Purchase



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.).

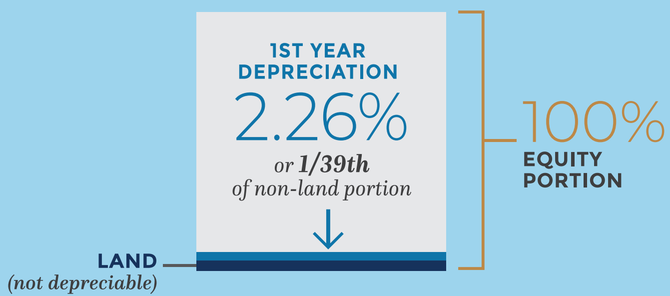
A relatively small percentage of real estate has been granted a depreciation schedule shorter than 20 years and are therefore able to take 60% bonus depreciation (excluding land) without completing a cost segregation study, if acquired in 2024. Retail Motor Fuel Outlets (gas stations) are one such property 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

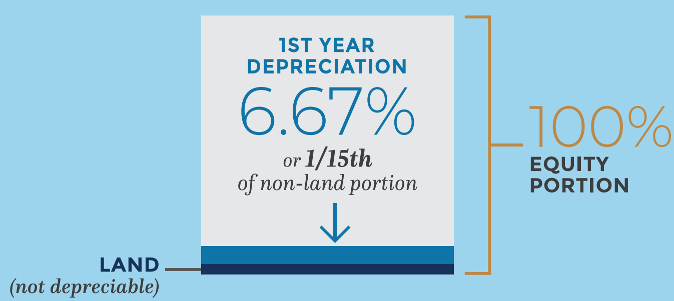
In 2024, a sophisticated investor can invest in gas stations, take on leverage, bonus depreciate the non-land portion 60% in the first year and claim depreciation expenses greater than the amount of cash used to acquire the property.

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

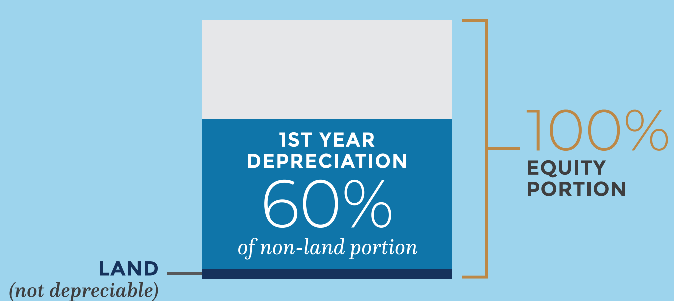
Scenario 1[1]
Commercial Property with Straight Line Depreciation



Scenario 2[1]
Motor Fuel Retail Outlet

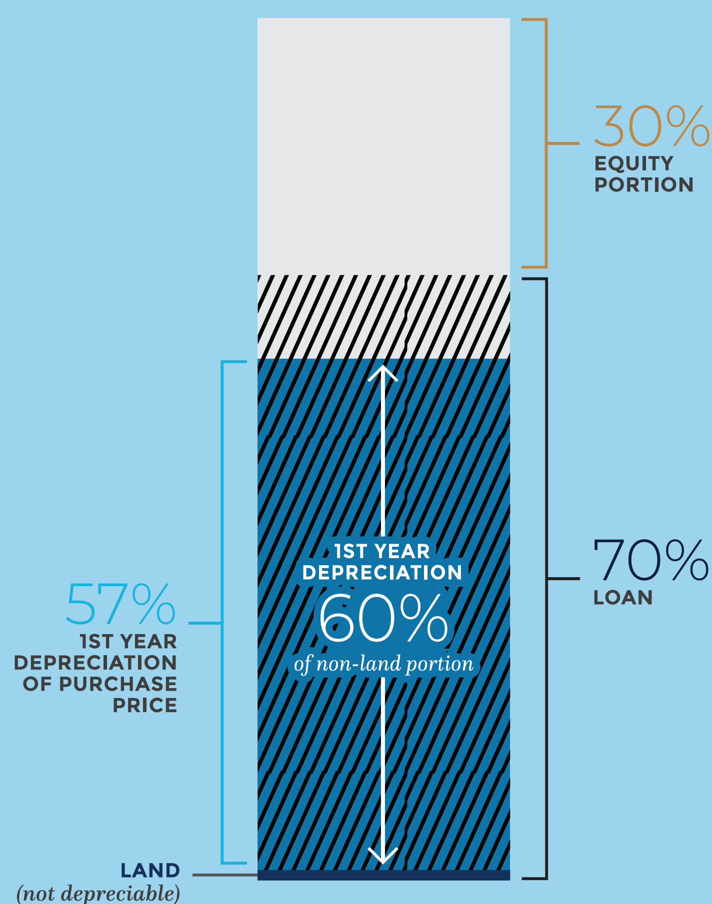


Scenario 3[1]
Motor Fuel Retail Outlet electing Bonus Depreciation



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 1.90:1 – this assumes no acquisition related expenses or other costs that would reduce the impacts.*