PacificCPE

COURSE
34303B

Landlords: Depreciation Basics

Depreciation ranks among the most powerful tax advantages available to landlords, yet it's frequently misapplied or left on the table. This course builds the foundational knowledge tax professionals need to understand how depreciation works in a rental property context, calculate deductions accurately, and walk clients through the mechanics with confidence. Whether you're reinforcing existing knowledge or approaching rental property taxation with fresh eyes, this course delivers a clear and practical look at depreciation fundamentals.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the basics for depreciation.
-

Recall limits of bonus depreciation and Section 179 expensing.

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Chapter 1: DEPRECIATION BASICS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the basics for depreciation.
- Recall limits of bonus depreciation and Section 179 expensing.

Of all the chapters in this course, this one should give you the most pleasure to read. Admittedly, depreciation is a rather dry, technical subject. But depreciation means money in a landlord's pocket. So, whenever you hear the word "depreciation," think "money."

This chapter covers the basics of depreciation. It shows you why depreciation is such a great deal for landlords, and how to calculate and take the deduction. It also explains Section 179 expensing, an alternative to depreciation that landlords can use for certain personal property.

DEPRECIATION: THE LANDLORD'S BEST TAX BREAK

The largest expense landlords have is the purchase price for the rental property they own. However, unlike the interest you pay on a loan to buy the property or other operating expenses related to the property, you can't deduct the cost of the rental property in the year in which you pay for it. Because real estate lasts for more than one year, you must deduct its cost over a much longer time period through a process called "depreciation."

The basic idea behind depreciation is simple: Real estate and other long-term property may last longer than a year, but not forever. Little by little, year by year, buildings and other types of long-term property wear out, decay, become unusable or obsolete, or get used up. The annual decline in the value of such property is a cost of doing business or engaging in an investment activity. Depreciation is an annual tax deduction that business owners and investors take to reflect this annual cost.

The reason depreciation is such a valuable deduction for landlords is that you get it year after year (27.5 years for residential real property) without having to pay anything beyond your original investment in the property. Moreover, rental real property owners are entitled to depreciation even if their property goes up in value over time (as it usually does).

Example

George buys a rental condominium with a depreciable basis (value) of $400,000. He is entitled to an annual depreciation deduction of $14,545 for the next 27.5 years (excluding the first and last years, which will be somewhat less). All George has to do to get these annual deductions is continue to own the condo as a rental property, file a tax return every year, and do some simple bookkeeping. He doesn't have to spend an additional penny on his property. And he is entitled to depreciation even though his condominium increases in value every year. What a deal!

It's true that if you sell your property you'll likely have to pay a tax of up to 25% on the total amount of depreciation deductions you took over the years. (See "Effect of Adjusted Basis When You Sell," below.) However, in the meantime, these annual deductions have lowered your annual taxes. In effect, depreciation allows you to defer payment of tax on your rental income from the years in which it was earned to the year it is sold. And, you'll get an additional tax savings if your regular income tax rate when you sell is more than the 25% rate you'll have to pay on your depreciation deductions. Moreover, if you never sell the property you'll never have to pay the 25% tax, which is one reason why many veteran landlords hold onto their property for years and years.

Depreciation is a complicated subject. The IRS publication describing it is more than 100 pages long (IRS Publication 946, *How to Depreciate Property*). Many landlords simply have their accountants handle their depreciation and never bother to learn much about it. However, it's worth your time and trouble to understand it in some detail. This will enable you to:

- Make sure you determine your depreciation deductions properly—depreciation isn't as cut and dried as you might think, and
- Make better-informed decisions on whether to invest in a particular rental property because you fully understand the tax benefits.

Depreciation is one of the largest deductions a landlord has. It can be the difference between a profit and a loss each year on a rental property. That's why it's so important that you understand it.

Caution!

Depreciation isn't optional. Unlike all the other tax deductions discussed in this course, depreciation isn't optional. You must take a depreciation deduction if you qualify for it. If you fail to take it, the IRS will treat you as if you had taken it. So, when you sell your property, its basis (value for tax purposes) will be reduced by the amount of depreciation you failed to claim. As a result, you'll have a larger profit from the sale that you'll have to pay taxes on.

If you have unclaimed depreciation, you should act to claim it this year. To claim such depreciation, you must make what is known as an "I.R.C. Section 481(a) adjustment." You can deduct the entire amount in a single year by filing IRS Form 3115 to request a change in accounting method. The IRS ordinarily grants this type of change automatically (Rev. Proc. 2004-11) and you don't need to file any amended tax returns. Unfortunately, IRS Form 3115 is an extremely complex form.

UNDERSTANDING THE BASICS

The fundamentals of depreciation aren't difficult to grasp. Gaining familiarity with these basic concepts will help you understand the later sections in this chapter that describe in detail how to depreciate real and personal property.

What Property Can Be Depreciated?

You may depreciate property that:

- Lasts for more than one year
- Wears out or gets used up over time
- You own for more than one year, and
- You use in your rental activity (or some other business or income-producing activity). (I.R.C. § 167).

Let's look at these requirements in some detail.

Long-Term Property

You can depreciate only property that lasts longer than one year—for example, buildings, tangible personal property like stoves and refrigerators, office or construction equipment, cars, and other vehicles. In tax parlance, such long-term property is called a "capital asset" because it is part of your capital investment in your rental business or investment activity.

Items you buy that are for, or related to, your rental activity that aren't long-term property (such as the food you eat when traveling for your rental activity, fertilizer you use for your rental property

landscaping, and chlorine you buy to clean an apartment complex swimming pool) can usually be fully deducted in the year in which you purchase them as operating expenses. (See Chapter 2 of course 34302C.)

Property That Wears Out or Gets Used Up

You can depreciate only property that wears out, decays, gets used up, or becomes obsolete over time. So, for example, you can't depreciate stocks, bonds, or other securities. These assets never wear out. And you can't depreciate collectibles that appreciate in value over time—for example, antiques, coins, or artwork.

Land—that is, the ground a building rests on and the surrounding area—can't be depreciated because, for all practical purposes, it lasts forever. (If the land you own permanently disappears due to flooding, earthquake, or some other catastrophe, you'll have a deductible casualty loss; see Chapter 1 of course 34307C.) When you determine your depreciation deduction for a rental building or other structure, you can't include the value of the land it rests on in its value for tax purposes. Only the cost of the building itself can be depreciated.

Unlike land, buildings and structures on land don't last forever and, therefore, can be depreciated. Indeed, all or most of your depreciation deduction will come from the value of your rental buildings. You can depreciate any type of structure you use for your rental activity—apartment buildings, houses, duplexes, condominiums, mobile homes, swimming pools, parking lots, parking garages, tennis courts, clubhouses, and other facilities for your tenants. You can also depreciate structures that you own and use for your rental activity even though they aren't used by your tenants —for example, a building you use as your rental office, or a storage shed where you keep maintenance equipment. The cost of landscaping for rental property can also be depreciated.

You can also depreciate tangible *personal* property that lasts for more than one year. This includes property inside a rental unit, such as stoves, refrigerators, furniture, and carpets. Other personal property that you use in connection with your rental activity can also be depreciated, even if it isn't located on your rental property—for example, a computer, cell phone, lawn mower, or automobile you use to conduct your rental activity.

You get no annual tax deductions for capital assets that can't be depreciated. This is one reason why depreciable assets like rental properties are better investments, taxwise, than nondepreciable assets like stocks, antiques, or art.

Property You Own for More Than One Year

You can only depreciate property that you own. You can't depreciate property that you lease for your rental activity (such as office space). In addition, you must own the property for at least one year to depreciate it. You get no depreciation for property you buy and sell, or otherwise dispose of, in the same year.

It makes no difference if you own the property free and clear or if you borrow money to buy it. If you hold title to the property, you get the depreciation—even if you have little or no equity in the property. The amount of your depreciation is determined by the cost of the property; how much you borrowed to purchase it is irrelevant.

Property You Use in Your Rental Activity

You may only depreciate property that you use in your rental business or investment activity (or some other business or investment activity you conduct). You may not depreciate property you use solely for personal purposes. So, you get no depreciation for your personal residence. If you convert a rental property to personal use, you must stop taking the depreciation for the property.

If you use property for both rental and personal uses, you may depreciate only a part of its value, based on the percentage of the property used for rental purposes.

Example

Jennifer owns a duplex. She lives in one unit and rents the other. Because she uses 50% of the duplex for rental purposes, she may depreciate only 50% of its value.

How Depreciation Works

At its core, depreciation is simple: You figure out how much the property is worth for tax purposes (the property's basis) and how long the IRS says you must depreciate it for (its recovery period), and then you deduct a certain percentage of its basis each year during its recovery period. The devil is in the details:

- When does depreciation begin (and end)? The answer to this question depends on when rental property is placed in service.
- How do you determine how much your property is worth for depreciation purposes? You'll have to understand the concept of basis and how to calculate it.
- How long do you have to depreciate your property? The answer lies in knowing which recovery period applies.
- How much of your property's value do you get to deduct each year? The answer to this question depends on which depreciation method you use and which depreciation convention applies.

All of these topics are explained below.

When Depreciation Begins and Ends

You don't necessarily begin to depreciate property when you buy it. Rather, depreciation begins when property is "placed in service." Property is considered placed in service in a rental activity when it is ready and available to rent, which can occur at the same time you buy the property, or later. (See "How to Depreciate Buildings," below.)

You stop depreciating property either when you have fully recovered its value or when you retire it from service, whichever occurs first. Property is retired from service when you stop using it for your rental activity, sell it, destroy it, or otherwise dispose of it.

Example

Willa purchased a rental house that she placed in service by advertising it as available for rent in January 2016. She rented the property to various tenants over the next 10 years. She sold it on April 15, 2026. She gets no more depreciation as of the date of the sale—April 15, 2026. Had she not sold the property, she would have continued to depreciate the property over its 27.5-year depreciation period.

Determining Your Property's Basis

Depreciation allows you to deduct your total investment in a long-term asset that you buy for your rental activity. You take this deduction over the property's depreciation period, which the IRS determines. In tax lingo, your investment is called your "basis" or "tax basis." Basis is a word you'll hear over and over again when the subject of depreciation comes up. Don't let it confuse you; it just means the amount of your total investment in the property for tax purposes.

Usually, your basis is the cost of the property, plus expenses of the sale such as real estate transfer taxes and other fees. Land can't be depreciated, so it must be deducted from the cost of real property to determine its basis for depreciation.

Example

Jenna buys a rental house that cost $500,000, not including the land's value. The $500,000 cost is her basis in the property. She uses this amount to determine her annual depreciation deduction.

Your Recovery Period

The depreciation period (also called the "recovery period") is the time over which you must take your depreciation deductions for an asset. The tax code has assigned depreciation periods to all types of business assets. These periods are somewhat arbitrary. However, property that can be expected to last a long time generally has a longer recovery period than property that has a short life. So, software has a three-year period, while the period for commercial real property is 39 years.

Real property placed into service after 1986 is depreciated under the Modified Accelerated Cost Recovery System (MACRS). Under this system, the depreciation period for residential real property placed in service after 1986 is 27.5 years. Prior to 1987, different depreciation methods with different depreciation periods were in effect. The depreciation period for commercial property is 39 years. Some dwellings rented on a short-term basis to multiple tenants may qualify as commercial property instead of residential. (See "The Depreciation Period," below.)

The periods are the same whether the property being depreciated is old or new. When you buy property, you start a new depreciation period beginning with year one, even if the prior owner previously depreciated the property for several years or fully depreciated it. If you buy an old building that has changed hands many times over the years, it might have been fully depreciated several times. This depreciation makes no difference to you—your depreciation period starts when you place the property in service in your rental activity.

Calculating Your Deduction Amount

Your depreciation deduction is a set percentage of the basis of your property each year. The amount of the percentage depends on the depreciation method you use. All real property must be depreciated using the straight-line method. Under this method, you deduct an equal amount each year over the depreciation period. (See "How to Depreciate Buildings," below, for more on how to calculate your depreciation deduction.) The amount of your first-year deduction is prorated depending upon which month you place your property into service. Special depreciation rules called "conventions" govern how much you can depreciate the first year.

Personal property can be deducted over its full recovery period using accelerated depreciation, which provides larger depreciation deductions in the early years than the straight-line method. (See "Deducting Personal Property," below, for more on depreciating personal property.) Alternatively, all or most of the full cost of personal property may usually be deducted in one year using Section 179 expensing, the *de minimis* safe harbor, or bonus depreciation. (See "Deducting Personal Property," below.) Land improvements may also be deducted in one year with bonus depreciation. (See "Depreciating Land Improvements," below.)

Taking Separate Deductions

Typically, landlords don't have a single depreciation deduction. Instead, they have many separate depreciation deductions over time.

Rental Property Placed in Service

When a rental property is first placed in service, the landlord gets to depreciate its value. This includes the value of:

- The building and building components