PacificCPE

COURSE
34304B

Landlords: Maximizing Depreciation, Pass-Through, and Interest Deductions

Some of the largest deduction opportunities for landlords require digging a bit deeper — and this course covers three that deliver significant impact. You'll work through strategies for maximizing depreciation deductions, tackle the Section 199A pass-through deduction rules, and examine how interest expenses are treated for rental properties. Tax professionals advising landlord clients will find practical planning insights throughout, along with the tools to ensure clients are taking full advantage of these high-value deductions.

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

Start Course ↓ | Final Exam Copy ↓

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 ways for landlords to maximize their depreciation.
- Recall the requirements of the pass-through deduction.
- Recognize what interest expenses are deductible.

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Chapter 1: MAXIMIZING YOUR DEPRECIATION DEDUCTIONS

Chapter Objective

After completing this chapter, you should be able to:

- Identify ways for landlords to maximize their depreciation.

This chapter shows you two important ways to maximize your depreciation deductions. First, you'll learn how to best determine the value of your rental buildings and nondepreciable land. Next, you'll see how you can use cost segregation to greatly increase the depreciation deductions you get each year during the first few years you own rental property.

Beware the Passive Loss Rules

Using the methods described in this chapter to increase your depreciation deductions won't necessarily result in an immediate tax reduction, and might never do so. This will be the case if more deductions will only increase your real estate losses and the passive activity loss rules prevent you from currently deducting any more losses than you already are deducting (or deducting any losses at all). However, such losses aren't lost: They are deductible in future years if you have sufficient rental or other passive income. See Chapter 1 of course 34308C for a detailed discussion of the passive loss rules.

DETERMINING THE VALUE OF YOUR LAND AND BUILDINGS

As discussed in Chapter 1 of course 34304C, you can't depreciate land because it lasts forever. But when you buy a rental property, you usually pay one lump sum that covers the cost of both the land and buildings it contains. To determine the depreciable value of the buildings (their basis), you must allocate the purchase price between the land and buildings and other depreciable property.

How you do this allocation is the single most important factor that will determine how much depreciation you may deduct each year and in total. The more your land is worth, the less your basis in the property and the less depreciation you will receive.

Example

Miranda owns a rental duplex that cost $200,000. If the land is worth $50,000, she'll have a $150,000 depreciable basis for the building. If the land is worth $20,000, her basis in the building will be $180,000. The chart below illustrates the difference in the depreciation deductions she'll receive assuming the property was placed in service in January. She receives more than $1,000 more in depreciation each year with the lower land valuation.

Depreciation: $150,000 basis Depreciation: $180,000 basis

Year	($50,000 land value)		($20,000 land value)	
1		$5,228		$6,264
2-27		$5,454		$6,555
28		$2,955		$3,546

In addition, at higher income levels (for 2026, $201,750 for singles, $403,500 for marrieds filing jointly), the pass-through tax deduction is based wholly or partly on 2.5% of the value of your rental property, not counting the land. So, the less your land is worth, the greater your pass-through deduction will be. (See Chapter 2.)

It's up to you to decide how much your land and buildings are worth in the first year you depreciate your property. You don't need to provide your allocation or explain how you arrived at it on the forms you file with the IRS to claim depreciation—you simply list your property's depreciable basis. However, the IRS can review your determination if you're audited. In that event, you'll need to explain how you arrived at your basis.

If the IRS determines that your valuation is too low, you'll have to pay back some of the depreciation you received, along with interest and, in some cases, tax penalties. (See "Tax Penalties for Unreasonable Valuations," below.)

Most people don't give their land valuation much thought; they simply use a standard formula or their property tax bill to determine its value. But, as explained below, there are other ways to value your land and buildings that may yield much better results.

Tax Penalties for Unreasonable Valuations

The IRS may impose tax penalties if it determines that you overstated the value of your buildings and other depreciable property—and correspondingly understated the value of your land. The penalty is equal to 20% of the amount of tax you underpaid. However, the penalty may be imposed only if you overstated the value of your depreciable property by at least 200% over the correct amount and the overstatement resulted in an underpayment of tax of at least $5,000. Few small landlords ever overstate the value of their property by this much. Moreover, even if you do overstate your values by this amount, the IRS must waive the penalty if you had a "reasonable basis" for your valuation and acted in good faith. (I.R.C. § 6662.) The fact that your property valuations must be wildly inflated before you'll be subject to tax penalties gives you an idea of how much leeway you have in deciding what depreciable rental property is worth.

No One Way to Determine Land and Building Values

The IRS gives landlords virtually no guidance on how to go about calculating the value of their land and buildings for depreciation purposes. Its regulations simply provide that: "In the case of the acquisition. . . of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation can't exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time." (IRS Reg. § 1.167(a)-5.)

In other words, the basis of the nondepreciable land and the depreciable buildings and other improvements must be allocated in proportion to their relative values. But how do you arrive at these relative values? There is no single method to determine how much any property is worth, and the IRS doesn't require you to use any particular method. Different methods can yield very different results. The methods you may employ include using:

- Your property tax bill
- The replacement cost of your building and improvements
- Buyer-seller valuations, or
- Comparable land sales.

You can try all these methods and use the best result, or average the various results you obtain. Remember, your valuation doesn't have to be precise; it just has to be a reasonable ballpark figure.

Figuring Your Improvement Ratio

The easy way to determine how much of the value of the property you can depreciate is to figure your property's improvement ratio (also called the "land-to-building ratio" or "land-to-improvement ratio"). This ratio is the amount the improvements (buildings) are worth compared to the value of

the total property, expressed as a percentage. This ratio is a mathematical way to show the relative values of the land and improvements, as the IRS regulation requires.

For example, if you determine that the correct improvement ratio for your property is 80%, you multiply the total cost of the property by this amount to determine your depreciable basis. If your total cost (purchase price + certain depreciable expenses of the sale) is $100,000, the amount you can depreciate is $80,000 ($100,000 × 80% = $80,000). The other $20,000 is the value of the land, which may not be depreciated.

Improvement ratios vary from 85% to 40% or less depending on the location of the property. Obviously, land values vary widely—for example, land in Manhattan or San Francisco is worth much more than the same amount of land in Kansas City or Portland. So, an apartment building in San Francisco might have a 40% improvement ratio, while the same structure in Portland could have an 80% ratio.

It's important to understand that a precise improvement ratio for a property doesn't exist because land value isn't a fact, like the size of a lot; rather, it's based on someone's opinion or calculations based on certain assumptions. Different opinions or assumptions can lead to different ratios. You want your improvement ratio to be as high as possible, but not so high that the IRS will likely conclude it's unreasonable if you're audited.

Don't Use a Standard Improvement Ratio

Many accountants and tax preparers use a standard ratio for every property—for example, 75% or 80%. They don't bother to look at any evidence of the property's value, such as the county tax assessor's valuation or lender's appraisal. Don't use this method—it leaves much to be desired. If the IRS audits you and questions the ratio, you'll have no evidence to back it up.

Property Tax Bill

Most landlords determine their improvement ratios by using their property tax bill. The bill usually provides a valuation of the land and buildings together, and a value for each alone, or for just the buildings alone. The ratio is determined by dividing the assessed improvement value by the total assessed value of the property (assessed improvement value ÷ total assessed value = improvement ratio).

If you don't have a copy of your tax bill handy, you might be able to find the assessor's valuation at its website. The following website provides links to local tax assessor websites in the various states: www. pulawski.net.

Often, the values listed on your property tax bill don't reflect the true market value of your property. This isn't important, however, for purposes of determining your improvement ratio.

Example

Sara buys a rental duplex with a total basis of $200,000 (purchase price + depreciable sale expenses). The property tax bill lists the property's total value at $160,000, and provides that the improvements are worth $110,000 and the land $50,000. According to the county tax assessor, therefore, the property has a 69%improvement ratio ($110,000 ÷ $160,000 = 69%). Using this percentage, her depreciable basis is $138,000 (69% × $200,000 = $138,000). She may use this amount to determine her depreciation each year.

This way of calculating the value of your land and buildings is very easy and simple. It is what most people do, and the IRS will almost never object if you use this method. Using this method has been approved by the tax court. (*Nielsen v. Comm'r.*, T.C. Summ. Op. 2017-31.) But improvement ratios determined from a property tax assessment often don't reflect reality. County tax assessors aren't greatly concerned about arriving at an accurate breakdown of the relative values of your land and improvements because it has no effect on your property tax bill—your tax is based on the total assessed value of your property. Often, county assessors apply a standard percentage to all property in the area—for example, 70%. Or, they might use sales data from previous years that is out of date.

As a general rule, tax assessor improvement ratios are on the low side. You can usually do better using a different means to determine your basis.

You Don't Have to Use the Assessor's Valuation

Many people believe they have to use their county tax assessor's valuations to calculate their basis. But nothing in the tax law or IRS regulations requires you to use a county tax assessor valuation or hire an appraiser to do a valuation. Indeed, in at least one case, the tax court found that the improvement ratio derived from the county assessor's valuation shouldn't be used, declaring that there was no evidence that "the assessor's allocations of value between land and building comport with reality." (*Meiers v. Comm'r.*, T.C. Memo 1982-5.) This case is a good one to point out to any IRS auditor who says you have to use your county tax assessor's valuation.

Replacement Cost

Another way to determine your improvement ratio is to use the replacement cost of your building and other improvements. The replacement cost is the cost to build a brand-new structure that is identical to the structure currently on your land. If the building you're depreciating isn't brand new, you must reduce the replacement cost according to its age and useful life. The reference guides listed below can help you do this.

Example

Steven Meiers purchased two condominiums in 1977. His property tax bill gave an improvement ratio of 55%—that is, the land was worth 45% of the purchase price and the building 55%. Meiers didn't think this was good enough. He investigated the replacement costs for his buildings, and determined that a fair improvement ratio was 80%. This approach, of course, gave him a much higher depreciable basis. The IRS audited Meiers and insisted that he should use the tax assessor's ratio. Meiers appealed to the tax court and won. The court found that Meiers's 80% ratio was reasonable and should be used. How did Meiers calculate his ratio?He used the replacement cost of the buildings. (*Meiers v. Comm'r.*, T.C. Memo 1982-5.)

Several ways to determine replacement cost include:

- Getting an appraisal
- Doing your own calculations
- Getting an expert opinion, or
- Using construction records.

Appraisal

If you borrowed money from a bank or another lender to acquire the property, the lender almost certainly required an appraisal before approving your loan. You should make sure to obtain and keep a copy of the appraisal. It should contain the appraiser's estimate of how much it would cost to replace the structure and how much the land is worth. This estimate might be in the section of the appraisal report called "Cost Approach." The appraiser provides an estimate of how much it would cost to replace the structure with an identical new structure, and then reduces this amount with an allowance for depreciation, depending on the age of the building. The appraiser also gives an estimate of the cost of replacing improvements other than the building—for example, walkways. These costs are added together to come up with the total replacement cost—often called the "indicated value by cost approach." The IRS will probably accept the appraiser's valuation, unless it's clearly unreasonable.

You calculate your improvement ratio by dividing the amount of the appraiser's replacement cost by the appraised value of the entire property (structures and land). In other words, appraiser's replacement cost of building and land improvements ÷ appraised value of entire property = improvement ratio.