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What is Depreciation?

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Depreciation is an annual non-cash expense allowed by the IRS for the wear and tear on property used in business or the production of income.

What factors determine how much depreciation I can deduct?

For real estate the basis for the depreciable improvements is the starting basis less the percentage value assigned to the land. Land can never be depreciated. Example: The starting basis in a rental property is $500,000. If the land value is 20% of the total value, then the basis for the depreciable improvements is 80% or $400,000.

For real estate there are currently two possible depreciation recovery periods. These are 27½ years for residential property and 39 years for commercial property. A property is considered residential if 85% of the gross income for the property is from living units.

Currently for real estate only the straight-line method of depreciation may be used. Example: If our rental property was considered commercial, we would divide the $400,000 value for depreciable improvements by 39 years. This straight-line method would give us an annual depreciation expense of $10,256.

If, during the life of the property, improvements or additions are made to the buildings, then a separate depreciation schedule is created using the same period and method as if the basic structure was being placed in service now.

Do I have to claim depreciation?

If the IRS allows depreciation on your property, then it must be taken. If you do not claim the allowed depreciation, the IRS will consider it taken when figuring the taxable gain or recapture on any sale.

What is a starting basis?

To figure a depreciable basis, we must know the starting basis. If you obtain a property in a straight purchase, then the starting basis is basically the acquisition cost of the property. However, you may have received the property in some other way, such as by inheritance, on the death of a spouse, in a partnership distribution, or in an exchange.

If you received the property in an exchange, the simple way to learn your starting basis is to look at Line 25 (the last line) of the IRS Form 8824, Like-Kind Exchange, that you filed for the year the relinquished property was transferred. Form 8824 has been in use since 1991 (also see IRS Publication 551, Basis of Assets).

How do I determine the starting basis for my new replacement property?

The starting basis for the new replacement property is determined by taking the contract price of the replacement property less the total gain deferred. If there is more than one replacement property, then a share of the total starting basis is allocated to each property based on the contract price for each replacement property. The percentage value of the land is then subtracted from the starting basis to get the value of the depreciable improvements.

If IRS Form 8824 has been completed for the exchange, then the last line, Line 25, reflects the total starting basis for the new replacement property.

What is the "recapture of Section 1250 depreciation"?

Section 1250 property is basically all rental real estate. Over the years the rental property has been depreciated and the taxpayer's ordinary income has been reduced by that amount. Upon the sale of the rental property, the IRS recaptures all the depreciation taken or allowed. The tax on recapture of Section 1250 depreciation is 25%.

In an exchange, if the reinvestment requirements are met, all the Section 1250 depreciation recapture will be deferred. If some of the gain is recognized (becomes taxable income), then the Section 1250 depreciation will be taxed first at 25%.

> **Note**: Prior to 1987 real estate could be depreciated using an accelerated method (called ACRS). If, when the property was sold, the accelerated depreciation exceeded what would have been claimed straight-line, then the excess depreciation was recaptured as ordinary income. For all practicable purposes this "depreciation recapture" no longer exists, except for commercial properties that used ACRS. Therefore, Line 21 on the Form 8824 is almost always zero. However, the old "depreciation recapture" is often confused with the current "Section 1250 depreciation recapture" rules.

What is the recovery period used for personal property in a rental activity?

Since personal property has a shorter life cycle, a shorter recovery period is used. For rental property the recovery period is:

Appliances (such as stoves)	5 years
Carpets	5 years
Furniture	5 years
Fences, roads, shrubbery	15 years

Personal property may be depreciated using the Modified Accelerated Cost Recovery System (MACRS). This permits additional or accelerated depreciation in the early years. See IRS

Publication 946, *How to Depreciate Property*, for tables showing the percentage of depreciation to be claimed each year.

Where is depreciation claimed?

For most rental property depreciation is claimed on **Schedule E** of IRS Form 1040. For farmers it is on Schedule F. For corporations and other entities, it is claimed on the corporate or other tax return.

When does depreciation start?

Depreciation starts when the property is placed in service for its intended use. For rental property, depreciation starts once the property is ready for a renter.

How does depreciation taken or allowed impact the capital gain?

When selling a property the realized capital gain is determined as follows:

Selling Price $500,000

Less: Selling Expenses - 30,000

Equals: Adjusted Selling Price		470,000
Starting Basis (Cost)	$250,000	
Plus: Improvements	+50,000	
Equals: Adjusted Cost Basis	300,000	
Less: All Depreciation taken or allowed	**-75,000**	
Equals: Adjusted Tax Basis		- 225,000
Equals: Recognized Gain (taxable capital gain		$245,000

Warning: Many taxpayers forget that all the depreciation taken or allowed must be subtracted from their adjusted cost basis to get the correct Adjusted Tax Basis.

REMEMBER, TOTAL CAPITAL GAIN IS **PROFIT PLUS DEPRECIATION.**

Is there a rule of thumb to estimate the depreciation taken on a residential rental property?

To estimate the amount of depreciation taken or allowed for a residential rental property, you can: Multiply the total starting basis by 3%, and then multiply the number of years the property was depreciated.

Example:	Total Starting Basis (cost)	$250,000
	Multiply: 3% ($250,000 X .03)	X.03
	Equals:	$ 7,500 per
	year Multiply: Number of Years Depreciated	X 10 years
	Equals: Estimated Depreciation Allowed	$ 75,000

What are the current rules for the depreciation of the replacement property?

In January 2000 IRS Notice 2000-4 provided guidance on how to depreciate like-kind exchange replacement property. IRS has since released temporary and proposed regulations on the topic. In Notice 2000-4 the IRS favorably changed the way new replacement property was to be depreciated. Under the new regulation (T.D. 9115), the general rule remains that the taxpayer must depreciate the remaining relinquished property adjusted basis over the remaining recovery period using the same depreciation method as if it were a continuation of the relinquished property depreciation schedule. Any increase in the basis will be treated as newly acquired property and will be depreciated over 27.5 or 39 years using a new separate straight-line depreciation schedule.