

Maximizing depreciation deductions for business real estate

When buying business real estate—for your own occupancy or for rental to others—you should take steps that maximize the income tax depreciation deductions that you can claim for the property. Here are a few suggestions.

Separating improvements from land. Not all of the cost of acquiring real estate is depreciable. Specifically, the cost of *improvements* to land is depreciable, but the cost of the land itself is not. Clearly, then, it is desirable to identify and document, at the time that you acquire real estate, the part of your overall acquisition cost allocable to improvements. Thus, when you buy a property, you should either retain a qualified real estate appraiser to make an allocation between land and improvements based on a detailed written analysis, or, if you have enough valuation expertise and knowledge of the locality, write your own detailed analysis and allocation. In either case, I will be happy to review the analysis to determine whether it is in accordance with valuation techniques that are respected by the tax law. Also, regarding the allocation, you should be aware that the cost of improvements includes not only the cost of buildings, but also the cost of items such as landscaping and roads, and even some costs of grading and clearing. I can assist an appraiser (or you) in identifying which of these seemingly land-related costs are, actually, costs of improvements, and should, therefore, be reflected in the improvements portion of the allocation.

Turning land into a deductible asset. Even though land isn't depreciable, there are ways to obtain deductions, for your land cost, that provide a similar tax benefit. One technique is to enter into a long-term lease of the land rather than buy it. If you lease the land, the rents you pay under that “ground lease” are deductible. We can decide together, in the case of any specific acquisition, whether a ground lease can be made to work for you, your lender and the prospective landlord. A different technique, but one which also can turn land into a deductible asset, is the acquisition of an interest in land known as an “estate-for-years.” Under an estate-for-years, you would own the land, but not forever, while an individual or entity “unrelated” to you would own the interest in land that begins when your estate-for-years ends. As the owner of the estate-for-years, you would be allowed to “amortize” (deduct ratably) the cost of the estate-for-years over its duration. Thus, for example, if your estate-for-years is for 50 years, you would be allowed to deduct each year 1/50th of the cost of the estate-for-years. I can identify for you which individuals or entities qualify as “unrelated”, and analyze with you the practicality of an estate-for-years as applied to a specific acquisition.

Separating personal property from buildings. Most business buildings must be depreciated over a period of 39 years, with exceptions for residential rental real estate (27.5 years) and for restaurants and certain leasehold improvements (15 years). On the other hand, most personal property (furniture, equipment, etc.) is depreciable over 5 years or 7 years. As you can see, if a specific item is classified as personal property rather than as a part of a building, the depreciation deductions for that item will be available sooner and, in economic terms, have a

greater “present value” to the property owner. Thus, in the same way that it is desirable to properly allocate between improvements and land, it is important to take steps to identify and document, at the time that you acquire real estate, the items that are personal property and the items that are building parts. For some items, the distinction follows “common sense”—an ordinary chair is personal property, a weight-bearing brick wall is part of a building. However, for many items—for example, lighting fixtures, signs, floor coverings, wall coverings, plumbing, electrical systems and heating and cooling systems—the distinctions are governed by tax rules that can be complex, can involve projections as to the future use of the items, and may even necessitate consultation with engineers or other construction experts. Also, after the personal property and building items are separately identified, they must be separately valued, either by an appraisal, a breakdown of construction costs or both.

Please contact us with any questions you have about the above planning techniques. We will be pleased to work with you in implementing them (and any other available strategies) should you undertake a specific business real estate acquisition.