

Let's talk about the D word... Depreciation

For high income earners the benefits of real estate depreciation are substantial. Investors should always view their returns through a "Net of Tax" lens.

I put together the following excel to illustrate the cashflow benefits that result from depreciation. (Happy to share with anyone that comments on the posts and send me their email via DM)

A \$250k real estate investment with 50% debt produces a 1.54% higher IRR on a 10 year hold compared to an investment that does not provide any tax shelter (See IRR comparison Image).

Couple Notes:

If you are a real estate professional for tax purposes you could take the full available depreciation in year one to offset ordinary income.

Instead of selling in year 10 you could 1031 Exchange to defer the recapture.

Depreciation benefits should be thought of as an additional benefit. Investing in a bad real estate deal for depreciation losses makes no sense.

I am not your Tax Attorney or CPA, this is not financial advice.

Assumptions		
Total Equity Investment		\$250,000
Leverage	50%	\$250,000
Total Asset Investment		\$500,000
Starting Annual Return on Equity	5.50%	\$13,750
Annual ROE Growth	3%	
Depreciable Basis (Minus Land)		\$400,000
Year 1 Accelerated Depreciation		(\$50,000)
Annual Depreciation	27.5	(\$12,727)
Investor Tax Rate	45%	
Depreciation Recapture Tax Rate	25%	

Year	Annual Net Income	Available Depreciation With Loss Carryforward	Depreciation Used	K-1 Taxable Income	Tax Deferred Savings	Cashflow Without Depreciation	Tax Sheltered Cashflow	IRR Without Tax Shelter	Tax Sheltered IRR	Depreciation Recapture
1	\$13,750	(\$62,727)	\$13,750	\$0	\$6,188	\$7,563	\$13,750	3.03%	5.50%	\$ -
2	\$14,163	(\$61,705)	\$14,163	\$0	\$6,373	\$7,789	\$14,163	3.12%	5.67%	\$ -
3	\$14,587	(\$60,269)	\$14,587	\$0	\$6,564	\$8,023	\$14,587	3.21%	5.83%	\$ -
4	\$15,025	(\$58,409)	\$15,025	\$0	\$6,761	\$8,264	\$15,025	3.31%	6.01%	\$ -
5	\$15,476	(\$56,111)	\$15,476	\$0	\$6,964	\$8,512	\$15,476	3.40%	6.19%	\$ -
6	\$15,940	(\$53,363)	\$15,940	\$0	\$7,173	\$8,767	\$15,940	3.51%	6.38%	\$ -
7	\$16,418	(\$50,150)	\$16,418	\$0	\$7,388	\$9,030	\$16,418	3.61%	6.57%	\$ -
8	\$16,911	(\$46,459)	\$16,911	\$0	\$7,610	\$9,301	\$16,911	3.72%	6.76%	\$ -
9	\$17,418	(\$42,276)	\$17,418	\$0	\$7,838	\$9,580	\$17,418	3.83%	6.97%	\$ -
10	\$17,941	(\$37,585)	\$17,941	\$0	\$8,073	\$9,867	\$17,941	3.95%	7.18%	\$ (39,407)
Total	\$157,628		\$157,628	\$0	\$70,933	\$86,696	\$157,628			\$ (39,407)

Notes**
Initial investment of \$250,000 and year one annual cashflow of 5%, increasing 3% per annum
Accelerated Depreciation of \$40,000 in year one of the investment per Section 168(k) of the Internal Revenue Code based on estimated results from a cost segregation study
The investor is in the 45% marginal tax bracket (combined Fed and State marginal tax rates)
This example is used for illustrative purposes only and is not guarantee of returns or tax savings
Properties are assumed to be purchased in January to qualify for full year depreciation in year 1.
At disposition in year 10 investors will incur depreciation recapture tax expense.
All investors are advised to speak with their tax professional to understand how their investment will impact their tax situation

Without Depreciation	1/1/2024	12/31/2024	12/31/2025	12/31/2026	12/31/2027	12/31/2028	12/31/2029	12/31/2030	12/31/2031	12/31/2032	12/31/2033
Initial Investment	\$ (250,000.0)										
Net of Tax Annual Cashflow		\$7,563	\$7,789	\$8,023	\$8,264	\$8,512	\$8,767	\$9,030	\$9,301	\$9,580	\$9,867
Return of Investment											\$250,000
Total	\$ (250,000.0)	\$ 7,562.5	\$ 7,789.4	\$ 8,023.1	\$ 8,263.7	\$ 8,511.7	\$ 8,767.0	\$ 9,030.0	\$ 9,300.9	\$ 9,579.9	\$ 259,867.3
Irr	3.44%										

With Depreciation	1/1/2024	12/31/2024	12/31/2025	12/31/2026	12/31/2027	12/31/2028	12/31/2029	12/31/2030	12/31/2031	12/31/2032	12/31/2033
Initial Investment	\$ (250,000.0)										
Net of Tax Annual Cashflow		\$13,750	\$14,163	\$14,587	\$15,025	\$15,476	\$15,940	\$16,418	\$16,911	\$17,418	\$17,941
Depreciation Recapture											\$ (39,407)
Return of Investment											\$250,000
Total	\$ (250,000.0)	\$ 13,750.0	\$ 14,162.5	\$ 14,587.4	\$ 15,025.0	\$ 15,475.7	\$ 15,940.0	\$ 16,418.2	\$ 16,910.8	\$ 17,418.1	\$ 228,533.5
Irr	4.97%										

IRR Spread from Depreciation 1.54%