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Depreciation Without the Headache

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Making Change Simple, Cheaper, AND GREEN

Depreciation Without the Headache

Depreciation is a “non cash” expense that is used to recover the cost of something you have already paid for, that accountants and tax collectors didn’t let you write off when you spent the money.
Don’t ask why; the answer will give you a headache.

When dealing with depreciation and buildings, there are two types of property: tangible real property and tangible personal property. Tangible real property is depreciated over 39 years, or 2.56 percent each year. Tangible personal property uses a 7-year depreciation schedule. This schedule uses different percentages for each year and takes eight years. Don’t think about the logic of that; you’ll get a headache.

39-Year vs. Seven-Year
Under a 39-year depreciation schedule, only 20.5 percent of costs you paid for something are recovered by the eighth year. In contrast to 7-year depreciation, it’s 100 percent.

And it gets better. In the first two years, 38.8 percent of your costs have been recovered. By the third year, it is 56.3 percent. Compare that to the 7.7 percent under a 39-year schedule. That is 733-percent faster. Now you know why they call it accelerated depreciation!

Regarding depreciating tenant improvements, some mistakenly assume they are written off over the lease term. The answer is yes and no. Before you reach for the aspirin, an explanation is needed. Consider a 10-year lease where both the landlord and the tenant have each paid $100,000 ($200,000 total) to have fixed drywall partitions installed. Fixed drywall partitions are considered tangible real property and depreciated using a 39-year schedule, or 2.56 percent each year.

If the tenant moves when the lease expires, then the tenant can deduct the undepreciated balance, or $74,358.97. If the tenant firm stays, it continues to deduct $2,560 a year until moving out or the fixed partitions are demolished. Even if the tenant moves out of the space, the landlord must continue to depreciate the landlord's fixed partitions over 39 years or until those fixed partitions are demolished.

Gimme Shelter

If depreciation is a "non cash" expense, why is it such a big deal? Simple: income taxes. Depreciation reduces a company's profits, and profits are taxed. At a 39-precent income tax rate, every $100 of depreciation can reduce income taxes by $39. The fewer dollars spent on taxes, the more money available to invest in the business or pay employees. In the end, it increases the money collected by the government.

If the tenant or landlord had invested their tax savings at 12 percent a year, in 10 years it grows to $17,549. However, using movable partitions, not fixed partitions, allows them to use a 7-year depreciation schedule. Those tax savings would have grown to $82,483 – a 470-percent increase.

Forget Real; Be Personal

Maximizing the use of tangible personal property in a project has tax benefits from 5 percent to 20 percent of construction costs. The standard for defining tangible personal property is based on Revenue Ruling 75-178. The key issue is the character of how an element is attached to the building, not its "nature and use." Elements like movable wall systems, raised access floors, carpet tile, modular cabling systems, lighting, sound-masking, and even underfloor HVAC can be classified as tangible personal property.

The intent of the taxpayer is crucial in determining what is tangible personal property. Therefore, common phrases like "permanently attached" in construction documents can literally cost a tenant or landlord millions of dollars. It is worth the effort to have your architects, engineers, accountants, and vendors address this issue.

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