RealEstateJournal
THE WALL STREET JOURNAL *Guide to Property*

How New Rulings Affect Depreciation Deductions

02/17/2004

By RAY A. SMITH
Staff Reporter of The Wall Street Journal

From The Wall Street Journal Online

Some recent Internal Revenue Service decisions are affecting the way some real-estate investors seek tax deductions for depreciation.

There are two ways depreciation can be calculated on a tax return. One is full depreciation of the entire property over a span of 39 years for commercial and 27.5 years for residential properties. The other is through cost segregation, which is the itemization of individual building assets that aren't essential to the building's operations. These include carpeting or sidewalks or parking lots. The life spans of those components usually are shorter than for an entire property, so owners can depreciate them faster and benefit quicker.

In the past, some investors simply switched from one type of calculation to another without permission. Now, the IRS has decided that because of too many inconsistencies, the change must be made in a separate tax form. This decision applies to the tax year ended Dec. 31, 2003.

One caveat when it comes to switching calculation methods: Investors will need to have studies done by experts to calculate specific kinds of depreciation and those studies can be costly, says Gary C. Pokrant, a certified public accountant and tax principal with Reznick Fedder & Silverman, CPAs, P.C. in Bethesda, Md. Still, he says, compared with the tax savings, the costs are "modest."

In a separate action, called Revenue Procedure 2004-11, the IRS waived a rule that required investors to wait two years before changing the way they calculate depreciation. In the past, if investors bought a property and depreciated it one way in the first year of ownership and then realized that they would be better off if they calculated it the other way, the investors would have to wait another two years before they could change the calculation. Now, investors can make the change any year.

What's more, if an investor sold a property in the same year in which he or she changed the depreciation, or took less depreciation than allowed or none at all, that investor can now recoup depreciation for previous tax years.

Mr. Pokrant offers this example. Take a building that is purchased in 2002 for $10 million and the owner allocates 10% of the cost to land and depreciates the other 90% as building over a 39-year period. The owner then replaces all the carpeting and wallpaper in the building at a cost of $500,000, depreciated as part of the building over 39 years, deducting $233,795 in depreciation on his or her 2002 tax return.

But after having a cost-segregation study done, the owner determines that the land and improvements such as new carpeting should have been separated out and depreciated over a five-year period. He or she can now do a change in accounting on the 2003 tax return that results in a depreciation deduction

of $1.1 million, instead of $243,580.

"The IRS made it easier for taxpayers to fix depreciation mistakes in the year after the property was purchased," says Julie A. Welch, a certified public accountant and director of the tax department at Meara, King & Co., a Kansas City, Mo., auditing and accounting firm.

Some accountants warn, however, that making accounting changes for past calculations can increase an investor's risk of being audited.