# Depreciate It

**Many small-time landlords miss out on tax savings. Do you know how long the dishwasher will last?**

By Ashlea Ebeling

ROBERT KELLY AND his wife, Sue Ann, retired young—he from pharmaceuticals, she from Cisco—and moved from Mountain View, Calif. to Louisville, Colo. Kelly, now just 40, became a landlord after sinking $225,000 into two rental properties and discovered an arcane subject that bedevils many of the nation's 15 million small-time landlords: accelerated depreciation.

These amateur real estate investors have a comparatively simple alternative. They can claim straight-line depreciation, deducting the initial value of a residential rental building in equal amounts over 27.5 years or an office building over 39 years. (You can't claim depreciation on the land.) On a $100,000 rented house, you'd write off $3,636 a year in depreciation, in addition to deducting your interest, utilities and other operating costs.

Kelly's accountant suggested he do it the easy way. But instead, Kelly found a Web site, Depreciate'em, that convinced him it was worth claiming depreciation the more complicated, accelerated way: You break the property into components and group those that theoretically don't last as long into writeoff periods of 15, 7 or even 5 years. By breaking out items that can be depreciated in 5 years, such as kitchen appliances and blinds, Kelly figures to save $6,000 in taxes over the first 5 years from his rental venture. He says, "Now I'm telling all of my investor buddies: 'If you have an investment property, take it like a sponge and squeeze it.'" Furniture gets written off over 7 years. The 15-year schedule applies to driveways, fencing and shrubs.

Whether you do taxes yourself or use a tax pro, you should at least consider accelerated depreciation, particularly now that software makes tracking and calculations easier. "It's an overlooked tax deduction," says Stephen Fishman, author of *Every Landlord's Tax Deduction Guide* (Nolo, 2006).

Even some relatively sophisticated investors miss out, says James Wittmer, head of Grant Thornton's "cost segregation" practice—a fancy name for professionals who charge $5,000 to take your buildings apart like a jigsaw puzzle, down to the electrical wiring, to maximize depreciation.

Last year Wittmer's unit helped a Texas investor who bought eight apartment buildings in 1989 deduct an extra $168,000 by finding $370,000 worth of missed short-life deductions. (You're allowed to recoup these missed items in one fell swoop, without filing amended returns.)

Be wary, however, of segregators who work on commission—they have a built-in incentive to inflate your deductions, Wittmer says. And the Internal Revenue Service knows it.

Many CPAs believe that accelerated depreciation isn't worth the hassle for small landlords. And the risk of an audit is only part of their leeriness. A big reason is that after interest and other costs, many small landlords don't report a taxable profit anyway. And claiming more depreciation to produce a loss doesn't help them. That's because most high earners can use "passive" real estate losses only to offset passive income (say, from profitable rentals) and not to reduce tax on income from their salary or stock and bond investments.

Still, there are two important exceptions to those passive-loss rules. First, if your modified adjusted gross income is below $100,000, you can use up to $25,000 in passive losses from your properties to offset other income of any type. Up to $150,000 in AGI, you'll be allowed to claim part of the $25,000.

Second, if you or your spouse "materially participate" in the management of the properties and can prove to the IRS that one of you is a real estate professional, you can deduct unlimited losses from real estate against any family income. (That's the sweet spot Kelly found.)

The other problem with accelerated depreciation is that it defers, not eliminates, tax. So the additional writeoff you claim in year 11 is a writeoff you're not claiming in year 26. Moreover, if you sell the building at a profit, all the accelerated depreciation is "recaptured" back into ordinary income and taxed at rates of up to 35%. (The straight-line portion of the depreciation gets recaptured and taxed at 25%; further profits get the 15% long-term rate.) If you flip the property, all the fancy footwork with the components gets you only a modest interest-free loan from the government.

But there's a big exception that can make accelerated depreciation more valuable, not less. If those blinds you depreciated over five years have since been

## REMEMBER THE DEDUCTIONS

Many small landlords miss a lot of deductions that have nothing to do with depreciation, says Scott Brueggeman, founder of Completelandlord.com, which offers online deduction tips. "One of the biggest things and least glamorous part of being a landlord is the record-keeping," he says. But it can pay off.

**Deductions for landlords:**

- ☑ 48.5 cents a mile for trips to your rental property or the hardware store
- ☑ a cell phone used exclusively for your landlord duties
- ☑ lease forms, tenant credit checks
- ☑ interest on credit card purchases of items for your property
- ☑ startup expenses, including insurance premiums (but not title insurance)
- ☑ advertising for vacancies, including the cost of building a Web site

JACOB THOMAS FOR FORBES

replaced, you don't have to recapture any prior depreciation claimed on them.

If you decide to use accelerated depreciation, can you do it yourself? Narinder Sandhu and Pankaj Shukla, who left jobs developing payroll and accounting software for Intuit to build the Depreciate'em Web tool, think so. Their service works like this: You start with your closing statement and check off whether you have such items as a high-end stove, kitchen cabinets, ceiling fans. The program tags each asset with the right life span. You can plug in the actual cost for an item, if you have a receipt (or can get a copy of one from the previous owner), or pick among price ranges the software generates based on national market surveys.

For items where construction costs vary by region—say, a gravel driveway—the Web tool gives you tips on how to look up a realistic cost. Then, it calculates depreciation and spits out a "Depreciation and Amortization" Form 4562 to attach to the Schedule E of your tax return. Depreciate'em is free—for now—but the owners plan to start charging for it, likely by this summer.

One caution: If you're audited, you'll need to show support for your estimates. If you can't get receipts from the previous owner, take pictures to document the high-end appliances or fancy shrubs you're writing off.

Why might you need professional help? Which category something fits into isn't always cut-and-dried. The IRS arms its auditors with a Cost Segregation Audit Techniques Guide. (You can read it at the "Businesses" section of IRS.gov.) As the guide notes, there have been many (and sometimes conflicting) court decisions on the classification of property. Most relate to commercial properties but can also apply to residential rentals. An appendix lists some real examples: The hanging lanterns and chandeliers at a Shoney's restaurant are five-year property, recessed bed lighting at a hospital is a 27.5-year property, and spotlights and flood lamps can be either. "Welcome to the IRS confusing the ---- out of people," says Grant Thornton's Wittmer.

Another source of help: Publisher CCH just put out a how-to book on the subject: *Practical Guide to Cost Segregation*, by Paul G. Di Nardo. **F**



# A Goldbug's Guide

## For the truly fearful, owning the barbarous relic can give peace of mind. Some ways are more bothersome or risky than others.

By Chana R. Schoenberger

SUPERSTOCK

IN THE PANTHEON OF COMMODITIES with nice price runs over the past several years, gold has a special shine. Gold is what investors turn to when they're scared. If you want to make money, buy stocks. If you're afraid of losing all your money, buy gold. Not a lot of gold—even the most bearish portfolio managers recommend putting only 10% of your money into commodities—but enough to give assurance that you won't be destitute if the U.S. economy falls over dead.

That's because gold's price isn't correlated, positively or negatively, with stock market averages. It's more closely tied to how investors think the economy, inflation and the dollar are doing. Since the dollar has been weak recently, gold prices are up. Worries about international instability and oil shortages add to its allure.

The price of a troy ounce, $666 in early May, is considerably up from last year's average $606. That's not as high as the alltime peak of $850 in 1980, when double-digit inflation was rampant and oil was, it seemed, headed to $100 a barrel. But that $850 in today's dollars is $2,275.