TAX & WEALTH STRATEGY

Depreciation in Plain English

Why your taxable income can be different from the cash you receive.

Real estate has an unusual characteristic. An apartment property can generate positive cash flow while also generating depreciation deductions for tax purposes.

That sometimes leads investors to ask:
"How can I receive cash from an investment and still be allocated little taxable income - or even a tax loss?"

Depreciation is one of the main reasons.

In simple terms, depreciation is a tax deduction that allows the cost of certain property used to produce income to be recovered over time. Under current federal rules, residential rental buildings are generally depreciated over 27.5 years under the General Depreciation System. Land itself is generally not depreciable.

But depreciation is a tax-accounting concept. It does not mean the apartment building necessarily declined in market value that year.

THE IMPORTANT IDEA
Tax depreciation and market value are not the same thing. A property can appreciate in market value while the owner is simultaneously claiming depreciation deductions for tax purposes.

01 WHAT IS DEPRECIATION?

A Tax Deduction for the Cost of Long-Lived Property

When an apartment property is purchased, the cost of the building is generally not deducted all at once. Instead, the tax system allows the owner to recover the depreciable basis of the property over prescribed periods.

For a typical apartment building, much of the building and its structural components fall into the residential-rental-property category, which is generally depreciated over 27.5 years under current federal rules.

Think of it as cost recovery. The tax system generally does not treat a long-lived asset in the same way as an ordinary one-year operating expense. Instead, the cost may be recognized over time through depreciation.

WHAT DEPRECIATION DOES - AND DOES NOT DO

- May reduce taxable income: Depreciation can reduce the taxable income reported by the property or partnership.
- Does not require an annual cash payment: That is why depreciation is commonly described as a non-cash deduction.
- Does not measure market value: It reflects tax rules for recovering qualifying property cost, not an annual appraisal.

02 WHY LAND IS NOT DEPRECIATED

Buildings Wear Out. Land Generally Does Not.

When an apartment community is purchased, the acquisition typically includes both land and buildings and other property. Those components are treated differently for depreciation purposes.

Land is generally not depreciated because it is considered to have no determinable useful life in the same way as a building or equipment. It generally does not wear out, become obsolete, or get used up.

Therefore, the portion of the investment basis attributable to land must generally be separated from the depreciable property.

SIMPLE ILLUSTRATION

Purchase price	$10,000,000
Illustrative Land Value	$2,000,000
Illustrative Depreciable Basis	$8,000,000

The $2 million attributed to land would generally not be depreciated. The depreciable portion would generally be recovered according to the applicable depreciation rules.

Why the allocation matters: The amount allocated to land affects the amount available to depreciate. A larger land allocation generally means less depreciable basis; a smaller land allocation generally means more depreciable basis. The appropriate allocation should be supportable and based on the facts of the property and appropriate tax analysis.

THE IMPORTANT IDEA
You generally depreciate the qualifying property - not the dirt underneath it.

03 A SIMPLE DEPRECIATION EXAMPLE

See the Basic Mechanics Before Adding Complexity

Using our simplified example, assume the property has an $8,000,000 depreciable basis. If the entire amount were treated simply as 27.5-year residential rental property, dividing $8,000,000 by 27.5 years produces roughly:

$291,000 per year

of depreciation in a simplified full-year illustration.

Actual tax depreciation will differ because of placed-in-service dates, conventions, asset classifications, improvements, cost segregation, and other tax rules. The purpose of the example is simply to demonstrate the concept.

No $291,000 check was written. The deduction reflects tax cost recovery. That means depreciation can reduce taxable income without reducing cash flow by the same amount.

04 CASH FLOW AND TAXABLE INCOME ARE DIFFERENT

This Is the Concept Passive Investors Should Understand

Suppose an apartment property's rental income exceeds its deductible operating expenses and interest expense. For illustration, assume that before depreciation the partnership has $500,000 of taxable operating income.

Now assume the property generates approximately $291,000 of depreciation.

Taxable operating income before depreciation	$500,000
Less: Depreciation	($291,000)
Simplified Taxable Income	$209,000

The depreciation reduced taxable income even though it did not require a corresponding $291,000 cash payment during that year. That is one reason real estate cash flow and taxable income can be very different.

05 CASH DISTRIBUTIONS CAN BE DIFFERENT AGAIN

Three Numbers That Investors Sometimes Confuse

PROPERTY CASH FLOW
The actual cash generated by the property after operating costs and other cash obligations.

CASH DISTRIBUTED TO INVESTORS
The amount the partnership actually chooses and is permitted to distribute.

TAXABLE INCOME OR LOSS
The investor's allocated tax result determined under tax accounting rules.

These amounts do not have to be equal. An investment could generate cash, retain some cash in reserves, pay loan principal, make capital improvements, claim depreciation, and distribute only part of the available cash to investors.

An investor might receive $7,000 in cash distributions while the Schedule K-1 shows $2,000 of taxable income - or perhaps even a tax loss - depending on the investment's results and the investor's allocated tax items.

THE IMPORTANT PRINCIPLE
Cash received and taxable income measure different things.

06 HOW DEPRECIATION REACHES A PASSIVE INVESTOR

The Property Claims It. The Partnership Allocates It.

In a typical private multifamily investment, the passive investor does not personally depreciate the apartment building. The ownership entity generally owns the property.

The partnership calculates its taxable income, deductions, depreciation, and other tax items. Those items are then allocated among the partners according to the governing documents and applicable tax rules.

The investor typically receives that information on a Schedule K-1.

A K-1 MAY SHOW THE INVESTOR'S SHARE OF

- Income
- Losses
- Deductions
- Credits
- Capital activity
- Other tax information

The amount reported on the K-1 may bear little resemblance to the amount of cash you received during the year. That is one reason passive real estate investors need to understand both investment reporting and tax reporting. They answer different questions.

07 A TAX LOSS DOES NOT NECESSARILY MEAN YOU LOST MONEY

Suppose an apartment investment collects rent successfully, pays its expenses, generates positive cash flow, makes investor distributions - and still reports a tax loss.

Depreciation and other allowable deductions may reduce taxable income below zero even though the investment generated positive cash flow.

Tax loss vs. economic loss: A tax loss is a tax-accounting result. An economic loss means the investor has actually lost value or capital economically. They are not automatically the same.

The reverse can also occur. An investor could potentially have taxable income even when little or no cash is distributed.

REMEMBER
Cash received does not equal taxable income, and a tax loss does not automatically mean an economic loss.

08 CAN YOU USE THE LOSS?

This Is Where Individual Tax Circumstances Matter

Receiving a tax loss on a K-1 does not necessarily mean you can immediately deduct that loss against your salary or other income.

Federal tax rules include limitations that may affect whether and when a taxpayer can use losses. For many passive investors, rental real estate activity is generally treated as passive activity, and passive losses may be limited when they exceed passive income. Disallowed passive losses may generally be carried forward subject to applicable rules.

Other limitations may also matter: tax basis, at-risk rules, passive activity rules, other income and losses, ownership structure, state tax rules, and individual taxpayer circumstances.

09 WHEN DOES DEPRECIATION BEGIN?

When Property Is Placed in Service

For tax purposes, depreciation generally begins when property is placed in service - meaning it is available and ready for its intended income-producing use.

It does not necessarily begin simply because a purchase contract was signed, investor capital was raised, a loan closed, or renovation money was spent.

The placed-in-service rules and timing can affect the amount of depreciation available in the first tax year.

WHY THIS MATTERS
If an investment closes late in the year, the first-year depreciation allocation may differ from what someone casually expects based on a full-year calculation. Newly added or improved property may also have separate placed-in-service dates.

10 WHAT ABOUT RENOVATIONS AND IMPROVEMENTS?

Apartment properties change during ownership. Sponsors may renovate units, replace roofs, upgrade HVAC systems, improve common areas, add amenities, replace equipment, or improve landscaping and site components.

Some expenditures may be current expenses. Others may need to be capitalized and depreciated over time. Different assets can also have different recovery periods.

This leads to cost segregation. A cost segregation study may identify property components that appropriately fall into shorter depreciation categories. That can accelerate some depreciation deductions into earlier years.

We cover that separately in Cost Segregation Basics. For this guide, the key concept is simply:

KEY CONCEPT
Not every component of an apartment property is necessarily depreciated in exactly the same way.

11 DEPRECIATION DOES NOT MAKE TAXES DISAPPEAR

Timing Matters

One of the easiest mistakes is describing depreciation as though it creates "free money." It does not.

Depreciation can provide meaningful tax benefits, but it is part of a larger tax lifecycle. Depreciation generally reduces the property's adjusted tax basis over time. That can affect the tax consequences when the property is eventually sold.

Depending on the circumstances, depreciation recapture and other gain-recognition rules may apply.

Think beyond the current year. An accelerated deduction today may have implications later. That does not mean depreciation is unattractive. It means the benefit should be understood as part of the entire investment and tax picture - not as an isolated first-year deduction.

12 WHY DEPRECIATION CAN BE VALUABLE

Timing Has Economic Value

Suppose an investor can legitimately recognize a tax deduction today rather than many years from now. Receiving the benefit earlier may have value because the investor may retain or deploy money that otherwise might have been paid in taxes sooner.

That is one reason real estate depreciation can be attractive.

THE VALUE DEPENDS ON

- Whether the investor can actually use the deduction
- The investor's tax rates
- Other passive income or losses
- State taxes
- How long the investment is held
- Future tax consequences
- Changes in tax law

That is why we say potential tax benefit rather than guaranteed tax savings. The same real estate investment can create very different tax outcomes for different investors.

13 DEPRECIATION SHOULD NOT DRIVE THE INVESTMENT DECISION

An apartment investment should make sense before tax benefits are considered. The fundamental questions remain:

- Is this a good property?
- Is it in a market we believe in?
- Is the purchase price reasonable?
- Is the financing appropriate?
- Is the business plan realistic?
- Is the sponsor capable?
- Are the risks acceptable?

Depreciation may improve the after-tax economics for a particular investor. It cannot repair poor real estate fundamentals.

ROBERT'S PERSPECTIVE

I like depreciation - but I buy real estate, not tax deductions.

One of the benefits I appreciate about apartment investing is that the tax system recognizes depreciation even though a well-operated property may simultaneously produce cash flow and appreciate over time. That can create attractive tax characteristics.

But I never want the tax story to become the investment story. If someone has to convince me that a mediocre property, aggressive underwriting, inexperienced sponsor, or questionable market is attractive because of the tax benefits, I am starting in the wrong place.

MY RULE

First decide whether you want to own the investment. Then determine how the tax benefits may apply to you. A good tax outcome can make a good investment better. It does not make a bad investment good.

14 QUESTIONS TO ASK ABOUT DEPRECIATION

Questions for the Sponsor

You do not need the sponsor to provide personal tax advice. You should be able to understand what is happening at the investment level.

- How is the property expected to be depreciated?
- What portion of the purchase price is allocated to land?
- Is a cost segregation study planned?
- Who prepares the partnership's tax returns?
- When should investors expect Schedule K-1s?
- Are investors expected to receive state K-1s?
- Has the property undergone significant improvements that affect depreciation?
- How are tax documents communicated to investors?

QUESTIONS FOR YOUR TAX ADVISER

Your personal adviser can help answer the questions the sponsor should not.

- How might depreciation allocated from this investment affect me?
- Will the activity generally be passive for me?
- Can I currently use any passive losses allocated to me?
- If not, what happens to suspended losses?
- Do basis or at-risk limitations affect me?
- Could I have filing obligations in another state?
- How could depreciation affect my tax consequences when the property is sold?
- How does this investment fit with my broader tax picture?

15 FIVE THINGS TO REMEMBER

1. Depreciation Is a Tax Deduction	It allows the cost of qualifying income-producing property to be recovered over time.
2. Land Is Generally Not Depreciable	Land generally does not have the type of determinable useful life required for depreciation.
3. Depreciation Does Not Require An Equivalent Annual Cash Expense	That is why taxable income may be lower than property cash flow.
4. Your K-1 And Your Cash Distributions Can Be Very Different	Tax allocations and cash distributions follow different accounting and economic rules.
5. Your Personal Tax Result Is Individual	Receiving a depreciation-related loss does not guarantee you can use it immediately.

THE MOST IMPORTANT TAKEAWAY

Cash Flow and Taxable Income Are Not the Same Thing

Depreciation is one of the primary reasons.

An apartment property can potentially generate positive operating cash flow while also claiming depreciation deductions. Those deductions may result in lower taxable income - or potentially a tax loss - even while investors receive cash distributions.

- Land generally is not depreciated.
- Depreciation is determined at the property and partnership level.
- Your share of tax items generally reaches you through your K-1.
- Your ability to use those deductions depends on your individual circumstances.
- Depreciation can affect future tax consequences when the property is sold.

THE BOTTOM LINE

Depreciation should be viewed as a potential benefit of a sound real estate investment - not the reason to make the investment.

TAX EDUCATION NOTICE

Federal and state tax laws, depreciation rules, recovery periods, passive-activity rules, and individual circumstances can change. The examples in this guide are intentionally simplified for educational purposes and should not be used to calculate the depreciation or taxable income associated with a specific investment.

EDUCATIONAL PURPOSE

This material is provided for general educational and informational purposes only and does not constitute tax, financial, investment, legal, or accounting advice. Nothing presented is intended to predict or guarantee an investor's tax outcome. Tax treatment depends on the property, investment structure, applicable law, and each investor's individual circumstances. Investors should review the tax information for any specific investment and consult their own qualified CPA, tax adviser, attorney, or other professional before making tax or investment decisions.