Real Estate Entrepreneurs -- Supercharge Your Depreciation Deductions And Save Thou sands In Taxes

By: Albert Aiello, CPA, RE Broker

How much extra did you pay in taxes not using the component method of depreciation because your accountant did not know about this powerful legal strategy? According to the follow quote from one of my students, probably a lot!

"Al, your component depreciation method saved me almost $20,000 dollars in income taxes that year. It helped me financially having four girls in College at the same time."
...Angelo D. Guerra, Broker/Owner, ERA Platinum Realtors, Conshohocken, PA.

SCENARIO 1 - Typical unsophisticated way: On April 1, *Irene Investor* runs to *Pistol Pete* Preparer who owns a "paper mill" that knocks out about 899 tax returns a year from January to April. Irene gives Pete the settlement sheet on a 4-plex that she purchased January, last year for $100,000 (including basis closing costs). Pete (who has to do 898 other returns) has his own "pistol" formula for *quickly* allocating the $100,000 cost for computing depreciation > first, 20% or $20,000 toward non-depreciable land; second, 80% or $80,000 toward the building to be depreciated over 27-1/2 years. For Irene, this equates to about $2,700 a year in deprecation deductions. However, while it may be "fast & easy" for Pistol Pete, it certainly is not a way that is creative and most beneficial to Irene Investor.

SCENARIO 2 - Creative sophisticated way: With the same $100,000 property, let's get rid of Pistol Pete (and the likes of him) and redo the allocation using my *Multi- Component\Land-Residual Method.* By componentizing you can substantially increase depreciation deductions by **first** identifying 5-year personal property and 15-year land improvements. Componentizing the depreciable components first is also a way to arrive at a lower, leftover ("residual") land value. With this method, you do not start with non-depreciable land. Instead, you start with the depreciable components that have the lowest recovery periods and therefore yield the largest depreciation deductions. The last (or residual) allocation will be toward what's left over -- non-depreciable land. Here you allocate the total property cost into its four major components **in this order:** (1) Personal property, (2) Land improvements, (3) Building* and (4) Land (*You also can further segment the building into its structural components.)

Using my system, the depreciation in this example on these components is as follows:

Component	**Allocated Amount**	**Depreciation (first year)**
Personal Property	$15,900	$ 3,180 (20% x 15,900)
Land Improvements	$10,200	510 (5% x 10,200)
Building	70,000 (subtotal 96,100)	2,440 (3.485% x 70,000)
Land (left over)	3,900 ($100,000 less 6,100)	none
Total	$100,000 cost basis	**$6,130***

***The $6,130 first year depreciation deduction is *more* than double Pistol Pete's deduction of $2788! Moreover, in the second year the depreciation deduction would be $8602 or TRIPLE Pistol Pete's deduction of $2909!...And this is only for a $100,000 property!!**

Componentizing is totally backed up tax support since 1973. There seems to be a misconception that the valuation of the different components must be exact for componentizing to qualify. One can determine the cost of the components from professional appraisal books, such as *Marshall & Swift's* or contact an appraiser. However, it is not required that you do either. Independent appraisal may have its place for larger projects. However it may be too expensive for many real estate investors. Moreover, while independent appraisal can be permitted (*Pittsburg Plate Glass Co*.TCM 1965-159), it has been disallowed if it is determined that the appraiser is not qualified. The IRS is no authority either. In a number of cases on valuation the courts have either disregarded the IRS's expert testimony, or refused to let an IRS employee to testify at all, because they had little or no familiarity with local real estate market conditions. You can value each item according to its present condition from your own estimates, the opinion of a building contractor, or from construction costs books used by contractors, architects or appraisers.

Do componentizing! It will generate huge deductions for you and it's perfectly legal!!

The above are excerpts from *The Real Estate Investor's Goldmine of Brilliant Tax Strategies*, A Tax Reduction System And Special Forms Software Package which includes Albert Aiello's own specially designed forms for huge deductions via componentizing. Al will discuss the power of componentizing in his special presentation on April 6, 2005 at East Bay Wealth Builders Club Meeting in San Ramon, California.