

## Multifamily vs. Office: Why Differences in Depreciation Matter

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One of the many benefits Tenant-In-Common investors receive is the depreciation deduction, which may help reduce (or eliminate) taxes paid on income generated by a real estate investment. Depreciation applies to several classes of real estate assets such as buildings (bricks and mortar), fixtures (an HVAC unit, for example), personal property (new carpet, for example), and land improvements (blacktop, for example). Land is not a depreciable asset.

Depreciation is determined by the value allocated to each asset as well as by the period of time over which it is depreciated. The key point to remember is that different classes of real estate are depreciated differently. For example, building depreciation for office and retail property is taken over 39 years while building depreciation for multifamily property (apartments) is taken over 27.5 years. In addition, asset allocation varies with property type. These differences among property classes may affect the amount of the depreciation deduction and therefore after-tax cash flow.

Here's an example. Let's assume Investor A and Investor B each has \$1 million to invest. Investor A chooses a multifamily development and Investor B chooses an office building. This is how the investment breaks down:

INVESTOR A: MULTIFAMILY		INVESTOR B: OFFICE	
Initial investment	\$1,000,000	Initial investment	\$1,000,000
Cash-on-cash (before-tax)	6.5%	Cash-on-cash (before-tax)	6.5 %
Cash yield	\$65,000	Cash yield	\$65,000
Depreciation deduction	\$127,273	Depreciation deduction	\$101,538

Each receives a cash-on-cash yield of 6.5%, or \$65,000, but Investor A has a larger depreciation deduction. Why is that?

The answer lies in the way each property is depreciated. Here's what a typical depreciation calculation looks like for each property type, using a tax basis of \$3 million.

### INVESTOR A: MULTIFAMILY DEPRECIATION DEDUCTION\*

Asset	Allocation	Value	Depreciation Schedule	Depreciation Deduction
Land	10%	\$300,000	0	\$0
Building	80%	\$2,400,000	27.5 years	\$87,273
Accelerated Depreciation Property	10%	\$300,000	5 years/15 years	\$40,000
<b>Total</b>		<b>\$3,000,000</b>		<b>\$127,273</b>

### INVESTOR B: OFFICE DEPRECIATION DEDUCTION\*

Asset	Allocation	Value	Depreciation Schedule	Depreciation Deduction
Land	10%	\$300,000	0	\$0
Building	80%	\$2,400,000	39 years	\$61,538
Accelerated Depreciation Property	10%	\$300,000	5 years/15 years	\$40,000
<b>Total</b>		<b>\$3,000,000</b>		<b>\$101,538</b>

*\*This example is based on a January purchase and shows only the first year of depreciation. Also, this investment example assumes the investor has full basis in the property. Keep in mind that in any given year, an investor can use only as much depreciation as he has passive income. The excess can be carried forward to be used against future passive income or the gain on the sale of the property.*

Investor A gets a \$127,273 deduction and Investor B gets a \$101,538 deduction. That's a \$25,735 gap, and it illustrates how the different depreciation methods for multifamily vs. office may play a role in determining the final deduction. Why is this important? Well, it directly affects the after-tax cash flow of the two investments. The charts below complete the picture:

INVESTOR A: MULTIFAMILY		INVESTOR B: OFFICE	
Initial investment	\$1,000,000	Initial investment	\$1,000,000
Cash-on-cash (before-tax)	6.5%	Cash-on-cash (before-tax)	6.5%
Cash yield	\$65,000	Cash yield	\$65,000
Depreciation deduction	\$127,273	Depreciation deduction	\$101,538
Taxable income	(\$62,273)	Taxable income	(\$36,538)
Tax benefit (at 36% rate)	(\$22,418)	Tax benefit (at 36% rate)	(\$13,154)
<b>AFTER-TAX CASH FLOW</b>	<b>\$87,418</b>	<b>AFTER-TAX CASH FLOW</b>	<b>\$78,154</b>
<b>AFTER-TAX CASH FLOW %</b>	<b>8.7%</b>	<b>AFTER-TAX CASH FLOW %</b>	<b>7.8%</b>

Each investor invested the same amount of money, but the larger multifamily depreciation deduction results in \$9,264 or 11.5% more in after-tax cash flow ( $[(8.7\% \div 7.8\%) - 1]$ ). This model assumes the investor has other passive income that can be sheltered by the tax losses produced from the investment.

This example holds true even if Investor B invested in a retail or industrial property, since these property types are depreciated similarly to an office property. In addition, multifamily has historically provided competitive returns relative to these other asset types. According to data from the National Council of Real Estate Investment Fiduciaries, multifamily investments provided a higher total return (over a 20-year period) with less variance than the average for all property types.

Does this all mean that multifamily TIC investments are better than other property types? No, but it does indicate that multifamily investments may offer tax benefits over other property classes. All TIC investments offer potential benefits along with corresponding risks. Each specific opportunity must be evaluated on its own merits to make sure it meets the priorities of the individual investor.

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