

Excerpt from
***Introduction to Real Estate Finance and Investment:
Sample Problems, Student Edition, by Frank Gallinelli***

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Chapter 34: Depreciation

If you own income-producing real estate, you can write off a portion of the cost basis of your asset each year. That write-off is called depreciation. With regard to real estate, the depreciable asset is the physical structure or structures (i.e., the improvements), but not the land. Keep in mind that when you sell the property your accumulated depreciation deductions will be recaptured.

The cost of the asset is depreciated over the “useful life” of the asset. Under the tax rules at this writing, residential real estate has a useful life of 27.5 years, and non-residential 39 years.

You start depreciating when you place the property in service, but when figuring your actual depreciation allowance, you must also use something called a half-month convention. This means that the month you place the property in service, and also the month you dispose of the property, you may take only one half of the regular monthly amount of depreciation.

$$\text{Depreciation Allowance (annual)} = \text{Depreciable Basis} / \text{Useful Life}$$

Problem 34-1:

Two years ago you purchased an apartment building. At the time you acquired the property, the cost basis of the improvements was \$1,752,300. What was your depreciation allowance for last year?

Problem 34-2:

In the scenario of Problem 34-1, what was your depreciation allowance for the year you purchased the property, if you made the purchase in May?

Problem 34-3:

In the scenario of Problem 34-1, what is your depreciation allowance for this year, if you sell the property in August?

Answer 34-1:

You purchased the property two years ago, and it is fair to assume that you placed it into service when you purchased it. Since you didn't place it into service *last* year, the half-month convention is not applicable; you'll be taking a full year of depreciation.

The property is residential, so the useful life is 27.5 years.

$$\text{Depreciation Allowance (annual)} = \text{Depreciable Basis} / \text{Useful Life}$$

$$\text{Depreciation Allowance (annual)} = 1,752,300 / 27.5$$

$$\text{Depreciation Allowance (annual)} = 63,720$$

Answer 34-2:

You get to take one-half month of depreciation for May, plus 7 months of depreciation for June through December.

As shown earlier, the depreciation allowance for a full year is 63,720. So the depreciation allowance for 7 ½ months is

$$63,720 \times 7.5 / 12 = 39,825$$

Answer 34-3:

You get to take 7 month's depreciation for January through July, plus one-half month of depreciation for August.

As shown earlier, the depreciation allowance for a full year is 63,720. So the depreciation allowance for 7 ½ months is

$$63,720 \times 7.5 / 12 = 39,825$$