Understanding Depreciation

Learn how it **impacts your taxes** as a **property owner**.

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About Depreciation

In accounting, **depreciation** is the **process of spreading the cost of a tangible asset over its estimated useful life**.

The value of the following **gradually decrease over time due to wear and tear**.

- Buildings (commercial & residential rental properties)
- Furniture & Fixtures
- Machinery & Equipment
- Improvements (fences, sidewalks, etc.)
- Vehicles

Depreciation allows you to **systematically account** for this **decline in value throughout the lifespan**.

In terms of taxation, **the IRS recognizes depreciation** and allows businesses to **deduct it as an expense on their tax returns**.

This means **depreciation can significantly reduce your taxable income**, which **translates to lower taxes**.

So, while your **asset might be losing value on paper**, **depreciation** helps make up for that when it's time to **file your taxes**.

How Depreciation Works

Every depreciable asset has a **"useful life"** as determined by the IRS.

This is the **estimated period** during which the asset is **expected** to be **usable for your business** or **income-generating activity**.

Methods of Depreciation

1) Straight-Line Depreciation Method - The simplest and most commonly used. It allocates the cost of an asset **EVENLY** over its useful life. The formula:

$$\textbf{Annual Depreciation} = \frac{\textbf{Cost of Asset - Salvage Value}}{\textbf{Useful Life}}$$

2) Accelerated Depreciation Methods

Accelerated depreciation methods **allocate more depreciation in the EARLY YEARS** of an **asset's life** and **less depreciation in later years**.

x2 **Declining Balance (DDB) DOUBLES** the **straight-line depreciation rate** and is used to recognize that assets often lose value more rapidly in their initial years.

Sum-of-the-Years' Digits (SYD) involves **adding** the digits of an asset's useful life and **allocating** depreciation based on a fraction of those digits, with **more depreciation in the FIRST YEAR** followed by **gradually decreasing amounts**.

The Role of Depreciation in Taxation

Depreciation as a **Non-Cash Tax Deduction**

Depreciable Basis — Let's say you purchase a **commercial property for $1 million**. **A portion of this cost**, excluding the value of the land, **is depreciable**.

Annual Deduction — Using IRS guidelines (typically **27.5 years for residential rental properties** or **39 years for commercial properties**), you determine the annual depreciation deduction.

Taxable Income Reduction — If your **annual depreciation deduction is $25,000** and your business has **$100,000 of income**, **only $75,000 is subject to taxes**

With Depreciation		**Without** Depreciation	
Gross Income:	$200,000	Gross income:	$200,000
Depreciation:	$125,000	------------------------	
Taxable Income:	$75,000	Taxable income:	$200,000
Tax rate:	22% *(checking)*	Tax rate:	32%
Total tax due:	**$16,500**	**Total tax due:**	**$64,000**

Total tax saved with **$125,000** of **depreciation** = **$47,500**