The convenience in depreciation - by Kyle Kadish

April 14, 2023 - Financial Digest

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A handful of convenience stores with gas stations have opened across southern New Hampshire in the past few years, and many more like them have sold across the region. More likely than not, benefits and advantages from 2017's Tax Cut and Jobs Act drove interest in the asset class.

Classified as retail motor fuel outlets, gas stations already had a shorter depreciation schedule versus other investment properties. While residential properties have a 27.5-year schedule and other commercial properties use a 39-year schedule, retail motor fuel outlets allow for a 15-year depreciation schedule. Sophisticated investors will often conduct a cost segregation study to utilize faster schedules for improvements. Further promoting interest, the law from 2017 allowed for bonus depreciation on the retail motor fuels outlet, allowing owners to depreciate 100% of the property during the year it is placed in service.

The property must pass any of the following three tests to qualify as a retail motor fuel outlet:

• 50% or more of its gross revenues come from petroleum sales; or

• 50% or more of its floor space is devoted to petroleum marketing sales; or – the C-store building is 1,400 s/f or less (regardless of whether it meets the criteria above).

Property placed in service before 2023 benefited from 100% depreciation. Bonus depreciation begins a gradual stepdown this year (80%), with a lesser advantage in future years as the policy sunsets. Despite the lower benefit for new property in 2023, the numbers could still be desirable for many investors. Even with conservative debt financing, the right property might create a loss as high as 250% of the equity investment. In other words, a $100,000 investment could provide up to $250,000 in depreciation this year.

Depreciation provides the investor with an immediate benefit by offsetting income. Generally, the investor must consider depreciation recapture when disposing of the property. Thoughtful planning with tax-efficient strategies (§1031 exchange or §721 UPREIT) could easily make recapture moot. Investors can extend the short-term benefits with additional tax deferral and mitigation strategies.

Who might benefit best from this strategy?

The tax code does not discriminate, but bonus depreciation affects each taxpayer differently. A passive real estate investor, an active investor, or even a real estate professional could utilize bonus depreciation through varying applications and benefits. The taxpayer’s classification and involvement will determine deduction limits. In addition, any depreciation not used in the first year can be carried forward and applied in future years.

Generally, investors unable to complete a 1031 exchange will have passive income reported as capital gains or recapture, which depreciation expenses can often offset. For most investors, income or loss from rental real estate is a passive activity; depreciation reduces reportable income otherwise taxed at the ordinary rate (review Form 8582 from your recent tax filing). Real estate professionals can invest as active participants in a C-store or aggregate all real estate activity to claim active status. Carefully consider your situation with competent tax representation.

New construction is one way to participate in this strategy; if beginning now, the permitting process alone might push the grand opening into another calendar year - significantly depressing the economics of the transaction. Purchasing an existing C-store will provide all of the same benefits. Are current owners incentivized to offload a property from a pending debt maturity? Is an owner/operator exploring ways to unlock capital with a sale leaseback? The market exists to unlock benefits within the tax code.

Investors seeking a turnkey solution can take advantage of this strategy as well. Securitized investment opportunities exist for passive investors with limited (or no) experience in retail motor fuel outlets. Professionally managed portfolios provide a convenient and diversified entry point for accredited investors.

Advantage Wealth Solutions believes investors can only maximize investment returns when tax liabilities are minimized. Depreciation can play an incredible role in boosting net cash flow. Our existing (and expanding) roster of real estate clients consistently seeks multiple tax mitigation strategies.

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