Depreciating Residential Rental and Commercial Real Property: Avoid Surprises

If you own a motel with a depreciable basis of $1 million, you get to deduct $25,640 each year for depreciation (except the first and last years).

But if you own an apartment building that also has a $1 million basis, your depreciation deduction is $36,360 a year (except the first and last years).

Why the $10,720 larger deduction with the apartment building?

Answer: recovery periods.

Recovery Periods for Real Property

The tax code assigns a certain amount of time—called the recovery period—over which you depreciate all business assets that last more than one year.

The longer the recovery period, the less you deduct each year. As you might expect, real property, such as a building, has a longer recovery period than personal property, such as a car.

But this is tax law, so the recovery period is not the same for all types of real property.

- The recovery period for residential rental real property is 27.5 years.
- The recovery period for non-residential real property— that is, commercial rental and business property—is 39 years. The 39-year period applies to commercial rental property, such as an office building, hotel, or strip mall, as well as to real property you own and use in your business, such as an office or warehouse.

How Much You Depreciate Each Year

To depreciate any real property, you must use the straight-line method, which is the slowest depreciation method. You deduct an equal amount of the property's basis (usually its cost, not counting the land) each year, except for the first and last years.

- If your property qualifies as residential property, you deduct 1/27.5 (3.636 percent) of its depreciable basis each year.
- If your property is classified as commercial property, you deduct 1/39 (2.564 percent) of its basis each year.

You do not get a full year's worth of depreciation for the first year you place depreciable real property in service. No matter what day of the month you place your depreciable real property in service, you treat it as being placed in service at the midpoint of that month, so you get half of a month of depreciation in that month.

The tax code calls this the mid-month convention. You then get that remaining half-month depreciation in the earlier of

- the year you sell the property or
- the year after the last year of the recovery period.

Speed Matters

If you keep the property for 40 years, the total depreciation deductions are the same for both types of properties. But you get your deductions 42 percent faster with property classified as residential rental property (39 ÷ 27.5). Given the time value of money, this is a valuable benefit of owning residential rental property.

What Is Residential Rental Property?

Not all property you might think of as residential qualifies as such for depreciation purposes.

For depreciation, residential rental property is a building or other structure for which 80 percent or more of the gross rental income for the tax year is from dwelling units. How much space the dwelling units take up in the building is irrelevant; all that counts is how much money you earn from them. If you live in any part of the building, the gross rental income includes the fair rental value of the part you occupy.

Example. Bill owns a two-story building with a $500,000 depreciable basis that consists of a storefront on the first floor and four apartments on the second floor. He receives $2,000 rent per month from the store and $8,000 per month from the four apartments.

Bill uses the speedier 27.5-year residential depreciation period for the entire building because 80 percent of his total rental income from the property comes from the apartments ($8,000 is 80 percent of $10,000). He claims an$18,180 annual depreciation deduction ($500,000 x 3.636 percent).

What if Things Change?

If a building changes from a residential rental property to a non-residential real property due to the 80 percent rule, you switch to the non-residential rate of depreciation on the first day of that year.

Example. Bill raises the rent on the store to $3,000 per month, while leaving the rents on the apartments the same. Now, less than 80 percent of his total rental income comes from the apartments ($8,000 of $11,000 is only 73percent). Thus, for the full year, he must use the 39-year depreciation period for non-residential rental property, which results in a $12,820 depreciation deduction for the year.

Likewise, if non-residential real property becomes residential real property, you switch on the first day of that year and depreciate over the 27.5-year recovery period for residential rental property instead of the 39-year period.

Key point. When switching, you apply the new rate to the existing basis. For example, if the original basis is $1 million, that's the basis to which you apply the appropriate rate after the switch.

What Is a Dwelling Unit?

The definition of a dwelling unit for purposes of depreciation is more expansive than what you find with vacation homes. For example, the vacation home rules state that a dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities.

Kitchen

For 27.5-year residential rental property depreciation, you don't need the kitchen.

The Tax Code

When defining the dwelling unit for residential rental property depreciation, the tax code states that the term "dwelling unit" means

- a house or apartment used to provide living accommodations in a building or structure,
- but does not include a unit in a hotel, motel, or other establishment in which more than one-half of the units are used on a transient basis, and
- if any portion of the building or structure is occupied by the taxpayer, the gross rental income from such building or structure shall include the rental value of the portion so occupied.

No Kitchens Here

Because nursing homes, retirement homes, prisons, and dormitories provide "living accommodations in a building or structure," they are dwelling units for purposes of a residential construction contract only if no more than one-half of the units are used for less than 30 days by the same tenant. For example, a prison is not a dwelling unit if it is a holding cell in a courthouse or a police station, because the average stay by a tenant is less than 30 days.

In IRS Chief Counsel Advice Memoranda 201049026, the IRS concluded that the four bedrooms used in an adult care business should be depreciated using the residential rental property period of 27.5 years. In this advice, the IRS noted that tax law defines dwelling unit differently for depreciation than for the disallowances under the vacation home rules—thus, there's no need for the kitchen in the adult-care bedroom property.

In earlier advice, the IRS stated that it intended that a "dwelling unit" was to include nursing homes, old-age homes, and college dormitories. So you can see that the kitchen is not critical to qualifying for the residential 27.5-year depreciation.

What Is Transient Use?

Before 1993, the IRS stated this on transient use: “A dwelling unit was used on a transient basis if, for more than one-half of the days in which the unit was occupied on a rental basis during the taxpayer’s taxable year, it was occupied by a tenant, sub-tenant, or series of tenants or sub-tenants each of whom occupied the unit for less than30 days.”

Although the IRS withdrew this regulation, the 30-day average occupancy definition has stood the test of time, still exists in the investment credit regulations, and is considered informative by the IRS.

Example. Sarah owns a rental unit in Washington, D.C. During the year, she had 17 renters. The average stay per renter is 21.5 days (one unit x 365 ÷ 17). Sarah has to treat the building as a commercial building that she will depreciate using the 39-year schedule.

39 Years

If you own hotels, motels, or similar establishments with primarily transient users, you must depreciate the building over the 39-year recovery period for non-residential (commercial) real property.

The 30-day transient rule applies not only to hotels, motels, prisons, and nursing homes, but to short-term Airbnb-type rentals as well. Many Airbnb rental hosts who rent to short-term guests need to classify their property as commercial property for depreciation purposes. It’s likely that few hosts are aware of this.

Example. Max rents his Chicago condominium through Airbnb to 40 different guests for a total of 180 days during the year. None of the guests stays over 14 days. He used the condominium himself for only 60 days during the year. Since more than 50 percent of the total days of use is transient (less than 30 days average use), the condominium is rented on a transient basis and should be classified as a commercial rental property for depreciation purposes.

This means Max would depreciate the condo over 39 years instead of 27.5 years. The unit has a $200,000 depreciable basis; so, he can claim only $5,128 in depreciation. Had the 27.5-year depreciation period for residential property applied, he could have claimed $7,272 in depreciation for the year.

If you’ve been using the wrong depreciation period for your residential or commercial rental property, you should correct the error by filing an amended return, or if the error is more than two years old, use IRS Form 3115.

Takeaways

If you keep the property for 40 years, the total depreciation deductions are the same for both residential and non-residential real property. But you get your deductions 42 percent faster with property classified as residential rental property (39 ÷ 27.5). Given the time value of money, this is a valuable benefit of owning residential rental property.

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