

F Street Investors: Real Estate Tax Strategy

Depreciation, §1031 exchanges, and high-impact structuring opportunities.

Tax alpha is timing arbitrage, basis discipline, and navigating statutory landmines.



IRC §168 MACRS FRAMEWORK

Cost segregation replaces 39-year drag with engineered acceleration

§1250 real property: Residential 27.5-year and nonresidential 39-year straight-line depreciation; no acceleration.

15-year land improvements: Paving, sidewalks, curbing, drainage, outdoor lighting and site fencing: 150% declining balance; historically bonus eligible.

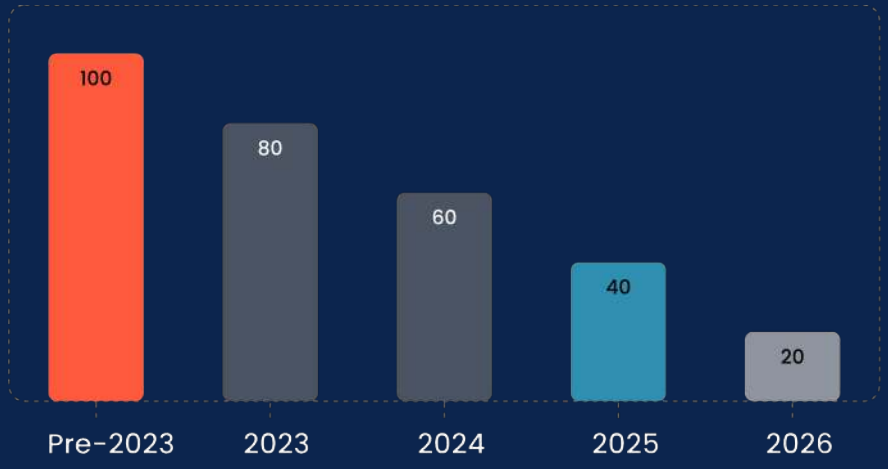
§1245 personal property · 5- and 7-year: Dedicated electrical feeds, specialty plumbing, millwork, appliances and decorative fixtures use 200% declining balance, the engine of Year 1 deductions.

Lookback Opportunity: No amended returns needed. Form 3115 under §481(a) recovers all cumulative missed depreciation in the current year.

STATUTORY EXPIRATION VS. AUDIT RISK

Bonus depreciation is only as strong as the land allocation behind it

§168(k) historical bonus depreciation phase-down (%)



Percentage depends on OBBBA / extenders, placed-in-service dates, and binding written contracts.

§168(k) Property Scope

MACRS property with recovery periods ≤20 years qualifies, including 5, 7, and 15-year components.

The Land Valuation Trap

Land is non-depreciable. Assessor ratios like 10% land in high-value urban or coastal markets invite audit adjustment.

Defensible Appraisals

Independent engineering-based cost segregation appraisals should set defensible land-to-improvement splits before bonus.

CAPITAL STACK ARBITRAGE

Leverage turns a 20% asset-level deduction into a 57% equity write-off

Both: $10M purchase

Shared basis	Both deals
Total purchase price	$10,000,000
Land allocation (20%)	$2,000,000
Depreciable basis	$8,000,000
Cost seg reclassification (25%)	$2,000,000
Year 1 deduction (100% bonus)	$2,000,000

Unlevered vs. 65% LTV

Metric	Unlevered	Levered
LP equity invested	$10,000,000	$3,500,000
Asset-level first-year yield	20.0%	20.0%
Equity-level first-year write-off	20.0%	**57.1%**

§731 warning: §752 nonrecourse debt increases basis and enables loss pass-through; distributions above outside basis trigger taxable capital gain, regardless of property-level operations.

EXIT CHARACTER MISMATCH

Depreciation recapture is a tax loan, not a free gift

IRC §1245 ORDINARY RECAPTURE

Up to 37%

5- and 7-year personal property and accelerated land improvements: bonus and accelerated depreciation is ordinary income on disposition, up to total gain—not preferential capital gains.

IRC §1250 UNRECAPTURED GAIN

25% Max

27.5- and 39-year straight-line real property: recapture capped at 25%. Gain beyond unrecaptured §1250 is taxed at 20% long-term capital gains plus 3.8% NIIT.

The Core Thesis: Accelerated depreciation is an interest-free Treasury loan. At an 8% hurdle over a 5-to-7-year hold, compounding time value dramatically exceeds the deferred recapture liability.

STATUTORY ORDERING RULES

A K-1 loss must clear three statutory gates before reaching Form 1040

Losses must clear each gate in statutory order.

01

Gate 1: Outside Basis

IRC §704(D)

Basis includes cash equity, allocated net profits and partnership debt under §752. Excess losses are suspended at the partnership level indefinitely.

02

Gate 2: At-Risk Rules

IRC §465

Nonrecourse debt is disallowed unless it is Qualified Nonrecourse Financing (QNF) under §465(b)(6): real estate secured, from an institutional lender.

03

Gate 3: Passive Activity

IRC §469

Rental real estate is per se passive (§469(c)(2)). Losses offset only passive income and bank indefinitely on Form 8582 for future passive gains or final disposition.

TAX MYTH VS. CODE REALITY

Syndication paper losses will not shelter W-2 salary

THE PROMOTER MYTH

~~'Invest $100K, receive an $80K bonus depreciation loss, and wipe out taxes on your executive or medical salary.'~~

A widespread retail syndication pitch that ignores the strict statutory wall erected by the Tax Reform Act of 1986 under IRC §469.

THE STATUTORY REALITY

§469 Basket Segregation

Passive losses cannot offset active business income, W-2 wages, or portfolio income. They shield rental distributions and gains from other passive investments.

The §469(g) Release Valve

Suspended losses release against ordinary income only upon a fully taxable disposition of the entire interest to an unrelated party.

IRC §469(C)(7) EXECUTION BARRIERS

REPS has technical traps, especially for limited partners

Statutory Gateways (§469(c)(7)(B))

750 hours: Annually in real property trades or businesses.

50% of working time: Real estate must exceed 50% of all personal service hours.

Spouse solo test: One spouse must meet both tests alone; hours cannot be pooled.

W-2 employees: Real estate hours count only for ≥5% owners (§469(c)(7)(D)(ii)).

The LP Trap (Reg. §1.469-9(f))

No automatic exemption: REPS alone does not make LP losses non-passive.

Material participation: An aggregated portfolio with LP units is limited to Tests 1 (500 hours), 5, or 6.

Exception: The LP restriction is waived if LP gross rents are <10% of total portfolio gross rents.

CONSEQUENCES OF ACTIVE CONVERSION

When active status backfires: §461(l) and character locks

Achieving non-passive treatment can trigger severe statutory caps and permanent tax asymmetry.

EXCESS BUSINESS LOSS CAP

§461(l) Loss Ceiling

Aggregate net business deductions capped at inflation-adjusted thresholds (~$626,000 joint / $313,000 single). Disallowed active losses convert into an NOL carryforward.

NOL LIMITATION

80% §172(a)(2) Restraint

NOLs carried forward into subsequent tax years can offset a maximum of 80% of future taxable income, preventing total tax shelter even during years of major gains.

IRREVOCABLE ELECTION

§1.469-9(g) Character Lock

Aggregating all rentals into one activity locks future disposition gains into non-passive character. Other passive losses can never shelter those gains, and revocation requires material changes.



IRC §1031(A)(2)(D) EXCLUSION

You cannot 1031 out of an LP interest without structured co-ownership

Entity bar: Partnership and multi-member LLC interests are excluded; the partnership may exchange, but an LP cannot at sale.

TIC (Rev. Proc. 2002-22): Direct undivided deed interests permit individual exchanges; leases, sales and debt require unanimous consent.

DST (Rev. Rul. 2004-86): Securitized fractional interests qualify for §1031; “Seven Deadly Sins” bar new financing, refinancing and redevelopment.

Drop-and-swap risk: Liquidating an LLC into a TIC on the eve of sale often fails scrutiny (*Chase v. Commissioner*) under economic substance and holding-intent doctrines.

UNANTICIPATED RECAPTURE UPON EXCHANGE

The §1245(b)(4) landmine: a fully deferred exchange can trigger ordinary income

THE FLAWED ASSUMPTION

'If I roll all equity and take equal or greater debt, 100% of tax is deferred.'

§1031 boot analysis can miss component-level character.

A 300-unit apartment with $2M in 5-year fixtures exchanged for an NNN warehouse with minimal §1245 property can incur ordinary tax on the $2M shortfall.

STATUTORY RECAPTURE MECHANICS

Cost segregation shifts basis to §1245 personal property. Under §1245(b)(4), acquiring less §1245 property by fair market value can trigger immediate ordinary recapture on the shortfall.

An apartment with $1.5M of cost-segregated 5-year fixtures exchanged for raw land or a single-tenant NNN facility triggers ordinary income on the differential.

SYNTHETIC EXCHANGE ALTERNATIVE

The 'Lazy 1031' accelerates basis instead of deferring gain

The Execution Protocol

Asset Liquidation: Sell Property A, realizing capital gain and unrecaptured §1250 depreciation on Form 4797 and Schedule D.

Reinvestment: Deploy proceeds into Property B or syndicated LP deals executing aggressive cost seg and bonus depreciation.

Form 8582 Netting: Year 1 passive paper losses net dollar-for-dollar against Property A's passive capital and §1250 gains.

Hard Constraints & Structural Friction

Same-Tax-Year Rule: Relinquished gain and replacement bonus must occur in the identical tax calendar year; no carrybacks allowed.

§706(d) Varying Interest: LP capital deployed late in Q4 suffers daily proration of operating depreciation under partnership rules.

Basis Burn: Consumes fresh asset basis immediately, creating an even larger ordinary recapture exposure on the subsequent exit.

TREAS. REG. §1.168(I)-8 PROTOCOL

Partial asset dispositions stop phantom depreciation

Standard accounting practice continues to depreciate discarded components while capitalizing replacements. PAD fixes this drag.

01

Identify Retirement

STRUCTURAL REPLACEMENTS

Document demolition of structural building components: roofs, central HVAC units, elevators, window assemblies, and repaved parking lots.

02

Compute & Expense Basis

REG. §1.168(I)-8 ELECTION

Use cost seg records or Producer Price Index (PPI) discounting to calculate unamortized basis. Deduct it through the PAD election in the retirement year.

03

Capitalize & Depreciate

DUAL TAX BENEFIT

Layer bonus depreciation or §179 expensing onto the replacement asset, securing double tax relief in the renovation year.

TREAS. REG. §1.469-1T(E)(3)(II)(A)

The short-term rental exception unlocks non-passive deductions without REPS

The Statutory Gateway

Under Treasury Regulation §1.469-1T(e)(3)(ii)(A), an activity with average customer use of **7 days or less** is not a rental activity and bypasses per se passive classification under §469(c)(2).

No REPS prerequisite: W-2 professionals can qualify without 750 real estate hours. Cost segregation and bonus losses can be non-passive and offset W-2 income.

Material Participation

Meet one of seven tests under Reg. §1.469-5T. Commonly, Test 3 requires **more than 100 hours** and more hours than any other individual, including managers, cleaners, or contractors.

Audit exposure: Substantiate participation; management hours exceeding the owner's defeat Test 3. Non-passive losses remain subject to §461(l) caps.



TAX-EXEMPT & ESTATE STRUCTURING

Retirement accounts and estates carry their own traps

Solo 401(k) · §514(c)(9)

§401(a) trusts qualify for the exception: syndication leverage does not trigger UDFI and passes through 100% tax-free.

IRA · UDFI landmine

No §514(c)(9) relief: leverage creates UDFI taxed at trust rates up to 37%. Under §514(a)(3), only straight-line depreciation applies; bonus cannot offset UBTI.

Step-up · §1014

Basis resets to fair market value at death; a §754 election steps up partnership inside basis.

Forfeiture · §469(g)(2)

Suspended losses deduct on the final return only to the extent they exceed the basis step-up. The rest is forfeited.

Master decision framework: match the profile to the pathway

High W-2 / portfolio earner
Bank passive losses against syndications; STR carveout for active deductions. Lazy 1031 into syndications (same year). Trap: Expecting LP losses to offset W-2 salary.

Full-time real estate pro (REP)
Bonus ✦ cost seg on whole portfolio; aggregate under §1.469-9(g). Traditional §1031 via TIC/DST. Trap: §461(l) caps; §1245(b)(4) recapture mismatch.

Self-directed retirement account
Straight-line depreciation to absorb UDFI; avoid wasting bonus. Direct internal exchange; rollover into §401(a) trust. Trap: IRA leverage generating UDFI; §168(h)(6) tax-exempt allocation rules.

Generational wealth / legacy
Partial asset dispositions on capex cycles; retain cost seg records. Swap till you drop via §1031; §754 election at death. Trap: §469(g)(2) loss forfeiture against stepped-up basis.

Closing mandate: Tax efficiency depends on structural alignment before closing, not retroactive return preparation. Coordinate tax counsel, engineering, and qualified intermediaries well before transaction dates.