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WHITE PAPER

TAX EFFICIENCY IN REAL ESTATE
THE STRATEGIC ADVANTAGE OF Depreciation and Cost Segregation

For high-net-worth investors, tax efficiency can be a strategic advantage.



An effective tax strategy is one of the most overlooked yet powerful drivers of long-term wealth creation. While investors often focus on pre-tax returns, the reality is that after-tax performance determines how much wealth is ultimately preserved and passed on. For high-net-worth individuals and institutional investors, understanding the tax implications of investing in real estate could be a strategic advantage.

Traditional investments such as stocks, bonds, and private equity offer limited opportunities for tax mitigation. Dividends, interest income, and capital gains are generally taxed at rates that erode overall returns. In contrast, direct real estate ownership provides a unique set of tax benefits that can significantly enhance after-tax performance. These include depreciation deductions including cost segregation strategies, capital gains deferral through 1031 exchanges, and even estate planning advantages that other asset classes simply cannot match.

Depreciation is a tax deduction that allows real estate investors to recover the cost of income-producing property over its useful life and, as a tax concept, dates to the early 20th century, when the U.S. tax code first allowed businesses to deduct a "reasonable allowance" for the exhaustion, wear and tear of property used in trade or business. This principle was codified in Section 167 of the Internal Revenue Code, which remains the foundation for depreciation rules today. Initially, the straight-line method was standard, spreading deductions evenly over an asset's useful life.[1]

In 1954, Congress introduced accelerated depreciation methods—such as declining balance and sum-of-the-years-digits—to stimulate investment during economic downturns. These methods allowed businesses to claim larger deductions in the early years of an asset's life, providing immediate tax savings and encouraging capital investment.[2]

The most significant shift came with the Economic Recovery Tax Act of 1981 (ERTA), signed by President Ronald Reagan. ERTA introduced the Accelerated Cost Recovery System (ACRS), which radically shortened asset recovery periods and simplified depreciation classes. For real estate, this meant shorter write-off periods and more favorable tax treatment.[3]

[1] https://www.law.cornell.edu/uscode/text/26/167
[2] https://www.ebsco.com/research-starters/history/us-tax-laws-allow-accelerated-depreciation
[3] https://bclawreview.bc.edu/articles/1675/files/63c9434bec2b4.pdf

Although some provisions were later scaled back by the Tax Equity and Fiscal Responsibility Act of 1982, the accelerated depreciation framework remained influential and evolved into today's Modified Accelerated Cost Recovery System (MACRS).[4]

The IRS recognizes that buildings wear out or become obsolete over time, so it permits owners to deduct a portion of the property's costs each year as an expense—even though no cash is spent. This deduction applies only to the building and qualifying improvements costs, not the land, which is considered to have an indefinite life.

Under the Modified Accelerated Cost Recovery System (MACRS), residential rental property is depreciated over 27.5 years, while commercial property uses a 39-year schedule. The method is typically straight-line, meaning the same amount is deducted annually. Depreciation begins when the property is placed in service and continues until the cost basis is fully recovered or the property is retired from service.[5]

Delaware Statutory Trust (DST) investors are treated as owning a direct fractional interest in the underlying real estate. This means they receive their proportionate share of depreciation deductions to use in their tax return filings each year.

For instance, assume a DST owns a multifamily property valued at $52,000,000, with 80% allocated to the building and 20% to land.

The depreciable basis is:
$52,000,000 x 80% = $41,600,000

Annual depreciation, on a straight-line basis, for the entire property:
$41,600,000 ÷27.5 = $1,512,727

If an investor contributes $500,000, their ownership share is:
$500,000 ÷ $52,000,000 = 0.96%

Their annual depreciation deduction:
$1,512,727 x 0.0096 = $14,522

[4] https://www.britannica.com/topic/Economic-Recovery-Tax-Act
[5] https://www.investopedia.com/articles/investing/060815/how-rental-property-depreciation-works.asp





This means the investor can deduct $14,522 per year from taxable income, even while receiving positive cash flow distributions. Depreciation often creates a paper loss that shelters income. For example, if the DST distributes $20,000 in cash flow and the investor claims $14,522 in depreciation, their taxable income drops to $5,478. In some cases, depreciation exceeds cash flow, resulting in a passive loss that can offset other passive income or carry forward to future years. This is one of the most powerful tax benefits of DST investments.[6]

Additionally, cost segregation may enhance the tax benefits for a DST investor by accelerating depreciation deductions beyond the standard 27.5-year schedule for residential property. Cost segregation is an engineering-based tax strategy that identifies and reclassifies components of a building—such as structural components, like roof, walls, and foundation, flooring, lighting, cabinetry and HVAC systems—into shorter-lived asset categories. Instead of depreciating everything over 27.5 years (residential) or 39 years (commercial), these components can be depreciated over five, seven, or 15 years, depending on their cost segregation category, allowing for much larger deductions in the early years of ownership.[7]

Although DST investors own fractional interests, they still benefit proportionally from any cost segregation study performed on the underlying property. The DST sponsor typically commissions the study, and the resulting accelerated depreciation flows through to each investor for tax reporting purposes.

Using our initial example, a $52 million multifamily DST might allocate $10 million of its building cost to shorter lived assets. Instead of spreading that $10 million over 27.5 years, cost segregation allows some of it to be depreciated in 5–15 years, front-loading deductions.

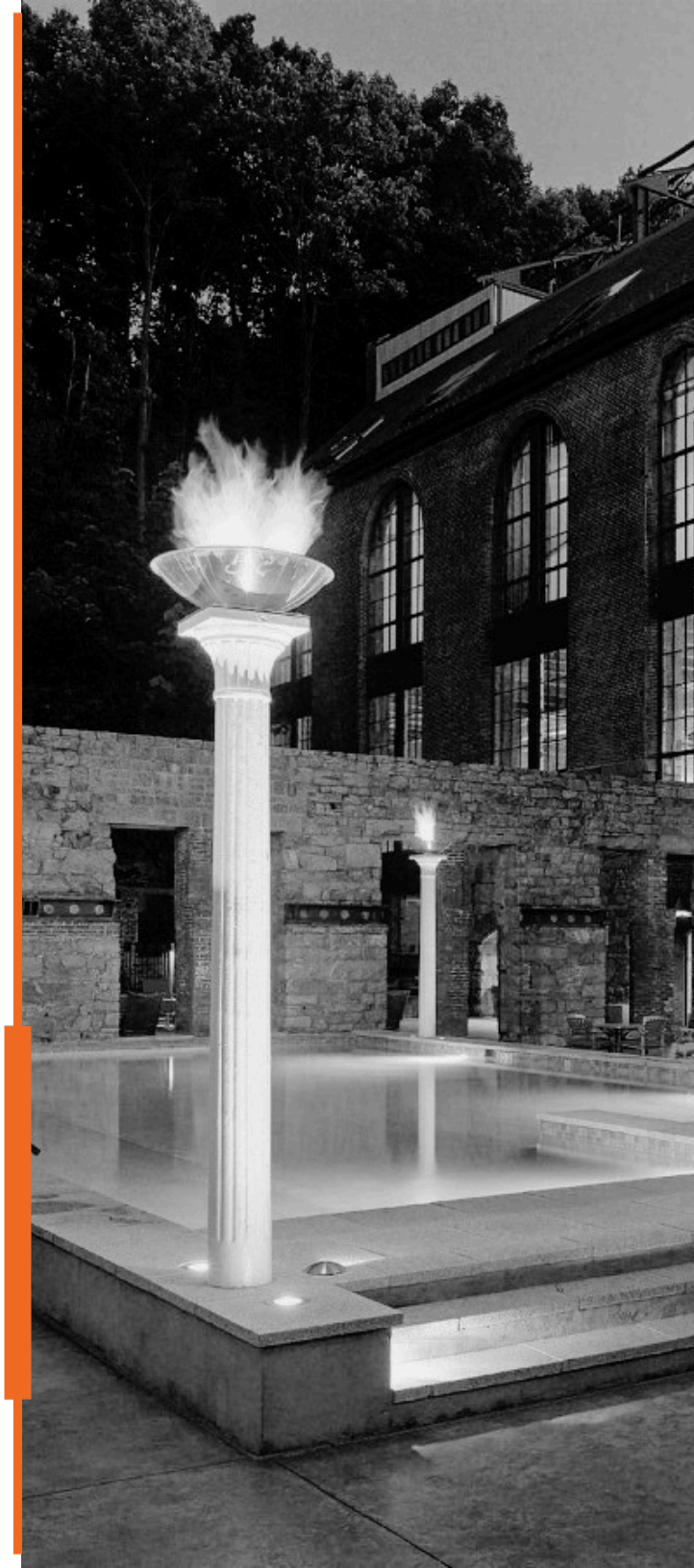
Additionally, 2025 tax legislation, officially known as the One Big Beautiful Bill Act (OBBBA) reinstated and expanded bonus depreciation provisions that had been phasing out under the original Tax Cuts and Jobs Act (TCJA). The OBBBA restored full 100% expensing, or bonus depreciation, for qualified property including equipment and other short-lived assets.[8] Depreciation has long been one of the most powerful tax advantages in real estate

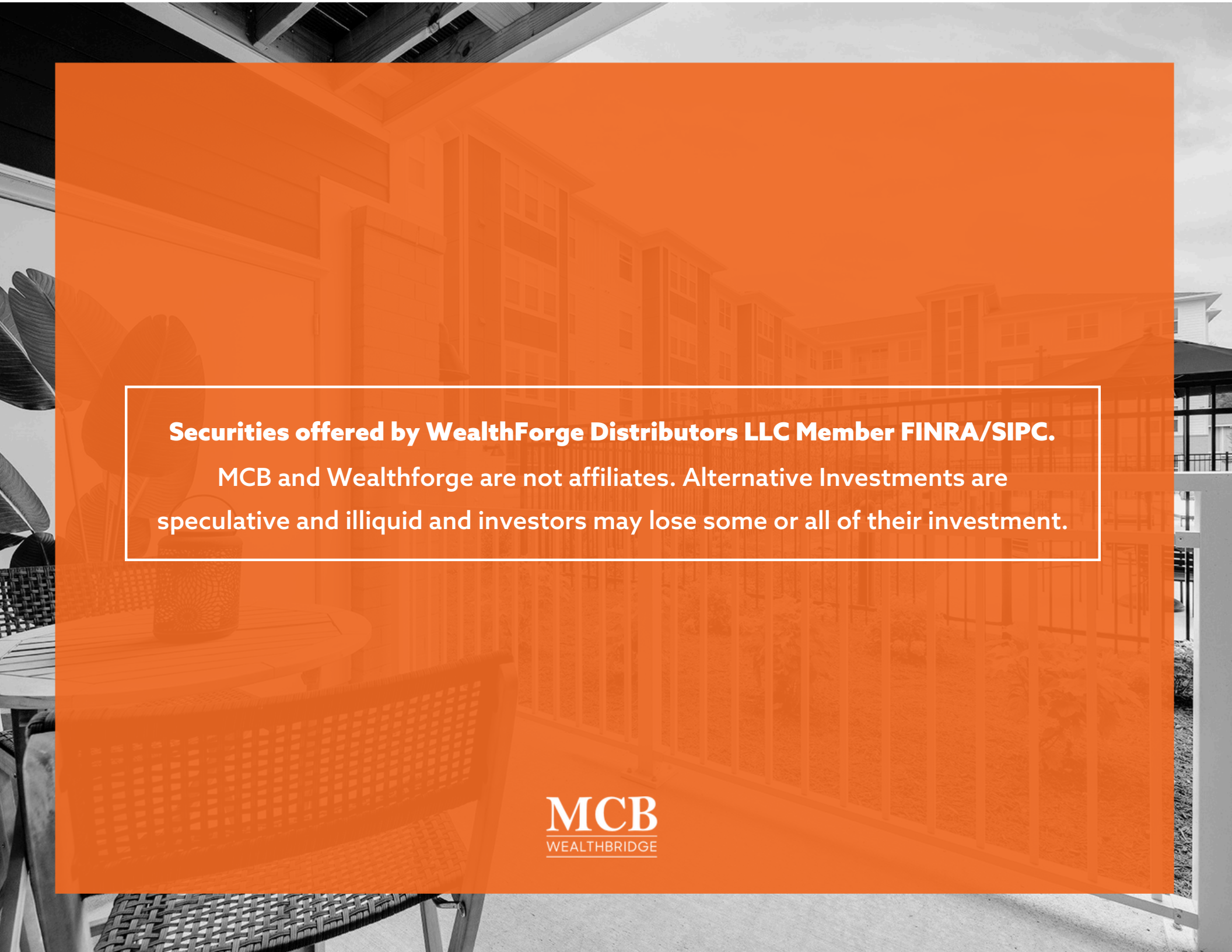
[6] https://www.irs.gov/publications/p52
[7] https://www.irs.gov/pub/irs-pdf/p5653.pdf
[8] https://www.congress.gov/crs-product/R48631

investing, and DST structures allow investors to access these benefits without the operational burden of direct ownership. By leveraging standard depreciation schedules, DST investors may significantly reduce taxable income while maintaining positive cash flow. When combined with advanced strategies like cost segregation, the impact becomes even more compelling, front-loading deductions to maximize early-year tax savings and improve after-tax returns.

For high-net-worth and institutional investors seeking tax-efficient solutions, DST offerings provide a unique opportunity to defer capital gains through 1031 exchanges, generate predictable income, and accelerate depreciation benefits, all within a professionally managed structure. These strategies not only enhance current cash flow but also support long-term wealth preservation and estate planning objectives.

In an environment where tax efficiency is critical to portfolio performance, understanding and utilizing depreciation and cost segregation can transform real estate from a simple income generator into a cornerstone of strategic wealth management.
As with any investment, it is important that stakeholders consult with their attorney, tax advisor and other trusted tax professionals as part of the process of investing in a DST offering for a 1031 exchange.





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