



# Potential Tax Savings from adding ADU to your Property

## ADU Tax Deductions

**ADU Tax Deductions** allow homeowners to deduct certain expenses related to the construction, renovation, or rental of an ADU. This could include deductions for building materials, labor costs, and operational expenses if the ADU is used for rental purposes. These deductions can significantly reduce taxable income, providing valuable financial relief.

### Construction Costs:

Expenses related to the actual building of the ADU, including labor, materials, and fees for contractors, can be deducted. Keep detailed records of all expenses to ensure you maximize your deductions.

#### *Disclosure: (12/25)*

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## Protecting yourself plus some benefits

Consider wrapping your ADU in an LLC. If a mishap were to happen with your ADU renter, you can rest assured knowing you and your assets (like your existing home on the property) can be protected. The benefits of running your new rental business under an LLC, aside from the protection, is being able to deduct all the startup costs (builder fees, permit fees, and other soft costs) as well as organizational expenses (all charges incurred to create the LLC entity). The maximum deduction is \$5,000, which is reduced dollar-for-dollar by the amount over \$50,000. Any remaining startup costs and organizational costs that are not immediately deducted may be amortized over 15 years.

The cost of the ADU itself is allowed to be depreciated over 27.5 years, starting the month the ADU becomes available for rent. Explained differently, you can write off a huge expense (depreciation) as soon as your ADU is completely built and available to rent. Even if you don't have a renter in the ADU, as long as the unit is made available (e.g., is listed 'for rent' online or in the local paper), then you get to recognize the depreciation expense. If your ADU cost is \$100,000 and assuming it was available for rent January 1, the first year's depreciation would be \$3,485 ( $[\$100,000 / 27.5 \text{ years}] \times [11.5 / 12] = \$3,485.85$ ).

The business income is recorded directly on your tax return, which means you're getting the legal protections of an LLC and writing off almost all the expenses (including depreciation) and then only having to pay taxes once on the income. All of your rental income and expenses will be captured on your Schedule E, which flows to page 1 of your tax return\*.

## Depreciation Delivers Savings: Unlocking Long-Term Tax Advantages

Depreciation is a powerful tool in the arsenal of ADU owners, allowing them to spread the cost of property investments over several years. According to IRS guidelines, residential properties can be depreciated over 27.5 years. This means that you can deduct a portion of the property's cost each year, lowering your taxable income and potentially pushing you into a lower tax bracket.

Statistics from the Urban Land Institute (ULI) reveal the long-term advantage of depreciation. The ULI found that rental property owners who take advantage of depreciation can save thousands of dollars in taxes annually. As ADU owners embrace this

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tax benefit, they not only generate immediate cash flow from rental income but also enjoy sustained financial advantages over the years.

Standard depreciation for residential investment real estate is based on a 27.5 year schedule. The study's results showed that 76% of the property was still considered "real property," still belonging to the normal depreciation schedule.

However, nearly a quarter of the property could be reclassified as 5-year or 15-year property for faster depreciation, including 20% now classified as personal property (cabinets, plumbing, etc.) and 4% as land improvements (paving, landscaping, etc.).

With nearly 25% of the property reclassified for faster depreciation, our client will save as much as \$118,000 in taxes.

While it may seem hard to believe, cost segregation is a perfectly legitimate tax strategy that real estate investors like yourself can use to their advantage to lower their tax burden over time.

## Ongoing Tax Deductions (Rental Use)

If you rent out your ADU, you can take advantage of significant tax deductions against the rental income.

- **Mortgage Interest:** Deduct a portion of your mortgage interest payments based on the ADU's share of the property.
- **Property Taxes:** The additional property taxes from the ADU's new assessment are deductible.
- **Depreciation:** You can depreciate the cost of the ADU structure and major appliances over 27.5 years, which provides substantial annual deductions even without a cash expense.
- **Operating Expenses:** Costs for insurance, maintenance, repairs, utilities paid for by the landlord, and advertising expenses are all deductible.

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"Step-up depreciation" is not an official tax term, but you can achieve **accelerated depreciation** on an Accessory Dwelling Unit (ADU) primarily through a **cost segregation study**. The primary method of depreciation for a rental ADU is over 27.5 years, but cost segregation allows certain components to be depreciated faster.

## What is Cost Segregation?

**Cost segregation** is a tax planning tool that allows property owners to accelerate depreciation deductions on specific components of their real estate investments. By reclassifying assets into different depreciation categories, like the roof, cabinets, or other appliances, cost segregation can help reduce tax liability and increase after-tax cash flow.

## Accelerating Depreciation with a Cost Segregation Study

To "step up" or accelerate these deductions, you can use a cost segregation study. This engineering-based tax strategy identifies and reclassifies certain property components that would otherwise be depreciated over the standard 27.5-year period into shorter depreciation schedules.

- **How it works:** Instead of depreciating the entire ADU structure over 27.5 years, a cost segregation study carves out specific items as personal property or land improvements, which can be depreciated over 5, 7, or 15 years.
- **Eligible items:** Examples often include specific electrical systems, dedicated plumbing, certain lighting fixtures, and land improvements like paving or specific landscaping.
- **Bonus Depreciation:** These shorter-life assets may also be eligible for bonus depreciation, allowing for significant deductions in the first year the ADU is placed in service, provided current tax

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A cost segregation study can typically accelerate depreciation on many building components, including:

- Electrical installations (e.g., dedicated computer power, special lighting)
- Plumbing systems (e.g., kitchen plumbing, bathroom fixtures)
- HVAC components
- Flooring (e.g., carpet, vinyl, tile)
- Window treatments
- Cabinetry and countertops
- Decorative finishes and millwork
- Security systems
- Fire protection systems
- Parking lot paving and lighting
- Landscaping and site improvements
- Certain building exterior components

## How Does Cost Segregation Work for ADUs?

**Cost segregation** for ADUs involves identifying and reclassifying the various components of the building into different asset categories, such as 5-year and 15-year property. These shorter-lived assets are depreciated at an accelerated rate, allowing property owners to claim larger depreciation deductions in the early years of ownership.

To perform a cost segregation study, tax and engineering experts will analyze the construction documents, blueprints, and other relevant information to determine the appropriate asset classifications. The cost of a study can vary depending on the size and type of the property.

## Benefits of Cost Segregation for ADUs

1. **Increased after-tax cash flow:** By accelerating depreciation deductions, cost segregation can help property owners reduce their tax liability and increase their after-tax cash flow in the early years of ownership.

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2. **Tax savings:** The amount of tax savings will depend on the depreciable basis of the improvements, property type, and the amount of short-life assets the property has. In many cases, the benefits of cost segregation outweigh the additional tax due to recapture when the taxpayer holds the property for greater than three to five years.
3. **Improved investment returns:** Cost segregation can help improve the overall return on investment for ADUs by reducing the tax burden and increasing cash flow.

Expense Category	Deductible Items	Tax Form
Property Costs	Mortgage interest, property taxes	Schedule E
Operating Expenses	Insurance, utilities, maintenance	Schedule E
Depreciation	Building structure, appliances	Form 4562

To significantly reduce your tax burden from ADU rental income, document these expenses properly. We encourage you to work with experienced tax professionals to ensure you maximize all available ADU tax deductions while staying compliant with federal and state requirements.

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